Global Economic Prospects

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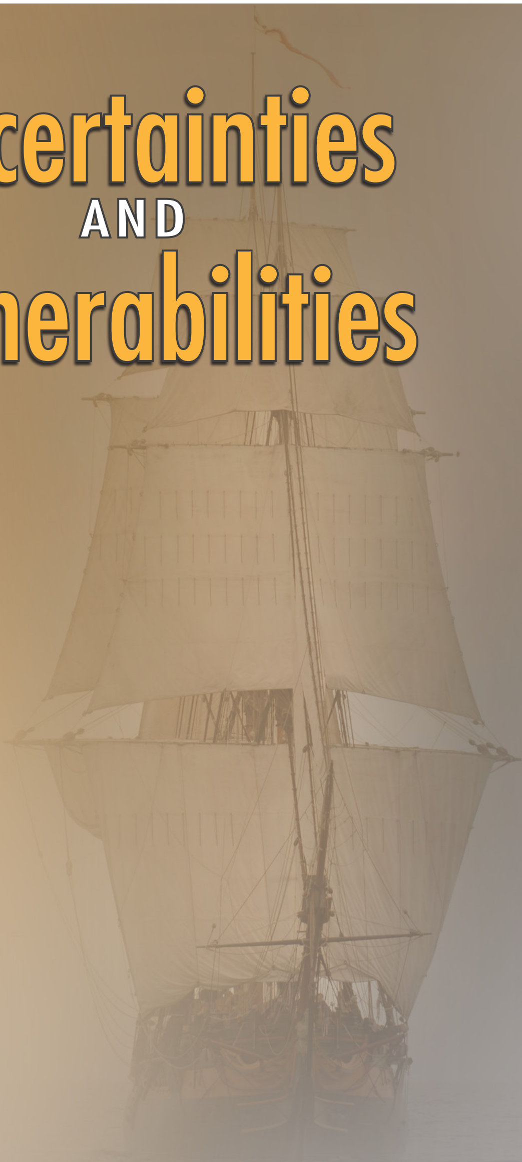

Uncertainties AND Vulnerabilities

THE WORLD BANK

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Global Economic Prospects January 2012:
Uncertainties and vulnerabilities

Overview & main messages

The world economy has entered a very difficult phase characterized by significant downside risks and fragility.

The financial turmoil generated by the intensification of the fiscal crisis in Europe has spread to both developing and high-income countries, and is generating significant headwinds. Capital flows to developing countries have declined by almost half as compared with last year, Europe appears to have entered recession, and growth in several major developing countries (Brazil, India, and to a lesser extent Russia, South Africa and Turkey) has slowed partly in reaction to domestic policy tightening. As a result, and despite relatively strong activity in the United States and Japan, global growth and world trade have slowed sharply.

Indeed, the world is living a version of the downside risk scenarios described in earlier editions of *Global Economic Prospects* (GEP), and as a result forecasts have been significantly downgraded.

- The global economy is now expected to expand 2.5 and 3.1 percent in 2012 and 2013 (3.4 and 4.0 percent when calculated using purchasing power parity weights), versus the 3.6 percent projected in June for both years.
- High-income country growth is now expected to come in at 1.4 percent in 2012 (-0.3 percent for Euro Area countries, and 2.1 percent for the remainder) and 2.0 percent in 2013, versus June forecasts of 2.7 and 2.6 percent for 2012 and 2013 respectively.
- Developing country growth has been revised down to 5.4 and 6.0 percent versus 6.2 and 6.3 percent in the June projections.
- Reflecting the growth slowdown, world trade, which expanded by an estimated 6.6 percent in 2011, will grow only 4.7 percent in 2012, before strengthening to 6.8 percent in 2013.

However, even achieving these much weaker outturns is very uncertain. The downturn in Europe and weaker growth in developing countries raises the risk that the two developments reinforce one another, resulting in an even weaker outcome. At the same time, the slow growth in Europe complicates efforts to restore market confidence in the sustainability of the region's finances, and could exacerbate tensions. Meanwhile the medium-term challenges represented by high deficits and debts in Japan and the United States and slow trend growth in other high-income countries have not been resolved and could trigger sudden adverse shocks. Additional risks to the outlook include the possibility that political tensions in the Middle-East and North Africa disrupt oil supply, and the possibility of a hard landing in one or more economically important middle-income countries.

In Europe, significant measures have been implemented to mitigate current tensions and to move towards long-term solutions. The European Financial Stability Facility (EFSF) has been strengthened, and progress made toward instituting Euro Area fiscal rules and enforcement mechanisms. Meanwhile, the European Central Bank (ECB) has bolstered liquidity by providing banks with access to low-cost longer-term financing. As a result, yields on the sovereign debt of many high-income countries have declined, although yields remain high and markets skittish.

While contained for the moment, the risk of a much broader freezing up of capital markets and a global crisis similar in magnitude to the Lehman crisis remains. In particular, the willingness of markets to finance the deficits and maturing debt of high-income countries cannot be assured. Should more countries find themselves denied such financing, a much wider financial crisis that could engulf private banks and other financial institutions on both sides of

Table 1 The Global Outlook in summary
(percent change from previous year, except interest rates and oil price)

	2009	2010	2011e	2012f	2013f
Global Conditions					
World Trade Volume (GNFS)	-10.6	12.4	6.6	4.7	6.8
Consumer Prices					
G-7 Countries [1,2]	-0.2	1.2	2.2	1.6	1.7
United States	-0.3	1.6	2.9	2.0	2.2
Commodity Prices (USD terms)					
Non-oil commodities	-22.0	22.4	20.7	-9.3	-3.3
Oil Price (US$ per barrel) [3]	61.8	79.0	104.0	98.2	97.1
Oil price (percent change)	-36.3	28.0	31.6	-5.5	-1.2
Manufactures unit export value [4]	-6.6	3.3	8.9	-4.5	0.8
Interest Rates					
$, 6-month (percent)	1.2	0.5	0.5	0.8	0.9
€, 6-month (percent)	1.5	1.0	1.6	1.1	1.3
International capital flows to developing countries (% of GDP)					
Developing countries					
Net private and official inflows	4.2	5.8	4.5		
Net private inflows (equity + debt)	3.7	5.4	4.3	3.3	3.7
East Asia and Pacific	3.7	6.0	4.7	3.4	3.7
Europe and Central Asia	2.7	5.0	3.6	2.0	2.9
Latin America and Caribbean	3.9	6.0	4.8	4.1	4.3
Middle East and N. Africa	2.8	2.4	2.0	1.2	1.6
South Asia	4.6	5.0	3.9	3.3	3.7
Sub-Saharan Africa	4.0	3.7	3.9	3.5	4.4
Real GDP growth [5]					
World	**-2.3**	**4.1**	**2.7**	**2.5**	**3.1**
Memo item: World (PPP weights) [6]	-0.9	5.0	3.7	3.4	4.0
High income	**-3.7**	**3.0**	**1.6**	**1.4**	**2.0**
OECD Countries	-3.7	2.8	1.4	1.3	1.9
Euro Area	-4.2	1.7	1.6	-0.3	1.1
Japan	-5.5	4.5	-0.9	1.9	1.6
United States	-3.5	3.0	1.7	2.2	2.4
Non-OECD countries	-1.5	7.2	4.5	3.2	4.1
Developing countries	**2.0**	**7.3**	**6.0**	**5.4**	**6.0**
East Asia and Pacific	7.5	9.7	8.2	7.8	7.8
China	9.2	10.4	9.1	8.4	8.3
Indonesia	4.6	6.1	6.4	6.2	6.5
Thailand	-2.3	7.8	2.0	4.2	4.9
Europe and Central Asia	-6.5	5.2	5.3	3.2	4.0
Russia	-7.8	4.0	4.1	3.5	3.9
Turkey	-4.8	9.0	8.2	2.9	4.2
Romania	-7.1	-1.3	2.2	1.5	3.0
Latin America and Caribbean	-2.0	6.0	4.2	3.6	4.2
Brazil	-0.2	7.5	2.9	3.4	4.4
Mexico	-6.1	5.5	4.0	3.2	3.7
Argentina	0.9	9.2	7.5	3.7	4.4
Middle East and N. Africa	4.0	3.6	1.7	2.3	3.2
Egypt [7]	4.7	5.1	1.8	3.8	0.7
Iran	3.5	3.2	2.5	2.7	3.1
Algeria	2.4	1.8	3.0	2.7	2.9
South Asia	6.1	9.1	6.6	5.8	7.1
India [7, 8]	9.1	8.7	6.5	6.5	7.7
Pakistan [7]	3.6	4.1	2.4	3.9	4.2
Bangladesh [7]	5.7	6.1	6.7	6.0	6.4
Sub-Saharan Africa	2.0	4.8	4.9	5.3	5.6
South Africa	-1.8	2.8	3.2	3.1	3.7
Nigeria	7.0	7.9	7.0	7.1	7.4
Angola	2.4	2.3	7.0	8.1	8.5
Memorandum items					
Developing countries					
excluding transition countries	3.3	7.8	6.3	5.7	6.2
excluding China and India	-1.7	5.5	4.4	3.8	4.5

Source: World Bank.
Notes: PPP = purchasing power parity; e = estimate; f = forecast.
1. Canada, France, Germany, Italy, Japan, the UK, and the United States.
2. In local currency, aggregated using 2005 GDP Weights.
3. Simple average of Dubai, Brent and West Texas Intermediate.
4. Unit value index of manufactured exports from major economies, expressed in USD.
5. Aggregate growth rates calculated using constant 2005 dollars GDP weights.
6. Calculated using 2005 PPP weights.
7 In keeping with national practice, data for Egypt, India, Pakistan and Bangladesh are reported on a fiscal year basis in Table 1.1. Aggregates that depend on these countries, however, are calculated using data compiled on a calendar year basis.
8 Real GDP at market prices. GDP growth rates calculated using real GDP at factor cost, which are customarily reported in India, can vary significantly from these growth rates and have historically tended to be higher than market price GDP growth rates. Growth rates stated on this basis, starting with FY2009-10 are 8.0, 8.5, 6.8, 6.8 and 8.0 percent – see Table SAR.2 in the regional annex.

the Atlantic cannot be ruled out. The world could be thrown into a recession as large or even larger than that of 2008/09.

Although such a crisis, should it occur, would be centered in high-income countries, developing countries would feel its effects deeply. Even if aggregate developing country growth were to remain positive, many countries could expect outright declines in output. Overall, developing country GDP could be about 4.2 percent lower than in the baseline by 2013 — with all regions feeling the blow.

In the event of a major crisis, activity is unlikely to bounce back as quickly as it did in 2008/09, in part because high-income countries will not have the fiscal resources to launch as strong a counter-cyclical policy response as in 2008/09 or to offer the same level of support to troubled financial institutions. Developing countries would also have much less fiscal space than in 2008 with which to react to a global slowdown (38 percent of developing countries are estimated to have a government deficit of 4 or more percent of GDP in 2011). As a result, if financial conditions deteriorate, many of these countries could be forced to cut spending pro-cyclically, thereby exacerbating the cycle.

Arguably, monetary policy in high-income countries will also not be able to respond as forcibly as in 2008/09, given the already large expansion of central bank balance sheets. Among developing countries, many countries have tightened monetary policy, and would be able to relax policy (and in some cases already have) if conditions were to deteriorate sharply.

Developing countries need to prepare for the worst

In this highly uncertain environment, developing countries should evaluate their vulnerabilities and prepare contingencies to deal with both the immediate and longer-term effects of a downturn.

If global financial markets freeze up, governments and firms may not be able to finance growing deficits.

- Problems are likely to be particularly acute for the 30 developing countries with external financing needs (for maturing short and long-term debt, and current account deficits) that exceed 10 percent of GDP. To the extent possible, such countries should seek to pre-finance these needs now so that a costly and abrupt cut in government and private-sector spending can be avoided.
- Historically high levels of corporate bond issuance in recent years could place firms in Latin America at risk if bonds cannot be rolled over as they come due (emerging-market corporate bond spreads have reached 430 basis points, up 135 basis points since the end of 2007).
- Fiscal pressures could be particularly intense for oil and metals exporting countries. Falling commodity prices could cut into government revenues, causing government balances in oil exporting countries to deteriorate by more than 4 percent of GDP.
- All countries, should engage in contingency planning. Countries with fiscal space should prepare projects so that they are ready to be pursued should additional stimulus be required. Others should prioritize social safety net and infrastructure programs essential to assuring longer-term growth.

A renewed financial crisis could accelerate the ongoing financial-sector deleveraging process.

- Several countries in Europe and Central Asia that are reliant on high-income European Banks for day-to-day operations could be subject to a sharp reduction in wholesale funding and domestic bank activity — potentially squeezing spending on investment and consumer durables.
- If high-income banks are forced to sell-off foreign subsidiaries, valuations of foreign and domestically owned banks in countries with large foreign presences could decline abruptly, potentially reducing banks' capital adequacy ratios and forcing further deleveraging.
- More generally, a downturn in growth and continued downward adjustment in asset prices could rapidly increase the number of non-performing loans throughout the developing world also resulting in further deleveraging.
- In order to forestall such a deterioration in conditions from provoking domestic banking crises, particularly in countries where credit

has increased significantly in recent years, countries should engage now in stress testing of their domestic banking sectors.

A severe crisis in high-income countries, could put pressure on the balance of payments and incomes of countries heavily reliant on commodity exports and remittance inflows.

- A severe crisis could cause remittances to developing countries to decline by 6.3 percent — a particular burden for the 24 countries where remittances represent 10 or more percent of GDP.
- Oil and metals prices could fall by 24 percent causing current account positions of some commodity exporting nations to deteriorate by 5 or more percent of GDP.
- In most countries, lower food prices would have only small current account effects. They could, however, have important income effects by reducing incomes of producers (partially offset by lower oil and fertilizer prices), while reducing consumers' costs.
- Current account effects from reduced export volumes of manufactures would be less acute (being partially offset by reduced imports), but employment and industrial displacement effects could be large.
- Overall, global trade volumes could decline by more than 7 percent.
- GDP effects would be strongest in countries (such as those in Europe & Central Asia) that combine large trade sectors and significant exposure to the most directly affected economies.

Global economy facing renewed uncertainties

The global economy has entered a dangerous phase. Concerns over high-income fiscal sustainability have led to contagion, which is slowing world growth. Investor nervousness has spread to the debt and equity markets of developing countries and even to core Euro Area economies.

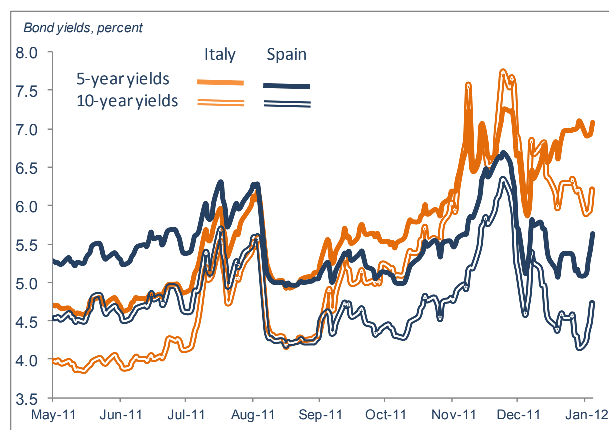
So far, the biggest hits to activity have been felt in the European Union itself. Growth in Japan and the United States has actually firmed since the intensification of the turmoil in August 2011, mainly reflecting internal dynamics (notably the bounce back in activity in Japan, following Tohoku and the coming online of reconstruction efforts).

Growth in several major developing countries (Brazil, India, and to a lesser extent Russia, South Africa and Turkey) is also slowing, but in most cases due to a tightening of domestic policy introduced in late 2010 or early 2011 to combat domestic inflationary pressures. So far, smaller economies continue to expand, but weak business sector surveys and a sharp reduction in global trade suggest weaker growth ahead.

For the moment, the magnitude of the effects of these developments on global growth are uncertain, but clearly negative. One major uncertainty concerns the interaction of the policy -driven slowing of growth in middle-income countries, and the financial turmoil driven slowing in Europe. While desirable from a domestic policy point of view, this slower growth could interact with the slowing in Europe resulting in a downward overshooting of activity and a more serious global slowdown than otherwise would have been the case.

A second important uncertainty facing the global economy concerns market perceptions of the ability of policymakers to restore market confidence durably. The resolve of European policymakers to overcome this crisis, to consolidate budgets, to rebuild confidence of

Figure 1. Short-term yields have eased but long-term yields remain high



Source: Datastream, World Bank.

Box 1. Recent policy reforms addressing concerns over European Sovereign debt

Banking-sector reform: In late October the European Banking Authority (EBA) announced new regulations requiring banks to revalue their sovereign bond holdings at the market value of September 2011. The EBA estimates that this mark-to-market exercise will reduce European banks' capital by €115 billion. In addition, the banks are required to raise their tier1 capital holdings to 9 percent of their risk-weighted loan books. Banks are to meet these new requirements by end of June 2012 and are under strong guidance to do this by raising equity, and selling non-core assets. Banks are being actively discouraged from deleveraging by reducing short-term loan exposures (including trade finance) or loans to small and medium-size enterprises. As a last resort, governments may take equity positions in banks to reach these new capital requirements.

Facilitated access of banks to dollar markets and medium-term ECB funding: Several central banks took coordinated action on November 30th, lowering the interest rate on existing dollar liquidity swap lines by 50 basis points in a global effort to reduce the cost and increase the availability of dollar financing, and agreed to keep these measures in place through February 1st, 2013. In addition in late November the ECB re-opened long-term (3 year) lending windows for Euro Area banks at an attractive 1% interest rare to compensate for reduced access to bond markets, and has agreed to accept private-bank held sovereign debt as collateral for these loans.

Reinforcement of European Financial Stability Facility: On November 29, European Union finance ministers agreed to reinforce the EFSF by expanding its lending capacity to up to €1 trillion; creating certificates that could guarantee up to 30 percent of new issues from troubled euro-area governments; and creating investment vehicles that would boost the EFSF's ability to intervene in primary and secondary bond markets. Precise modalities of how the reinforced fund will operate are being worked out.

Passage of fiscal and structural reform packages in Greece, Italy and Spain: The introduction of technocratic governments with the support of political parties in Greece and Italy, both of which hold mandates to introduce both structural and fiscal reforms designed to assure fiscal sustainability. In Greece, the new government fulfilled all of the requirements necessary to ensure release of the next tranche of IMF/ EFSF support, while in Italy the government has passed and is implementing legislation to make the pension system more sustainable, increase value added taxes and increase product-market competition. In addition, a newly elected government in Spain has also committed to considerably step up the structural and fiscal reforms begun by the previous government.

Agreement on a pan-European fiscal compact: In early December officials agreed to reinforce fiscal federalism within most of the European Union (the United Kingdom was the sole hold out), including agreement to limit structural deficits to 0.3 percent of GDP, and to allow for extra-national enforcement of engagements (precise modalities are being worked out with a view to early finalization).

markets and return to a sustainable growth path is clear. Indeed, recent policy initiatives (box 1) have helped restore liquidity in some markets, with short-term yields on the sovereign debt of both Italy and Spain having come down significantly since December (figure 1). So far, longer-term yields have been less affected by these initiatives — although they too show recent signs of easing albeit to a lesser extent.

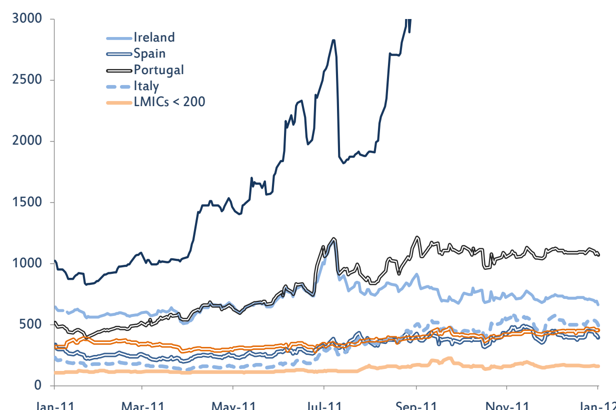
Despite improvements, markets continue to demand a significant premium on the sovereign debt of European sovereigns. Indeed, credit default swaps (CDS) rates on the debt of even core countries like France exceed the mean CDS rate of most developing economies.

Enduring market concerns include: uncertainty whether private banks will be able to raise sufficient capital to offset losses from the marking-to-market of their sovereign debt holdings, and satisfy increased capital adequacy ratios. Moreover, it is not clear whether there is an end in sight to the vicious circle whereby budget cuts to restore debt sustainability reduce growth and revenues to the detriment of debt sustainability. Although still back-burner issues, fiscal sustainability in the United States and Japan are also of concern.

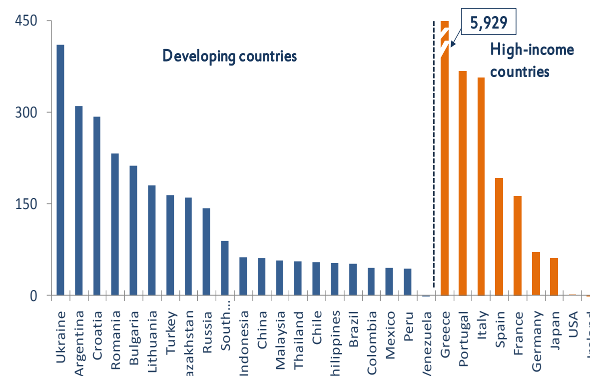
As in 2008/09, precisely how the tensions that characterize the global economy now will resolve themselves is uncertain. Equally uncertain is how that resolution will affect developing countries. The pages that follow do

Figure 2 Persistent concerns over high-income fiscal sustainability have pushed up borrowing costs worldwide

CDS spread on 5 year sovereign debt, basis points



Change in 5-year sovereign credit-default swap, basis points (as of Jan. 6th, 2012)*



Source: DataStream, World Bank.

not pretend to foretell the future path of the global economy, but rather explore paths that might be taken and how such path might interact with the pre-existing vulnerabilities of developing countries to affect their prospects.

Financial-market consequences for developing countries of the post August 2011 increase in risk aversion

The resurgence of market concerns about fiscal sustainability in Europe and the exposure of banks to stressed sovereign European debt pushed credit default swap (CDS) rates (a form of insurance that reimburses debt holders if a bond issuer defaults) of most countries upwards beginning in August 2011 (figure 2).

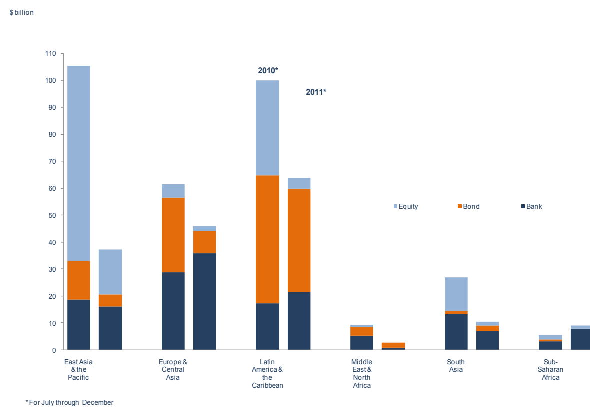
This episode of heightened market volatility differed qualitatively from earlier ones because this time the spreads on developing country debt also rose (by an average of 130 basis points between the end of July and October 4th 2011), as did those of other euro area countries (including France, and Germany) and those of non-euro countries like the United Kingdom.

For developing countries, the contagion has been broadly based. By early January, emerging-market bond spreads had widened by an average of 117 bps from their end-of-July levels, and

Figure 3 Declining stock markets were associated with capital outflows from developing countries since July

MSCI Index, January 2010=100

Gross capital flows (July to December), bn of dollars



Sources: Bloomberg, Dealogic and World Bank.

developing-country stock markets had lost 8.5 percent of their value. This, combined with the 4.2 percent drop in high-income stock-market valuations, has translated into $6.5 trillion, or 9.5 percent of global GDP in wealth losses (figure 3).

The turmoil in developing country markets peaked in early October. Since then the median CDS rates of developing country with relatively good credit histories (those whose CDS rates that were less than 200 bp before January 2010) have declined to 162 points and developing country sovereign yields have eased from 672 to 616 basis points.

Capital flows to developing countries weakened sharply. Investors withdrew substantial sums from developing-country markets in the second half of the year. Overall, emerging-market equity funds concluded 2011 with about $48 billion in net outflows, compared with a net inflow of $97

Table 2. Net capital flows to developing countries
$ Billions

	2004	2005	2006	2007	2008	2009	2010	2011e	2012f	2013f
Current account balance	141.6	244.9	379.8	384.9	354.5	276.7	221.2	190.0	99.0	32.0
as % of GDP	1.8	2.6	3.4	2.7	2.1	1.7	1.1	0.9	0.4	0.1
Financial flows:										
Net private and official inflows	347.3	519.7	686.5	1129.7	830.3	673.8	1126.8	1004.4		
Net private inflows (equity+debt	371.6	584.0	755.5	1128.2	800.8	593.3	1055.5	954.4	807.4	1016.4
Net equity inflows	245.5	382.0	495.2	667.1	570.7	508.7	629.9	606.2	583.7	697.1
..Net FDI inflows	208.5	314.5	387.5	534.1	624.1	400.0	501.5	554.8	521.6	620.6
..Net portfolio equity inflows	36.9	67.5	107.7	133.0	-53.4	108.8	128.4	51.4	62.1	76.5
Net debt flows	101.9	137.7	191.2	462.6	259.6	165.1	496.8	398.2		
..Official creditors	-24.3	-64.3	-69.0	1.5	29.5	80.5	71.2	50.0		
....World Bank	2.4	2.6	-0.3	5.2	7.2	18.3	22.4	12.0		
....IMF	-14.7	-40.2	-26.7	-5.1	10.8	26.8	13.8	8.0		
....Other official	-11.9	-26.8	-42.0	1.5	11.5	35.4	35.0	30.0		
..Private creditors	126.1	202.0	260.2	461.1	230.1	84.6	425.6	348.2	223.7	319.3
....Net M-L term debt flows	73.2	120.4	164.9	292.8	234.4	69.9	157.1	168.2		
......Bonds	33.9	49.4	34.3	91.7	26.7	51.1	111.4	110.1		
......Banks	43.4	76.2	135.0	204.7	212.5	19.8	44.1	68.0		
......Other private	-4.2	-5.1	-4.4	-3.5	-4.8	-1.1	1.6	0.1		
....Net short-term debt flows	52.9	81.6	95.3	168.3	-4.4	14.7	268.5	180.0		
Balancing item /a	-142.5	-401.7	-473.1	-486.4	-786.1	-273.0	-596.0	-611.9		
Change in reserves (- = increase	-395.7	-405.1	-636.9	-1085.3	-452.5	-681.9	-752.0	-578.4		
Memorandum items				292.8						
Net FDI outflows	-46.1	-61.7	-130.4	-150.5	-214.5	-148.2	-217.2	-238.1		
Migrant remittances /b	155.6	187.0	221.5	278.2	323.8	306.8	325.3	351.2	376.7	406.3
As a percent of GDP										
	2004	2005	2006	2007	2008	2009	2010p	2011f	2012f	2013f
Net private and official inflows	4.3	5.4	6.1	8.1	4.9	4.2	5.8	4.5		
Net private inflows (equity+debt	4.6	6.1	6.7	8.0	4.8	3.7	5.4	4.3	3.3	3.7
Net equity inflows	3.1	4.0	4.4	4.8	3.4	3.1	3.2	2.7	2.4	2.5
..Net FDI inflows	2.6	3.3	3.4	3.8	3.7	2.5	2.6	2.5	2.1	2.2
..Net portfolio equity inflows	0.5	0.7	1.0	0.9	-0.3	0.7	0.7	0.2	0.3	0.3
..Private creditors	1.6	2.1	2.3	3.3	1.4	0.5	2.2	1.6	0.9	1.2

Source: The World Bank

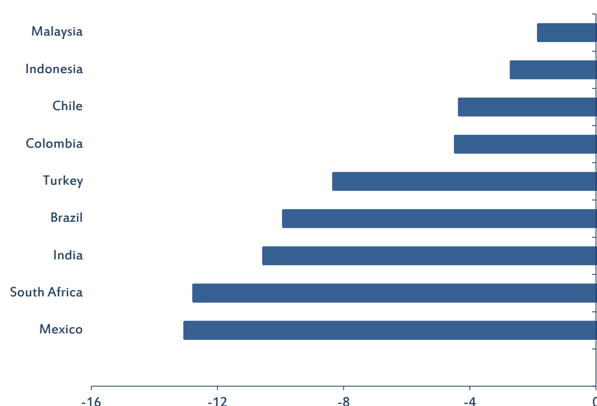
Note:

e = estimate, f = forecast

/a Combination of errors and omissions and transfers to and capital outflows from developing countries.

/b Migrant remittances are defined as the sum of workers' remittances, compensation of employees, and migrant transfers

Figure 4. Capital outflows resulted in significant currency depreciations for many developing countries
Percent change in nominal effective exchange rate (Dec. - Jul. 2011)



Source: World Bank.

billion in 2010. According to JP Morgan, emerging-market fixed-income inflows did somewhat better, ending the year with inflows of $44.8 billion — nevertheless well below the $80 billion of inflows recorded in 2010. Foreign selling was particularly sharp in Latin America, with Brazil posting large outflows in the third quarter, partly due to the imposition of a 6 percent tax (IOF) on some international financial transactions.

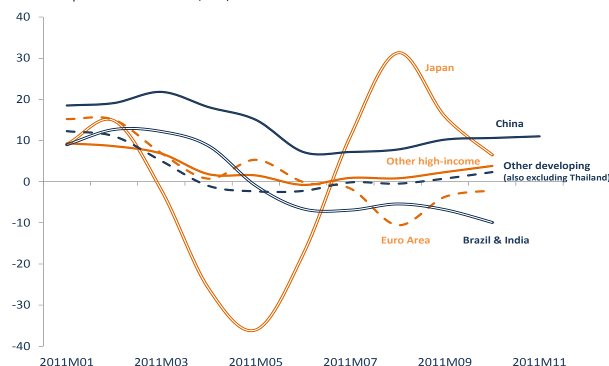
In the second half of 2011 gross capital flows to developing countries plunged to $170 billion, only 55 percent of the $309 billion received during the like period of 2010. Most of the decline was in bond and equity issuance. Equity issuance plummeted 80 percent to $25 billion with exceptionally weak flows to China and Brazil accounting for much of the decline. Bond issuance almost halved to $55 billion, due to a large fall-off to East Asia and Emerging Europe. In contrast, syndicated bank loans held up well, averaging about $15 billion per month, slightly higher than the $14.5 billion in flows received during the same period of 2010.

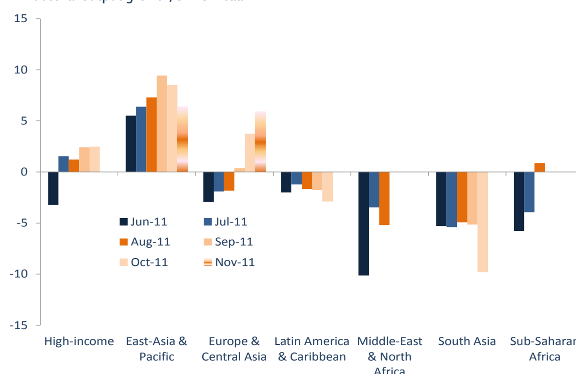
Reflecting the reversal in bond and equity flows in the second half of the year, developing country currencies weakened sharply. Most depreciated against the U.S. dollar, with major currencies such as the Mexican peso, South African rand, Indian rupee and Brazilian real having lost 11 percent or more in nominal effective terms (figure 4). Although not entirely unwelcome (many developing–country currencies had appreciated strongly since 2008), the sudden reversal in flows and weakening of currencies prompted several countries to intervene by selling off foreign currency reserves in support of their currencies.

For 2011 as a whole, private capital inflows are estimated to have fallen 9.6 percent (table 2). In particular, portfolio equity flows into developing countries are estimated to have declined 60 percent, with the 77 percent fall in South Asia being the largest.

The dollar value of FDI is estimated to have risen broadly in line with developing country GDP, increasing by 10.6 percent in 2011. FDI flows are not expected to regain pre-crisis levels

Figure 5 Industrial production appears to have held up outside of Europe and economies undergoing policy tightening





Source: World Bank.

until 2013, when they are projected to reach $620.6 billion (vs. $624.1 billion in 2008). Overall, net private capital flows to developing countries are anticipated to reach more than $1.02 trillion by 2013, but their share in developing country GDP will have fallen from an estimated 5.4 percent in 2010 to around 3.7 in 2013.

Data since August suggest negative real-side effects have been concentrated in high-income Europe

Available industrial production data (data exist through October for most regions — November for the East Asia & Pacific and Europe & Central Asia regions) suggest that global growth is about normal, expanding at a 2.9 percent annualized pace, just below the 3.2 percent average pace during the 10 years preceding the 2008/09 crisis (figure 5).

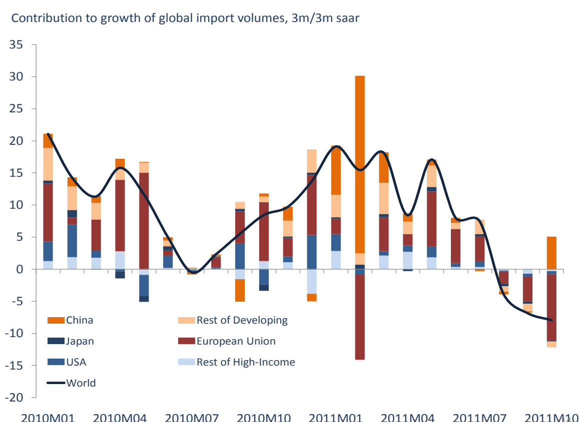
Importantly, the data suggest that the financial turmoil since August has had a limited impact on growth outside of high-income Europe. In the Euro Area, industrial production declined at a 2.2 percent annualized rate during the 3 months ending October 2011 (-4.7 percent saar through November if construction is excluded), and had been declining since June. In contrast, Japanese industry was growing at a 6.5 percent annualized pace over the same period, boosted by reconstruction spending and bounce-back effects following the Tohoku disaster. Growth in the United States through November was a solid 3.8 percent. And growth among the remaining high-income countries was also strong at 4.4 percent during the three months ending October.

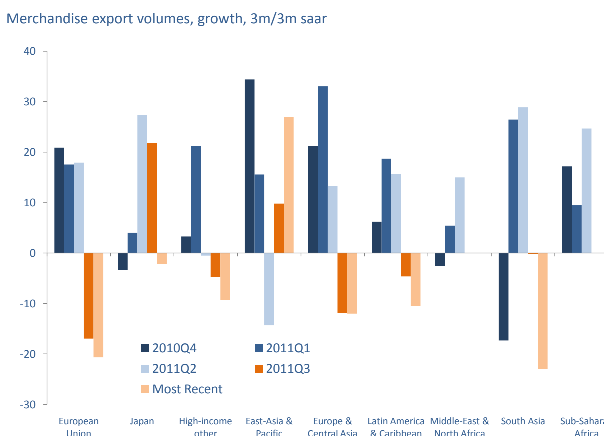
Among large developing countries, industrial production has been falling for months in Brazil, India, and weak or falling in Russia and Turkey — reflecting policy tightening undertaken to bring inflation under control. Output in China has been growing at a steady 11 percent annualized rate through November, while smaller developing countries (excluding above mentioned countries and Thailand where output fell 48 percent in October and November following flooding) have also enjoyed positive, if weak growth of around 2.4 percent (versus 3.7 average growth during the 10 years before the August 2008 crisis (see box 2 for more). November readings in India and Turkey suggest that the downturn in those two economies may have bottomed out.

The post August turmoil has impacted trade more directly

Trade data suggests a clearer impact from the turmoil in financial markets and weakness in Europe. The dollar value of global merchandise imports volumes fell at an 8.0 percent annualized pace during the three months ending October 2011. And import volumes of both developing and high-income countries declined, with the bulk of the global slowdown due to an 18 percent annualized decline in European Union imports (figure 6).

Figure 6 Trade momentum has turned negative





Source: World Bank.

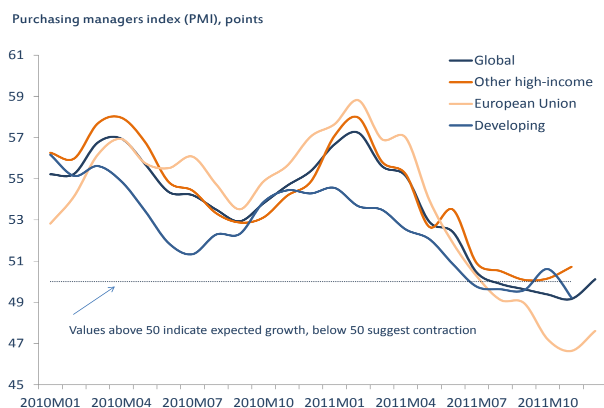
Box 2. Mixed evidence of a slowing in regional activity

Regional data suggest a generalized slowing among developing economies, mainly reflecting domestic rather than external factors.

- In the **East Asia and Pacific** region, industrial production growth eased from a close to 20 percent annualized pace during the first quarter of 2011 (3m/3m, saar), to 5.6 percent in the second quarter. Since then growth recovered, except in Thailand where flooding has caused industrial production to decline sharply. Excluding Thailand, industrial production for the remainder of the region accelerated to a 10.1 percent annualized pace in the three months ending November 2011 (5.7 percent if both Thailand and China are excluded).
- In developing **Europe and Central Asia** industrial production also began the year expanding at a close to 20 percent annualized rate (3m/3m saar), but weakened sharply beginning in the second quarter and declined during much of the third quarter. Since then activity has picked up and expanded at a 5.9 percent annualized rate during the three months ending November 2011.
- In **Latin American and the Caribbean**, activity in the region's largest economies has been slowing mainly because of policy tightening and earlier exchange rate appreciations. For the region as a whole industrial production has been declining since May, and was falling at a 2.9 percent annualized rate in the 3 months ending November, while GDP in Brazil was stagnant in the third quarter. Weaker export growth (reflecting a slowing in global trade volumes and weaker commodity imports from China) is also playing a role. Regional export growth has declined from a 14.1 percent annualized rate in the second quarter to 5.2 percent during the three months ending November.
- Activity in the **Middle East and North Africa** has been strongly affected by the political turmoil associated with the "Arab Spring", with recorded industrial activity in Syria, Tunisia, Egypt and Libya having fallen by 10, 17, 17 and 92 percent at its lowest point according to official data. Output has recouped most or more than all of those losses in Egypt and Tunisia. Elsewhere in the region output has been steadier, but weakened mid-year and was falling at a 0.8 percent annualized rate during the three months ending July (latest data).
- Activity in **South Asia**, like Latin America, has been dominated by a slowdown in the region's largest economy (India). Much weaker capital inflows and monetary policy tightening contributed to the 2.9 percent decline in India's industrial output in October (equivalent to a 12.4 percent contraction at seasonally adjusted annualized rates in the three-months ending October). Elsewhere in the region, industrial production in Sri Lanka and Pakistan is expanding rapidly. The global slowdown has also been taking its toll on South Asia, with merchandise export volumes which had been growing very strongly in the first part of the year, declining almost as quickly in the second half -- such that year-over-year exports in October are broadly unchanged from a year ago.
- Industrial activity in **Sub-Saharan Africa** (Angola, Gabon, Ghana, Nigeria, and South Africa are the countries in the region for which industrial production data are available) was declining in the middle of the year, with all countries reporting data showing falling or slow growth with the exception of Nigeria. Recent months have however shown a pick up. In the three months ending in August, industrial activity expanded at 0.8 percent annualized rate, supported by output increases among oil exporters and despite a decline in output in South Africa during that period, the region's largest economy. Industrial activity in South Africa has since strengthened, growing at a picked up to 14.9 percent annualized rated in the three months ending in October.

The mirror of the slowing in global imports has been a similar decline in export volumes. High-income Europe has seen its exports decline in line with falling European imports (data include significant intra-European trade). In Japan, exports expanded at an 18.5 percent annualized pace in the third quarter, while the exports of other high-income countries grew at a relatively rapid 3.4 percent annualized pace. Developing country exports declined at a 1.2 percent annualized pace in 2011Q3 and have continued to decline through November, with the sharpest drop in South Asia (although this follows very rapid export growth in the first half of the year). Exports in East Asia have also been falling at double-digit annualized rates, in part because of disruptions to supply chains caused the by the flooding in Thailand. The exports of developing Europe and Central Asia were expanding slowly during the three months ending October 2011, while data for Latin America suggest that at 5.2 percent through November, export growth is

Figure 7 Business surveys point to a slowing in activity



Sources: JPMorgan, World Bank aggregation using country-

strengthening. Insufficient data are available for other developing regions to determine post-August trends.

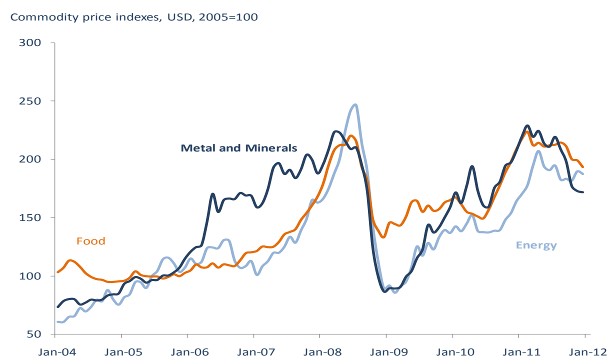
Overall, the real-side data available at this point are consistent with a view that the turmoil that began in August has dampened the post Tohoku rebound in activity. The dampening effect has been most pronounced in Europe, but is observable everywhere. This interpretation is broadly consistent with forward looking business sentiment surveys. All of these point to slower growth in the months to come, but the sharpest negative signal (and the only one to deteriorate markedly post August 2011) is coming from the European surveys. Other high-income surveys are more mixed suggesting slower but still positive growth. PMI's for developing countries are also mixed, with two thirds indicating strengthening growth, but the aggregate declining in November, mainly because of a sharp deterioration in expectations coming out of China—although at least one December indicator for China shows a pickup (figure 7).

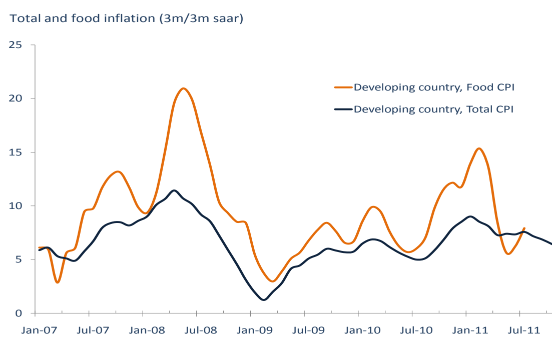
Declining commodity prices and inflation are further indicators of the real-side effects of recent turmoil

Commodity prices, which increased significantly during the second half of 2010, stabilized in early 2011 and, except for oil whose price picked up most recently, have declined since the beginning of August (figure 8). Prices of metals and minerals, historically the most cyclical of commodities[1], averaged 19 percent lower in December compared with July, while food and energy prices are down 9 and 2 percent, respectively. Although concerns over slowing demand certainly have played a role, increased risk aversion may also have been a factor in causing some financial investors in commodities to sell.

Among agricultural prices, maize and soybeans prices fell 17 and 15 percent over the past 6 months on improved supply prospects, especially from the United States and South America. Partly offsetting these declines, rice prices rose 14 percent in part due to the Thai government's increase in guarantee prices (which induced stock holding and less supply to global markets). The flooding in Thailand may have led to some tightness in the global rice market, but the impact was marginal as most of the crop had already been harvested. Indeed, rice prices have declined most recently by almost 5 percent during December 2011. Looking forward, India's decision to allow exports of non-Basmati

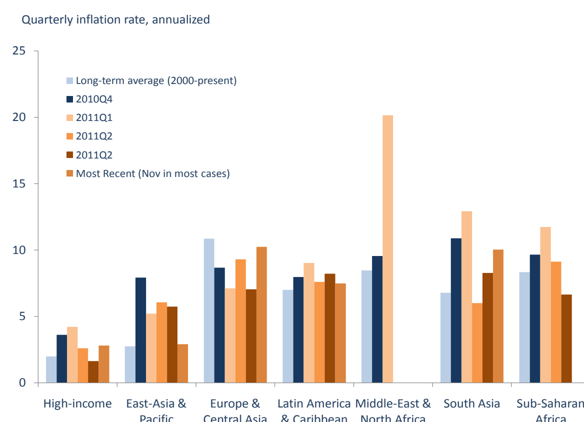
Figure 8 Stable food prices and falling metals and energy prices have contributed to a deceleration in developing-world inflation





Source: World Bank.

Figure 9 Inflationary pressures are rising in Europe & Central Asia and South Asia



Source: World Bank.

rice along with good crop prospects elsewhere in the region, are likely to keep rice prices in check.

Despite recent declines, commodity prices remain significantly higher in 2011 than in 2010 (14.4, 29.9 and 23.9 percent higher for the prices of metals and minerals, energy, and food respectively).

But alongside this generalized improvement, severe localized food shortages persist, notably in the Horn of Africa, where crop failure and famine threaten the livelihoods of over 13 million people (World Bank, 2011).

Weaker commodity prices have contributed to lower inflation

Partly reflecting the initial stabilization and then decline in commodity prices, but also the slowing in economic activity, headline inflation has eased in most of the developing world (second panel figure 8). The annualized pace of inflation has declined from a peak of 9.0 percent in January 2011, to 6.0 percent during the three months ending November 2011. Domestic food inflation has eased as well from a 15.7 percent annualized rate in February 2011, to about 6.2 percent during the three months ending June 2011.

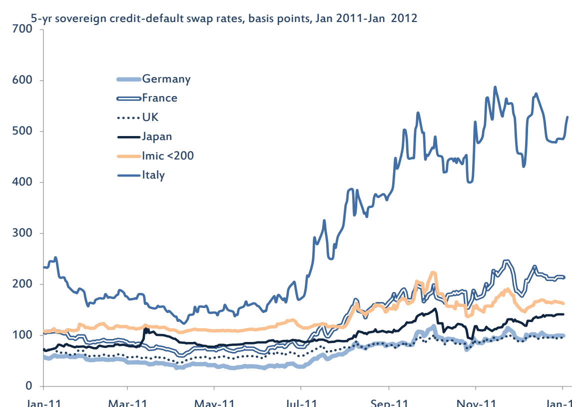
Inflationary pressures have declined in most regions, but appear to be strengthening once again in Europe & Central Asia and South Asia (figure 9). Although inflation is decelerating in most regions, inflation remains elevated and of concern in several countries, including Bangladesh, Ethiopia, India, Kazakhstan, Kenya, Nigeria, Tanzania, Turkey, and Vietnam. Among high-income countries, inflation has softened from 4.5 percent annualized rates in February 2011 to 2.2 percent by October.

An uncertain outlook

Overall, global economic conditions are fragile, and there remains great uncertainty as to how markets will evolve over the medium term. While data to-date does not indicate that there was strong real-side contagion from the up-tick in financial turmoil since August, the pronounced weakness of growth and the cut-back capital flows to developing countries will doubtless way on prospects and could potentially undermine the expected recovery in growth among middle-income countries that underpins the projections outlined earlier in Tab1e 1.

Additional risks to the outlook include the possibility that geopolitical and domestic political tensions could disrupt oil supply. In the Middle-East and North Africa, although political turmoil has eased, there remains the possibility that oil supply from one or more countries could be disrupted, while mounting tensions between Iran and high-income countries could yield a sharp uptick in prices, because of disruption to supply routes, or because of sanctions imposed

Figure 10 Market uncertainty has spread to core-European countries



Source: DataStream, World Bank.

Box 3 Regional outlook

The regional annexes to this report contain more detailed accounts of regional economic trends, including country-specific forecasts

The **East Asia and Pacific** region was disrupted by Japan's Tohoku disaster. Industrial production and exports were hard hit, but are recovering as production chains re-equilibrate. Severe summer floods in Thailand have also caused significant disruption and contributed to regional slowing in the second half of the year. Overall, GDP growth in the region is projected to expand by 8.2 percent in 2011 while inflation is easing across the region. Strong domestic demand and productivity growth should help the region withstand the effects of the projected global slowing in the baseline scenario. As a result, regional growth is projected to slow only modestly to 7.8 percent in both 2012 and 2013. However, the very open nature of the regional economy makes it particularly vulnerable to a major decline in global demand. All the more so, as there is less room than in 2008 for fiscal expansion should a major crisis emerge.

In developing **Europe and Central Asia**, growth has been slowing due to a combination of weakening domestic as well as external demand (especially from the Euro area). While resource-rich economies are benefiting from still high commodity prices and good harvests, several countries have been affected by the ongoing euro debt crisis because of their significant financial and trade linkages to problem countries. Despite strong growth in the earlier part of the year, growth for the region is expected to just exceed the 5.2 percent pace of 2010 in 2011. Ongoing household and banking-sector deleveraging and global economic uncertainty are projected to contribute to a decline in growth to 3.2 percent in 2012, before the pace of the expansion picks up to 4.0 percent in 2013. Several Central European countries are particularly vulnerable to the deepening crisis in the Euro Area, due to trade linkages, high-levels of maturing debt, and domestic-bank dependency on high-income Europe parent-bank lending. Commodity exporters in the region could also run into difficulties if a deterioration in the global situation results in a major decline in commodity prices.

Growth in **Latin America and the Caribbean** is expected to decelerate to a below-trend pace of 3.6 in 2012 from an estimated 4.2 percent in 2011. Softer global growth in high-income countries and China is projected to hurt exports, while rising borrowing costs and scarcer international capital will take a toll on investment and private consumption. Growth is expected to strengthen to above 4.0 percent in 2013 boosted by stronger external demand, but weaker domestic demand reflecting recent policy tightening is projected to keep growth in Brazil, for example relatively weak. Growth is projected to decelerate sharply in Argentina due to easing domestic demand. Slow albeit stronger growth in the United States is expected to temper prospects in Mexico and in Central America and the Caribbean due to weak tourism and remittances flows, although reconstruction efforts in Haiti will sustain strong growth there and in the Dominican Republic. Incomes in many countries in the region have benefitted because of high commodity prices, and future prospects will be vulnerable to the kinds of significant declines that might accompany a sharp weakening in global growth.

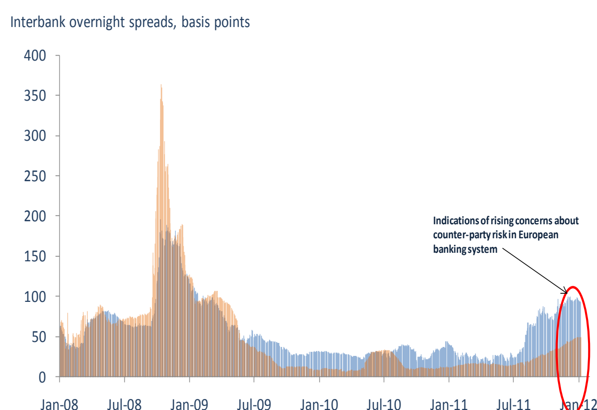
Economic activity in the developing **Middle East and North Africa** region has been dominated by the political turmoil of the "Arab Spring" and strong oil prices. Despite high exposures to the weakening European export market, industrial production is improving and exports and remittances have performed better than earlier anticipated. But tourism and FDI revenues are exceptionally weak, and government deficits high. Oil exporters of the region have used substantial revenue windfalls to support large infrastructure and social expenditure programs, while in other countries political tensions have carried large negative effects on households and business, knocking GDP to losses for the year. Looking forward, the region is vulnerable to a global downturn in 2012, through adverse terms of trade effects, and strong linkage with the Euro area. Assuming that the domestic drag on growth from political uncertainty begins to ease, regional GDP is projected to expand by 2.3 percent in 2012, with output strengthening further to a 3.2 percent rate in 2013.

In **South Asia**, GDP growth is expected decelerate to 5.8 percent during the calendar year 2012, down from 6.6 percent rate recorded in 2010, reflecting domestic and external headwinds. Domestic demand is expected to continue to slow, with private consumption being hampered by sustained high inflation that has cut into disposable incomes. Rising borrowing costs have cut into outlays for consumer durables and investment, with heightened uncertainty and delayed regulatory reforms also playing a role. The external environment is expected to remain difficult, with continued market unease and a significant weakening of foreign demand. South Asian governments have limited space with which to introduce counter-cyclical fiscal stimulus measures due to large fiscal deficits,

while the possibility of monetary easing is constrained by still high inflation. Given the possibility of further weakening in the global economy, efforts at greater revenue mobilization (particularly in Pakistan, Sri Lanka, Bangladesh, and Nepal) and expenditure rationalization (especially in India) could pay dividends by allowing governments to maintain critical social and infrastructure programs.

Notwithstanding the recent perturbations in the global economy, as well as the drought in the Horn of Africa, growth prospects in **Sub Saharan Africa** remain healthy over the forecast horizon. Recent economic developments have, however, reduced the growth momentum in Sub-Saharan Africa and shaved off between 0.1 and 0.5 percent of GDP growth in the region. Thus, GDP is now estimated to have expanded 4.9 percent in 2011—about 0.2 percentage points slower than had been expected in June, and output is projected to expand 5.3 and 5.6 percent in 2012 and 2013, respectively, assuming no further significant downward spiral in the global economy. However, the uncertain global environment means that downside risks are significant. In the event of a deterioration of conditions in Europe, growth in Sub-Saharan Africa could decline by 1.6-4.2 percent compared with the current forecasts for 2012, with oil and metal prices falling by as much as 18 percent and food prices by 4.5 percent. The fiscal impact of commodity price declines could be as high as 1.7 percent of regional GDP.

Figure 11 Indicators of counter-party risk in banking-sector continue to rise



Source: DataStream, World Bank.

by high-income countries that shift demand away from Iran toward other producers.[2]

The situation in Europe also presents an important source of risk going forward. Most recently, several successful bond sales by high-spread countries have caused spreads to decline, offering some hope that the worst of the crisis may have passed (see earlier figures 2 & 3). However, experience suggests they may yet sour yet again — even though from an objective point of view steps taken go along way to alleviating the concerns that initially led to the loss of confidence and freezing up of capital markets (see earlier box 1).

Overall, as of early January CDS spreads for high-spread European countries were about 173 basis points higher than in July (1,153 basis points if Greece is included in the mix) and stock markets some 17.6 percent below their July levels.

That said, steps taken thus far have been successful in reducing or stabilizing spreads on several major high-income countries (Germany and the United Kingdom) and in developing countries (figure 10). Moreover, as noted above yields on several recent bond auctions (especially short-term bonds), including by Spain and Italy, have declined.

Despite progress made, markets remain volatile, and funding pressures on banks elevated. Worryingly, the spread between interbank interest rates and central bank overnight lending rates (a measure of private banks' concerns over counter-party risk) continue to rise and have reached almost 100 basis points in Europe and

Table 3. Baseline represents a significant downgrade from June edition of Global Economic Prospects

	2011	2012	2013
	(Difference in aggregate growth rates)		
World	-0.5	-1.1	-0.5
High-income countries	-0.6	-1.3	-0.6
Euro Area	-0.2	-2.1	-0.9
Other high-income	-0.8	-0.9	-0.5
Developing	-0.2	-0.8	-0.3
Low-income	0.1	0.0	0.0
Middle-income	-0.2	-0.8	-0.3
Oil exporting	0.1	-0.5	0.0
Oil importing	-0.4	-0.9	-0.4
Regions			
East Asia & Pacific	-0.3	-0.3	-0.5
Europe & Central Asia	0.6	-1.1	-0.3
Latin America & Caribbean	-0.3	-0.6	0.1
Middle-East & North Africa	-0.1	-1.2	-0.7
South Asia	-0.9	-1.9	-0.8
Sub-Saharan Africa	-0.1	-0.4	-0.1

Source: World Bank.

50 basis point in the United States (figure 11). And, markets are likely to remain skittish for some time until they become convinced that the initiatives announced at the national and multinational level are being carried through and are succeeding in restoring economic growth and fiscal accounts to a sustainable path.

The baseline projections of this edition of *Global Economic Prospects* presented in the earlier Table 1 assume that efforts to-date and those that follow prevent the sovereign-debt stress of the past months from deteriorating further, but fail to completely eradicate market concerns. With high -income country growth of 1.4 and 2.0 percent in 2012 and 2013, and developing country growth of 5.4 and 6.0 percent over the same two years, these projections reflect a substantial downward revision to prospects from those of June 2011 (table 3).

In the baseline, the recovery in the United States is projected to continue in the fourth quarter of 2011, with growth around 3 percent before weakening to an average of 2.2 percent in 2012 as fiscal stimulus is withdrawn, and 2.4 percent in 2013. In high-income Europe, uncertainty has taken its toll, with annualized growth declining from 2.9 percent in the first quarter to 1.1 percent in the third quarter of 2011 due to fiscal tightening, financial stress, banking-sector deleveraging, and plunging confidence (the ECB's latest bank lending survey shows a tightening of lending standards to households and corporations that will weigh on activity in the fourth quarter and beyond). As a result, the Euro Area is expected to enter into recession in the fourth quarter of 2011 and whole-year GDP is forecast to decline by 0.3 percent in 2012 (the broader European Union is expected to grow 0.1 percent). Growth in Japan is projected to accelerate to around 1.9 percent in 2012, reflecting reconstruction efforts and continued rebound from the Tohoku disaster.

Under these conditions, growth in developing countries is now estimated to have eased to 6 percent in 2011 and projected to decline further to 5.4 percent in 2012, before firming somewhat to 6.0 percent in 2013—a 0.2, 0.8 and 0.3 percentage point reduction in the growth outlook since the June 2011 edition of *Global Economic Prospects* (see table 3, box 3, and Regional Annexes for more details on regional economic prospects).

Global trade in goods and non-factor services is projected to slow to about 4.7 percent in 2012 before picking up to 6.8 percent in 2013.

Thinking through downside scenarios

The slow unwinding of tensions implicit in the baseline projections of this *Global Economic Prospects* remains a likely outcome for the global economy. But, how that plays out is highly uncertain. As a result, even assuming no serious deterioration (or rapid improvement) in conditions, growth could be noticeably stronger or weaker than in this baseline projection.

Moreover, the possibility of much worse outcomes are real and market tensions are particularly elevated. What form an escalation of the crisis might take, should one occur, is very uncertain — partly because it is impossible to predict what exactly might trigger a deterioration in conditions, and partly because once unleashed the powerful forces of a crisis of confidence could easily take a route very different from the one foreseen by standard economic reasoning.

It follows that any downside scenario that might be envisaged to help developing-country policymakers understand the nature and size of potential impacts will suffer from false precision (both in terms of the assumptions that the scenario makes about the nature and strength of precipitating events, and as to the path and magnitude of their impacts).

The scenarios outlined in Box 4 are no different in this respect and are presented, in the spirit of recent stress-tests of banking systems, as a tool that could help policymakers in developing countries prepare for the worst by helping them better understand the relative magnitude of potential effects, and gain some insights as to the extent and nature of vulnerabilities across countries. These simulations should not be viewed as predictive. They are presented with full recognition of the limitations of the tools that underpin them. If a downside scenario actually materializes, its precise nature, triggers, and impacts will doubtless be very different from these illustrations.

Box 4 Downside scenarios

In the current economic context, the risk that markets lose confidence in the ability of one or more high-income countries to repay their debt is very real. The OECD (2012) estimates that high-income countries will need to borrow $10.5 trillion in 2012 (almost twice their borrowing levels in 2005). Moreover, almost 44 percent of the debt in the OECD is relatively short-term debt, meaning that borrowers will have to come repeatedly to the market. Ratings agencies have warned of further downgrades, and although reforms to date have been greeted positively, markets are requiring a significant premium on the debt issues of stressed economies.

In a first scenario (box table 4.1) it is assumed that one or two small Euro Area economies (equal to about 4 percent of Area GDP) face a serious credit squeeze. An inability to access finance that extends to the private sectors of the economies causes GDP in the directly affected countries to fall by 8 or more percent (broadly consistent with the decline already observed in Greece and in other high-income economies that have faced financial crises — see Abiad and others, 2011). Other (mainly European) economies are affected through reduced exports (imports from the directly affected countries fall by 9 percent). It is assumed in this scenario that although borrowing costs in other European economies rise and banks tighten lending conditions due to losses in the directly affected economies, adequate steps are taken in response to the crisis to ensure that banking-sector stress in Europe is contained and does not spread to the rest of the high-income world. However, uncertainty and concerns about potential further credit squeezes does induce increased precautionary savings among both firms and households worldwide.[3]

Overall, GDP in the Euro Area falls by 1.7 percent relative to baseline, and by a similar margin in the rest of the high-income world. Developing countries are also hit. Direct trade and tighter global financial conditions plus increases in domestic savings by firms and households as a result of the increased global uncertainty contribute to a 1.7 percent decline in middle-income GDP relative to baseline in 2012. The decline among low-income countries (1.4 percent) is slightly less pronounced reflecting weaker financial and trade integration. Weaker global growth contributes to a 10-12 percent decline in oil prices and a 2.5 percent drop in internationally-traded food commodity prices.

In a second scenario (box table 4.2) the freezing up of credit is assumed to spread to two larger Euro Area economies (equal to around 30 percent of Euro Area GDP), generating similar declines in the GDP and imports of those economies. Repercussions to the Euro Area, global financial systems and precautionary savings are much larger because the shock is 6 times larger.[4] Euro Area GDP falls by 6.0 percent relative to the baseline in 2013. GDP impacts for other high-income countries (-3.6 percent of GDP) and developing countries (-4.2 percent) are less severe but still enough to push them into a deep recession. Overall, global trade falls by 2.6 percent (7.5 percent relative to baseline) and oil prices by 24 percent (5 percent for food).

Table box 4.1 Impact of a small contained crisis

	2011	2012	2013
	(% deviation of GDP from baseline)		
World	0.0	-1.7	-1.7
High-income countries	0.0	-1.7	-1.7
European Union	0.0	-1.7	-1.5
Other high-income	0.0	-1.6	-1.7
Developing	0.0	-1.7	-1.8
Low-income	0.0	-1.4	-1.5
Middle-income	0.0	-1.7	-1.8
Oil exporting	0.0	-1.8	-2.0
Oil importing	0.0	-1.7	-1.7
Regions			
East Asia & Pacific	0.0	-1.8	-1.8
Europe & Central Asia	0.0	-1.8	-1.9
Latin America & Caribbean	0.0	-1.7	-2.0
Middle-East & North Africa	0.0	-1.3	-1.6
South Asia	0.0	-1.7	-1.7
Sub-Saharan Africa	0.0	-1.8	-1.6

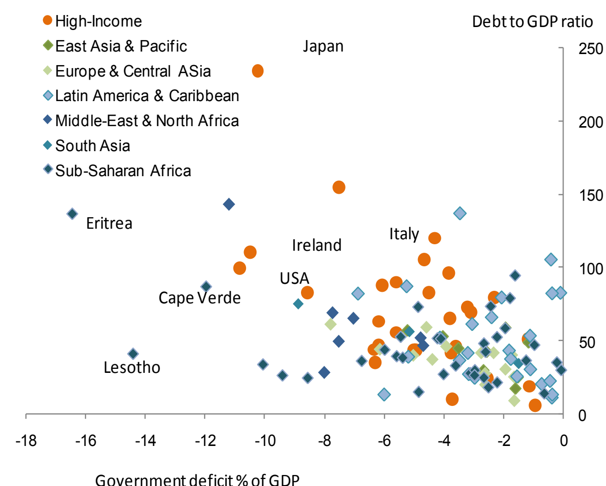
Table box 4.2 Impact of a larger crisis also affecting two large Euro Area economies

	2011	2012	2013
	(% deviation of GDP from baseline)		
World	0.0	-3.8	-4.3
High-income countries	0.0	-3.8	-4.3
European Union	0.0	-5.6	-6.0
Other high-income	0.0	-3.1	-3.6
Developing	0.0	-3.6	-4.2
Low-income	0.0	-2.9	-3.4
Middle-income	0.0	-3.6	-4.2
Oil exporting	0.0	-3.5	-4.4
Oil importing	0.0	-3.6	-4.0
Regions			
East Asia & Pacific	0.0	-3.7	-4.1
Europe & Central Asia	0.0	-4.4	-5.2
Latin America & Caribbean	0.0	-3.0	-3.8
Middle-East & North Africa	0.0	-3.1	-4.4
South Asia	0.0	-3.5	-3.9
Sub-Saharan Africa	0.0	-3.7	-3.7

Source: World Bank.

With these caveats in mind, these simulations suggest that if there were a major deterioration in conditions, GDP in developing countries could be much (4.2 percent) weaker than in the baseline. Moreover, unlike 2008/09, global growth is not expected to bounce back as quickly because economies enter into this crisis in much weaker positions than in 2008/09. They have much less fiscal and monetary policy space (especially high-income countries) with which to offset the collapse in demand and to bailout banks and other financial institutions that may find themselves in trouble.

Figure 12 Most developing countries have modest debt levels



Source: World Bank Debt Reporting System.

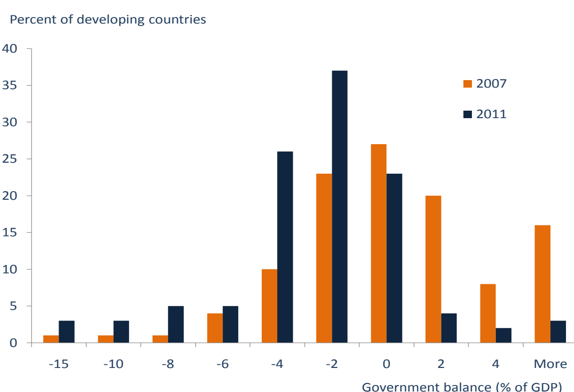
Developing countries are more vulnerable than in 2008

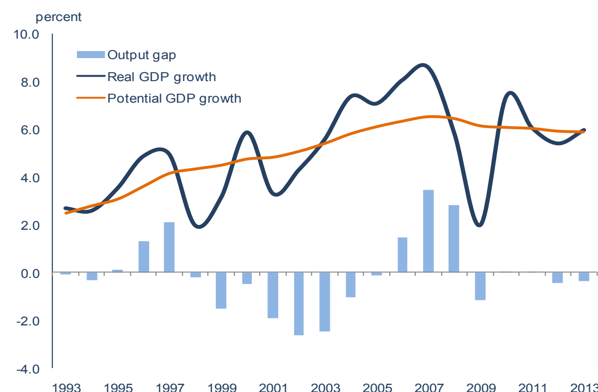
Whatever the actual outcomes for the world economy in 2012 and 2013 several factors are clear. First, growth in high-income countries is going to be weak as they struggle to repair damaged financial sectors and badly stretched fiscal balance sheets. Developing countries will have to search increasingly for growth within the developing world, a transition that has already begun but is likely to bring with it challenges of its own. Should conditions in high-income countries deteriorate and a second global crisis materializes, developing countries will find themselves operating in a much weaker global economy, with much less abundant capital, less vibrant trade opportunities and weaker financial support for both private and public activity. Under these conditions prospects and growth rates that seemed relatively easy to achieve during the first decade of this millennium may become much more difficult to attain in the second, and vulnerabilities that remained hidden during the boom period may become visible and require policy action.

The remainder of this report examines some of these potential vulnerabilities and attempts to offer some policy advice for developing countries to help prepare for what is likely to be a weaker global economy going forward, and what potentially could be a second major global recession.

Figure 13 Developing countries have much less fiscal space than in 2008, partly for cyclical reasons

43% of developing countries have government deficit of 4% of GDP or more in 2011, vs 18% in 2007





Source: World Bank

Box 5 Structural budget balances

Fluctuations in the business cycle and external factors such as commodity prices can have a significant impact on a country's fiscal position. In developing countries, tax revenues vary significantly with the business cycle, rising when economic activity is buoyant or commodity prices are high. In similar, but reverse fashion, expenditures (unemployment and social security related) tend to rise when activity is low. Indeed, during the boom year 2007 developing countries' fiscal revenues increased by nearly 26 percent in U.S. dollar terms, only to fall by 10 percent in 2009 during the recession.

The structural budget balance (or cyclically adjusted budget balance) attempts to provide a sense of what the budget balance would be if GDP were equal to its underlying trend. By definition, estimates of structural budget balances are subject to significant imprecision, partly because they rely on estimates of potential output (itself subject to significant estimation error) and partly because isolating the cyclical component of government revenues and expenditures in a constantly changing policy environment is very difficult.

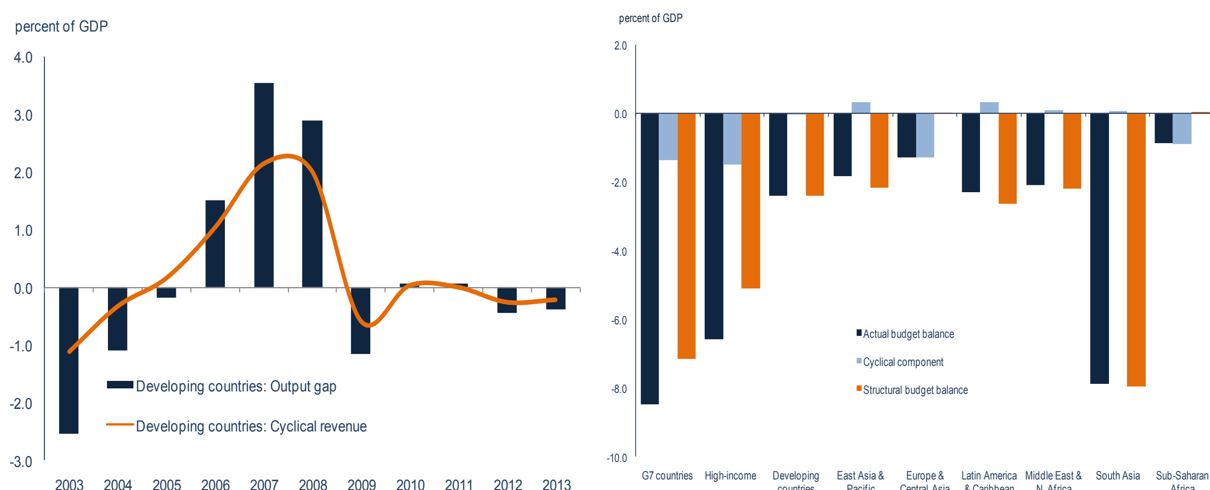
The estimates of structural budget balance presented here are based on World Bank estimates of potential output, which project developing country potential growth of around 5½ – 6 percent during 2011/13 (World Bank, 2010) buoyed by strong productivity growth and fixed investment growth of around 7 – 8½ percent.

According to these estimates, cyclical revenue in developing countries peaked at 2.1 percent of GDP in 2007, but fell to about -0.6 in 2009 – a total cyclical fiscal revenue swing of nearly 3 percent of GDP within two years. This was mostly related to developing country output gaps declining from +3.5 percent in 2007 to -1.2 percent in 2009 for the 125 countries with fiscal data.

Overall, and reflecting that developing country output gaps are close to zero, the structurally adjusted fiscal balance of developing countries in 2011 is estimated to be roughly equal to the actual budget balance. But there is significant divergence among the regions' estimated budget balances in calendar 2011 (box figure 5.1). In high-income countries, the estimated cyclical revenue component is relatively large and negative, reflecting the still large output gaps observed in many of these economies.

Fiscal deficits among commodity exporters (and countries with large subsidies on commodity consumption) are sensitive to fluctuations in commodity prices. Turner (2006) uses estimates of a real-income gap (or the output gap adjusted for terms of trade effects) that adjusts government revenues and expenditures for abnormally high/low commodity prices as well as the business cycle. Such a measure assumes that much of the run up in commodity prices since 2005 was temporary. As a result, it ascribes a larger share of increased government revenues to cyclical forces and results in higher structural deficits than the more traditional measure that is retained here.

Box figure 5.1 Cyclical surplus in 2007 has disappeared, although results by region differ widely



Source: World Bank.

Conditions today are less propitious for developing countries than in 2008

One of the more positive elements of the recession of 2008/9 was the speed with which developing countries (other than those in Central and Eastern Europe) exited the crisis. Indeed, by 2010, 51 percent of developing countries had regained levels of activity close to or even above estimates of their potential output).

This was in stark contrast to many high-income countries, where, even now, GDP remains well below the levels that might have been expected had pre-crisis trends continued. The good performance partly reflects the healthy fiscal, current account and reserves positions with which most developing countries entered the crisis, which allowed most to absorb a large external shock without serious domestic dislocation (see Didier, Hevia, and Schmukler, 2011).

Today fiscal conditions are still generally better in developing countries than in high-income countries (figure 12). Only 27 countries for which comprehensive data exist, have fiscal deficits in excess of 5 percent of GDP, and while 14 have gross debt to GDP ratios in excess of 75 percent, only 3 countries (Eritrea, Egypt and Lebanon) combine a deficit in excess of 5 percent of GDP and a gross debt to GDP ratio in excess of 75 percent of GDP in 2011.

Table 4 Impact on fiscal balance of a fall in commodity prices like that observed in the 2008/09 crisis
(change in fiscal balance percent of GDP)

	2012
World	-0.1
High income countries	0.4
Developing countries	-1.0
Oil exporting	-4.3
Oil importing	0.4
East Asia and Pacific	0.7
Europe and Central Asia	-2.9
Latin America and the Caribbean	-2.4
Middle East and North Africa	-4.8
South Asia	0.3
Sub-Saharan Africa	-4.0

Source: World Bank.

Nevertheless, fiscal positions in developing countries have deteriorated markedly since 2008. In particular, government balances have fallen by two or more percent of GDP in almost 44 percent of developing countries in 2012 (figure 13). As a result, developing countries have much less fiscal space available to respond to a new crisis.

To a large extent the reduced fiscal space reflects the fact that in 2007 many countries were at the peak of a cyclical boom that had boosted fiscal revenues above normal rates. As a result, fiscal deficits were smaller by about 2 percent of GDP than they would have been had activity been in line with underlying potential. Now most developing countries are much closer to normal levels of output, and this cyclical windfall has disappeared.

Fiscal balances have not deteriorated by the whole (windfall) amount because policy reforms and high commodity prices have benefitted fiscal balances. In most regions structural fiscal balances (the balance that would be observed if demand was just equal to potential GDP) have neither increased nor decreased appreciably (box 5).

Europe and Central Asia and South Asia are exceptions in this regard. In Europe and Central Asia the policy reforms necessitated by the very large shock that the region encountered in 2008/9 resulted in a 3.0 percent of GDP reduction in structural deficits, from -3 to 0 percent of GDP. In contrast, a sharp increase in fiscal spending in South Asia contributed to a 3.1 percent deterioration in structural budget balances to -8.0 percent of GDP in 2011.

High commodity prices have also boosted government revenues and served to keep deficits low. For oil exporting developing countries, the increase in commodity prices since 2005 has improved government balances by an average of 2.5 percent of GDP, among metal exporters the improvement has been of the order of 2.9 percent of GDP, while for non-oil non-metals commodity exporters the improvement has been much less pronounced.

Independent of whether fluctuations in commodity revenues (and subsidy expenditures)

Table 5 Countries with large funding requirements may be vulnerable to a tightening of credit conditions [5]

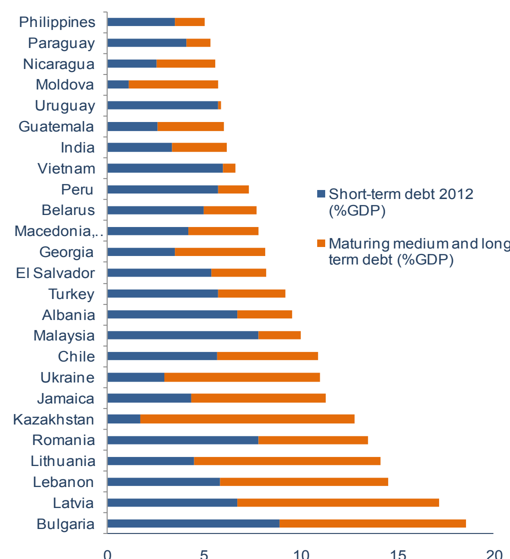
External Financing Needs Projections for 2012

	Account Deficit (share of	Debt Repayment (share of GDP)	EFN (share of GDP)
Lebanon	20.6	14.5	35.1
Nicaragua	16.3	5.6	21.9
Albania	11.7	9.6	21.3
Jamaica	9.8	11.3	21.1
Georgia	12.7	8.2	20.9
Turkey	9.8	9.2	19.0
Lao PDR	14.0	4.7	18.7
Guyana	10.6	7.8	18.4
Belarus	10.5	7.7	18.2
Romania	4.5	13.5	18.0
Moldova	12.1	5.7	17.8
Latvia	0.4	17.2	17.6
Armenia	12.7	4.9	17.6
Bulgaria	-2.0	18.6	16.6
Lithuania	2.3	14.1	16.4
Ukraine	5.4	10.9	16.3
Panama	12.3	3.2	15.6
Mauritania	11.2	3.9	15.1
Macedonia, FYR	5.1	7.8	12.9
Jordan	8.5	4.0	12.5
Tanzania	9.1	3.0	12.2
El Salvador	3.8	8.2	12.0
Dominican Republic	8.2	3.4	11.6
Vanuatu	6.7	4.9	11.5
Vietnam	4.9	6.6	11.5
Chile	0.4	10.9	11.3
Kyrgyz Republic	6.9	3.7	10.6
Ghana	7.0	3.4	10.4
Tunisia	5.8	4.4	10.2
Peru	2.7	7.3	10.0

Developing country external financing needs are defined as the current account deficit (assumed to equal its 2011 share of GDP times projected nominal GDP in 2012), plus scheduled payments on short-term and longer-term debt to private creditors.
Source: World Bank

are included in the cyclical or structural deficit, if commodity prices were to fall then fiscal conditions in exporting countries would deteriorate rapidly. Simulations suggest that if commodity prices were to fall as they did in the 2008/09 crisis, fiscal balances in oil exporting countries could deteriorate by more than 4 percent of GDP. Impacts in metals exporting countries could also be large, with some regional impacts exceeding 4 percent of GDP (table 4).

Figure 14 Countries with high levels of short- or maturing long-term debt are at risk



Source: World Bank, Debt Reporting system.

Financial vulnerabilities

The contagion of risk aversion from a few well defined high-spread, high-income European countries to developing countries and even to core Euro Area countries since August 2011 has changed the game for developing countries. As noted above, capital flows to developing countries have declined sharply and risk premia on both their private and sovereign debt have increased – raising borrowing costs.

Tighter financial conditions could make financing current account and government deficits much more difficult

Should risk aversion escalate further, international capital flows could decline even more, forming a binding constraint on the balance of payments of some countries, potentially freezing some governments out of capital markets and even threatening the fiscal sustainability of some heavily indebted developing countries by raising borrowing costs.[5]

As a whole, the external financing needs of developing countries have risen slightly since the 2008/9 financial crisis from an ex ante estimate

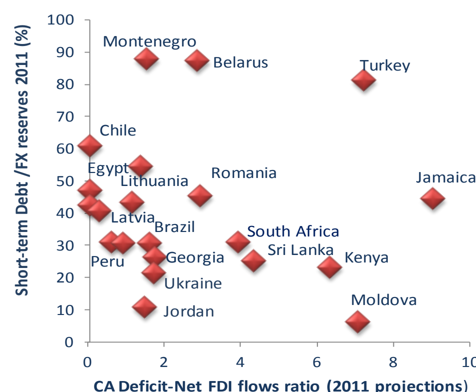
of $1.2 trillion (7.6 percent of GDP) in 2009 to $1.3 trillion (7.9 percent of GDP) in 2012.[6] This apparent stability masks a situation where all regions, except South Asia, have reduced their external financing needs as a share of GDP since 2008. South Asia's estimated external financing requirements have increased from 5.8 percent to 8.4 percent, mainly because of a sharp rise in India's external debt in 2011. As in the 2008/9 crisis, Eastern Europe and Central Asia remains the most vulnerable developing region, with external financing needs on the order of 17 percent of GDP. Several countries in the region have high current account deficits as well as private debt coming due in 2012.

Estimated financing requirements for 2012 exceed 10 percent of GDP in some 30 developing countries (table 5).[7] In the baseline scenario, the financing of that debt is unlikely to pose a problem for most countries, coming in the relatively stable form of FDI, or remittances. For others, however, a significant proportion will have to be financed from historically more volatile sources (short-term debt, new bond issuances, equity inflows).[8]

If international financial market conditions deteriorate significantly, such financing might become difficult to maintain. Twenty-five developing countries have short-term debt and long-term debt repayment obligations to private sector equal to 5 or more percent of their GDP (figure 14). Should financing conditions tighten and these debts cannot be refinanced, countries could be forced to cut sharply either into reserves or domestic demand in order to make ends meet.[9]

Risks are particularly acute for countries like Turkey that combine large current account

Figure 15 Countries exposed to external financing risks



Source: World Bank.

Box 6 Domestic bonds — an imperfect hedge against capital flow reversals?

Developing countries are increasingly turning to domestic bond markets for funding (see World Bank, 2011B). While this reduces their exposure to currency risk, it does not necessarily make them less exposed to a reversal in capital flows. More than 25 percent of the domestic bonds sold in Peru, Indonesia, Malaysia, South Africa and Mexico (foreign holdings of local government bonds in Mexico have surged because of their inclusion in international bond indexes, such as the WBGI — normally a relatively stable source of funding) were bought by foreigners (Table B6.1). Should foreigners lose confidence in the local issue, or be forced by losses elsewhere in their portfolio to sell these bonds – there could be significant adverse effects for the countries involved – including for domestic bond yields, government financing costs, investment and currency stability. According to JP Morgan figures, EM bond funds received $44.8 billion of inflows in 2011, down from $80 billion in 2010, mostly due to sharp decline in local-currency bonds–partly contributing to the depreciation of currencies described earlier. Foreign selling has been particularly sharp in Latin America, with Brazil posting large outflows in the third quarter of 2011.

By the same token, firms that rely on foreign investment in local stock markets may also be exposed to a deterioration in foreign investor sentiment or by an externally generated need to deleverage – particularly in cases where local markets are relatively illiquid. Indeed, emerging market equities have declined by 8.5 percent since recent peaks, much more than the 4.2 percent observed in high-income equity markets.

Box table B6.1. Foreign bonds holdings as a percentage of outstanding local government bonds

	2007	2008	2009	2010	Most recent
Turkey	13	10	9	13	17
South Africa	13	16	15	23	27
Brazil	n/a	n/a	8	12	12
Mexico	11	12	12	19	26
Peru	30	30	21	46	49
Indonesia	16	17	19	31	33
Malaysia	15	14	17	22	27
Thailand	0.2	2	2	6	8

Source: JP Morgan

Box 7 The Banking system and the transmission of deleveraging pressures

The transmission of a crisis can occur through several financial channels. Increased risk aversion raises the cost of debt, and decreases its supply. To the extent that high-income banks are forced through losses in their portfolio (or regulatory changes) to rebuild their capital stock they may engage in de-leveraging – either by calling or not renewing loans (thereby reducing loans to capital ratios), or by selling assets or issuing new equity (thereby raising capital).

In the current crisis, high-income banks have already engaged in a significant degree of deleveraging. Although the large and ill-defined nature of the shadow banking sector makes this process difficult to quantify, European banks do appear to be decreasing their loan books (by 2.5% y-o-y in the case of Spain). In the U.S., loan books have started to grow once again after falling 1.7 percent last year. While given the excesses of the boom period, an orderly deleveraging of high-income banks is desirable, a too rapid or fire-sale deleveraging process could have serious implications for developing countries.

In general, developing countries with large shares of bank debt, either short-term debt or maturing longer-term debt are most vulnerable to de-leveraging as non-renewal of loans coming due is a relatively easy mechanism for banks to reduce leveraging. The effect of de-leveraging may also be more acute in economies whose domestic banking systems have close ties with banks in troubled high-income countries.

Overall, high-income European banks have $2.4 trillion in foreign claims in the assets of developing countries, which could be called upon in the case of crisis. The bulk of these claims lie in Europe & Central Asia ($633bn or 21 percent of GDP) and Latin America & the Caribbean ($861bn or 16 percent of GDP). Other regions carry less large, but still significant exposures to high-income banks in general (claims on East Asia total $440 billion, Sub-Saharan Africa $190 billion and South Asia $176 billion).

The nature of these holdings and vulnerabilities to deleveraging differ across regions and countries. European bank claims are very significant for some African countries, representing more than 45 percent of countries GDP, in the Seychelles (200 percent), Cape Verde (82 percent) and Mozambique (45 percent). In Latin America and the Caribbean, European banks claims are 38 and 21 percent of GDP in Chile and Mexico.

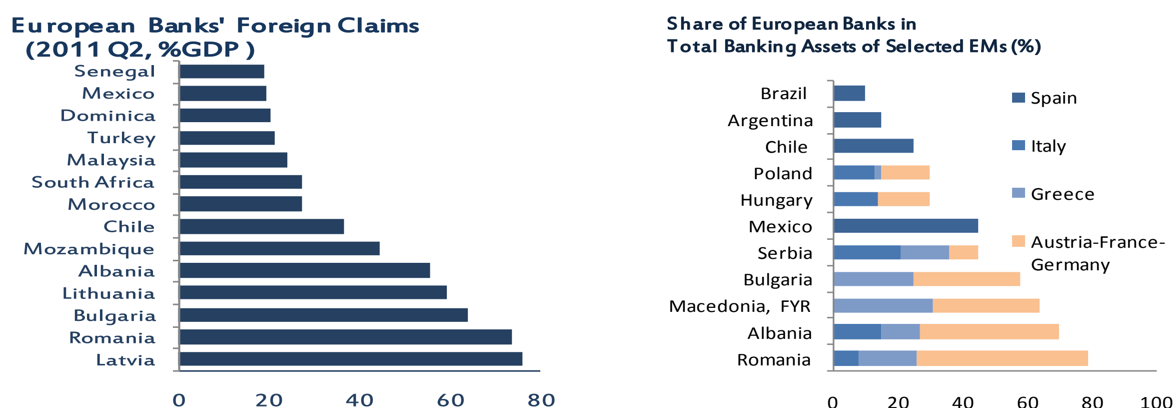
Despite these claims, banking systems in these countries are operated independently of their mother companies through subsidiaries, with their loan books fully funded domestically (loan to deposit ratios of close to or below 100 percent). Moreover, some countries (e.g. Mexico and Brazil) have regulations limiting the amount of inter-company loans between parent and daughter banks and limiting the ability of parent banks to reduce daughter bank's capital below prudential levels. As a result, the financial systems in these countries would not be excessively exposed to a sharp reduction of inflows of funding from European banks (except through the trade finance channel). As long as this kind of deleveraging occurs gradually, domestic banks and non-European banks should be able to take up the slack – as appears to be taking place in Brazil.

Banking in Eastern Europe and Central Asia is more exposed to deleveraging because many daughter banks in the region are heavily dependent on cross-border lending from their parents rather than domestic depositors to support their loan portfolios. In contrast, foreign owned banks in Latin America tend to have strong deposit bases and do not depend on continuing inflows from their parents to maintain lending levels. In Europe & Central Asia loan–to–deposit ratios exceed 100 percent by a large margin in several countries: Latvia (240 percent), Lithuania (129 percent) and Russia (121 percent). Should inflows from parent banks be cut off, and local sources not found daughter banks in these countries could be forced to dramatically reduce lending in order to maintain capital adequacy requirements. The situation is made more problematic because loan portfolios of banks in the region are not healthy, with non-performing loan ratios in excess of 15 percent in several countries.

In a worrying development, Austrian bank supervisors have instructed Austrian banks to limit future lending in their central and eastern European subsidiaries — while several high-income European banks have independently announced their intention to reduce operations in Europe and Central Asia.

deficits, high short-term debt ratios and low reserves (which have been falling in recent months and now represent less than 4 months of import cover). By this measure but to a lesser extent, Belarus and Montenegro are also vulnerable to a freezing-up of global credit. Other countries also have significant vulnerabilities. Jamaica, for example, is at risk since it finances its current account deficit with flows other than FDI, which tend to be volatile.

Figure 16 Outstanding claims of banks in high-spread European countries



Source: World Bank, BIS

Source: Citibank.

If global credit does freeze up, firms in economies such as Albania, Chile and Egypt with high levels of short-term debt could be forced to cut activity back if existing loans are not renewed (figure 15).

Indications are that trade finance is already being squeezed as European banks deleverage

The sensitivity of short-term finance to changes in financing conditions could pose problems for trade. A significant portion of short-term debt is thought to reflect trade finance (e.g. as much as 75 percent of Chinese short-term debt is reported to be for trade-finance). Since 2010, there has been a 20 percent increase in short-term debt taken out by developing countries — with the total now equal to $1.1 trillion or 4.8 percent of developing-country GDP — or 15.7 percent of total developing country exports.

Press and market participants report that conditions for trade finance are already tightening. In what may be a permanent change in behavior, commercial banks appear to be rationalizing their participation in trade finance and concentrating on larger markets. Such a trend, to the extent it is occurring, would be to the detriment of smaller markets and particularly smaller and newer enterprises that lack longer-term relationships with trade partners that might lead to inter-company solutions that could substitute for bank intermediated finance. Others banks are cutting trade finance exposures as part of a broader move toward reducing loan books (see deleveraging discussion, box 7). Recent IMF and Bankers' Association for Finance and Trade surveys indicate that larger banks are tightening lending standards and some of the European Banks that have suffered the largest declines in equity values are particularly active in trade finance.

In the event of a significant deterioration in global conditions, trade finance could freeze up. The evidence from 2008 is mixed in this regard, with some authors (Mora & Powers, 2009; Levechenko, Lewis and Tesar, 2010) suggesting that the large observed drop in trade finance in 2008/09 was mainly due to reduced trade volumes, rather than a drop in trade finance having caused the decline in global trade. On the other hand, there is strong anecdotal evidence of trade finance having become more scarce suggesting that perhaps there was a drying up in trade finance availability, but that trade volumes fell more quickly so that for most firms reduced availability of trade finance was not a binding constraint.

Banking-sector linkages could be another source of vulnerability, notably for Europe and Central Asia

Banking sector linkages remain strong between several high-spread Euro area countries and developing countries, and their solvency also represents a risk to other European banks through various interlinkages (see box 6 for a discussion of the relative merits of domestic versus foreign capital markets and box 7 for the

vulnerabilities associated with reliance on foreign banks). Currently, funding pressures in the European banking sector remain high due to concerns about exposure to stressed sovereigns (figure 16). Several banks have been squeezed out of the dollar interbank market, and Euribor-Eonia spreads (a measure of banks' willingness to take on the debt of other banks) have risen to levels last observed in the early days of the financial crisis of 2008 (see earlier figure 11).

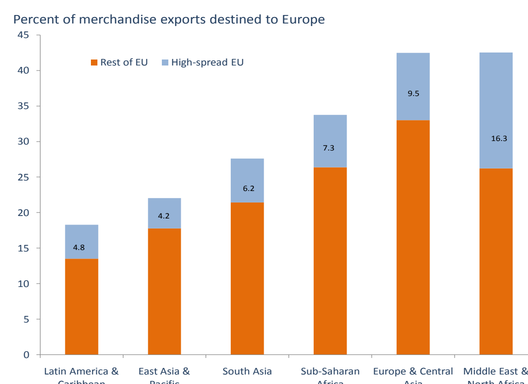
Among developing regions, the most direct exposures to high-income European banks are in Europe and Central Asia and in Latin America — reflecting both inter-regional lending and ownership patterns. As of 2011Q2, total foreign claims by European banks in developing countries was $2.4 trillion ($1.4 trillion for Euro Area banks), with two-thirds of these claims in Latin America and developing Europe. On the ownership-side of the ledger, key European banks account for large shares of domestic bank assets in several developing economies (e.g. Spanish banks own over 25 percent of bank assets in Mexico and Chile, while Portuguese banks account for almost one-third of banking assets Angola and Mozambique).

These cross-border relationships take many forms, ranging from autonomous subsidiaries (with their own locally-funded capital and asset base) to more traditional branch operations and in most their operations are subject to host-country prudential regulation that includes safeguards against many forms of capital repatriation. While such rules should limit the scope for a wholesale repatriation of assets in the event of a crisis in the home country, they are unlikely to prevent a significant tightening of capital conditions in host countries if parent banks run into financial difficulty.

Banking in Europe & Central Asia is likely more exposed to European deleveraging because daughter banks in several countries are dependent on cross-border flows from parent banks to service their loan portfolios. In contrast in Latin America the loan books of daughter banks are almost entirely covered by local deposits. As a result, if deleveraging in high-income countries causes them to cease funding new loans in daughter banks, lending in Europe and Central Asia would be affected, but not in Latin America.

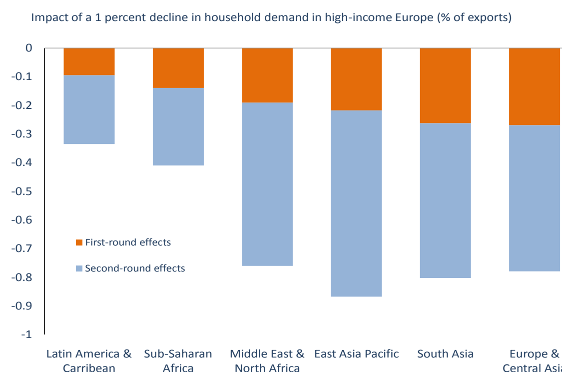
Indeed, Austrian Banks have been advised by domestic regulators to limit future lending to their regional subsidiaries. Depending on how binding this directive proves to be it could significantly tighten financial conditions in Albania, Bosnia-Herzegovina and Romania—countries where Austrian banks are very active.

Figure 17 Direct trade exposures to high-spread European countries are largest in the Middle-East & North Africa and in Europe and Central Asia



Sources: U.N. COMTRADE (WITS), World Bank.

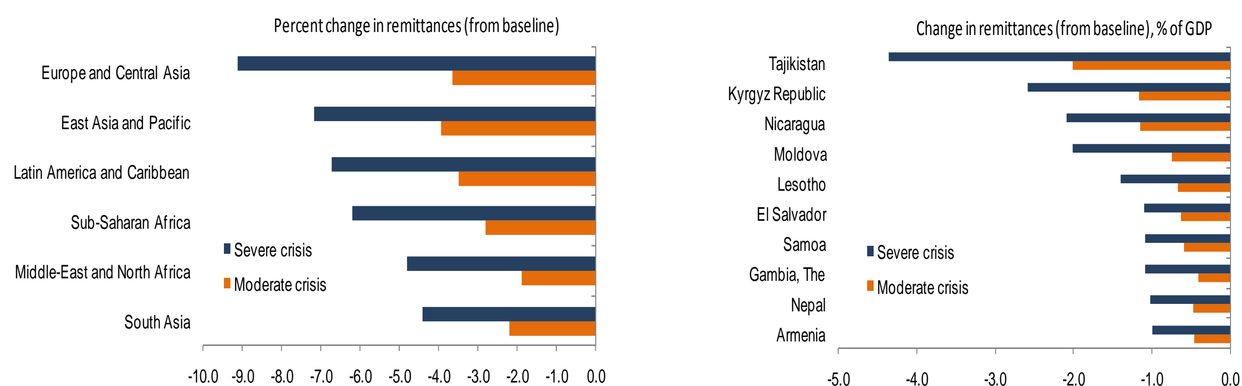
Figure 18 Second and third-round trade effects likely to dominate initial impacts



Note: First round effects – declines in exports directly attributable to reduced European imports; Second round effects – difference between total decline in exports and first round effects.

Source: World Bank simulations using GTAP.

Figure 19 Estimated declines in remittances in the event of deterioration in global conditions



Source: World Bank.

Indeed, Austrian Banks have been advised by domestic regulators to limit future lending to their regional subsidiaries. Depending on how binding this directive proves to be it could significantly tighten financial conditions in Albania, Bosnia-Herzegovina and Romania—countries where Austrian banks are very active.

Developing countries with close trade linkages to crisis prone high-income countries may be at risk

A significant slowdown in import demand, such as might accompany a market-induced credit event in high-income Europe, would initially impact hardest those economies with the closest trade ties and those countries exporting the most demand-elastic commodities (see below for a discussion of commodity impacts). If the crisis is concentrated among high-spread countries, it is likely to hit exporters in the Middle-East and North African economies (whole economy impacts would not be so severe because the non-oil exports are a relatively small share of overall GDP) most directly because of strong trade ties with high-spread European economies (figure 17). Were the wider euro area to become embroiled, the impact on the exports of all regions would be significantly larger, with developing Europe and Central Asia (Romania, Lithuania and Latvia among others) and Sub-Saharan Africa (Cape Verde, Cameroon, Niger among others) facing the largest direct exposures.

While initial impacts in these regions would be large, once second, third and fourth-round effects are taken into account, negative impacts would be more widely felt. Overall, large trading areas such as East Asia and the Pacific would feel the largest hits to overall GDP as the initial decline in high-income European demand for the exports of other countries (including Europe and Central Asia but also the United States and Japan) would cause the imports of these countries from other regions such as East Asia & Pacific to decline. Ultimately these knock-on effects would be larger than the initial direct trade effects (figure 18).

In addition to trade effects, a significant cycle in high-income Europe would tend to reduce incomes in host-countries for developing world migrants, and, as a result, reduce remittances, which, in addition to combating poverty, are in many countries a critical source of foreign currency. Assuming a cycle of the size of the small crisis scenario outlined above, remittance flows to developing countries would decline by 3.1 percent in US dollar terms in 2012 relative to the baseline. In a severe crisis scenario, remittance flows to developing countries could fall by as much as 6.3 percent, with declines of 7 percent or more in Europe and Central Asia (figure 19) and several other developing regions. Remittance declines as a percent of GDP would be biggest in countries receiving large levels of remittances, including Tajikistan, Kyrgyz Republic, Nicaragua, Moldova, Lesotho and Honduras among others. Even with these large projected declines relative to the baseline, overall remittance flows to the developing world would remain almost flat in US dollar terms even in the more serious scenario. This reflects the stability

Box 8 Commodity prices expected to ease in the context of weaker global growth

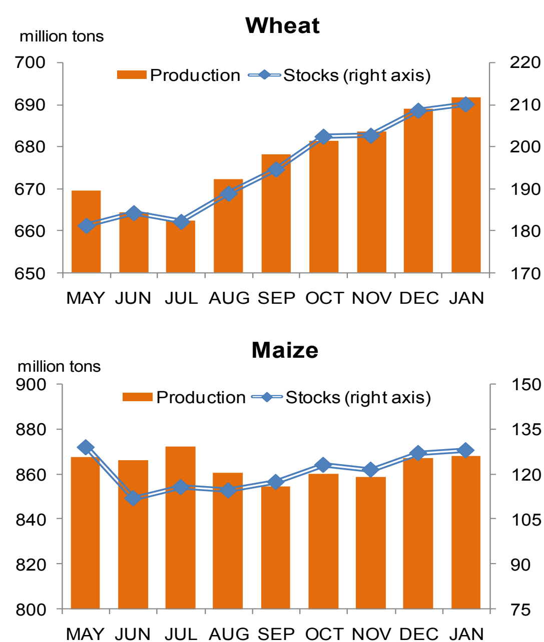
The slowing of growth in the second half of 2011 has already resulted in a significant easing of commodity prices, with metals and minerals prices — the most cyclically sensitive group of commodities — having given up all of their gains since 2010. Oil prices have also eased, although not as much, and are currently at levels observed in December 2010 — about 35 percent higher than in January 2010. Food prices have also eased in recent months (down 14 percent since their February 2011 peak).

Looking forward, given the weaker growth projected for the global economy, commodity prices are expected to continue to ease in 2012 — although at a slower pace. Overall, metals and mineral prices are projected to decline 6 percent in 2012 relative to the average price in 2011. The price of crude oil (World Bank average) is expected to average $98 per barrel in 2012, down 6 percent from the 2011 average; while food prices are expected to ease about 11 percent.

Prospects are, however, uncertain and will be sensitive to both supply and demand factors. Continued political unrest in the Middle East and North Africa could further disrupt oil supplies resulting in higher prices in the short-term — especially given low stocks and market shortages of light/sweet crude. Metals prices are now at levels where high-cost producers may shutter capacity so it is unlikely that they will decline sharply from current levels, while supply disruptions or an uptick in Chinese demand (China currently consumes more than half of the world's metal production) could cause prices to strengthen. Agricultural and (to a lesser extent) metal prices will remain sensitive to developments in energy prices. While lower energy prices should translate into lower production and final sales prices for food crops, stock-to-use ratios for some food commodities (particularly maize and rice) remain below their 15 year averages and lower prices will mean that prices will remain sensitive to adverse events (such as policy changes and flooding in Thailand).

Downside risks entail mostly slower demand growth due to the deterioration of the debt crisis, especially if it expands to emerging countries where most of the growth in commodity demand is occurring. The downside risks apply mainly to metals and energy, which are most sensitive to changes in industrial production, and less so to agriculture; the latter, however, may be affected indirectly through energy.

Box figure B8.1 Prospects for Wheat and Maize have been improving throughout the year



Source: US Department of Agriculture.

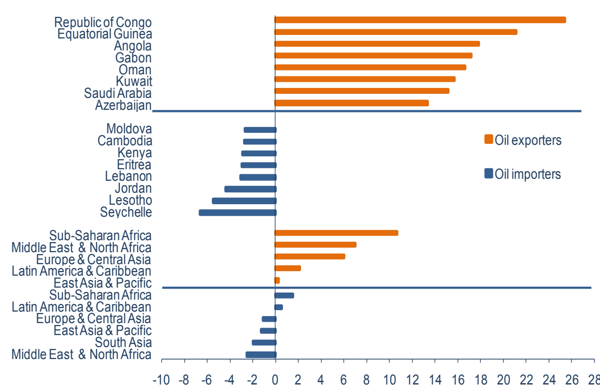
Although prices of wheat and maize eased recently (they declined about 17 percent each from July to December 2011), rice prices were increasing up until recently due to policy factors and the recent flooding in Thailand. They began weakening in December, on news of good crop prospects elsewhere in the region. Globally, markets for wheat and rice are well supplied, while maize stocks remain well below long-term averages. That said the supply outlook for the 2011/12 crop for all three grains has been improving throughout the year (box figure B8.1).

Developing countries remain vulnerable to developments in commodity markets

The past six years have driven home the importance of commodity price developments for prospects in developing countries. Strong commodity prices boost incomes in commodity producing countries, but reduce them in commodity importing countries.

The large commodity price hikes of 2010 had important terms-of-trade effects in many economies, with income gains of more than 10 percent in several oil exporting developing countries, while losses were concentrated among

Figure 20 Large terms of trade effects in 2011



Source: Thomson Datastream & World Bank.

heavy food and oil importing regions (figure 20). At the regional level, the biggest percentage gains (10.6 percent of GDP) were among Sub-Saharan African oil exporters — reflecting the size of the oil sector in their overall economies. The biggest losses were among the oil- and food-importing countries of the Middle-East and North Africa, whose real incomes were reduced by 1.5 percent of GDP. South Asia, which is largely self-sufficient in food, registered a 2.0 percent deterioration – mainly because of high oil prices.

Looking forward, commodity prices are expected to ease (see box 8). On the basis of these projections, regional terms of trade effects can be expected to be modest. However as the past 10 years have illustrated, commodity prices can be volatile, especially in the face of sharp fluctuations in economic activity.

In the case of the 2008/09 crisis, energy prices fell by 60 percent, metals prices by 57 percent and food prices by 31 percent between August 2008 and their first-quarter 2009 lows—although all three indexes rejoined earlier levels relatively quickly as the global economy recovered.

Simulations suggest that a 4 percentage point decline in global growth (broadly consistent with the large crisis of scenario 2) could be expected to result in a 24 percent decline in energy and a 5 percent decline in food prices, mainly reflecting the impact of lower energy prices on production costs.

Consistent with historical experience, these simulations suggest that were commodity prices to fall sharply in the context of a crisis, then incomes of major exporters would be hit hardest, while the benefits for importers would be more diluted. Oil exporting countries/ regions would be hardest hit, while large food and fuel importing regions would take the largest benefit.[10]

Major winners in these scenarios include China, Nepal and Uruguay (because oil prices decline more than the prices of Uruguay's exports), while losers are concentrated among the commodity exporting nations of the Latin America, Sub-Saharan Africa and Middle-East and North Africa regions. Oil exporters in these regions should see the biggest swings in their external accounts, with Venezuela, Russia and Angola among the most exposed.

Among the larger developing country commodity exporters, Brazil and particularly Argentina, are vulnerable to agricultural price swings. Brazil and South Africa are major exporters of iron ore, while Chile and Zambia are also significantly exposed to metal (copper) prices. With Chinese demand the key driver of global demand outturns in these markets, prices would depend importantly on Chinese growth and the commodity-intensity of any stimulus plan introduced in that country. In 2008/09 stimulus targeted infrastructure development which is relatively metals intensive activity, a more services or safety-net oriented program would likely not affect metals demand to the same extent. South Africa would also be particularly vulnerable to changes in platinum and gold prices, with limited offsets from lower oil prices due to the relatively low weight of oil in total imports.

Negative impacts could be larger in so far as the model assumes that declines in current account balances and government revenues can be financed. If these declines occur in the context of a global crisis, this assumption may not be met and domestic demand in these countries could be forced to contract even further.

As discussed earlier, commodity prices also play a major role in determining inflation rates in developing countries because the share of food

and energy in overall consumption tends to be much higher than in high-income countries. Indeed, rapidly rising food and energy prices in the second half of 2010 and persistent strength of these prices in 2011 contributed to a sharp acceleration in developing country inflation in 2010 and into the first half of 2011.

Overall, internationally traded food prices are projected to ease further in 2012 as very tight stock conditions ease (box 8). However, grain stocks are low, making prices vulnerable to supply disruptions. Should international food prices surge, developing country inflation is likely to pick up once again, putting monetary policy under pressure even as economic growth is slowing.

In addition to these vulnerabilities that stem from the international environment, many developing countries remain vulnerable to local food shortages, when domestic crops fail and countries either cannot afford internationally traded food products or do not have connections to international markets. Indeed, although conditions in the Horn of Africa are improving due to recent rains, the situation there remains a grave concern, with crop failure and famine threatening the livelihood of over 13 million people.

Concluding remarks

The global economy is at a very difficult juncture. The financial system of the largest economic bloc in the world is threatened by a fiscal and financial crisis that has so far eluded policymakers' efforts to contain it. Outside of Europe, high-income country growth, though strengthening, remains weak in historical perspective. At the same time some of the largest and most dynamic developing countries have entered a slowing phase.

These are not auspicious circumstances, and despite the significant measures that have been taken, the possibility of a further escalation of the crisis in Europe cannot be ruled out. Should this happen, the ensuing global downturn is likely to be deeper and longer-lasting than the recession of 2008/2009 because countries do not have the fiscal and monetary space to stimulate the global economy or support the financial system to the same degree as they did in 2008/09. While developing countries are in better shape than high-income countries, they too have fewer resources available (especially if international capital is not available to support deficit spending). No country and no region will escape the consequences of a serious downturn.

Importantly, because this second crisis will come on the heels of the earlier crisis, for any given level of slowdown its impact at the firm and household level is likely to be heavier. In 2008 developing countries went into the crisis in very strong cyclical positions (GDP was on average 3 percent higher than potential), now they are at best in a neutral position. Like national governments, firms and households are likely to be less resilient than in 2008, because the earlier crisis has depleted the cushions and buffers that allowed them to cope so well last time.

While the main responsibility for preventing a global financial crisis rests with high-income countries, developing countries have an obligation to support that process both through the G-20 and other international fora.

Now is not the time to pursue narrow national agendas on the global stage — too much is at stake. In this regard, developing (and high-income) countries could help by avoiding entering into trade disputes and by allowing market prices to move freely. On the one hand, developing countries could take steps to ensure that lower international commodity prices are passed through more quickly to domestic prices; while on the other hand, producers should avoid using their market power to resist market pressures for lower prices.

Faced with the enormous economic forces that would be unleashed by an acute crisis, there is little that developing countries can do to avoid being hit. There is, however, much that they can do to mitigate the effects that a deep crisis might have domestically.

In the immediate term, governments should engage in contingency planning to identify spending priorities, seeking to preserve momentum in pro-development infrastructure programs and shore up safety net programs.

Contingencies should include the possibility that external financing is unavailable or that commodity prices (and therefore associated government revenues) fall abruptly.

Policymakers should also take steps to identify and address vulnerabilities in domestic banking sectors through stress-testing. Risks here include the possibility that an acute deleveraging in high -income countries spills over into domestic markets either as a cutting off of wholesale funding or asset sales. In addition, in the context of a major global recession the balance sheets of local banks could come under pressure as firms and households capacity to service existing debt levels deteriorate. This could be a particular problem in economies that have gone through a very rapid credit expansion in recent years.

From a longer-term perspective, countries may want to take the time now to identify new drivers of growth so that post-crisis investment and progress is concentrated in the sectors that are most likely to succeed over the longer-term. Finally, governments may wish to address long-standing and tough policy challenges. Often it is only in serious crises that the political will can be mustered to put through difficult and unpopular (but necessary) reforms.

Notes

1. Econometrically, a 1 percent decline from trend growth of industrial production will cause a more—than 9 percent decline in metals and minerals prices. The like elasticity for food prices is much smaller (0.7 percent). See discussion in the commodity annex for more information.
2. In reaction to concerns about Iran's nuclear program, the United States has passed a law that will prohibit foreign financial institutions that do business with Iran's central bank or other financial institutions from conducting financial operations in the United States. At the same time the European Union (EU) reached a preliminary agreement on an Iranian crude oil embargo that would force EU refiners to find alternative sources (for 0.5 mb/d of Iranian crude), potentially lifting demand and relative prices for North Sea, Mediterranean and West African crudes. Meanwhile Japan has said it will also take concrete steps to reduce its dependency on Iranian oil.
3. Scenario 1 is modeled as an exogenous 7 percent decline in consumer demand and a 25 percent decline in investment in 2 small high-income European countries, over the 2012-2013 period (with respect to the baseline). The effects on consumer and investment demand are drawn as the midpoint between the median and mean values derived from an analysis of financial crises over the past 20 years. Confidence effects in other countries are modeled as a 0.75 percentage point increase in household savings and a 1.5 percent decrease in investment growth, with impacts doubled in high-income Europe, and halved in low income countries (due to weak global financial integration).
4. Scenario two builds on scenario 1, by assuming that two larger European economies are also frozen out of capital markets and subjected to a 7 percent cut in consumer depending and a 25 percent fall in investment. Confidence effects in other countries are now modeled as a 1 percentage point increase in household savings and a 2.5 percent decrease in investment growth, with impacts doubled again in high-income Europe, and halved in low income countries (due to weak global financial integration).
5. Abiad and others (2009) in a study of 88 financial crises in OECD countries over the past half century found quasi permanent GDP effects of up to 7 percent of GDP as compared with pre-crisis growth trends up to 7 years following a financial crisis.
6. Developing countries' external financing needs, are defined as the current-account deficit (assumed to be a constant at its 2011 level as a percent of GDP) plus scheduled principal payments on private debt (based on information from the World Bank's Debtor Reporting System).
7. Countries with the debt repayment to GDP ratios that are less than three percent are

excluded from this list. These countries are mostly aid dependent and their vulnerabilities are mostly related to official flows.

8. During the 2008 financial crisis and even in 2011, equity and short-term debt flows have reacted rapidly to changing market conditions. FDI, aid and remittances flows are not immune to such changes but tend to react more slowly and are therefore considered to be more stable sources of finance.
9. Ex-post rollover-rates depend on both demand for new loans and supply. In the baseline, the stock of short-term loans is assumed to remain a constant share of GDP between the beginning and end of the year. For reference, the stock of loans increased by 40 percent in 2010 and declined by almost 30 percent in 2011 as conditions tightened after August.
10. While swings in oil prices tend to be macroeconomically important for both exporters and importers, swings in metals and mineral prices tend to be more important for exporters than importers (because their share in total import demand and GDP is relatively small). For most countries food price swings have larger impacts on internal balances (transferring money from producers to consumers domestically) rather than external balances because the vast majority of food in mostly all countries is produced and consumed in the same country. Nevertheless, large swings in food prices can have large poverty and domestic inflation effects.

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Industrial Production Annex

Recent economic developments

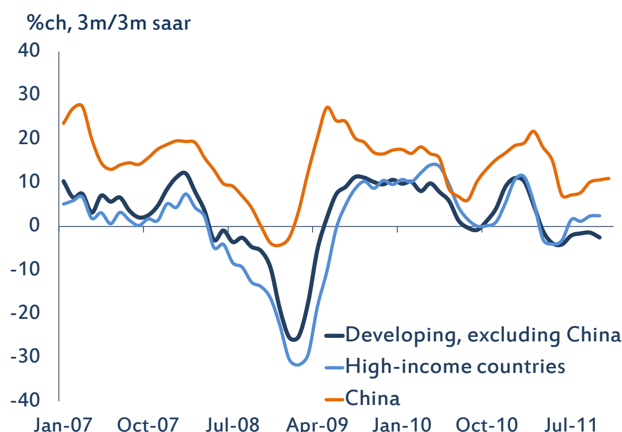
Unique exogenous shocks have affected industrial output throughout the year. The recovery in industrial output growth from the soft growth patch in the second half of 2010 was dampened earlier in 2011 by adverse weather conditions in Europe and the United States. Just as the impacts of adverse weather conditions were starting to ease, the shock to global supply chains from the Tohoku earthquake depressed industrial sector activity at the beginning of the second quarter, affecting in particular the auto and electronics sector.

Industrial output growth began to strengthen again into the mid-year boosted by restoration of global supply chains and reconstruction efforts in Japan post-Tohoku, only to face further headwinds as a crisis of confidence engulfed high-income countries in the wake of the U.S. debt ceiling debate and the surfacing of the Euro area fiscal crisis. The heightened uncertainty related to the sovereign debt concerns in high-income countries started to shake investors and consumers' confidence, weighing on the industrial sector recovery as consumers delayed purchases of durable goods and businesses drew down stocks. The recent floods in Thailand have disrupted some supply chains, although the magnitude of the impact is expected to be only a fraction of that induced by the Tohoku disaster. All these shocks and the rebound from them have impacted industrial output growth to different degrees and had a differentiated impact across regions and time (figure IP.1).

Reflecting the confluence of diverging forces affecting industrial production, global industrial output has been moving sideways since the start of the year, recording monthly growth in excess of 2 percent in May and August, followed by declines of about 1.2-1.3 percent in June and September and 0.1 percent in October (figure IP.2).

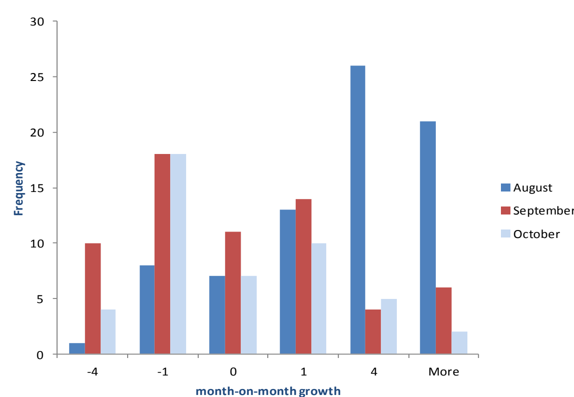
Two-speed industrial production growth in high-income countries. Growth in the industrial sector in the United States had proved resilient in the second half of 2011, with growth supported by revived consumer spending and relatively solid external demand. The relatively weaker pace of growth in the wake of the Tohoku disaster persisted however, even after the restoration of supply chains, with 3m/3m seasonally adjusted annualized rate of growth hovering around 3 percent in the second half of 2011. Industrial output advanced 0.7 percent in October month-

Figure IP.1 Industrial production moving sideways



Source: World Bank

Figure IP.2 Broad-based industrial output growth in August gives way to weak performance in September-October



Source: Datastream, World Bank.

on-month, supported by a 0.5 percent gain in manufacturing output on the back of strong increase in motor vehicle output and parts production, but growth dipped to 0.14 percent in November.

Industrial output in Japan staged a V-shaped recovery from the earthquake-induce plunge in industrial output. GDP posted a solid 5.6 percent quarter-on-quarter (saar) advance in the third quarter and industrial output expanded at more than 30 percent annualized rate in the three months to August, notwithstanding soft external demand, the strength of the yen, and the global slump in IT sector. Industrial sector growth remained strong through October (expanding 6.5 percent 3m/3m saar) and the supply disruptions from the floods in Thailand are expected to have only a short-lived impact on growth, with the auto sector impacted most severely. Growth in other high-income countries in East Asia and Pacific has also rebounded from the effects of the Tohoku supply chain disruptions, and it appears that the effects of weaker growth in the Euro area have been relatively limited so far and that confidence effects following the financial turmoil since August have also been less pronounced to date.

Overall, after growth decelerated throughout the first half of 2011, industrial sector performance in core euro area countries strengthened somewhat in the third quarter – reflecting a combination of strong growth in July and August and much weaker or even falling growth in September. Output in Germany was particularly robust, expanding at 7.2 percent annualized rate in the third quarter, and somewhat more subdued in France where it expanded at a 2.3 percent annualized rate. Growth in the industrial sector in core euro countries was supported by consumer spending and the post-Tohoku bounce back effect. Meanwhile industrial production declined 1.9 percent, 3.6 percent, and 2.8 percent in Italy, Spain, and Portugal, where consumer spending was affected by falling confidence. Despite a mild reacceleration in industrial output growth in the third quarter, Euro area GDP growth almost came to a standstill in the third quarter, advancing 0.2 percent relative to the previous quarter. Growth would have been even weaker were it not for the 0.5 percent and 0.4 percent expansion in Germany and France.

The performance of the industrial sector in the Euro Area started to deteriorate however as the sovereign debt crisis intensified and the latest industrial sector data suggests a very weak fourth quarter. Industrial output declined 4.7 percent in the three months to November in the Euro Area, with output in Germany down 7.4 percent after robust growth in the previous quarters. Industrial output continued to decline sharply in Italy, down close to 12 percent during the same period. Meanwhile output continue to decline in most high-spread economies. It fell more than 15 percent in Greece, and more than 7 percent in Spain. Due to a particularly weak fourth quarter, industrial output in the Euro Area rose a mere 4.1 percent in the first eleven months of the year. Industrial output in Greece declined 8.4 percent year-to-date, while output in Spain and Portugal was down 1.2 percent during the same period. Germany recorded one of the strongest performances in the Euro Area, with industrial output up 8.3 percent.

Events in high-income countries and domestic policies have impacted industrial production performance in developing countries. Most recent data for the developing countries show a generalized slowing across regions, with the exception of Middle East and North Africa where output is rebounding from the disruption associated with the Arab Spring.

In East Asia and Pacific, excluding China, growth reaccelerated in the three months to November to 6.4 percent annualized rate, following a sharp deceleration in the wake of the Tohoku earthquake. The effects of Tohoku and policy tightening has contributed to a deceleration in China's industrial production growth starting in the second quarter of 2011, with growth easing to an average 7 percent annualized growth throughout much of the third quarter, down from 21 percent growth in the first quarter. Growth has reaccelerated to around 10.5 percent 3m/3m annualized rate, as output gained 0.8 percent month-on-month in November,

notwithstanding the drag on domestic demand from some cooling in the housing market. In Thailand the disruptions caused by flooding have brought to a halt the recovery in the industrial sector, with output plunging at a 71.6 percent annualized rate in the three months to November.

Europe and Central Asia, whose industrial sector is most reliant on demand from Europe, started the year strongly, with industrial output expanding at a 17 percent annualized pace, but growth has weakened significantly since March, and output contracted during much of the second and third quarters, in large part due to a sharp slowdown in Turkey. Since then industrial activity has recovered slightly, with output rising at a 6.8 percent annualized rate in the three months to November, bolstered by a bounce-back in industrial activity in Romania and Ukraine.

Output is also declining in the Latin America region, with industrial production contracting at an accelerated rate through October (3 percent annualized rate) following the deceleration of activity in the largest economies in the region. Monetary policy and credit tightening in conjunction with a stronger currency have caused industrial production in the largest economy to contract starting with May. Weakness in domestic demand that caused Brazil's GPD to stall in the third quarter also explains the decline in industrial output. Meanwhile growth in Mexico's industrial output has also dipped into negative territory in the three months to October.

Industrial production in Sub-Saharan Africa, where data is available for only a few countries (Angola, Gabon, Ghana, Nigeria, and South Africa) has contracted through most of the second quarter remained relatively flat in the three months to August. Nigeria has been the strongest performer in the region with growth reflecting rising oil production. Output in South Africa, the region's largest economy started to recover, reaching a 15 percent annualized pace in the three months to October. The decline in industrial output in both Latin America and Sub Saharan Africa may reflect a pull back from the relatively higher demand for oil and metal and minerals resources in the first quarter of 2011.

Industrial activity in South Asia has been deteriorating for several months, as policy tightening and uncertainty about the implementation of proposed regulatory changes in India weighed heavily on industrial production, which was contracting at a 12 percent annualized pace in the three months to October. Meanwhile growth Sri Lanka continued at a robust pace, while in Pakistan industrial output recovered strongly in the third quarter, after a dismal performance earlier in the year.

Industrial output data for the Middle and North Africa are published with a considerable lag. In the aftermath of the political turmoil of the Arab Spring industrial activity in Syria, Tunisia, Egypt and Libya has fallen by 10, 17, 17 and 92 percent at its lowest point according to official data. Activity surged during the second quarter of 2011 as the negative effects of the political turmoil in Tunisia and Egypt faded and activity regained (and exceeded by more than 15 percent) pre-Arab Spring levels. Nevertheless Egypt's industrial output growth relapsed in the third quarter when growth turned sharply negative, and in Tunisia, where growth was slightly negative.

Weakening prospects for the industrial sector

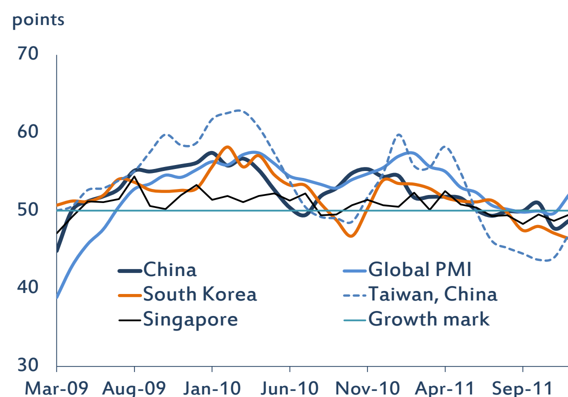
Given recent volatility in industrial output and the associated difficulties in extracting trend information from recent data, we rely on recent business surveys to gauge near-term developments in industrial output. In addition, uncertainties regarding the magnitude of the impact of supply-chain disruptions caused by the Thai floods further complicate the assessment of industrial sector outlook. There are indications however that these new supply disruptions are less damaging to global industrial output than the ones caused by the Tohoku earthquake, since factories elsewhere in Asia are able to make up for some of the lost Thai production.

The recent business surveys suggest industrial activity will remain weak in the months ahead. The readings of the global manufacturing purchasing managers index (PMI), down a sharp 7.7 points as of November from its 56-month peak recorded in February 2011 suggest that global industrial output has likely contracted in the fourth quarter, notwithstanding the modest improvement recorded in December (figure IP.3). The PMI remains at weak levels, indicating that global manufacturing growth is expected to remain weak, on weak economic activity in the Euro area, a slowdown in growth in China in part due to weaker external demand, and partly due to cooling in the real estate market (figure IP.4). In addition policy tightening and tighter credit conditions contributed to a slowing in domestic demand in Brazil, while in India policy tightening and uncertainties about the implementation of proposed regulatory changes are dampening growth.

Small open economies that are highly synchronized with global business cycles also suggest that global industrial production growth will slowdown in coming months. Business sentiment was depressed in Taiwan, China in November, with the diffusion index down to a depressed 43.9 level, with weak external demand from the U.S. and Japan taking a toll on tech exports in particular. The high ratio of inventory to shipments increases the likelihood of an inventory correction in the months ahead if external demand does not strengthen. The PMI has recovered sharply in December, rising 3.1 points to 47.1 but continues to point to contraction in output. The deterioration in business sentiment has been less pronounced in South Korea and Singapore, but sentiment remains depressed there as well. In South Korea both output and new orders PMIs have declined sharply, but other business surveys show a mild improvement in business sentiment (figure IP.3).

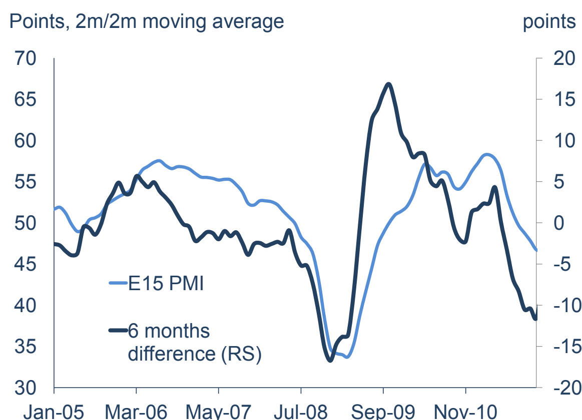
Industrial output in the Euro Area is likely have contracted in the fourth quarter. Indicators for Euro area industrial production are particularly weak, with the PMI for the Euro area sliding further below the 50 no-growth mark for the fourth consecutive month in November (46.4 pts nearing the level recorded in July 2009) and recovering only slightly to 46.9 in December (figure IP.4.). Business sentiment is lowest in Greece, Spain, and Italy. Business sentiment as measured by the PMI deteriorated in core countries in November, while those for high-spread countries remained stable or inched up slightly before improving almost across the board in December (figure IP.5). Business sentiment indicators suggests that German industrial output will stall in coming months, with the PMI index below the 50 no-growth mark for a third consecutive month, in December (figure IP.6).

Figure IP.3 China's PMI fell below the 50 no-growth mark



Source: World Bank

Figure IP.4 Euro area PMI points to recession



Source: World Bank

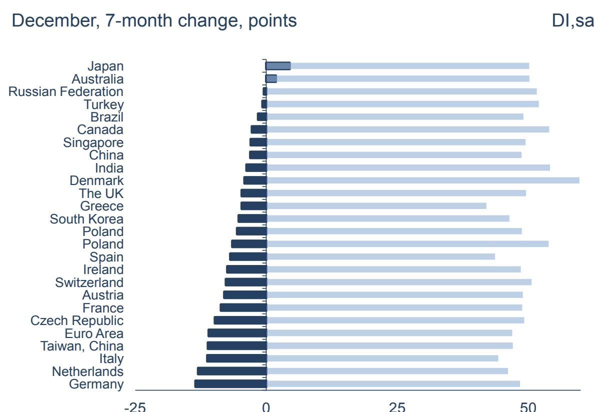
A 3.4 percent negative carry over from the third quarter, lingering weak business sentiment, weak consumer demand and continued fiscal austerity will depress industrial output in the Euro Area in the fourth quarter, and through the first half of 2012. Despite a modest recovery in the second half of 2012 industrial output is expected to contract in 2012.

In the United States and Japan, the picture is somewhat more positive. After falling in August industrial production in the US picked up in September and has increased 0.7 percent in October, the strongest pace since March, boosted by more robust retail sales and solid external demand. The Institute of Supply Management's Manufacturing Purchasing Managers' Index rose to 53.9 by December from 50.8 in October marking the 29th successive month of growth in manufacturing activity. The supply-chain disruptions from the Thai floods have weighed on the U.S. industrial output in the fourth quarter, with auto manufacturers having already announced lower output for November because of parts shortages. Indeed industrial production advanced only 0.1 percent in November from the previous month. Nevertheless with stocks at relatively low levels and US consumer and business spending remaining resilient amidst financial turmoil elsewhere, manufacturing output is likely to continue increasing in the months ahead with growth expected to be in excess of 3.5 percent, in the fourth quarter before weakening in the first half of 2012. Growth is expected to average about 2 percent in 2012, about half the growth pace recorded in 2011.

Industrial output growth in Japan is expected to be more upbeat next year, although quarterly growth should decelerate somewhat after the speedy and impressive rebound in the aftermath of the Tohoku disaster (figure IP.7). Several factors will exert opposing pressures. On one hand increased public sector spending stipulated in the third supplementary budget, the easing of electricity shortages that hampered production during the course of the summer, and the replenishment of depleted auto inventories at Japanese overseas affiliates, and resilient personal consumption will support growth in coming months. The supply-chain disruptions from the Thai floods that have weighed on growth in the fourth quarter will ease early next year, but the strong yen and weakening external demand, in particular from the Euro area will limit growth. One source of weakness for next year is subdued growth in the auto sector as demand in major export markets, namely the U.S. and Euro area is expected to be weak.

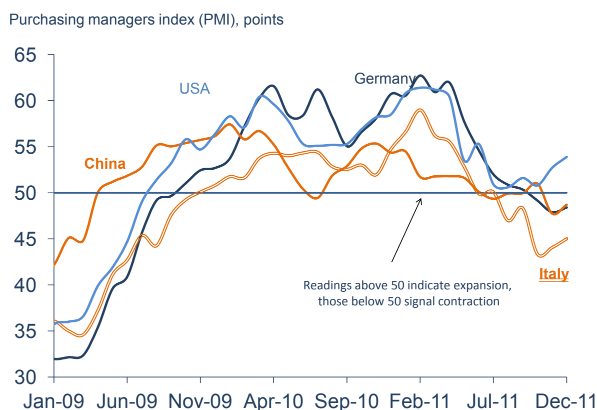
Among developing regions the outlook is more upbeat than in high-income countries. Led by China, developing country industrial production growth will remain stronger than high-income countries although growth will moderate due to weakness in external demand, and in particular

Figure IP.5 Deterioration in business sentiment



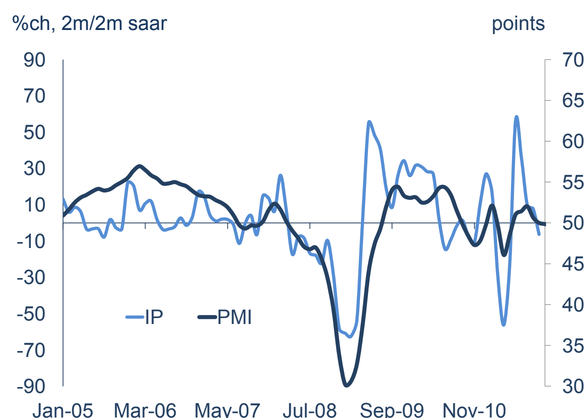
Source: World Bank

Figure IP.6 Manufacturers' business sentiment is consistent with weak output growth



Source: Haver and World Bank

Figure IP.7 Japan's industrial production bounces back



Source: World Bank.

subdued demand from high-income countries, especially in the first half of 2012, as well as some policy-induced deceleration in growth.

China's industrial production growth shows signs of policy-induced deceleration in growth, with the PMI below the 50 no-growth mark in both November and December. The policy-induced correction in the housing market led to moderation in real estate investment and contributed to the slowdown in industrial output in related industries. Furthermore, concerns about funding conditions for small and medium enterprises have emerged recently, which together with softer global demand could moderate growth somewhat in coming months. In Thailand production will likely contract through the fourth quarter of 2011 and stage a modest recovery starting in the latter part of the first quarter of 2012. Given Thailand's importance as an auto parts hub, floods will likely affect output in other countries both within the East Asia region and outside, although some countries in the region could benefit as they will likely produce some of the parts and materials that used to be produced in Thailand.

In Europe and Central Asia, industrial output outlook has deteriorated, as the region is likely to suffer from the financial turmoil in Euro area. In Turkey after a marked deterioration in the first part of 2011, sentiment has recovered somewhat with the PMI above the 50 no-growth mark since September. Similarly in Russia business sentiment improved since September, rising above the 50 growth mark in October.

Overall, global industrial output growth is expected to ease to around 2.0 percent in the fourth quarter, from 2.9 percent (saar) in the third quarter, and ease further in the first half of 2012, before reaccelerating in the second half of 2012, when the current headwinds will abate. The floods in Thailand, which are disrupting the global supply-chain, have created further headwinds and are likely to disrupt production for at least two quarters. Another headwind for global industrial production is the expected correction in the global inventory cycle in the near-term. Indeed, the inventory to shipment ratio in countries that provide timely and reliable data (South Korea, Taiwan, China) is still above long-term trends. Policy tightening in major emerging economies is also likely to contribute to the slowdown in industrial production over the short-term.

Risks and vulnerabilities

Should the financial turmoil and deterioration in financial market confidence lead to a market-induced freezing-up in capital markets, and a tightening in global credit, the prospects for the industrial sector would deteriorate markedly. In the small contained crisis scenario global GDP growth could be 1.7 percent lower than the baseline in 2012, while in the scenario of a larger crisis economic activity could see a 3.8 percent decline relative to the baseline in 2012 (See Main text). In these two downside scenarios, economic activity in developing countries, including industrial sector growth, could be 1.7 percent and 3.6 percent lower than the baseline, respectively, in 2012, and 1.8 and 4.3 percent lower than the baseline in 2013, respectively.

In the event of an economic downturn similar to the one following the 2008 crisis sharp declines will likely occur in the demand for machinery, capital goods and durables, with countries that depend heavily on this type of production being

the most vulnerable to postponement in capital expenditures by investors and government and big ticket purchases by consumers. Countries that rely heavily on manufactures (China, India, Korea, Malaysia, The Philippines, Thailand, Taiwan, China, and Turkey) would be affected.

Another risk to industrial output growth is the possibility of domestic banking crises, as non-performing loan ratios are likely to increase with the deceleration in GDP growth in developing countries. A sharp slowdown in credit growth or outright contraction will have marked impacts on domestic demand, and industrial output.

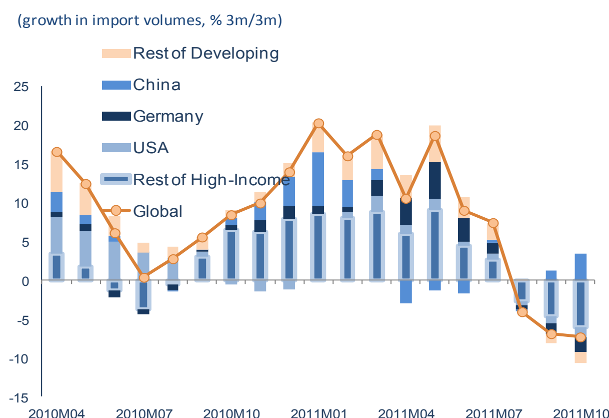
Economies in Europe and Central Asia and Latin America could be vulnerable to possible deleveraging by European banks. There are already signs that many emerging country banks are tightening terms and standards of lending across all regions, and all types of loans (business, real estate, and consumer).

Trade Annex

A year of shifting fortunes in global trade expansion. The volume of global trade (merchandise and services) is estimated to have expanded by 6.4 percent in 2011— over a percentage point above its ten-year average. However, performance across the year was not uniform. In the first quarter global trade growth was expanding at a historically high pace. However, the strong performance at the beginning of the year was punctured by multiple shocks to the global economy.

The Tohoku quake rattled supply chains, particularly in East Asia. The disruptions to supply chains that occurred in the wake of the Tohoku quake dealt a severe blow to trade in capital goods and electronic appliances. Though many regions were affected, the impact was most pronounced in East Asia (and in particular China), as many Japanese firms are vertically integrated with production networks in the region. Indeed, global trade decelerated rapidly from a high annualized pace of 22.6 percent (3m/3m, saar) in March to 12.4 percent (3m/3m, saar) in April (figure Trade.1). Much of this drop in growth was driven by a 6.5 percent contraction in import demand from East Asia. China's import demand fell by 11.3 percent and South Korea's by 13.7 percent.

Figure Trade.1 Global trade expansion interrupted by multiple shocks



Source: World Bank.

As sharp as the April trade contraction was, its rebound in May was equally strong, as much of the production capacity that had been sidelined in Japan was restored or replaced elsewhere, and the back log of unfilled orders boosted the expansion in trade, with trade growing at a 19 percent (3m/3m, saar) pace in April (30% in East Asia).

Global economic uncertainty rises, dampening what had looked like a robust recovery. Just as the effects of the Tohoku quake were dissipating, global economic uncertainty rose with the escalation of the Eurozone debt crisis, downward revisions to estimates of US growth, and contentious US debt ceiling discussions that led to a downgrade of US sovereign debt by S&P (see main text and finance annex for detailed discussion). The associated uncertainty and risk aversion had a rapid impact on the real economy, with global trade growth turning negative in August.

The slowdown in global trade volumes was more marked in high-income countries. High-income countries' contribution to global trade fell by 24.0 percentage points from May to October (from 14.7% to minus 9.3%), while developing countries' contribution to trade growth fell by only 0.9 percentage points (2.9% to 2.0%). The slowdown in global trade has been stronger in Europe, with imports volumes of European Union member states falling at a 17.4 percent (3m/3m), and 20.9% (3m/3m) annualized pace in September and October respectively, amid slowing industrial production and weakening order books (see Industrial production annex). In the US the deceleration has been less marked than in Europe, with import demand falling at 7.8 percent (3m/3m, saar) and 9.5 percent (3m/3m, saar) annualized pace in September and October respectively. And in developing countries, supported by a rebound in China's imports volumes, imports increased at an annualized pace of 0.6 percent and 6.4 percent

(3m/3m, saar) in the three months to September and October respectively.

Current recovery lags behind the previous recession.

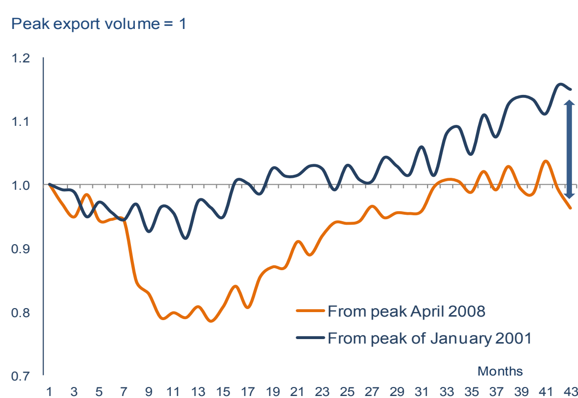
With the recent sharp deceleration in the pace of global trade volume growth, world trade is falling once again below its pre-crisis peak volumes a milestone that it reached in December 2010. In contrast, 39 months after the previous recession in global trade in 2001, trade was some 13 percent above pre-crisis peak levels (figure Trade.2). Given the greater depth of the 2008 recession, it took twice as long during the current recovery to regain pre-crisis levels of trade activity as it did in 2001 recession (32 vs 16 months).

Most of the weakness in global trade volumes reflects the relatively sluggish recovery in high-income countries. As of October 2011, developing country exports were 9.2 percent above their pre-crisis peaks, while high-income exports had fallen to 9.4 percent below their pre-crisis peak volumes, having previously reached 1.5% of their peak volumes in May 2011 (figure Trade.3).

Regional exports have slowed sharply, but growth has remained in positive territory through August

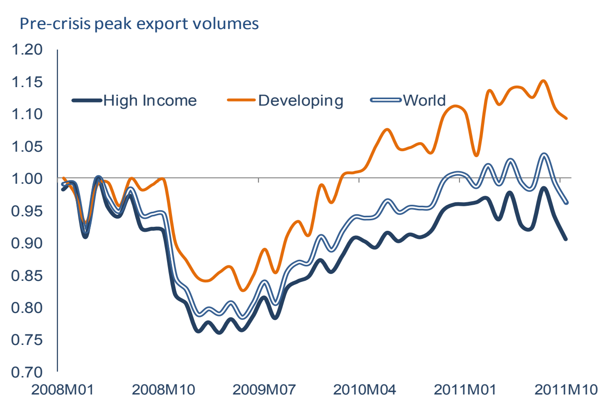
South Asia's exports, driven mostly by soaring Indian trade with China, eclipsed the performance of any other developing region in the first three quarters of 2011 (South Asian

Figure Trade.2 Trade recovery in current crisis still lags behind previous crisis



Source: World Bank.

Figure Trade.3 Recovery of exports in high-income countries lags behind that of developing countries



Source: World Bank.

Table Trade.1 Regional export growth slowed sharply in the third quarter
(Merchandise export volume growth, seasonally adjusted annualized rates, unless otherwise stated)

					2011			(month-on-month growth)	
	2007	2008	2009	2010	Q1	Q2	Q3	October	November
Developing	10.7	3.9	-8.8	18.5	-15	16	-1.2	-1.2	
East Asia & Pacific	14.5	5.3	-8.4	24.3	-1.4	18.7	-1.6	-0.9	4.0
Europe & Central Asia	10.7	3.2	-11.6	12.1	10.5	15.1	-6.8	3.0	
Latin America & Caribbean	4.6	-1.8	-7	12.3	4.3	14.2	1.1	1.4	
Middle-East & North Africa	5.9	6.2	-12	13.5	-20.8	0.8			
South Asia	8.1	7.1	0.4	19.2	23.8	24.8	-9.7	-10.9	10.3
Sub-Saharan Africa	9.4	5.5	-12.8	10.2	14	9.2			

Source: World Bank.

exports grew at about 24% for the first two quarters of 2011. Nevertheless, the region like all other developing regions saw export demand plummet in the third quarter as global uncertainty picked up and its export volumes actually declined 9.6 in the 3 months ending September 2011. Most developing regions (except the Middle-East & North Africa where activity was interrupted by the Arab Spring) saw their export growth decline from double digit rates to negative ground in the third quarter, with Latin America performing best. Third quarter performance in Europe and Central Asia (-6.8 percent) was among the worst (-6.8 percent), reflecting their close trading ties with high-income Europe, the epi-center of current financial market turmoil (table Trade.1).

Oil exporters have enjoyed large terms of trade gains. As discussed in more detail in the Commodity Annex, the rise in oil prices boosted oil exporters' terms of trade from January to September (figure Trade.4). Sub-Saharan African oil exporters gained the most (8.5% of GDP), while oil importers in every region except Sub-Saharan Africa experienced a decline in their terms of trade (many of the oil importers in Sub-Saharan Africa are exporters of metals and minerals, which also have seen increases in international prices).

Outlook and Risks

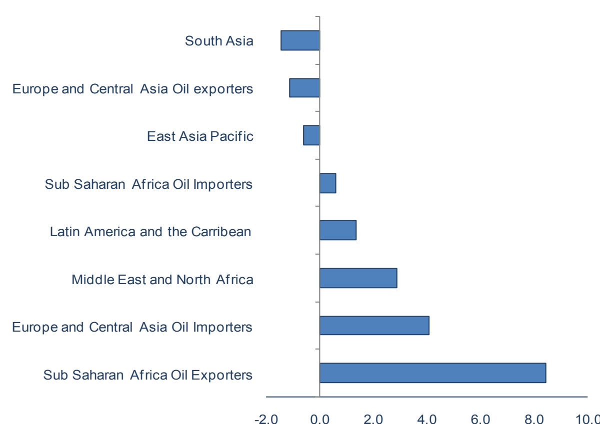
Outlook

The volume of global trade (merchandise and services) is estimated to have expanded by 6.6 percent in 2011. The sharp slowdown in growth in the second half of 2011, will have negative impacts on whole-year growth statistics in 2012 – even if, as we expect quarterly trade growth rates within year to return positive. This negative carry-over will reduce annual growth to around 5.2 percent in 2012, before it picks up to around 7.2 percent in 2013.

This rate of growth in 2012 is below the average 5.5% growth between 1991 and 2011, though it exceeds it in 2013. However, even with this growth, global trade will remain well short of the level it would have attained had the 2008/09 recession not occurred. Indeed, at a growth rate of 7.5% it would require some four years for trade to reach trend volumes (figure Trade.5).

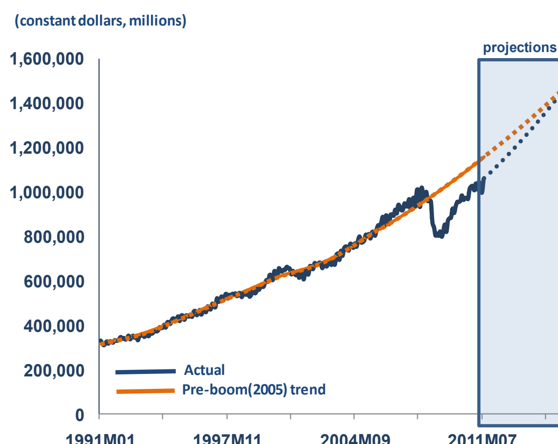
As has been the case throughout the recovery, trade growth in developing countries (between 8-10%) is projected to be higher than in high-income countries (between 5 to 7%) over the forecast horizon. However, with high-income countries still accounting for some two-thirds of global trade flows, trade developments in

Figure Trade.4 The recovery in prices has favored oil exporters
(Terms of trade changes as a share of GDP, percent)



Source: World Bank.

Figure Trade.5 It could take four years for global trade to catch-up with pre-boom trend volume.



Source: World Bank.

developing countries over the forecast horizon will not be decoupled from the growth trajectory of high-income countries.

Risks

An escalation of the debt crisis in the Eurozone (beyond what is currently envisaged under the baseline assumptions) would have strong negative effects on global trade. In the scenario of a contained crisis in some smaller euro-area countries described in the main text, global trade growth will slowdown to between 0.9 and 1.8 percent in 2012 depending on the extent of confidence effects. In the scenario, where several larger European economies also become involved global trade would contract between 4 to 6 percent.

Vulnerabilities to slow down in Europe differ by region.

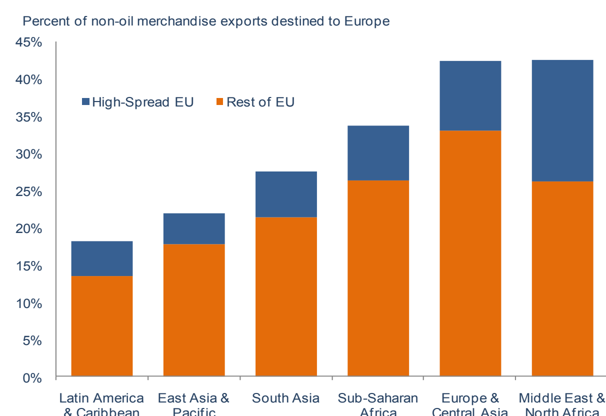
Thanks to their proximity, cultural links and existing preferential trade agreement Europe and Central Asia, and the Middle East and North Africa are the developing regions with the closest trade linkages with the European Union and would be hardest hit (figure Trade.6). In total, some 43% of exports for each of these two regions are destined for the European Union. Latin America and the Caribbean are the least dependent on Europe - accounting for only 18% of their exports. Hence, while all developing countries will be impacted by a slowdown in import demand from the EU, countries in the Middle East and North Africa as well as Europe and Central Asia could potentially suffer the greatest direct impacts.

The vulnerability of developing regions to a slowdown in Europe depends not only on the share of its exports going to Europe but also on the commodity composition of its exports to Europe. In addition, besides the first round effects of slowing demand from Europe, there will be second round demand slowdown effects from other regions, triggered by the initial EU slowdown.

To disentangle some of these effects we adapt the standard GTAP model to estimate the effects of a 1% reduction in EU consumption (say on account of increased precautionary savings due to a further escalation in the Eurozone debt situation).

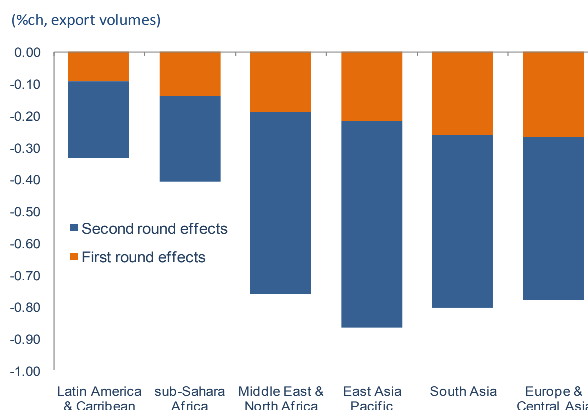
Simulation results using the standard GTAP (Global Trade and Protection) general equilibrium model of world trade suggest that although first-round effects for Europe and Central Asia are largest (and in line with export shares), first round effects are also strong for South Asia, because South Asian exports to Europe (in particular textiles and clothing) are more sensitive to a decrease in consumer demand. Moreover, second round effects are actually much higher than first round effects for all regions. In particular, knock on effects

Figure Trade.6 MENA & ECA regions remain the most exposed to a trade downturn in Europe



Source: WITS, COMTRADE

Figure Trade.7 A slowdown in EU will have varying effects on developing country exports...



Source: World Bank, GTAP.

(including reductions in derived demand from regions hit hardest in the first round) cut sharply into exports of East Asia & Pacific and to a lesser extent the Middle East and North Africa, even though for both regions the first round effects are relatively moderate (figure Trade.7).

Country vulnerabilities to a downturn in the global economy differ by the composition of exports.

Another approach to determining which developing countries would be most vulnerable to a deterioration in conditions is to look at the price and volume sensitivity of their exports in the context of a global downturn.

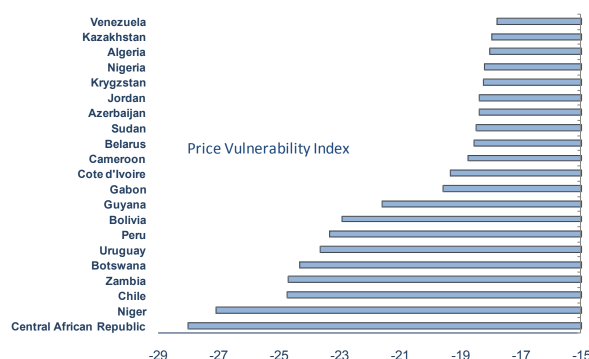
Looking at the fluctuations in trade prices and volumes of 97 commodities (commodities disaggregated at the two-digit level of the Harmonized System) following the 2008 crisis, we can calculate the extent to which the exports of individual countries might be hit if a similar downturn were to be reproduced.

According to these calculations that exporters of industrial metals such as copper (Chile and Zambia), precious stones (e.g. Botswana and Central African Republic) and oil and gas (Algeria, Yemen, Venezuela, Nigeria, Saudi Arabia) suffer the largest declines in export prices. Prices of non-industrial commodities proved to be more resilient. Moreover, the total value of exports declined even more sharply for industrial commodities, compared to other commodities (including food and oil) as fluctuations in the export volume of these commodities also were larger.

It follows from this analysis that major industrial commodity exporters like Chile, Botswana and CAF are likely to suffer large price and earnings swings and therefore be exposed to large swings in current account balances, government deficits and currency swings (figure Trade.8). Further, the negative income effects and loss in foreign currency earnings can in some instances provoke a significant deceleration in domestic demand and therefore GDP. Indeed, these secondary effects could be long-lasting if reduced export earning caused countries to delay the import of productivity and growth enhancing capital goods (Go and Timmer, 2010).

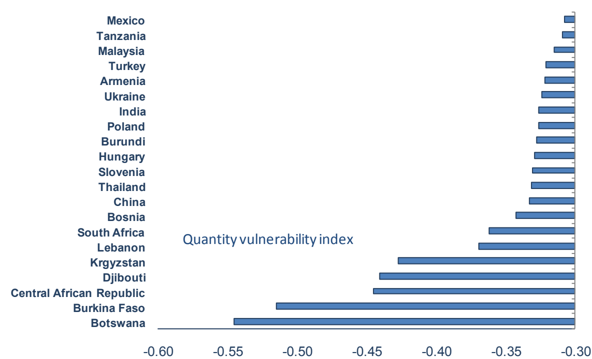
On the demand side, manufacturing goods saw the sharpest drop in volumes, with the demand for machinery, capital goods and durable goods dropping most as given uncertain prospects investors and consumers delay capital expenditures and big-ticket purchases (figure Trade.9). Countries more reliant on manufactures (such as China, India, Malaysia, Philippines, Thailand, and Turkey) may not see as large swings in their nominal balances, but are more likely to see bigger hits to GDP as the volume of exports falls relatively sharply.

Figure Trade.8 Commodity exporters are most likely to see a sharper fall in their export prices during a global downturn...



Source: World Bank.

Figure Trade.9 Manufactured goods and precious mineral exporters likely to see a sharper fall in demand during downturn



Source: World Bank.

In comparing the two effects – price and volume - Haddad and Harrison (2010) find that overall the impact from the volume effect is stronger, thus implying that countries vulnerable through the volume channel are more likely to experience greater down turns in their export receipts.

Developing country trade financing remains vulnerable to Eurozone financial crisis. Even for developing countries whose banking sectors are less integrated with the banking sector in the Eurozone, the ongoing debt crisis in the zone threatens to impact them indirectly through the trade finance channel. This is all the more important as European banks are major players in global trade finance. According to data from Dealogic, while US and Japanese banks accounted for 5 percent and 4 percent respectively of global trade finance in Q3 2011, large Euro Area banks alone accounted for at least 36 percent of the total. Over that period French and Spanish banks accounted for some 40 percent of trade credit to Latin America and Asia. Recent calls by regulators to European banks to shore-up their capital adequacy ratios albeit necessary could lead to significant deleveraging. The typical short-term maturity of trade finance lends itself to being cut. And indeed, there is already indication that this is taking place with developing regions being hit harder. Using data from Dealogic (figure Trade.10), we observe that while high-income countries trade financing volumes fell by 7.8 percent between the first half of 2011 and the second half of 2011 (when the Euro Area crisis escalated), for developing countries the fall was 42 percent with the sharpest declines occurring in Latin America and the Caribbean (57.3 percent), and in Africa (47.5 percent). Further evidence of this is observed by the increase in trade finance demand provided by multilateral development banks, including the International Finance Corporation.

Figure Trade.10 Decline in trade finance volumes between first and second half of 2011.

Source: Dealogic and World Bank staff calculations

A further slowdown in the global economy risks a rise in trade protectionist measures.

In general, during periods of economic downturns the application of trade defensive measures rise, as governments, pressured by the prospects of higher unemployment or existing macroeconomic imbalances, pursue mercantalistic policies to protect domestic industries (and employment) and or gain market shares. Indeed, during the recent recession, the incidence of trade restrictive measures implemented by G-20 economies rose by some 175 new measures over the 11-month period between April 2009 to February 2010, according to the World Trade Organization (WTO). While the number of new measures implemented continued to increase during 2010, there are worrying signs that since the latter half of 2011, as global economic conditions deteriorated, the incidence of trade restrictive measures is picking pace. Indeed, according to the latest Global Trade Alerts report, the number of harmful trade measures implemented in the third quarter 2011 increased by 12.5% (q/q).

However, the unilateral `implementation of trade measures has the potential to trigger tit-for-tat trade policy responses. A multilateral approach offers the best prospect (Hoekman, 2011). By one estimate, the gains to accepting what is already on the table as regards the market access gains from the Doha Development Agenda amounts to a conservative estimate of $160bn per year (Laborde, Martin, and van der Mensbrugghe).

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Finance Annex

Recent developments in financial markets

Contagion from the Euro area debt crisis to developing countries has emerged

Emerging markets have been engulfed by a wave of market volatility that had started with the August downgrade of U.S. sovereign ratings and sharply heightened with the increased uncertainty related to the resolution of the European debt crisis. In contrast with earlier episodes of market turmoil centered around high -spread European economies, this time contagion from high-income countries affected the risk premia, yields, stock markets, capital flows and currencies of developing countries.

Developing-country equity markets experienced significant sell-offs later in 2011…

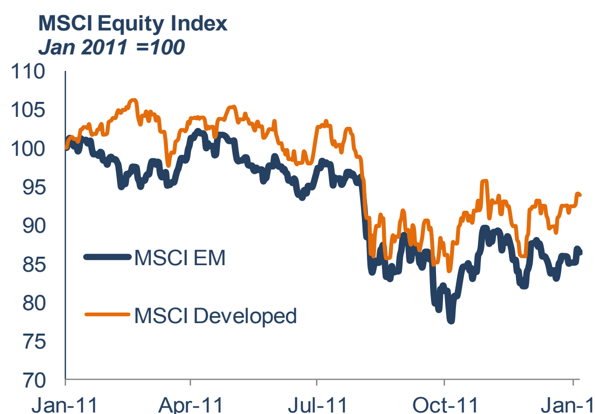
As of early-January 2012, emerging equity markets (as measured by MSCI index) dropped 8.5 percent since the end of July (figure FIN.1). All developing regions experienced price declines—although these were much more marked (around 20 percent) in Eastern Europe. Among the worst country declines were for Argentina, Brazil, Egypt, India, Serbia, Bulgaria, Ukraine, and Vietnam. In 2011, developing-country equities have fallen 15.6 percent compared with an 8.4 percent drop for mature markets.

Emerging market equity and fixed income funds experienced a sudden reversal of the positive inflows trend since early 2009. With many developing countries in a sweet spot both cyclically and structurally, the flows into these funds had gone up consistently since 2009, reaching a record volume in 2010. However, the turmoil of the second half of 2011 caused these flows to reverse. EM equity funds had registered an outflow of $48.5 billion in 2011—in sharp contrast to the net inflow of $97 billion for all of 2010. The reversal was less sharp for emerging market fixed-income funds, which posted net inflows of $17.3 billion in 2011. Foreign selling was particularly sharp in Latin America, with Brazil posting large outflows.

…and bond spreads have widened rapidly

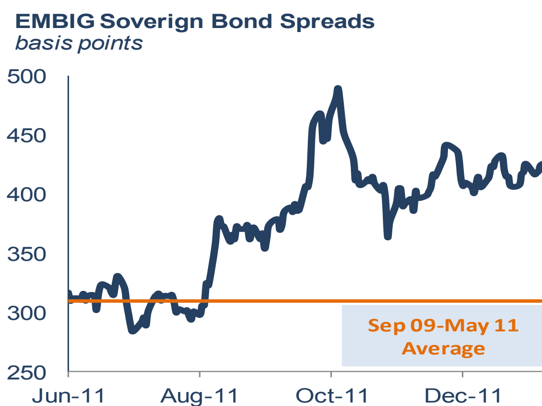
Reflecting this reversal in fortunes, developing-country composite spreads (EMBIG) widened by 152 basis points (bps) between July and early January (they had been broadly stable at around

Figure FIN.1 Emerging market equities fall by more than developed country equities



Source: Bloomberg.

Figure FIN.2 Contagion from Europe causes developing-country spreads to rise



Source: JP Morgan

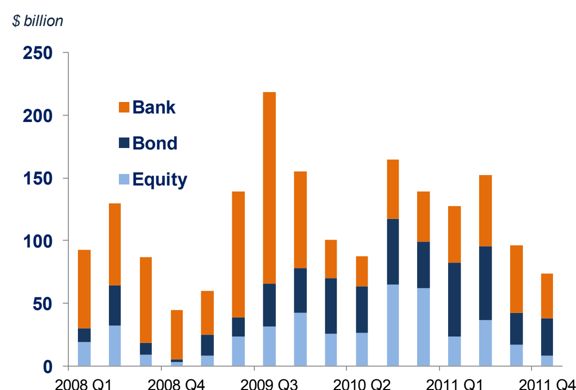
310 bps since late 2009) (figure FIN.2). The bulk of the deterioration in spreads occurred in the second half of September, with the EMBIG spread reaching a peak of 490 bps on October 4th—206 bps higher than July 2011. Spreads have narrowed after October 4th amid signs that EU policy action to address banking sector vulnerabilities would be forthcoming, but remained volatile reflecting the uncertainties about the size, funding and implementation of the Euro-zone rescue plan. By early-January, spreads were about 54 bps lower than their peak on October 4th.

Although significant, the deterioration of financial conditions in 2011 is much less marked than in the fall of 2008, when developing-country sovereign bond spreads widened by 385 bps and stock indexes dropped 40 percent between mid-September and mid-December 2008.

Gross capital flows to developing countries have been weak since September

The increased turmoil and risk aversion that drove the hike in spreads, was reflected in sharply weaker capital flows to developing countries in the second half of 2011. Gross capital flows (international bond issuance, cross-border syndicated bank loans and equity placement) totaled only $170 billion between July and December 2011, 55 percent less than of $309 billion received during the like period of 2010 (figure FIN.3). Equity issuance and bond flows were especially weak between September and December. The volume of equity issuance was 80 percent down at $25 billion compared to the same period last year that had the record breaking level of equity issuance particularly through initial public offerings (see GEP 2010 Winter). After a mere $2.6 billion in September—the lowest monthly level since December 2008, bond flows recovered slightly after October, following issuances by Venezuela ($6.4 billion), Russia ($2.4 billion), Indonesia and Turkey (both $2 billion). Bond issuance was strong in the first weeks of 2012 as January tends to be one of the busiest months for bond issuance. Brazil, Chile, Mexico, and Philippines issued a total of $6.6 billion combined in the first week of the month.

Figure FIN.3 Capital flows to EMs declined sharply in the third quarter



Source: Dealogic and World Bank Staff calculations

International syndicated bank loans, on the other hand, held up well even after the increased volatility, a reflection of several large loans to companies from natural resource related sectors in Russia and Mexico, the banking sector in Turkey and infrastructure sectors in Brazil and South Africa. The relative resilience of syndicated bank loans can be in part explained by the time that syndications take to be completed. In fact the decline in bank-lending was more gradual following the 2008 crisis compared to bond and equity flows.

As a result, gross capital flows in 2011 totaled $450 billion, 9.6 percent below the 2010 level of $498 billion reflecting the robust flows during the first half of the year.

Developing countries are vulnerable to mounting funding pressures in the European banking sector and loss of confidence in global financial markets

The volatility in high-income financial markets and the possibility that the situation deteriorates further represents a serious risk for developing countries (see discussion and scenarios in the main text). From a finance perspective, the main transmission channels from the ongoing crisis in high-income countries to developing countries have been through direct linkages with distressed

high-income European banks, and more generally through tightening up of global financial conditions that constrained developing-country access to high-income debt (bank and bond) markets. If conditions deteriorate further, FDI inflows might also contract spreading the negative effects of the crisis both to middle and low income countries.

Risks stemming from developing-country exposure to fragile high-income European banks...

Given the fragile state of high-income country banks, their extensive operations in some developing countries and regions are an important channel of contagion. As high-income European banks are forced through losses in their portfolio and regulatory changes to rebuild their capital stock, they are now engaged in de-leveraging—either by calling or not renewing loans (thereby reducing loans to capital ratios); or by tightened credit conditions or selling assets or issuing new equity (thereby raising capital).[1]

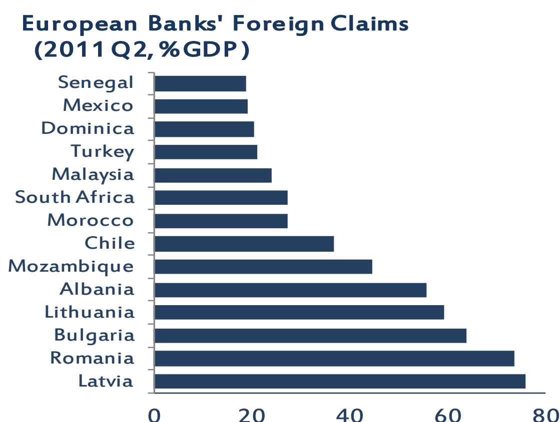
Starting in the early 2000s, European banks rapidly grew their exposure to developing countries, and now have $2.4 trillion in outstanding foreign claims on actors within these countries.[2] The bulk of these claims lie in Latin America & the Caribbean ($861 billion or 16 percent of GDP) and Europe & Central Asia ($633 billion or 21 percent of GDP) regions. In several Eastern European countries (Latvia, Romania, Bulgaria, Lithuania and Albania) as well as countries from other regions (Mozambique and Chile), these claims are quite significant as they are equal to more-than 25 percent of GDP (figure FIN.4).

European banks operate in developing countries also through their local subsidiaries and account for considerable shares of some countries' banking assets (figure FIN.5). In Latin American countries exposures are concentrated among Spanish banks, which own over 25 percent of bank assets in Mexico and Chile. In Europe and Central Asia, Austrian and Greek banks have played a significant role in Albania, Bulgaria and Romania, while the country source of holdings in other countries are more diversified. Portuguese banks account for almost one-third of banking assets in Angola and Mozambique.

...with the nature of the exposure determining its impact on domestic credit...

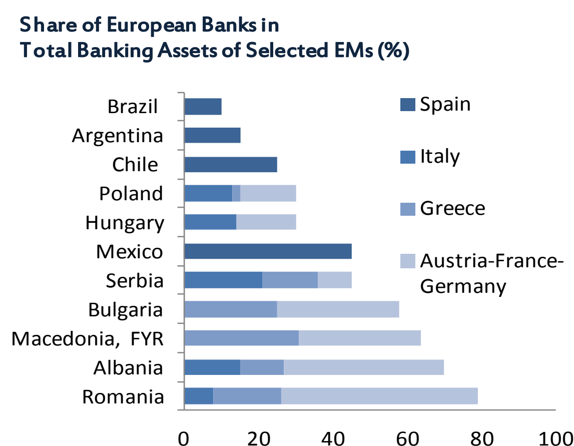
Despite their significant presence and high levels of foreign claims in Latin America, Spanish banks are mostly decentralized in their cross-border operation with independently managed affiliates in the region. Their claims are mostly in local currency/locally funded. Indeed, average loan to deposit ratios in the region are at or below 100%, with few exceptions including Chile (107%). Moreover, some countries (e.g.

Figure FIN.4 Developing countries with strong dependence on European Banks



Source: BIS

Figure FIN.5 Ownership position of European Banks in selected developing countries



Source: Citibank.

Brazil and Mexico) have regulations limiting the amount of inter-company loans between parent and daughter banks and limiting the ability of parent banks to reduce daughter bank's capital below prudential levels.

As a result, the financial systems in these countries would not be excessively exposed to a sharp reduction of inflows of funding from European banks (except through the trade finance channel). As long as this kind of deleveraging occurs gradually, domestic banks and non-European banks should be able to take up the slack – as appears to be taking place in Brazil.

In contrast, European banks operating in most of the Eastern European countries have relied heavily upon cross-border lending from their parents to support their loan portfolios, with loan –to–deposit ratios well over 100 percent in several countries: Latvia (240%), Lithuania (129%), Romania (127%) and Russia (121%). In addition, large portions of cross-border lending was short-term (see the next section) that can be easily reduced by simply not being rolled-over or renewed. As a result, these countries are extremely vulnerable to a cut off of lending by European banks. So far, deleveraging in the region has been orderly. In a worrying development, however, Austrian bank supervisors have instructed Austrian banks to limit future lending in their central and eastern European subsidiaries — while several high-income European banks have independently announced their intention to reduce operations in Europe and Central Asia.

Arguably, markets are already factoring in the risks from these connections. During the recent episode of elevated turmoil, developing-country CDS spreads rose most among those countries with close banking ties with troubled high-income European banks, for example, the spreads in Ukraine, Romania and Bulgaria rose by 422 bps, 231 bps and 203 bps, respectively versus an overall average for developing countries of 114 basis points.

...but the risk of rapid sales of bank assets is more widespread.

European banks have been trying to reduce exposure and/or raise capital also by selling stakes in developing country banks or fully-owned subsidiaries. The need to find a buyer forces Euro-area banks to disinvest from some of the better markets where they can have profitable exits. For example, Greek banks have started to sell Turkish bank assets.[3] Any of such sales represent FDI outflows when the buyer is not foreign but local, which was the case in one of the sales in Turkey.

Developing countries with relatively high private debt levels would be most vulnerable to a generalized tightening of financial conditions

The recent market turbulence has already led to declines in capital flows to developing countries and substantial losses to developing-country equity markets. Should financial conditions deteriorate sharply, countries with high external financing needs (current account projections and amortization of external debt) would be most vulnerable to sudden reversals in capital flows, a drying up of credits or substantial increases in borrowing costs.

Many developing countries remain vulnerable to deterioration in credit conditions. Overall, the external financing needs of developing countries have risen slightly since the 2008/9 financial crisis (box FIN.1) from an ex ante estimate of $1.2 trillion (7.6 percent of GDP) in 2009 to $1.3 trillion (7.9 percent of GDP) in 2012.[4] All regions except South Asia have reduced their external financing needs as a share of GDP since 2008. South Asia's estimated external financing requirements have increased from 5.8 percent to 8.4 percent mainly because of a sharp rise in India's external debt in 2011.

Nevertheless, ex ante external financing needs are very high for some countries and in some regions (figure FIN.6). As in the 2008/9 crisis, the Eastern Europe and Central Asia region remains the most vulnerable developing region with external financing need in the order of 17 percent of GDP. Several countries in the region

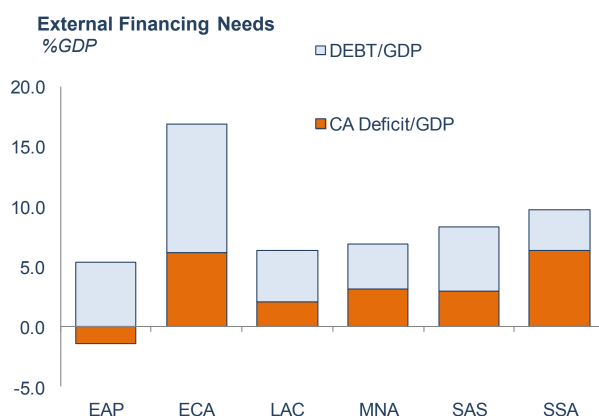
have high current account deficits as well as private debt coming due in 2012.

Among countries with access to international capital markets, estimated ex ante financing requirements in 2012 exceed 10 percent of GDP in 30 developing countries (table FIN.1).[5] For many, the financing is unlikely to pose a problem, coming in the relatively stable form of FDI or remittances. For others, however, a significant proportion will have to be financed from historically more volatile sources (short-term debt, new bond issuance, equity inflows).

If international financial market conditions deteriorate significantly, such financing might become difficult to maintain. Some 25 developing countries have short-term debt and long-term debt repayment obligations equal to 5 or more percent of their GDP in 2012. Should financing conditions tighten and these debts cannot be refinanced, these countries could be forced to cut sharply into reserves or domestic demand in order to make ends meet. Indeed, following the sharp contraction in capital flows in 2008 and 2009, many developing countries were forced to close external financing gaps through current account adjustments, increased aid or depletion of foreign exchange reserves (box FIN.1).

Risks are particularly acute for countries like Turkey that combine large current account

Figure FIN.6 External financing needs of developing countries[4]



Source: World Bank, Debt reporting system

Table FIN.1 External Financing Needs Projections for 2012

	Account Deficit (share of	Debt Repayment (share of GDP)	EFN (share of GDP)
Lebanon	20.6	14.5	35.1
Nicaragua	16.3	5.6	21.9
Albania	11.7	9.6	21.3
Jamaica	9.8	11.3	21.1
Georgia	12.7	8.2	20.9
Turkey	9.8	9.2	19.0
Lao PDR	14.0	4.7	18.7
Guyana	10.6	7.8	18.4
Belarus	10.5	7.7	18.2
Romania	4.5	13.5	18.0
Moldova	12.1	5.7	17.8
Latvia	0.4	17.2	17.6
Armenia	12.7	4.9	17.6
Bulgaria	-2.0	18.6	16.6
Lithuania	2.3	14.1	16.4
Ukraine	5.4	10.9	16.3
Panama	12.3	3.2	15.6
Mauritania	11.2	3.9	15.1
Macedonia, FYR	5.1	7.8	12.9
Jordan	8.5	4.0	12.5
Tanzania	9.1	3.0	12.2
El Salvador	3.8	8.2	12.0
Dominican Republic	8.2	3.4	11.6
Vanuatu	6.7	4.9	11.5
Vietnam	4.9	6.6	11.5
Chile	0.4	10.9	11.3
Kyrgyz Republic	6.9	3.7	10.6
Ghana	7.0	3.4	10.4
Tunisia	5.8	4.4	10.2
Peru	2.7	7.3	10.0

Developing countries' external financing needs, are defined as the current-account deficit (assumed to be a constant at its 2011 level as a percent of GDP) plus scheduled principal payments on private debt (based on information from the World Bank's Debtor Reporting System and Bank of International Settlements).

Source: World Bank.

deficits, high short-term debt ratios and low reserves. Indeed, Turkey's current account deficit in 2011 is estimated to be six times larger than its net FDI flows in 2011, and its short-term debt represents 80 percent of its reserves (which have been falling in recent months and already represent less than 4 months of import cover). In a similar fashion but to a lesser extent, Belarus

and Montenegro are also vulnerable to a freezing-up of global credit. Other countries have also significant vulnerabilities. Jamaica, for example, is at risk since it finances its current account deficit with flows other than FDI, which tend to be volatile. High levels of short-term debt to reserves ratios may put countries such as Chile, Albania and Egypt also at risk of roll-over despite their healthy current account balances (figure FIN.7).

The sensitivity of short-term finance to changes in financing conditions could pose problems for trade (box Fin.2). In China for example, as much as 75 percent of short-term debt is reported to be for trade-finance. Since 2010, there has been a 20 percent increase in short-term debt taken out by developing countries — with the total now equal to $1.1 billion or 4.8 percent of developing-country GDP—or 15.7 percent of total developing-country exports. Should a financial crisis cause trade finance to freeze up as banks

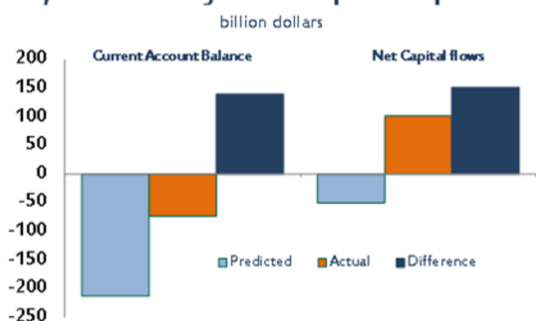
Box FIN.1 How did developing countries close the (ex-ante) external financing gap in 2009?*

When the global financial crisis hit in September 2008, developing countries' external financing needs (current account projections and amortization of external debt) for 2009 were projected to be around $1.2 trillion. With a projected sharp retrenchment in capital flows for 2009, the ex-ante external financing gap was estimated in the order of $352 billion (Global Development Finance 2009, page 82). Financing gaps are ex-ante notions and ex-post, can be closed through the combination of reduced spending, official flows, and running down the reserves.

As expected, high external financing needs in a time of sharp retrenchment in capital flows (40 percent actual decline in 2009) led to significant current account adjustments and slower growth in several developing countries in 2009. Current account adjustments reduced the ex-post gap by $140 billion. Current account balances in deficit countries were almost halved from -$283 billion to -$128 billion in 2009. In particular, in several ECA countries, deficits narrowed by more than 50 percent. Net private capital flows (inflows-outflows-debt repayments/redemptions of debt) were $152 billion higher than initial projections, while more-than doubled official flows and reserves depletion accounted for the reminder.

An important factor that helped developing countries with their 2009 external financing needs was official lending (including assistance from the IMF), which jumped to $28 billion immediately after the crisis in 2008, and more than doubled in 2009, reaching $70 billion. The World Bank Group tripled its lending to $21 billion. Between September 2008 and February 2010, more than 20 countries entered agreements with the IMF, with four of the stand-by agreements (Romania, Pakistan, Hungary and Ukraine) larger than $10 billion. The IMF also introduced a new flexible credit line that provided precautionary arrangements, but there have been no draws so far. Lending from other multilaterals as well as bilateral loans also increased in response to the crisis.

*Note: Some countries Croatia, Hungary, and Poland that were classified as developing countries for the earlier calculation are now classified as developed countries by the World Bank. The calculations referred here are based on 2008 classifications; hence the data might differ from the current capital flows tables.



Net official flows increased sharply in response to the crisis

billion dollars

	2005	2006	2007	2008	2009
World Bank	2.7	-0.5	4.8	7.1	21.1
IMF	-40.2	-26.7	-5.1	10.8	27.5
Other official	-34.0	-45.1	-0.6	10.2	20.9
Total	-71.5	-72.3	-0.9	28.1	69.5

Source: World Bank Debtor Reporting System, IMF

Box FIN. 2: Sharp increase in short-term debt

Short-term debt in the developing world is highly concentrated: 15 middle-income countries account for 86 percent.[1] Most of the borrowing is done by banks and corporations to finance their growing trade as firms contracted short-term loans to finance imports and prepay for exports. For example, trade finance accounted for almost 75 percent of short-term debt in 2011 in China and almost all of India's short-term debt.

Short-term debt flows have exhibited higher volatility than medium- and long-term flows, particularly during crises. During the Asian and 2008 financial crises, for example, short-term debt fell more sharply in developing countries than did other flows. One of the reasons is that banks can reduce their exposure quickly through short-term debt, which can be simply not renewed. The other reason may be that in times of crisis lenders tend to shift their portfolios to more creditworthy borrowers, which are in a better position to serve longer-maturity loans.

Some part of the decline in short-term debt following a crisis might be also due to demand factors, especially for trade credit portion of it. Several studies suggest that the sharp decline in trade volumes observed in 2008/9 caused trade finance to decline and not the reverse.[2] But others have argued that a more comprehensive analysis of the financial sector's role in international trade including the concept of a 'financial accelerator', shows how export flows are actually significantly affected by financial shocks.[3]

[1] China, India, Brazil, Turkey, Russia, Indonesia, Mexico, Malaysia, Chile, Romania, Thailand, South Africa, Peru, Philippines, and Argentina.

[2] Levechenko A., L. Lewis and L. Tesar. 2010. "The collapse of International Trade during the 2008-2009 Crisis" NBER Working Paper 16006.

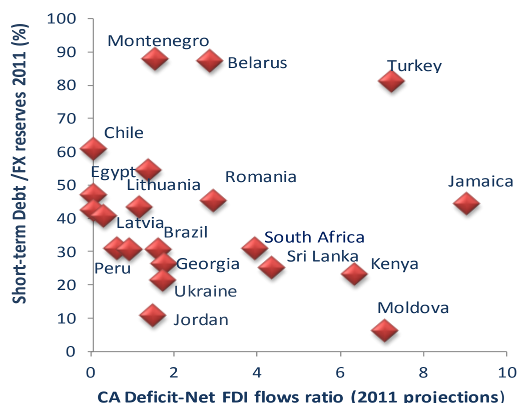
[3] Amiti M and D. Weinstein. 2009. "Exports and Financial Shocks." CEPR Working Paper 7590.

seek to deleverage (as it is reported to have happened for a short while in 2008) it could have serious consequences for global trade.

Foreign currency reserve accumulation has already declined sharply, even reversed in several developing countries

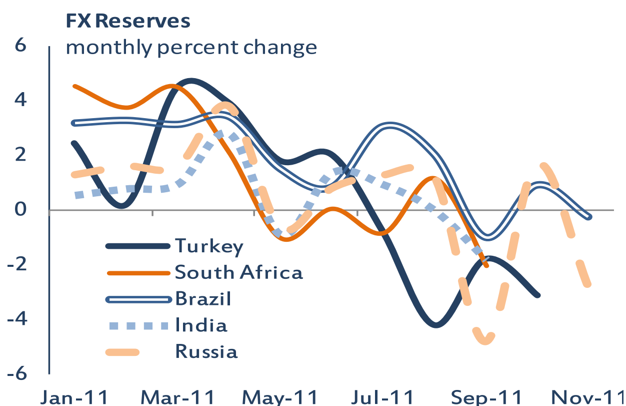
Large capital outflows in the second half of 2011 and ensuing currency fluctuations prompted several central banks to sell-off reserves (figure FIN.8). For example, in the first half of October, Turkey's central bank intervened directly, selling an estimated $0.5 billion of reserves, bringing the average monthly decline in reserves since end-July to $2.7 billion. Turkey's reserves currently are at $84.8 billion, equivalent less than 4 months merchandise import-cover. Given recent reserve sell-offs, South Africa faces similar exposures, but Brazil, Russia and India's

Figure FIN.7 Countries at risk should capital flows reverse



Source: World Bank, IMF IFS

Figure FIN.8 Depletion of FX reserves accelerated in recent months in selected economies



Source: IMF, Central Banks, World Bank

larger reserve-buffers offer more scope for extended currency support.

Following the strong domestic credit growth since the crisis, domestic banking sectors may also be vulnerable to a sharp increase in non-performing loans in the event of a slowdown in growth.

Although non-performing loans (NPLs) remain low in most developing regions so far, they could shoot up in the event of a sharp slowdown in growth (figure FIN.9). Given rapid credit expansion in recent years (loans to GDP ratios increased by more than 10 percentage points between 2005 and 2011 in several countries), commercial banks could see a marked deterioration in loan performance in the face of slowing growth, heightened risk aversion and restricted access to finance. In some countries, NPLs and provisioning are already an issue. The share of NPLs in outstanding bank lending in the Europe and Central Asia region lofted to 12 percent in 2010 from 3.8 percent in 2007. Available data indicates that NPL ratios have continued to deteriorate in 2011 in Kazakhstan (32.8%) and Romania (14.2%).

With the possibility of further economic slowdown, the need for macro-prudential reforms and stress tests have risen to ensure that banks are best placed to deal with deterioration in credit quality and much tighter liquidity conditions.

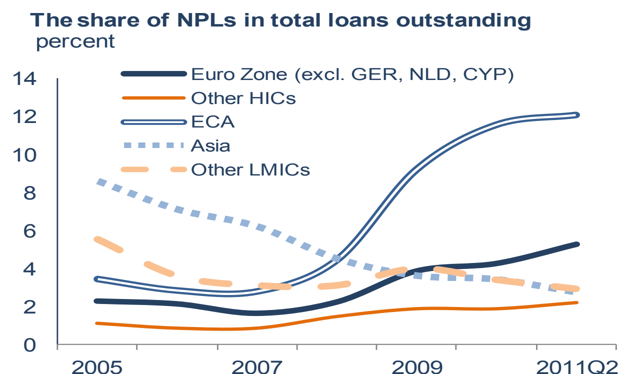
Some countries have undertaken steps to slow down the credit growth with limited success. China, for example, has raised interest rates and increased the required reserve ratios (RRR) five times in 2011. As a result, the credit growth in China has eased significantly but remains high compared to previous credit booms and busts. Similarly, credit growth in Brazil and Turkey has remained buoyant in 2011 despite the RRR hikes. Unlike China, however, Turkey lowered its key policy rate to deter volatile international portfolio flows and stimulate economic growth.

More recently concerns about the deteriorating global outlook and its potential adverse impact on output growth have caused a shift in policies. China, for example, cut its RRR by 0.5 percentage point in December, the first such cut since December 2008.

International capital flows to developing countries are expected to decline slightly in 2011 after a strong rebound in 2010

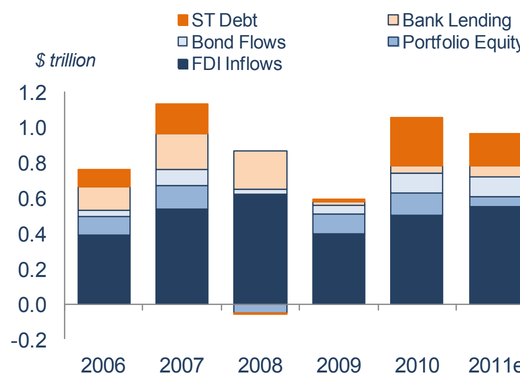
Net private capital flows (earlier data referred to gross flows) to developing countries are estimated to have declined to $0.95 trillion (4.3 percent of GDP) in 2011 from $1.1 trillion (5.4 percent of GDP) in 2010 (figure FIN.10).[6] The increased global market volatility of the second half of 2011, and associated equity-market sell-offs caused portfolio equity flows to decline by 60 percent, from $128.4 billion in 2010 to an estimated $51.4 billion in 2011. Overall, short-

Figure FIN.9 Possible resurgence in NPLs with slower growth…a danger to banking



Source: IMF Financial Soundness Indicators

Figure FIN.10 International capital flows fell in 2011



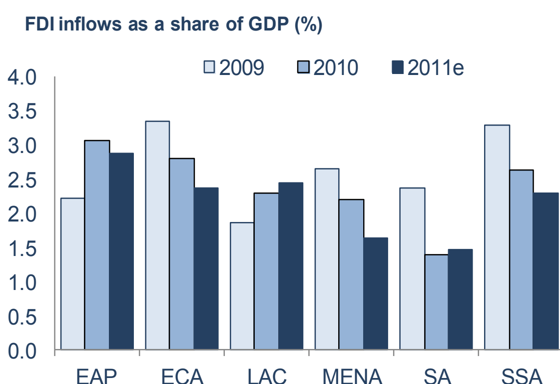
Source: World Bank.

term flows for the year as a whole also declined despite their strong performance in the first half of the year – partly because of slower trade growth (and therefore less trade finance) in the second quarter due to disruptions emanating from Tohoku. In addition, prudential measures taken by developing countries (such as China) to limit the risk associated with short-term flows also played a role. This year's fall in short-term debt flows is in sharp contrast with last year's surge, when these flows led the recovery in net capital inflows (box FIN.2).

FDI inflows to developing countries continued to increase modestly in 2011

Foreign direct investment (FDI) inflows to developing countries rose by an estimated 10.6 percent in nominal terms, reaching $555 billion (2.5 percent of GDP) in 2011 (figure FIN.11). Most of the gains in FDI came in the first half of the year, with flows slowing in the third quarter. The largest increase was in the Latin America and Caribbean region, which attracted investment due to relatively robust growth, rich natural resources and a large consumer base. The East Asia Pacific and South Asia regions remain attractive destinations for multinationals, with investors drawn to the fast growing regional economies of China, India, Indonesia and Malaysia. FDI inflows declined in other regions but for different reasons. The fall in FDI inflows in the Eastern Europe and Central Asia region was mainly driven by the economic problems in Europe, which weighed both on the capacity of high-income European firms to invest and on the attractiveness of developing countries in the region as destinations for FDI due to reduced growth prospects. Inflows to the Middle East and North Africa region suffered because of political turmoil associated with the Arab Spring, while the decline in Sub Saharan Africa is mainly due to net dis-investment from Angola. Despite the nominal increase, however, FDI inflows as a percent of GDP were flat or declined (figure FIN.11).

Figure FIN.11 Despite the nominal increase, FDI flows as a percent of GDP to most developing regions were flat or declined in 2011



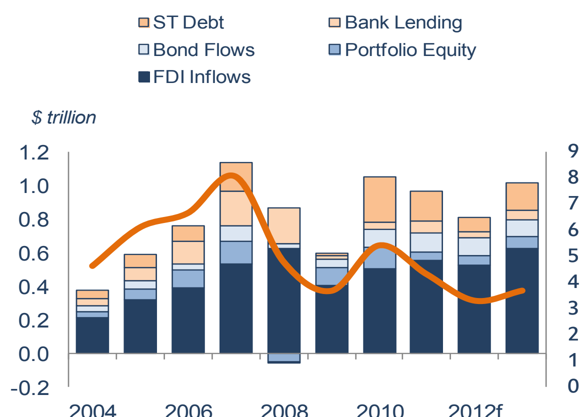
Source: World Bank

Prospects: Uncertain in the short-term but strong in the medium-term

The outlook for 2012 has become more challenging as the world economy has entered a very difficult period. The likelihood that the sovereign debt crisis in Europe deteriorates further resulting in a freezing up of capital markets and a global crisis similar in magnitude to the Lehman's crisis remains very real. The increased risk-aversion among global investors has reduced global financial flows including those to developing countries since mid 2011. The actual impact of the current turmoil on developing countries, in terms of international financial flows and the real economy, are not yet fully apparent but suggest a generalized slowing in global growth (see the main text) and reduced capital flows.

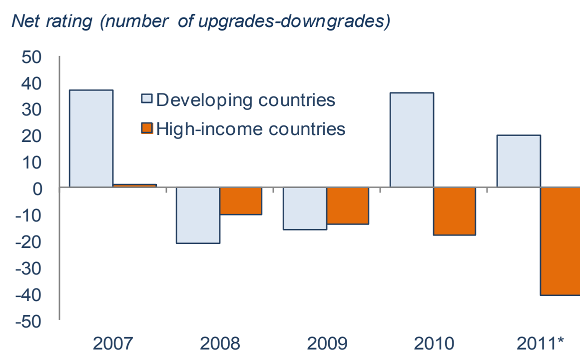
Increased risk aversion and banking-sector deleveraging are expected to continue cutting into capital inflows to developing countries in early 2012. As a result, net private debt and equity flows, which comprise net debt flows (incoming disbursements less principal repayments) and net equity flows (FDI and portfolio inflows net of disinvestments) are projected to decline further by 18 percent to $0.8 trillion (3.3 percent of GDP) in 2012, with sharp contraction in cross-border debt flows. Even FDI inflows to developing countries are expected to level out by 6 percent next year because of the uncertainly in global financial markets. The projected decline in FDI inflows is relatively

Figure FIN.12 Overall capital flows to remain a stable share of GDP



Source: World Bank

Figure FIN.13 Improving credit quality for emerging market sovereigns



Source: Bloomberg and DECPG staff calculation

small compared to the 40 percent contraction of 2009. The impact on capital flows is expected to be disproportionately higher for the developing Europe and Central Asia region, whose economies are more closely tied to those in high-income Europe.

Under the assumption that the ongoing turbulence in Europe will be resolved to market's satisfaction towards the end of 2012, net capital flows to developing countries are expected to have a sharp rebound in 2013 with the growth in global economy, reaching $1.02 trillion in 2013 (3.7 percent of GDP) (figure FIN.12). By 2013, all flows are expected to increase. Bond issuance is expected to level down slightly as bank lending picks up the pace supported by South-South flows.

The rebound should be supported by the fact that conditions that underpin the capital flows to developing countries remain strong. Emerging markets entered 2012 with an improved risk profile, higher growth prospects and higher interest rates than in high-income countries. Despite the recent downward revision, developing-country growth (between 5 and 6 percent) is expected to continue to be much higher than in developed countries (around 2 percent) in the medium-term.

At the same time, credit quality for developing countries has been improving, and the gap between mature and emerging markets sovereigns is narrowing (figure FIN.13). The wave of sovereign rating downgrades across Europe, the United States, and Japan stands in sharp contrast with the improved creditworthiness in emerging markets as measured by sovereign credit ratings. The ratio of emerging market rating upgrades to downgrades is six to one this year. Since the 2008 financial crisis, 47 developing countries have received 117 upgrades by major rating agencies, while the last rating upgrade for a developed country occurred in 2007, when Japan's sovereign debt was upgraded. Many developing countries currently have a positive outlook assigned to their sovereign debt, signaling that additional upgrades are possible.

Table FIN.2 Net capital flows to developing countries ($ billions)

	2006	2007	2008	2009	2010	2011e	2012f	2013f
Current account balance	379.8	384.9	354.5	276.7	221	190	99	32
as % of GDP	3.4	2.7	2.1	1.7	1.1	0.9	0.4	0.1
Financial flows:								
Net private and official inflows	686.5	1129.7	830.3	673.8	1126.8	1004.4		
Net private inflows (equity+debt	755.5	1128.2	800.8	593.3	1055.5	954.4	807.4	1016.4
Net equity inflows	495.2	667.1	570.7	508.7	629.9	606.2	583.7	697.1
..Net FDI inflows	387.5	534.1	624.1	400.0	501.5	554.8	521.6	620.6
..Net portfolio equity inflows	107.7	133.0	-53.4	108.8	128.4	51.4	62.1	76.5
Net debt flows	191.2	462.6	259.6	165.1	496.8	398.2		
..Official creditors	-69.0	1.5	29.5	80.5	71.2	50.0		
....World Bank	-0.3	5.2	7.2	18.3	22.4	12.0		
....IMF	-26.7	-5.1	10.8	26.8	13.8	8.0		
....Other official	-42.0	1.5	11.5	35.4	35.0	30.0		
..Private creditors	260.2	461.1	230.1	84.6	425.6	348.2	223.7	319.3
....Net M-L term debt flows	164.9	292.8	234.4	69.9	157.1	168.2		
......Bonds	34.3	91.7	26.7	51.1	111.4	110.1		
......Banks	135.0	204.7	212.5	19.8	44.1	68.0		
......Other private	-4.4	-3.5	-4.8	-1.1	1.6	0.1		
....Net short-term debt flows	95.3	168.3	-4.4	14.7	268.5	180.0		
Balancing item /a	-473.1	-486.4	-786.1	-273.0	-596.0	-611.9		
Change in reserves (- = increase	-636.9	-1085.3	-452.5	-681.9	-752.0	-578.4		
Memorandum items		292.8						
Net FDI outflows	-130.4	-150.5	-214.5	-148.2	-217.2	-238.1		
Migrant remittances /b	221.5	278.2	323.8	306.8	325.3	351.2	376.7	406.3
As a percent of GDP								
	2006	2007	2008	2009	2010p	2011f	2012f	2013f
Net private and official inflows	6.1	8.1	4.9	4.2	5.8	4.5		
Net private inflows (equity+debt	6.7	8.0	4.8	3.7	5.4	4.3	3.3	3.7
Net equity inflows	4.4	4.8	3.4	3.1	3.2	2.7	2.4	2.5
..Net FDI inflows	3.4	3.8	3.7	2.5	2.6	2.5	2.1	2.2
..Net portfolio equity inflows	1.0	0.9	-0.3	0.7	0.7	0.2	0.3	0.3
..Private creditors	2.3	3.3	1.4	0.5	2.2	1.6	0.9	1.2

Source: The World Bank

Note :

e = estimate, f = forecast

/a Combination of errors and omissions and transfers to and capital outflows from developing countries.

/b Migrant remittances are defined as the sum of workers' remittances, compensation of employees, and migrant transfers

Notes

1. The European banking sector remains under a significant funding pressure (see main text) as concerns about exposure to stressed sovereign debt have affected their liquidity. They were squeezed out of the USD interbank market as US money market funds reduced their exposure to banks in Euro area in late 2011. Also, European interbank lending has also been deteriorating, as Euribor-Eonia spreads have been rising to their beginning of 2008 crisis (September 15th 2008) levels.
2. Foreign claims by BIS reporting banks comprise cross-border claim, local claims of foreign affiliates in foreign currency, and local claims of foreign affiliates in local currency.
3. According to Bloomberg news on December 9th 2011, EU lenders including Deutsche Bank AG and France's Societe Generale SA have announced plans to shed more than $1 trillion (€750bn) of assets over the next two years to bolster capital. On top of selling loans, the banks put at least 50 businesses up for sale in markets spanning the globe. (See http://www.bloomberg.com/news/2011-12-07/bargain-bank-values-in-europe-fail-to-

lure-buyers-as-debt-crisis-deepens.html)

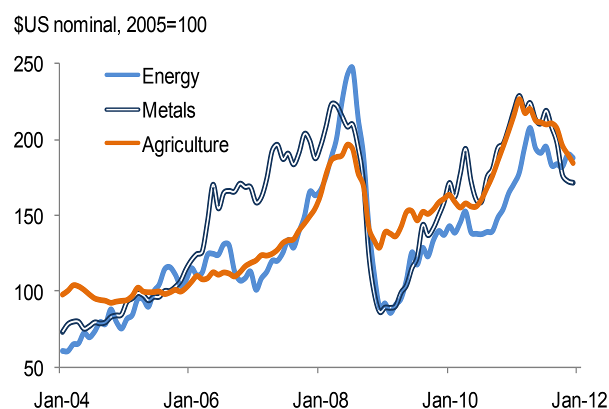
4. Developing countries' external financing needs, are defined as the current-account deficit (assumed to be a constant at its 2011 level as a percent of GDP) plus scheduled principal payments on private debt (based on information from the World Bank's Debtor Reporting System).
5. Countries with the debt repayment to GDP ratios that are less than three percent are excluded from this list. These countries are mostly aid dependent and their vulnerabilities are mostly related with official flows.
6. The capital inflows numbers are revised up for 2010. Our June estimate for total inflows was $930 billion, compared to $1129 billion (almost the same levels of 2007). Major revision in ST debt for 2010: from $120 billion to $268 billion, mostly because of the upward revisions for China and India.

Global Commodity Market Outlook

Following more than two years of strong growth, commodity prices peaked in early 2011 and then declined on concerns about the global macroeconomic and financial outlook and slowing demand in emerging markets, notably China (figure Comm.1). The biggest decreases were for metals but some of the largest individual declines were among agriculture raw materials (cotton and rubber), edible oils (coconut and palmkernel oil), and cocoa. Most indices ended the year much lower compared to their early-2011 peaks—agriculture down 19 percent, energy down 10 percent, and metals down 25 percent.

The recovery in prices in 2009-10 was due to strong economic growth, re-stocking in China, and a number of supply constraints. In early 2011, several disruptions, including drought and heavy rains that affected most agriculture markets as well as coal and mineral output in various locales, pushed prices to annual highs. Political unrest in North Africa and the Middle East resulted in a loss of significant oil supplies, most importantly in Libya. As markets absorbed these disruptions and supply conditions improved, prices began to come under additional downward pressure from slowing demand and uncertainty about the near-term economic and financial outlook.

Figure Comm.1 Commodity price indices



Source: World Bank.

Commodity prices are generally expected to decline from their high levels in 2012 due to a slowdown in demand and improved supply prospects—in part because high prices have led to greater investment. Crude oil prices are expected to average $98/bbl in 2012, assuming the political unrest in the Middle East is contained and Libyan crude exports return to the market. Metals prices are expected to decline by 6 percent in 2012 on moderating demand and commissioning of new supply projects—partly the result of a lengthy period of high prices. Food prices in 2012 are expected to average 11 percent lower than 2011, assuming a normal crop year and a moderation in energy prices (see table Comm.1).

There are both upside and downside risks to the forecast. Continuation of political unrest in the Middle East and North Africa could lead to further disruption of supplies and higher oil prices in the shorter term—especially given low stocks and a market short of light/sweet crude. Strong demand by China, including for re-stocking, could keep metal prices higher than projected, and a continuation of supply constraints that has plagued the industry the past decade could further aggravate markets.

Given low stock levels in some agricultural markets (especially grains), prices are still sensitive to adverse weather conditions, energy prices, and policy reactions. Moreover, the diversion of food commodities to production of biofuels (it reached almost 2 million barrels per day crude oil equivalent in 2011), makes markets tighter and more sensitive to weather and policy responses.

Downside risks entail mostly slower demand growth due to the deterioration of the debt crisis, especially if it expands to emerging countries where most of the growth in commodity demand is occurring. The downside risks apply directly to metals and energy, which are most sensitive to

Table Comm.1 Key nominal annual price indices—actual and forecasts (2005=100)

	ACTUAL						FORECAST	
	2006	2007	2008	2009	2010	2011	2012	2013
Energy	118	130	183	115	145	188	**179**	**177**
Non-Energy	125	151	182	142	174	210	**190**	**184**
Agriculture	112	135	171	149	170	209	**185**	**175**
Food	111	139	186	156	170	210	**188**	**177**
Beverages	107	124	152	157	182	208	**183**	**165**
Raw Materials	118	129	143	129	166	207	**183**	**177**
Metals & Minerals	154	186	180	120	180	205	**193**	**196**
Fertilizers	104	149	399	204	187	267	**252**	**234**
MUV	102	109	117	109	113	123	**117**	**118**

Source: World Bank

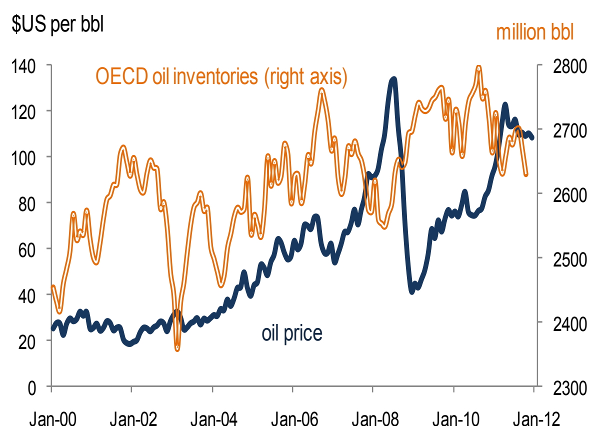
changes in industrial production, and indirectly to agriculture.

Crude Oil

Crude oil prices (World Bank average) peaked near $120/bbl in April following the loss of 1.4 mb/d of Libyan oil exports. This significantly tightened light/sweet crude markets, particularly in Europe where much of Libya's crude was sold. Disruptions of light crude production elsewhere—including other MENA countries, West Africa and the North Sea—led to a draw on inventories of both crude and products outside of North America (figure Comm.2). At OPEC's June meeting, oil ministers were reluctant to adjust production levels or even discuss how to make up for the shortfall in Libya's output. Subsequently, IEA member governments released 60 million barrels of emergency stocks over the summer, half of which were from the U.S. Strategic Petroleum Reserve. During the fourth quarter, the World Bank average oil price averaged a little over $100/bbl due to weakening oil demand, recovery in Libyan oil production, and surplus conditions in the U.S. mid-continent that saw WTI prices diverge substantially from internationally traded crudes (box Comm.1). However, heightened geopolitical concerns surrounding Iran's nuclear program, help lift prices toward year-end—it averaged $104/bbl in December.

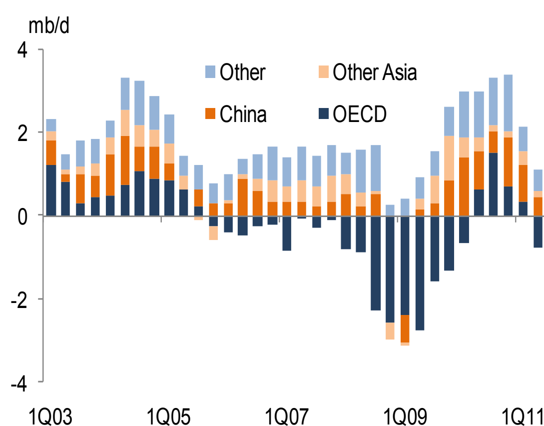
High oil prices and weakening economic growth impacted oil demand in 2011, with world consumption growth of just 0.7 mb/d or 0.8

Figure Comm.2 Oil prices and OECD oil stocks



Source: World Bank.

Figure Comm.3 World oil demand growth (y-y)



Source: World Bank.

percent—a little more than one-quarter of the large jump in 2010 (figure Comm.3). OECD oil demand declined for the fifth time in the past six years, and is on track to fall again in 2012. Non-OECD oil demand growth, of 1.2 mb/d or 3 percent, was down from a 2.2 mb/d climb in 2010. For 2012, world oil demand is projected to rise by 1.3 mb/d or 3.6 percent, with all of the growth in emerging markets.

In the near term, light/sweet crude markets could ease with recovery of oil production in Libya. Following the fall of Tripoli in early September, Libya's national oil company and joint venture

Box Comm.1 WTI-Brent price dislocation

In early 2011 the price of WTI (which historically traded at a small premium to Brent for quality and location reasons) fell by more than $25/bbl below Brent due to a large build-up of crude in the U.S. mid-continent near Cushing Oklahoma—the delivery point for the NYMEX WTI futures contract (box figures Comm.1.1 and Comm.1.2). Crude flows into the region have increased from the new Keystone Pipeline which brings greater volumes from Canada and from rapidly growing production of liquids-rich shale projects in North Dakota. The mid-continent also sources crude from elsewhere in the U.S. as well imports through the Gulf of Mexico. While there are plenty of options to bring crude into the region, there are few to move it out, especially to Gulf coast refineries.

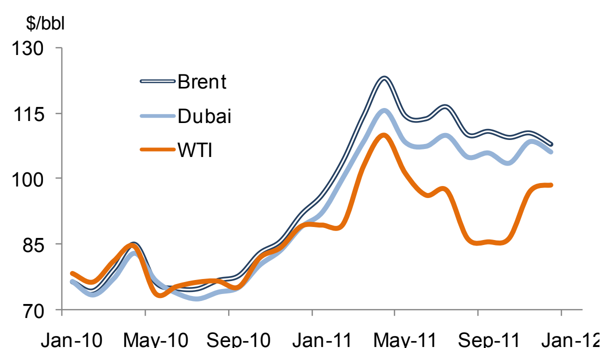
Stocks at Cushing rose in 1Q2011 but then declined, in part due to higher refining runs prodded by large margins from low crude input prices. Maintenance at local refineries was also deferred to take advantage of the high margins. Producers began moving crude to the Gulf coast by rail, barge and truck, as the large WTI-Brent price spread rendered such move profitable. Other pipeline flows into Cushing also eased substantially, as producers sought higher value alternatives for their crude.

In November, the price spread narrowed significantly, following announcement of a planned reversal of the Seaway pipeline that currently ships crude from the Gulf coast to Cushing. The pipeline's prospective new owners said that they will ship 0.15 mb/d to the Gulf in 2Q2012, and raise capacity to 0.4 mb/d by early 2013. Meanwhile the U.S. government deferred a decision until 2013 on the proposed 0.6 mb/d Keystone Pipeline extension, that would transport Canadian crude to the U.S. Gulf, so owners could re-route the pipeline away from environmentally sensitive areas in Nebraska.

Therefore, WTI is expected to be trading at a sizeable discount to Brent until adequate pipeline capacity is constructed to the Gulf of Mexico, or from Alberta to the Pacific coast (expected to be operational in 2017). In addition, more storage capacity is coming online, and lower net volumes flowing into the region are likely to reduce the spread.

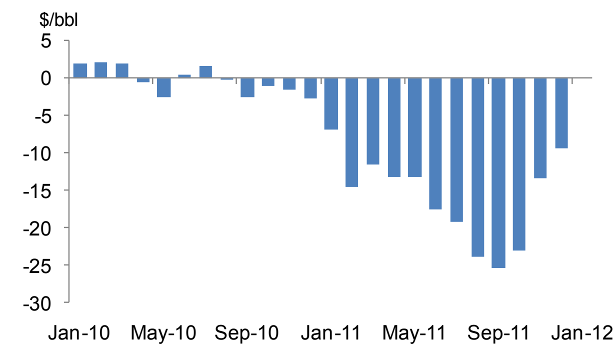
Meanwhile Brent crude prices have remained firm due to the tightness in light/sweet markets in the eastern hemisphere, strong demand in Asia, and low stocks. Brent became the main international marker crude in 2011, and prices averaged $111/bbl in the second half of the year. WTI, largely dislocated from international markets, averaged just $92/bbl.

Box figure Comm 1.1 Crude oil prices



Source: World Bank.

Box figure Comm 1.2 WTI-Brent price differential



Source: World Bank.

partners moved quickly to restore output in fields that were unaffected by the fighting. Production is reported to have reached 0.9 mb/d in December – more than half of pre-crisis levels of 1.6 mb/d. The IEA expects that production will fully recover by 2014.

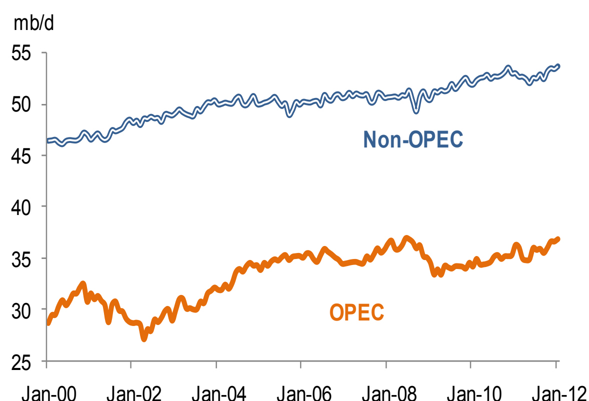
Non-OPEC supply developments (figure Comm.4) continue to perform above expectations due to double digit investment growth and less-tight conditions for rigs, equipment and services. These are bearing results, not only with new project developments but also by slowing the decline rates in mature OECD areas, such as the U.S. and North Sea. Last year saw a number of unplanned outages and heavier-than-expected maintenance in the North Sea that kept non-OPEC production growth fairly modest. However non-OPEC output (which accounts for 60 percent total world oil supplies) is expected to increase by 1 mb/d in 2012, according to the IEA, and satisfy much of the growth in global oil demand. The return of Libya's oil production may necessitate accommodation by other OPEC members to keep prices from falling significantly. This would in turn raise OPEC's spare capacity, at a time when most OPEC countries are also investing in new capacity. Iraq's production has risen above 2.7 mb/d, due to increased output from new joint venture projects, and oil exports have also reached new highs. Iraq's oil output is expected to reach nearly 3.2 mb/d in 2012.

In the medium term, world oil demand is expected to grow only moderately, about 1.5 percent p.a., owing to slower global GDP growth coupled with efficiency improvements in transport and ongoing efforts by governments and industry to reduce carbon emissions, particularly in high-income countries. As in the past, all of the consumption growth is expected to be in emerging markets (figure Comm.5), with modest declines in OECD countries—largely due to expected efficiency improvements.

On the supply side, non-OPEC countries are expected to continue to rise moderately their oil supply, in part due to high prices, but also continued technological advances that have brought forth new supplies from shale deposits and deepwater offshore. Production increases are expected from a number of areas, such as Brazil, Canada, the Caspian and West Africa. These will be offset by declines in from older fields, especially in the North Sea and Mexico. Globally there are no resource constraints into the distant future. Impediments are mainly policy issues, such as access to resources and suitable fiscal terms and conditions for investment.

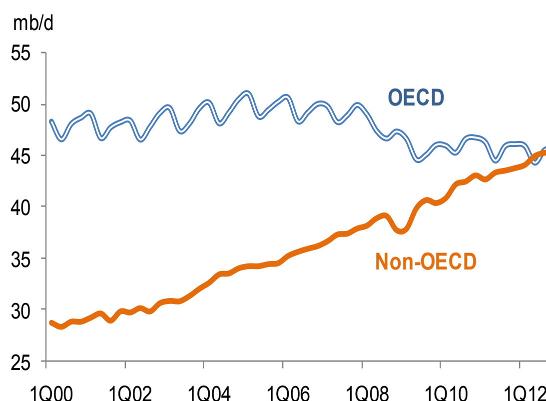
Oil prices (World Bank average) are expected to decline from $104/bbl in 2011 to an estimated $98/bbl in 2012 and fall over the forecast period due to slowing global demand, growing supply, efficiency improvements, and substitution away

Figure Comm.4 World oil production



Source: IEA

Figure Comm.5 World oil consumption



Source: IEA

from oil. The long-term oil prices that underpin these projections are based on the upper end cost of developing additional oil capacity, notably from oil sands in Canada, assessed at $80/bbl in constant 2011 dollars. It is expected that OPEC will endeavor to limit production to keep prices relatively high, given the large expenditure needs in most countries. However, the organization will also be wary of letting prices rise too high, having witnessed the impact this has had on demand in recent years, especially in OECD countries.

Metals

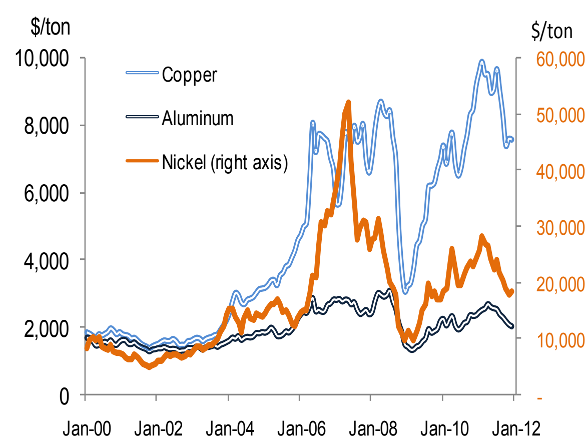
Metals prices fell from their highs in early 2011 due to concerns about global growth emanating from the debt crises and policy slowing in China. Prices were strengthening up to the first quarter of 2011 on strong demand in China (including earlier re-stocking), lower stocks, production cutbacks and various supply disruptions. However, China moved into de-stocking mode and stocks outside China began to rise. China's metal imports in the first half of 2011 fell sharply, but started to pick up in the second half, especially for copper. World metals consumption, which grew at 11 percent in 2010, slowed to 4 percent in the first 10 months of 2011, with growth slowing sharply in all main regions (world metals consumption grew 3.8 percent during 2000-10.) For China, however, the data only show apparent demand and do not include stock changes, indicating that underlying consumption may have been higher. Prices were also supported by numerous supply constraints, notably for copper. The aluminum market, which is in surplus, had a substantial portion of stocks tied up in warehouse financing deals and unavailable to the market.

All metals prices are well off their highs in early 2011 (figure Comm.6). Nickel prices have declined more than one-third because of slowing demand by the stainless steel sector and expectations of large new nickel production capacity additions in 2012 and beyond. Copper prices dropped one-quarter third, but still remain above the costs of production due to supply tightness at the mine level. Aluminum prices have declined less than one-quarter and have fallen into the upper end of the cost curve. Metals prices are expected to rebound from their lows in the near term on re-stocking in China, but are not expected to reach earlier highs because of moderating demand growth and expected supply increases for all metals (see box Comm.2 for the role of China in metal demand).

Prices are projected to decline into the medium term for all metals with the exception of aluminum, which is expected to rise, supported by higher costs for power and other inputs. Although there are no resource constraints into the distant future for any of the metals, over the longer term a number of factors could result in upward pressure on prices such as declining ore grades, environmental and land rehabilitation, as well as rising water, energy and labor costs.

Copper prices fell from over $10,000/ton in February to $7,500/ton during 4Q2011 on high stocks and slowing demand. Copper consumption growth in the first ten months of 2011 fell slightly from an 11 percent gain in 2010. China's apparent demand (excluding stock changes) slowed sharply from 2010, but given likely de-stocking, actual consumption was probably higher (China's copper imports picked up in the second half of the year suggesting an end to inventory withdrawal). In the OECD, strong demand growth at the start of the year turned sharply negative, and growth elsewhere also turned slightly negative. High prices in

Figure Comm.6 Refined metal prices ($/ton)



Source: World Bank.

recent years have taken their toll on consumption, as users substituted copper with other materials, such as aluminum and plastics, and lowered the copper content in applications. Copper prices have remained well above the costs of production because of continued problems at the mine supply level, including slower than expected ramp-up at new mines, technical problems at existing operations, declining ore grades, strikes, accidents and adverse weather. Many of these incidents have occurred in Chile, which supplies 35 percent of the world's mined copper. However, growth in new capacity globally is underway with

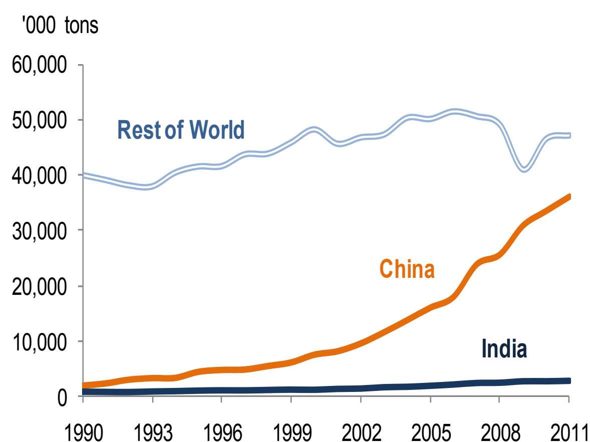
Box Comm.2 Metals consumption in China and India

India, with its large population, is often cited as the "next China" in terms of consumption of commodities. Since 1990, China's refined metal consumption (aluminum, copper, lead, nickel, tin and zinc) jumped 17-fold, and its share of world refined metal consumption grew from 5 percent to 41 percent (box figure Comm.2.1). Its average rate of growth since 2000 was 15 percent p.a., while demand in the rest of the world was essentially unchanged. Unquestionably, China has been the major driver of metals demand and higher prices, as the country consumed large quantities of metals (and other primary resources) for construction, infrastructure, and manufacturing to significantly raise its level of income. Consider, for example, that China's metal intensity (metal use per $1,000 of real GDP) was almost three times higher than the rest of the world back in 1990 and it reached almost 9 times in 2008 (box figure Comm 2.2).

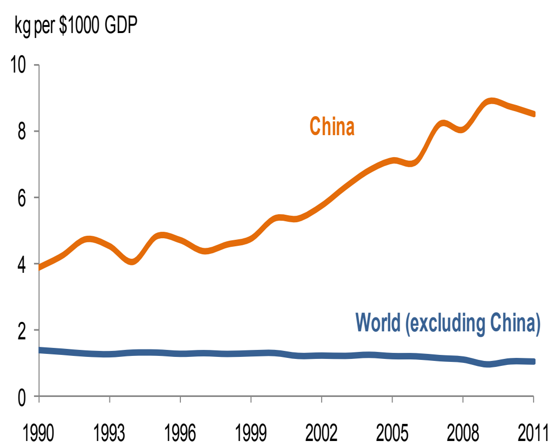
It is expected that metals demand will slow over the next decade as economic growth slows and the country transitions from an export-led and investment-driven economy to a domestic consumption and services economy, and seeks to improve the environment and air quality. Still metals demand will remain robust due to urbanization (more high-rise construction), infrastructure needs, and moving up the value chain in manufacturing—all are resource intensive.

India's share of world metals consumption has risen from 2 percent in 1990 to only 3 percent currently due to the very different structure of the economy, levels and direction of investment, sector growth trends, trade and policies. Moreover, its pace of metal demand growth has been only half that of China, and much closer to the pace of economic growth. Should India's refined metal consumption grow at 15 percent p.a., it would take nearly two decades to overtake China's current level consumption. Should that occur, it would present substantial challenges to the metals industry to supply these resources, similar or greater to the challenges the industry has faced the past decade. One possible impact is for even higher prices and pressures on the downstream sectors to innovate and substitute away from high-priced materials. India has ambitious plans for growth and has unveiled a significant power generation program. Thus, a key question is what other policy and structural changes would need to take place to have India's metal consumption growth double for the next twenty years.

Box figure Comm 2.1 Refined metal consumption



Box figure Comm 2.2 Metal consumption intensity



Source: World Bank.

numerous medium-sized projects expected online beginning in 2012, as well as the massive Oyu Tolgoi project in Mongolia which will add significant growth in 2013-14. Copper prices are expected to rebound from the recent drop as economic growth recovers and China re-stocks. Over the medium term, however, copper prices are expected to decline as demand moderates and new capacity pushes the market into modest surplus.

Aluminum prices, which traded close to copper back in 2000, languished the past decade despite demand growth twice as high copper. The main reason was China which expanded production capacity substantially and exported surplus aluminum to the global market—unlike for copper and other resources in which it is a significant importer. Robust aluminum demand is expected to continue, in part because of its lower relative price which helps it penetrate other markets such as copper, but mainly because of its light-weight, durable characteristics and multiple uses (in transport, construction, packaging and electrical). There are no resource constraints given the abundance of bauxite ore in the earth's crust. However, the recent price decline has fallen into the smelting industry's cost curve, where around 30 percent of the world's producers lose money on a cash-cost basis, much of it China at plants that use outdated technologies. A strengthening renminbi will accelerate closure of this capacity which will be replaced with lower-cost and more efficient facilities. The construction of new capacity will generally be directed to locations with lower power cost advantages, such as the Middle East (power accounts for about 40 percent of aluminum's production cost). Most of the world's new state of the art capacity will be added in China, but large plants are also planned in India and Russia. Aluminum prices are expected to increase over the forecast period driven by higher production costs for power, carbon, and alumina.

Nickel prices are down substantially from their 2007 highs, but remain volatile due to large stainless steel production cycles and stocking/destocking in China. Nickel prices recovered from their 2009 lows due to large growth in world stainless steel production in 2010 of nearly 25 percent, driven by China but there was also strong growth in Europe and Japan. Growth slowed to around 5 percent in 2011 on slowing output in China and in industrial countries. (About 70 percent of global nickel supply is used in the production of stainless steel.) Nickel prices came under pressure in 2011, despite falling inventories and positive demand gains, because of the expected surge in new nickel projects—the largest being in Brazil, Madagascar, New Caledonia, Papua New Guinea, but increases also expected in Australia, Canada and elsewhere. The new capacity from these and other projects will include traditional nickel sulphides, ferro-nickel and laterite high pressure acid leach (HPAL) projects, and Chinese nickel pig iron (NPI) producers. HPAL projects have had considerable technical problems and delays in recent years but are now scheduled to begin operation. The Chinese NPI industry developed as a result of the nickel price boom in the mid-2000s, with the import of nickel laterite ores from Indonesia and the Philippines. However, Indonesia has proposed developing its own NPI industry and is considering banning nickel ore exports from 2014, which could reduce China's output. NPI production is relatively expensive and may serve a longer-term cost-floor to prices. Nickel prices are expected to decline over the forecast period due to the substantial supply additions in the coming years, and are likely to reflect production costs in the medium term.

Agriculture

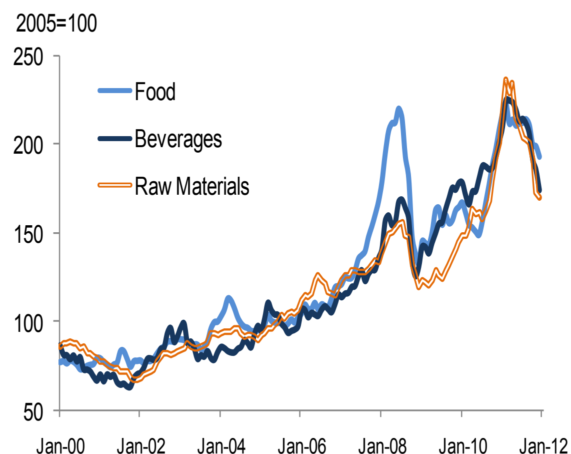
After reaching a peak in early 2011, prices for most agricultural commodities moderated with the index ending the year 19 percent below its February high (figure Comm.7); food prices declined 14 percent. Yet, average agricultural prices (including food) were up 23 percent in 2011, and in real terms averaged the highest level since the aftermath of the 1970s oil crisis (figure Comm.8). Most of the drivers of the post-2005 price increases are still in place (table Comm.2). Energy and fertilizer prices (key inputs to agricultural commodities) are still high,

production of biofuels (currently accounting for the equivalent of 2.2 percent of global crude oil demand) is still growing, the US$ remains weak by historical standards, while most grain markets are experiencing low level of stocks. On the other hand, investment fund activity is set to reach another record level—an estimated US$ 450 billion as of Q4:2011 have been invested in commodities (figure Comm.9). Though not expected to affect long term trends, such activity may induce higher price variability.

Following a brief period of relative stability during 2009, ***grain prices*** (especially maize and wheat), began rising in the summer of 2010 following weather-induced production shortfalls in Eastern Europe and Central Asia (figure Comm.10). From June to December 2010, wheat prices increased by almost 120 percent, exceeding $300/ton and having since remained above that mark. Maize prices followed a similar pattern, increasing from $152/ton in June 2010 to $320/ton in April 2011, fluctuating around $300/ton since then.

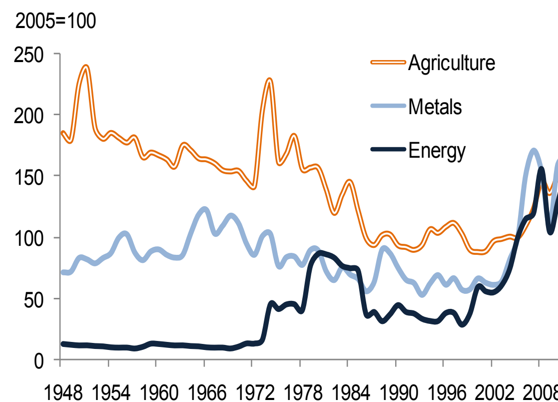
While maize and wheat markets are tight by historical standards, the ***rice*** market appears to be well-supplied. For most of 2010, rice prices fluctuated within a narrow band of $450 to $500 per ton, far below the early-2008 peak of $900 per ton, but twice as much as its historical average. However, they gained momentum and

Figure Comm.7 Nominal agriculture price indices



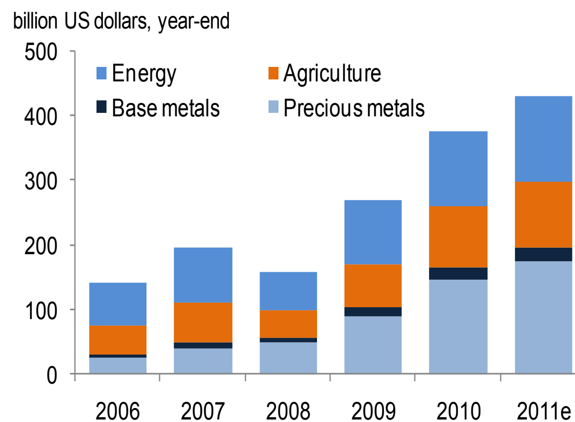
Source: World Bank.

Figure Comm.8 Real price indices (MUV-deflated)



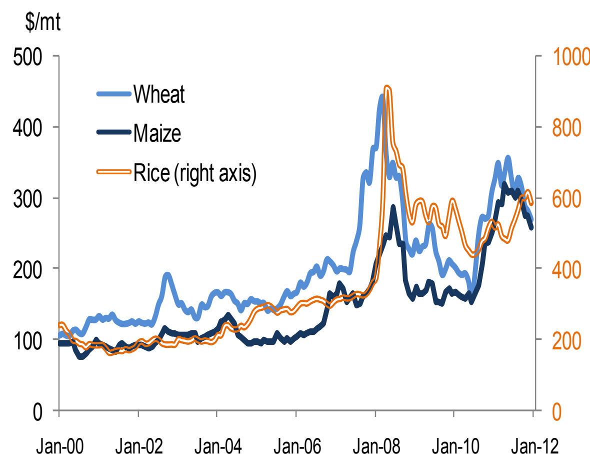
Source: World Bank.

Figure Comm.9 Funds invested in commodities



Source: Bloomberg, Barclays Capital.

Figure Comm.10 Grains prices



Source: World Bank.

Table Comm.2 Most of the price-boom conditions are still in place

	2001-05	2006-10	Change
Agricultural prices (nominal index, 2005 = 100)	**89**	**147**	**+66%**
Grain/oilseed price volatility (stdev of log differences, monthly)	**2.3**	**3.5**	**+52%**
Crude oil price (US$/barrel, nominal)	34	75	+120%
Fertilizer prices (nominal index 2005 = 100)	72	208	+172%
Exchange rates (US$ against a broad index of currencies)	119	104	-13%
Interest rates (10-year US Treasury bill)	4.7	4.1	-14%
Funds invested in commodities ($ billions)	30	230	+667%
GDP growth (low and middle income countries, % p.a.)	5.0	5.8	+16%
Industrial production (low and middle income countries, % p.a.)	6.3	7.1	+13%
Stocks (total of maize, wheat, and rice, months of consumption)	3.2	2.5	-21%
Biofuel production (millions of barrels per day equivalent)	0.4	1.3	+203%
Yields (average of wheat, maize, and rice, tons/hectare)	3.8	4.0	+7%
Growth in yields (% change per annum, average)	1.4	1.0	-32%
Natural disasters (droughts, floods, and extreme temperatures)	374	441	+18%

Source: World Bank.

increased almost 30 percent between May and November 2011, mainly in response to two problems. First, the decision by the Thai government to sharply increase the intervention price to 15,000 baht/ton under the Paddy Rice Program. At the time of the announcement, this new intervention price was 65% higher than market price. Under the program, growers and millers become eligible for a government loan (based on the intervention price) if they place their rice as collateral, stored at a government–certified facility. If, after the expiration of the loan, the market price is higher than the intervention price, the millers sell the rice and repay the loan. Otherwise, the millers can chose to default and the rice becomes property of the government. After the higher intervention price was announced, growers and millers began holding supplies of current off-season-crop paddy in order to participate in the program. Yet, the program is expected to have only limited long term impact as the stored rice will eventually find its way into the market. Second, on the weather front, some flooding in South East Asia appears to have damaged part of Thailand's rice crop. Because Thailand accounts for 25 to 30 percent of word rice exports, the policy and weather developments may affect the world market. On the positive side, India's decision to allow the export of non-Basmati rice along with good crop prospects elsewhere in the region, are likely to keep rice prices in check. Indeed, rice prices declined 5 percent in December 2011.

Edible oil prices were relatively stable and slightly declining during 2011; the World Bank edible oils index averaged 246 (2005 = 100) in January 2011 and ended the year below 200. A weather-induced shortfall of soybean oil earlier in the year was balanced by better palm oil production—these two oils account for almost two thirds of global edible oil production. The diversion of oils for biodiesel production in Europe appears to be the largest demand-driven factor and is likely to support high prices in the near and medium term. Unlike grains, where demand tends to be relatively stable above a certain income threshold, per capita demand for edible oils continues to rise even in high income countries, as a rising share of food consumed is prepared in professional establishments and in packaged form, both oil consuming processes (the income elasticity of edible oils is twice as high as that of grains).

Beverage prices averaged the year 14 percent higher than 2010, supported primarily by ***coffee (arabica)*** prices. During 2011 arabica prices averaged close to $6.00/kg, their highest nominal

level. The rally reflected tight supply conditions, especially from Brazil, the world's dominant arabica supplier. ***Cocoa*** price increases earlier in the year reflected political instability in Côte d'Ivoire but supplies have recovered more recently, which combined with weak demand in Europe due to the crisis induced price declines towards year's end—Côte d'Ivoire accounts for almost 40 percent of global supplies. The strength in ***tea*** prices reflects mainly East Africa supply shortages and strong demand, especially of high quality teas by Middle Eastern oil exporting countries.

The ***cotton market*** experienced tight supplies earlier in the year as well, further exacerbated by an export ban imposed by India to protect its domestic textile industry. The shortfall, coupled with strong demand and low stocks, boosted prices above $5.00/kg in March 2011, effectively doubling within six months. That price level, however, turned out to be unsustainable and by August 2011 cotton prices were down to $2.50/kg on strong supplies and weakening demand. ***Natural rubber*** prices reached historic highs earlier due to weather-related supply disruptions in South-East Asia rubber producing countries (accounting for 90 percent of global production). However, following weakness in crude oil prices (a key input to competing synthetic rubber) and weaker tire demand due to the economic downturn, rubber prices moderated and ended the year 46 percent below their February 2011 peak. ***Timber*** prices surged, especially Malaysian logs and to a lesser degree Cameroonian logs and Malaysian sawnwood. Strong demand following the Tohoku disaster in March 2011 contributed to the strength of timber prices.

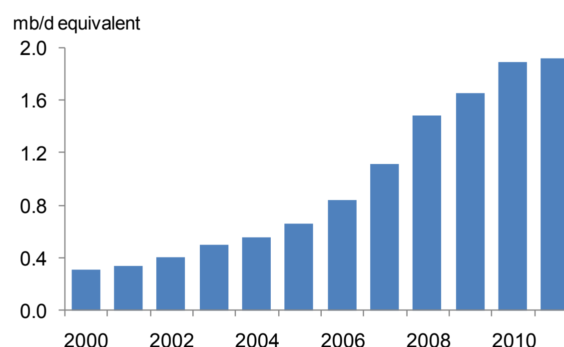
Fertilizer prices averaged 43 percent higher in 2011 than 2010 on strong demand for agricultural (especially grain and oilseed) production. Fertilizers are a key input to most agricultural commodities (especially grains) in value terms and, due to their tight relationship to natural gas prices, they tend to co-move with energy prices very closely—energy prices gained 25 percent in 2011.

Outlook

As supply conditions improve, agricultural prices are expected to decline 11 percent in 2012. Specifically, for 2012, wheat and maize prices are expected to average 9 and 12 percent lower than their 2011 levels while rice prices are anticipated to decline 6 percent. Soybean and palm oil prices are expected to be 16 and 20 percent lower, respectively. Beverage prices will experience declines as well (cocoa, coffee, and tea 11, 17, and 4 percent down, respectively). Cotton and rubber prices are expected to decline 30 percent, each.

A number of assumptions underpin the outlook. First, is that energy and fertilizer prices are projected to experience moderate declines. Second, it is assumed that the supply outlook during the 2011/12 crop year will improve. Third, no policy responses similar to the ones during 2008 will take place; if they do, they could always upset markets—the changes in rice policy in Thailand introduced in September 2012 is a case in point. On the other hand, the diversion of food commodities to the production of biofuels continues reached the equivalent of almost 2 million barrels per day of crude oil in 2011 (figure Comm.11). Nevertheless, there are signs of a slowdown in global biofuel production: preliminary estimates for 2011 indicate that it grew only marginally compared to the double digit growth rates during the past 10 years. The policy environment for biofuels begins to change as well. The US government let

Figure Comm.11 Biofuels production



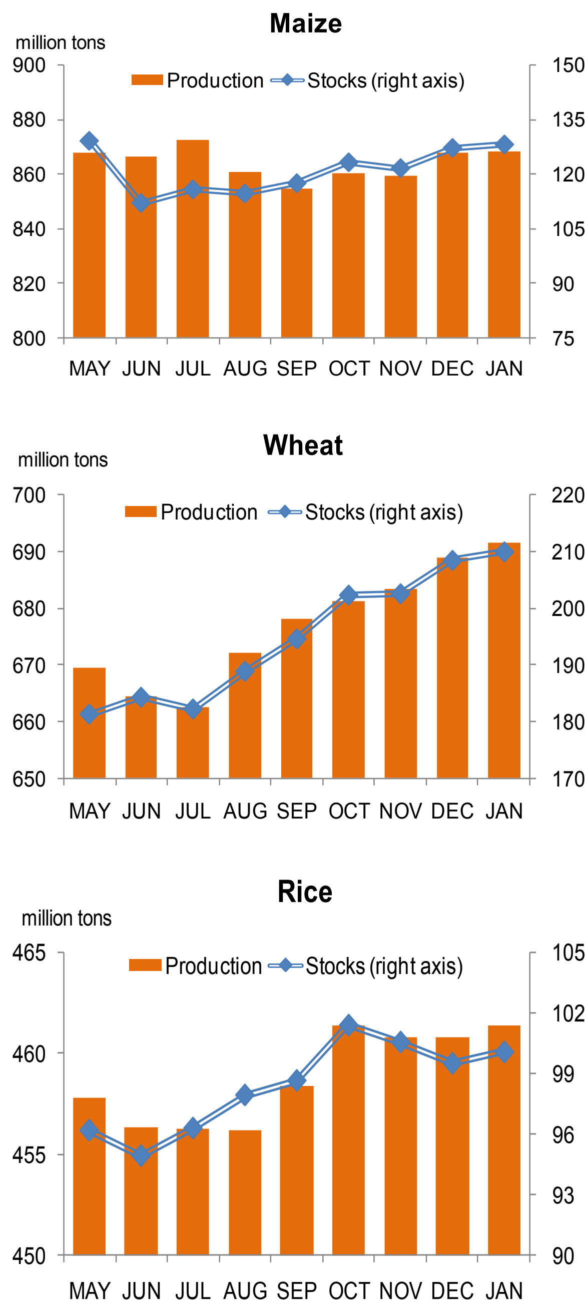
Source: BP Statistical Review

its ethanol tax credit expire as of January 1st 2012 and eliminated ethanol tariffs. Yet, these policy changes are expected to have only a minimal impact on ethanol production in the US (and biofuel related corn production), since mandates requiring minimum amounts of gasoline to be supplied through biofuels are still in place. Moreover, with crude oil prices over $100 per barrel most biofuel production is likely to be profitable without any government intervention. Thus, the role of energy prices in determining agricultural prices (both as a cost component and diversion to biofuels) is expected to remain important.

The USDA during its first assessment for the 2011/12 crop year (published in early May) projected that global food supply conditions will improve with production of maize expected to rise 6.4 percent over the previous crop year, wheat output higher by 3.3 percent, and rice by 1.4 percent. Maize stocks were expected to increase by 13 percent, while stocks for wheat were set to decline by 3 percent (no change was expected in rice stocks). During USDA's subsequent monthly assessments from June 2011 to January 2012, the outlook has been improving gradually, except for the large downward revision of maize stocks in June (figure Comm.12).

While low stocks and poor crops have been the key factors underpinning the early 2011 price hikes, most of the post-2005 increase in agricultural prices can be explained by energy price increases. Energy is a particularly important determinant of agricultural prices and hence an important risk to agricultural prices. Energy feeds into food prices through three main channels. First, as a cost of production (mainly fuel to run agricultural machinery and transporting commodities to markets), second, indirectly through fertilizer and other chemical costs (e.g., nitrogen-based fertilizers are made directly from natural gas), and third, via competition from land to produce biofuels. Indeed, econometric evidence (presented below) ranks energy as the most important driver affecting prices of food commodities, followed by stocks and exchange rate movements. Other drivers matter much less.

Figure Comm.12 Monthly updates on global production and stock estimates for 2011/12



Source: USDA

Fundamentals and long term food price movements

To examine the role of fundamentals in determining food prices, a reduced-form econometric model was utilized and concluded that oil prices contributed about two third to the price increase of key food commodities between 2000-05 and 2006-10. Exchange rate movements accounted for 23 percent while stocks were responsible for 8 percent.

Specifically, the following price determination model was utilized:

$$log(P_t^i) = \mu + \beta_1 log(S/U_{t-1}) + \beta_2 log(P_t^{OIL}) + \beta_3 log(XR_t) + \beta_4 log(R_t) + \beta_5 log(GDP_t) + \beta_6 log(MUV_t) + \beta_7 t + \varepsilon_t.$$

P_t^i denotes the annual average nominal price of commodity i (i = maize, wheat, rice, soybeans, and palm oil). S/U_{t-1} denotes the lagged stock-to-use ratio, P_t^{OIL} is the price of oil, XR_t is the exchange rate, R_t denotes the interest rate, MUV_t is a measure of inflation, GDP_t denotes global GDP, and t is time trend. The β_is are parameters to be estimated while ε_t is the error term.

The interpretation and signs of most parameters are straightforward. The stock-to-use ratio is expected to be negative, since a low S/U ratio (associated with scarcity) leads to high prices while a high S/U ratio (associated with surpluses) leads to low prices (Wright 2011). To circumvent endogeneity, the S/U ratio entered the regression in lagged form. The price of crude oil will have a positive impact on the prices of food commodities, since it is a key factor of production (Baffes 2007). The depreciation of the US dollar—the currency of choice for most international commodity transactions—strengthens demand (limits supply) from non-US$ commodity consumers (producers) thus increasing prices (Radetzki 1985). An increase of the interest rate reduces commodity prices by (i) increasing the required rate of return on storage, (ii) changing expectations about aggregate economic activity, and (iii) stimulating demand; but, it can raise prices by reducing capital investment thereby reducing supplies (Pindyck and Rotemberg 1990). Thus, the effect of interest rate changes on commodity price is ambiguous. Because of the long time period under consideration, the Manufacture Unit Value (MUV) is used as an inflation proxy.

Table Comm.3 Parameter estimates: 1960-2010

	Maize	Wheat	Rice	Soybeans	Palm oil
Constant (μ)	1.29 (1.57)	3.17*** (5.13)	6.41*** (3.33)	4.46*** (7.91)	4.25*** (3.01)
Stock-to-Use ratio (S/U_{t-1})	-0.45*** (4.67)	-0.53*** (3.78)	-0.08 (0.38)	-0.17** (2.31)	-0.38** (2.04)
Oil price (P_t^{OIL})	0.19*** (4.05)	0.24*** (5.18)	0.25** (2.55)	0.31*** (6.41)	0.45*** (5.26)
Exchange rate (XR_t)	0.02 (0.04)	-0.81** (2.21)	-2.83*** (4.50)	-1.31*** (3.65)	-1.09* (1.74)
Interest rate (R_t)	-0.05 (0.60)	0.05 (0.63)	0.34*** (2.75)	-0.06 (0.64)	-0.04 (0.27)
Global GDP (GDP_t)	-0.01 (0.32)	-0.01 (0.28)	-0.05** (2.56)	0.01 (0.66)	0.01 (0.31)
Inflation (MUV_t)	0.64*** (2.70)	0.08 (0.42)	-0.62 (1.32)	-0.01 (0.05)	0.04 (0.10)
Trend x 100 (t)	-1.76*** (3.07)	-0.65 (1.31)	-0.76 (0.99)	-1.14* (1.78)	-2.17** (2.02)
Adjusted-R^2	0.87	0.91	0.76	0.84	0.62
DW	1.03	1.10	1.03	1.27	1.24
ADF	-3.90***	-5.52***	-3.96***	-4.68***	-4.43***

Note: The numbers in parentheses denote absolute t-ratios. DW is the Durbin-Watson statistic of serial correlation and ADF denotes the Augmented Dickey-Fuller statistic for unit roots (Dickey and Fuller 1979). Asterisks indicate parameter estimates different from zero at the 1% (***), 5% (**) and 10% (*) levels of significance, respectively.

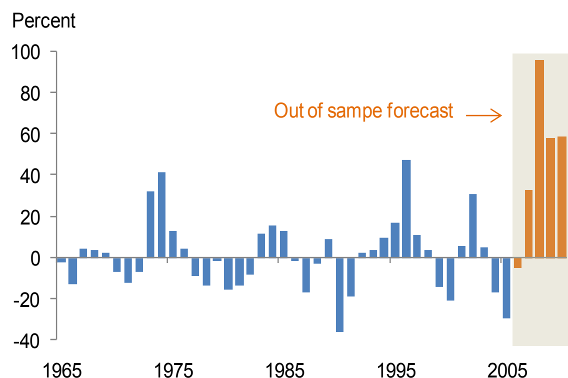
Source: Baffes (2011).

Furthermore, instead of deflating each price series, we used the deflator as an explanatory variable in order to relax the homogeneity restriction and obtain a direct estimate the effect of inflation (Houthakker 1975). Lastly, the time trend is expected to capture the effects of technological change, which for most agricultural commodity prices is expected to be negative.

Table Comm.3 reports parameter estimates for the 1960-2010 period for five food commodities. More than half of the parameter estimates are significantly different from zero, with an average adjusted-R^2 of 0.80 and a stationary error term (implying cointegration), confirming that the model performed well. A number of interesting results emerge from the analysis. First, the S/U ratio estimates are negative and all but one case significantly different from zero. Second, the parameter estimate of the oil price confirms that energy plays a key role in food price movements. In fact, the parameter estimate of the oil price is highly significant in all five cases. Third, with the exception of maize, exchange rate has a strong impact on food prices with the respective elasticity exceeding unity in three cases—the estimate of the exchange for maize (effectively zero) and rice (the highest among the 5 prices) most likely reflects that fact that the US is a dominant player in the global maize market but not a player in the rice market. Interest rate movements do not matter, except for rice. Income has no impact in all prices but rice (albeit negative). This result indicates that, despite what has been reported in the literature, increases of global GDP are not associated with food prices increases (similar results have been reported elsewhere, e.g. Ai, Chatrath and Song 2006). Indeed, per capita grain consumption in India and China has declined or flattened (these two countries are often mentioned as having contributed to food price increases because of their changing diets and high incomes). Price of manufactures (proxy for inflation) turned out not to be significant (with the exception in maize). Lastly, the parameter estimate of the time trend is negative as expected, but significantly different from zero in maize, wheat, and palm oil (not rice and soybeans). Estimates place the effect of technical change on prices to about 1 percent per annum, very close to the average 1.3 percent estimated here.

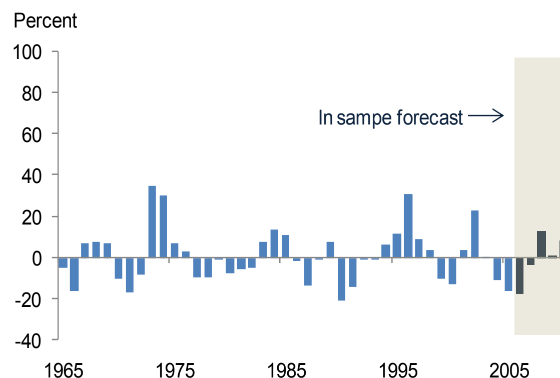
What portion of the post-2005 food price movements is explained by the fundamentals? The model was re-estimated by excluding the boom period (i.e., reduced the sample to 1960-2005). Then, based on these estimates, price levels of all five commodities were simulated for the post-2005 period. During the boom years of 2008-10, in all 5 commodities actual prices were much higher than the forecast prices—ranging from 35 percent (wheat in 2009) and 130 percent (rice in 2009). During 2008-10, prices were 70 percent higher than what the model forecasts. It is worth noting that since 1965, the highest model-generated gaps were in 1974 (+37

Figure Comm.13 Gap between actual and model-generated prices: wheat, 1965-2005



Source: Baffes (2011).

Figure Comm.14 Gap between actual and model-generated prices: wheat, 1965-2010



Source: Baffes (2011).

Table Comm.4 Decomposing the contribution of each variable to food price changes from 2000-20 to 2006-10 (percent)

	Maize	Wheat	Rice	Soybeans	Palm oil
Stock-to-Use ratio (S/U_{t-1})	12.0	14.4	0.9	-2.4	1.3
Oil price (P_t^{OIL})	32.6	41.4	27.2	57.0	58.2
Exchange rate (XR_t)	-0.1	11.5	25.4	19.9	11.9
Interest rate (R_t)	0.5	-0.5	-2.0	0.6	0.3
Global GDP (GDP_t)	0.4	0.4	1.2	-0.4	-0.3
Inflation (MUV_t)	13.6	1.7	-8.4	-0.2	0.7
Time trend	-0.3	-0.1	-0.1	-0.2	-0.3
SUM	58.7	68.8	44.2	74.3	71.8
Residual	41.3	31.2	55.8	25.7	28.2
All	100.0	100.0	100.0	100.0	100.0

Note: The contribution was based on the 1960-2010 model parameter estimates
Source: Baffes (2011).

percent) and 1990 (-20 percent). Figure Comm.13 depicts the out-of-sample forecast for the price of wheat. Based on the parameter estimates of the full sample model, fitted prices were calculated. The gap during 2008-10 was eliminated, implying that the addition of just 5 observations (the boom years) eliminates the model-generated error (figure Comm.14).

Finally, using the parameter estimates of the model, the relative contribution of each explanatory variable to price changes for the 2000-05 to 2006-10 was calculated (table Comm.4). The unexplained portion of the price changes during this period was 36 percent. Of the remaining 64 percent, oil's contribution was more than two thirds, followed by exchange rate movements (23 percent) and stocks (8 percent). The contribution of the remaining variables was negligible. Two key conclusions are reached. First, econometric evidence confirms that fundamentals explain most of the food price variation, including the 2005-10 boom years. Second, oil prices matter the most while from the macro perspective exchange rates movements matter as well; interest rates and income growth do not seem to have a long term impact on food prices.

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Inflation Annex

Inflation has fallen in the past year, on average, in both high-income OECD and developing countries. Inflation has declined rapidly in most of the high-income countries, while outcomes have been more varied in developing countries that nevertheless show an overall, declining trend.

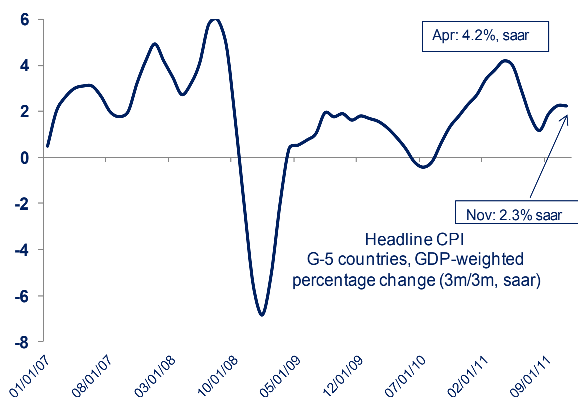
OECD: rapid demand-altering effects (fuels); lack of pass-through. Inflation is falling in the developed world. From April to November 2011, headline inflation in the G-5 countries dipped by nearly 2 percentage points (figure INF.1), while the earlier, rapid pass through of headline inflation to so-called "core prices" (which exclude food and fuels) appears to be abating (figure INF.2).[1] Among the G-5 countries, the United States and Germany achieved the largest decline (2 pts) in headline inflation since the first quarter of 2011; and other Euro Area countries have seen a substantial falloff of about 1.5 points, accentuated by the onset of sluggish growth there and a still fairly-strong euro to that time. Japan's initial low levels of inflation mean its delta in consumer prices is small. Still, the shift to deflation in Japan is reflective of the slow-build-up in activity since the Tohoku disaster of March 2011.

The decline in inflation has been driven by real- and financial aftereffects of the first financial crisis, and importantly by related developments in commodity markets. Producers and exporters of electronics and machinery have offered substantial price discounts linked to the massive buildup of inventories during the global growth downturn of 2009. This latter effect echoes the increasing importance of global factors, particularly the expansion of manufacturing production in East Asia, in determining inflation in the rich countries.[2]

Moreover, commodity price shocks have had a major, sustained impact on inflation during this period among the industrialized economies. In particular, international oil prices surged to near-record highs following the cut-off of Libyan crude oil in 2011, driving both increases in fuels prices and in food prices, the latter due to higher transport costs, increased prices for fertilizers, and reduced supply--as biofuel mandates shifted land usage towards the production of ethanol.[3]

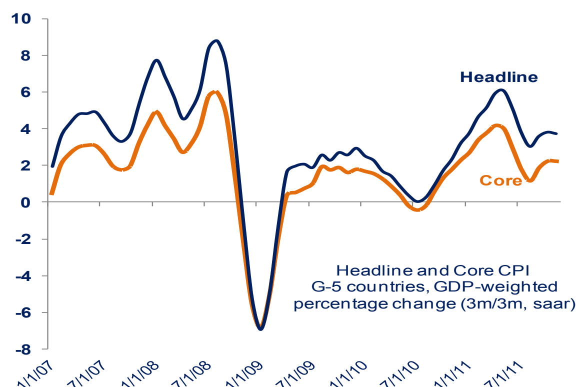
The direct effects of the hike in oil prices are seen quickly at the petrol pump. Demand for fuels soften with some lag, but also with

Figure INF.1 G-5 headline CPI drops nearly 2 points November vs April 2011



Source: Thomson-Reuters Datastream; World Bank.

Figure INF.2 Core picked up in recent recovery- but gap has widened recently



Source: Reuters-Thomson Datastream; World Bank.

substantial weight, with a shift toward e.g. public transport, improved efficiency automobiles, or "self-propelled" modes to getting places. But in contrast with conditions in developing countries, the co-rise in foods prices has smaller overall effects, given its diminished share in the OECD consumption basket. Typically, subdued inflation during a period of high unemployment should allow authorities some room for expansionary policies. However, as OECD inflation moves quickly in a broader direction toward zero (indeed the momentum of producer prices is now negative for the G-3 countries) and governments are beset by high debt burdens, authorities' ability to undertake expansionary policies has become more limited. Further reductions in demand as consumers begin to expect lower prices in the future (as may be happening in Japan) could possibly undercut hopes for a revival of economic activity.

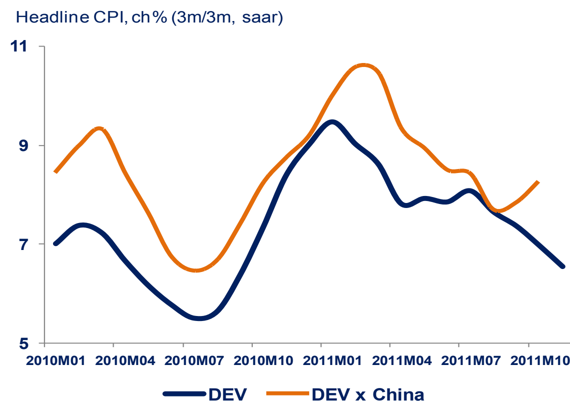
Developing countries: hysteresis and vulnerabilities. As is widely recognized, rising food prices contribute more to inflation in developing than in advanced economies, because food's share of the consumption basket in the former tends to be much larger than in the latter. For example, food accounts for 15 percent of the U.S. (CPI) basket but 50 percent of the consumption basket of the Philippines. Moreover, there is evidence to suggest that there is a more significant pass-through of food prices to non-food prices in developing countries compared with OECD economies--where there is almost none. An example of this possible transmission mechanism is higher food prices triggering protests for higher wages across Northern Africa, elsewhere in Africa, and the Middle East during 2007-08.[4]

Roundup of inflation trends across developing regions

For developing countries as a group, headline inflation rates have eased at a somewhat slower pace than for the advanced economies, falling by 3 percentage points since the start of 2011 and 1.3 percentage points from April through November (figure INF.3). The decline is moderately less if China is excluded from the group: while inflation in China in the first quarter was well below the average 10 percent rate in other developing countries, since then inflation in many countries has fallen sharply, but in China these have fallen more rapidly still—a reversal of recent price trends for the developing world. Easing price pressures in most developing countries should serve to boost domestic demand (over time), as well as provide additional headroom for staving off more severe effects of potential global economic difficulties ahead (for example with real interest rates now rising, monetary authorities could opt to cut nominal rates further).

- In East Asia and the Pacific, easing inflation is now the watchword in the wake of a period when higher Chinese inflation was "holding up" the index at higher levels. For China, the ASEAN countries and others in the region, underlying momentum in headline CPI is now diminishing: China to 2.8 percent over the three months to November (saar); for countries excluding China to 4 percent. The increase in the East Asian CPI reached a recent peak of 8 percent in January 2011 under increasing food and fuel price pressures, as well as still strong domestic demand, and is now running at rate below 3 percent thanks to developments in China. With economic activity now anticipated to continue fairly strong, accompanied by lower commodity prices,

Figure INF.3 DEV inflation eased by 3 points since Jan 2011 to 6% by November



Source: : World Bank.

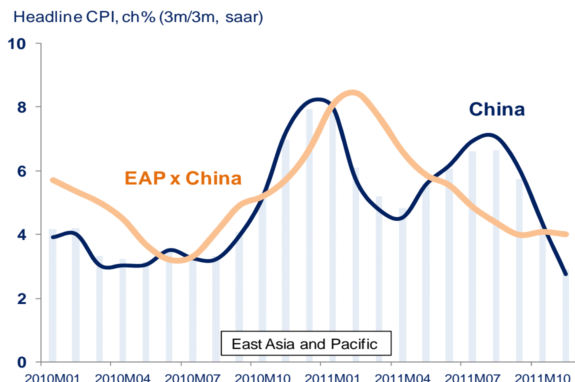
we may expect a continuing deflationary trend through 2012 at a minimum (figure INF.4).

- In Europe and Central Asia, Turkey is the outlier in this group of diverse economies, experiencing higher inflation (at 13.8% in November, saar) on the back of robust growth and recent reductions in interest rates. At the same time, inflation in Russia has eased rapidly from a 10 percent annualized pace in the first quarter of 2011 to 3.9 percent by October, but picked up in November, possibly reflecting ruble depreciation. Here, slowing growth and weaker oil prices have driven the sharp earlier fall in inflation. In the remainder of the region (Central Asian oil- and commodity exporters) inflation has trended down well into single digits essentially linked to similar developments in their larger neighbor, Russia. Regional inflation eased from 10.7 percent (saar) at end-2010 to a low of 7 percent in April, before returning to 9.6 percent by November 2011 (figure INF.5).

- In Latin America and the Caribbean, Brazilian inflation, which had been running at an overly-rapid 8 to 10 percent pace for most of 2011, eased to below 6 percent by August, owing to somewhat slower growth and determined monetary tightening (though the Central Bank recently has cut rates). A moderate uptrend has set in during the fall months, carrying inflation above 6.8 percent by November, which is nonetheless expected to be short-lived, given anticipated step-down in economic growth. In similar fashion, Mexico's recent upturn is more likely than not to be temporary. Average inflation for the region now lies at 7.5 percent (owing to continued double-digit advances for both Argentina and Venezuela), albeit down from 9 percent in the first quarter of the year (figure INF.6).

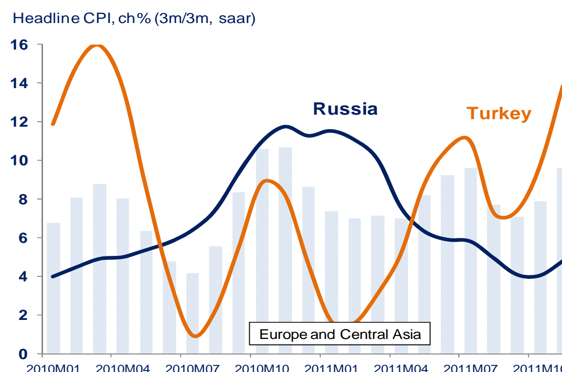
- In the Middle East and North Africa, higher food and oil prices, disruptions to economic

Figure INF.4 China shows sharp slowing of CPI momentum carrying East Asia & the Pacific to below 3%



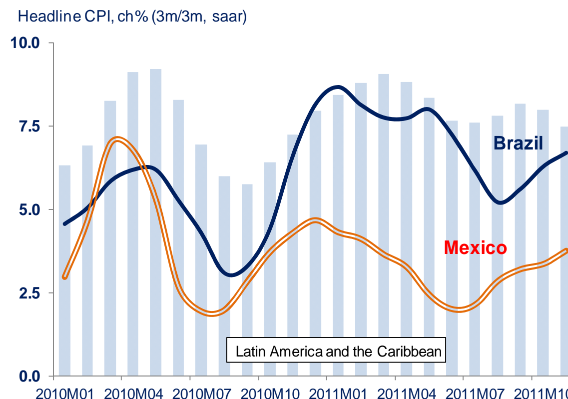
Source: World Bank.

Figure INF.5 Softer oil prices, slower growth start to weigh on Europe & Central Asia CPI--Turkey an outlier



Source: World Bank.

Figure INF.6 Brazil and Mexico still experience modest uptrend-- short lived?



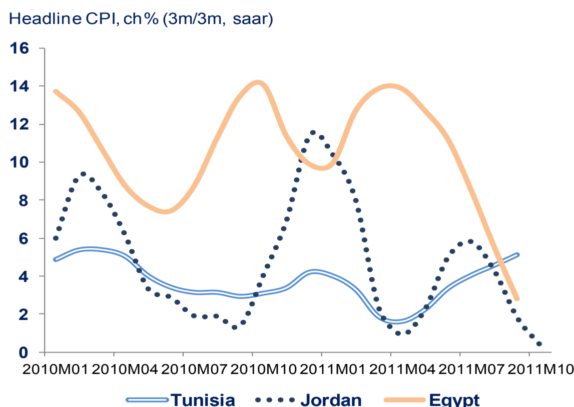
Source: World Bank.

activity occasioned by the "Arab Spring", as well as continuing violence in countries such as Yemen and Syria, have boosted regional inflation (as defined by limited data available for all countries of the region) to a 20 percent range as of June (3m/3m saar). As such data is less meaningful now that more recent indicators for Egypt, Morocco and Tunisia have become available we focus here and find that headline inflation in these economies show a clear tendency toward easing. However, consumer prices measured at the market are exceptionally biased by large-scale government subsidies for food and in some cases fuel that move such indicators lower. Underlying pressures are indeed much higher, but the cost is being borne by local governments. Still the region remains highly exposed to further food price hikes, weighing down budgets, leading to worsening trade deficits at a time of concern about MENA's largest trading partners in Europe (figure INF.7).

- In South Asia, headline inflation for India and several other countries remains high, for the former within a 5-6 point range (saar), and for Pakistan between 10-and 11 points. But when measured on a seasonally adjusted annualized rate, inflation in India has fallen by 2.5 percentage points since the start of 2011, to 5.2 percent in November. Inflation remains more problematic in Pakistan; but had earlier softened in the "post-conflict" environment in Sri Lanka (figure INF.8).

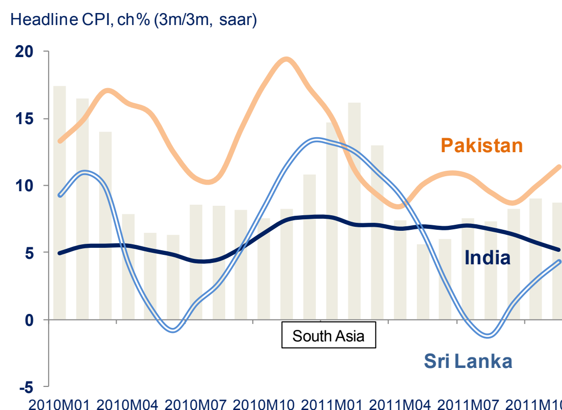
- And in Sub-Saharan Africa, South Africa and Nigeria, representing the bulk of the region's GDP, have shown opposing movements of late, with South African headline inflation moving to a range of 6 percent from 2 percent at the start of the year; in contrast, inflation is plummeting in Nigeria owing to lower oil prices, revenues and disposable incomes. For the region outside of South Africa, inflation remains elevated, but falling, currently ranging near 10 percent, in large measure due to developments in Kenya (figure INF.9).

Figure INF.7 MENA inflation easing as food subsidies distort "markets"



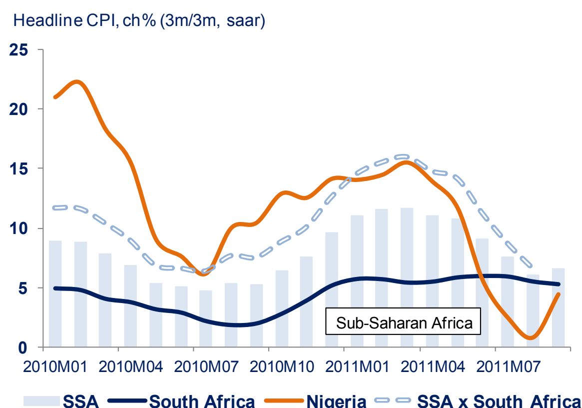
Source: World Bank.

Figure INF.8 India showing deceleration, but South Asia region still at high rates near 9%



Source: World Bank.

Figure INF.9 African inflation making some strides, but still high at near 7%



Source: World Bank.

Notes

1. Headline' inflation refers to price changes for all goods in an economy. 'Core' inflation excludes fuels and foods from that basket. G -5 headline CPI growth (inflation) is a GDP-weighted measure of price changes, computed as a 3m/3m "rolling quarter" and annualized "seasonally adjusted annualized rate", or SAAR. This method helps to remove what could be biased "base effects" from year-over-year calculations, as well as to present a clearer picture of turning points in the data.

2. "Globalization and Inflation in OECD Countries". Pehnel, Gernot; ECIPE Working Paper No 04/2007.

3. "A Note on Rising Food Prices". Donald Mitchell. World Bank Policy Research Working Paper. No. 4682. July 2008. The World Bank. Washington DC.

4. Guimaraes, Roberto. Osorio Buitron. Carolina; Porter, Nathan; Filiz, Unsal D. and Walsh, James. "Consolidating the Recovery and Building Sustainable Growth". Chapter 2, Washington DC: International Monetary Fund, October 2010, pp. 41-55.

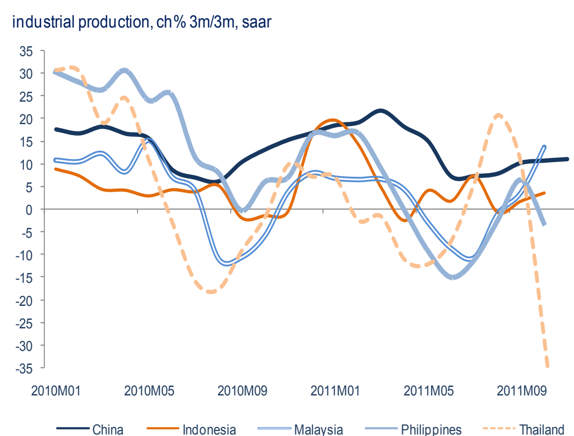
East Asia and the Pacific Region

Overview

Economies in the East Asia and Pacific region are being affected in varying ways by the current, difficult economic times.[1] After expanding 9.7 percent in 2010 on the back of strong performance in China, GDP in developing East Asia is estimated to have slowed to an 8.2 percent pace in 2011, and is projected to ease further to 7.8 percent in 2012 and 2013 (table EAP.1). The middle income countries of the region are generally well positioned to withstand the global slowdown underway (see main text), with substantial fiscal space available, a degree of downside flexibility in policy interest rates, significant reserve levels, and a still-strong underpinning for domestic demand.

Still, a more serious deterioration of conditions in high-income economies and an attendant sharp decline in global trade could have serious implications for these countries, which as a group are exceptionally open to world trade. Vietnam, and the region's low-income to lower-middle income economies (Cambodia and Lao PDR), as well as the small island economies are less well positioned than the major countries of the region, with limited space for policy change and less reserves to stem financial disturbances.

Figure EAP.1 Industrial production showing rebound post-Tohoku; Thailand suffers from flooding



Source: World Bank.

The anticipated modest slowing of overall growth in the base-case projections is due to an easing in China, offset in part by what may be sufficient vigor in ASEAN-4 domestic demand. The larger driver for the slowdown is found in faltering OECD demand, affecting exports both from China and from those middle income countries joined in tight manufacturing production chains with the former economy and with others. A more serious downturn in the high -income countries could certainly exact a larger toll on growth— and would likely be amplified by changes in commodity prices, potential narrowing of international sources of finance and, importantly for East Asia, a "second round" of adverse trade effects, given a "first round" slowing of worldwide demand.

Declines in commodity prices alongside a global downturn could exact a toll on East Asia's large exporters of agricultural products, fats and oils, and hydrocarbons, reducing fiscal revenues and pressuring deficits. At the same time, the diverse nature of the region means that falling commodity prices will help numerous countries, foremost including China, with lower oil prices also benefitting countries such as Indonesia, where budgets are still burdened by fuel subsidies. Remittance receipts are potent drivers for growth in countries from the Philippines to the small island economies—and these flows, as well as tourist arrivals (important for the region broadly) could slow because of sluggish labor market and growth developments in the OECD, although migrant remittances held up quite well during the 2008-2009 crisis.

GDP growth in China, the region's largest economy (about 80 percent of regional GDP), eased from 10.4 percent in 2010 to and estimated 9.1 percent in 2011, and is expected to dip further to a (still robust) 8.4 percent in 2012 as authorities continue to dampen quite rapid growth in a number of sectors of the economy.

Table EAP.1 East Asia and the Pacific forecast summary

(annual percent change unless indicated otherwise)	98-07[a]	2008	2009	Est. 2010	Forecast 2011	2012	2013
GDP at market prices (2005 US$) [b]	7.9	8.5	7.5	9.7	8.2	7.8	7.8
GDP per capita (units in US$)	7.0	7.6	6.6	8.8	7.4	7.0	6.9
PPP GDP [c]	7.8	8.4	7.5	9.6	8.2	7.8	7.8
Private consumption	5.9	7.4	7.3	7.7	7.6	7.8	7.7
Public consumption	7.9	8.6	7.3	6.6	7.6	7.0	6.4
Fixed investment	9.2	9.1	19.0	6.6	11.0	8.9	8.8
Exports, GNFS [d]	13.7	7.1	-9.2	22.6	10.3	8.5	11.2
Imports, GNFS [d]	12.1	4.7	-1.9	20.8	13.0	10.2	11.2
Net exports, contribution to growth	1.4	1.6	-3.6	1.9	-0.2	-0.1	0.6
Current account bal/GDP (%)	4.1	7.5	5.8	4.7	3.1	2.6	2.3
GDP deflator (median, LCU)	5.0	7.8	4.4	3.6	5.0	5.2	4.6
Fiscal balance/GDP (%)	-2.1	-0.5	-2.9	-1.9	-1.9	-2.3	-2.1
Memo items: GDP							
East Asia excluding China	4.5	4.8	1.5	6.9	5.2	5.5	5.6
China	9.1	9.6	9.2	10.4	9.1	8.4	8.3
Indonesia	4.1	6.0	4.6	6.1	6.4	6.2	6.5
Thailand	4.5	2.5	-2.3	7.8	2.0	4.2	4.9

a. Growth rates over intervals are compound average; growth contributions, ratios and the GDP deflator are averages.
b. GDP measured in constant 2005 U.S. dollars.
c. GDP measured at PPP exchange rates.
d. Exports and imports of goods and non-factor services (GNFS).
e. Estimate.
f. Forecast.

Source: World Bank.

Output is projected to ease in 2013 to 8.3 percent, in-line with the country's longer-term potential growth rate. GDP growth in the rest of the region slowed sharply in 2011 from 6.9 percent to a 4.8 percent pace, but is expected to strengthen gradually over 2012 and 2013, coming in at 5.8 percent in the final year.

Recent developments

GDP data for developing East Asia available for the first three quarters of 2011 (table EAP.2) together with high-frequency indicators, point to slowing from the region's strong growth of 2010. Natural disasters and more recently the financial market turmoil in Europe have started to exact a moderate toll on regional economic activity in the middle income countries. The disruption to international supply chains from the Tohoku earthquake and tsunami in Japan of March 2011 caused industrial production growth in the region to slip from 18 percent before the crisis to 6 percent in the three months ending in June (saar). Output then picked up, reaching 7.7 percent growth by November 2011. Indeed, China's production growth fell from a peak of 22 percent in the first quarter (saar) to 11 percent by November (figure EAP.1, earlier). In contrast, first quarter production in Malaysia increased by 6.5 percent; and in the Philippines by 8.8 percent, giving way to double digit declines as of August, before undergoing moderate rebounds. More recently the severe flooding in Thailand has dampened industrial output severely in the short run (72% contraction in output in the three months to November 2011) until repairs to infrastructure and utilities intensify through the course of 2012—a factor likely to boost growth for the country (box EAP.1).

Table EAP.2 Quarterly GDP over the first 3 quarters of 2011*, estimates for the year

	East Asia	China	Indonesia	Malaysia	Philippines	Thailand
2010	9.7	10.4	6.1	7.2	7.6	7.8
Q4	9.8	10.0	6.1	9.2	1.9	5.3
2011						
Q1	7.5	8.2	6.5	7.3	7.8	7.5
Q2	7.3	10.0	6.2	2.5	-1.9	0.2
Q3	7.0	9.5	6.2	4.4	5.0	2.1
2011 (est)	8.2	9.1	6.3	4.4	3.7	2.0

Source: Haver Analytics, Thomson/Reuters Datastream, China National Bureau of Statistics, World Bank.
Note: * Data at seasonally adjusted annualized rates.

Box EAP.1 Floods in Thailand—what consequences for growth?

Thailand is no stranger to natural disasters. However, the floods which inundated 66 of the country's 77 provinces from July through November 2011 were the worst in 50 years. Losses have mounted in part as the structural makeup of the Thai economy has shifted in the last decades to one of manufacturing intensity, and damages are well beyond what would have occurred in an earlier era.

In 2011, accumulated water from months of storms and high precipitation resulted in a severe flooding of the central regions, with water drifting southward toward Bangkok, affecting some 5 million people in this region alone. At the time of this writing, more than 680 lives have been lost, and the accumulated affected population is estimated at 13.6 million (a large 21% of total population). Social safety nets were rapidly put in place or upgraded, and new loans for firms and agricultural cooperatives have been proposed to invest in recovery operations. Total damages and losses have been estimated at $46.5 billion, with the manufacturing sector carrying some 70 percent of the damages and losses; overall the private sector has borne up to 90 percent of damages and losses.

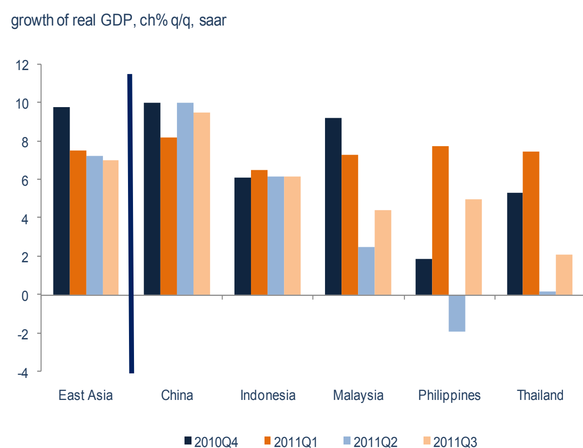
Official Thai sources have estimated that reconstruction will be realized over three years, from 2011 through 2013, and that the cost to Thai GDP of the flooding will be a fairly moderate loss of growth in 2011 of 1.1 percentage points, and additions to growth of 0.2 and 0.9 percent respectively over 2012 and 2013 as reconstruction moves toward completion.

Source: World Bank, East Asia and the Pacific region.

Quarterly GDP data for the region confirm a slowing in annualized growth from 9.8 percent for the final quarter of 2010 to an average of about 7.2 percent for the first three quarters of 2011 (saar). Third quarter numbers for major economies, excluding China and Indonesia, show some pickup from the second quarter, but with the exception of the Philippines the rebound was generally modest. Growth was driven across most countries by a surge in government outlays offset by inventory draw-downs (given the stalling out of industrial production) (figure EAP.2).

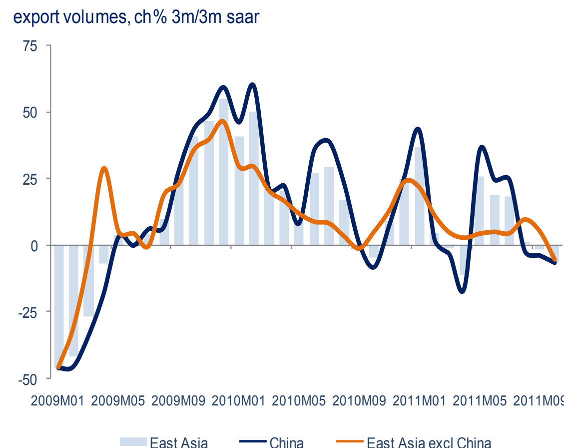
From a trough following Tohoku in April 2011, Chinese and middle-income regional exports rebounded sharply (figure EAP.3). But export volumes slowed dramatically beginning in August and fell at a 10.5 percent annualized pace during the 3 months ending November, likely reflecting knock-on effects from the financial turmoil in Europe. Most of the decline was due initially to weaker Chinese exports, while shipments from the rest of the region continued to expand sluggishly until falling 16 percent in the 3 months to November. Though press reports of the time suggested significant disruption to supply chains in specific sectors from flooding in Thailand, such impacts are just becoming apparent at the aggregate level. Over the course

Figure EAP.2 Recent weakness in ASEAN sets moderate downtrend for GDP growth



Source: Haver Analytics, China NBS, World Bank.

Figure EAP.3 Export volumes hit by Tohoku and sluggish OECD demand



Source: World Bank.

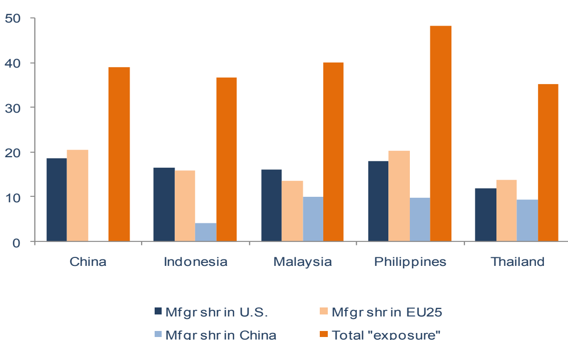
of 2012 these connections will likely be reset as infrastructure repairs are completed in Thailand.

Despite the erstwhile continued growth of regional exports (excluding China), exporters in the Philippines, Malaysia, Indonesia and Thailand and Vietnam are vulnerable to slowing import demand growth in OECD economies. For example, 48 percent of the Philippines' exports are destined to three markets: Europe (20%), the United States (18%) and China (10%), the latter in part representing demand from production chains serving Europe and the United States (figure EAP.4). Already, external demand for manufactures has weakened significantly (the dollar value of imports of the United States, the Euro Area and China declined 10 percent in the third quarter, saar) (figure EAP.5). A "China effect" in trade is also of concern for its regional partners: a slowdown China's import demand could be grounded in a quicker-than-expected slowdown in China's domestic demand or a falloff in orders from China's production chains due to slower high-income country demand. These developments could constitute a "double hit" on shipments from a number of East Asia region manufacturing export-intensive economies.

Volatile capital flows and exchange rate movements. During 2010, private and public capital inflows into developing East Asia jumped from their depressed $235 billion level of 2009 to $448 billion, with virtually all flows rising, particularly trade and other short term credits (one-year or less). Gross equity flows in the form of initial public offerings were robust during the year (table EAP.3). Although capital inflows were relatively stable year on year in 2011, this masks a pattern of unusually strong inflows during the first half– and sharply weaker inflows in the second half of the year. In particular, regional equity and bond markets soured markedly after August, reflecting increases in global risk aversion following the downgrading of U.S. sovereign debt and renewed concerns about European fiscal sustainability. Chinese equity markets—after modest gains from the start of the year through May — plummeted 25 percent from July to December, before recouping 5 percent into the New Year on somewhat more muted pessimism on European developments (figure EAP.6).

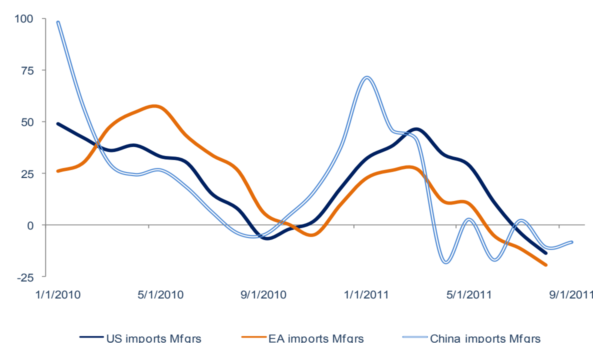
Fortunately, most countries in the region do not have significant external financing needs for 2012 (mainly due to current account surpluses or relatively small deficits). The sum of short- and long-term debt coming due plus expected current account deficits represent a relatively modest 3.4 percent of regional GDP in 2012, with a high of 4.2 percent for Malaysia (where reserves would be more-than sufficient to cover financing requirements). Reserve levels are exceptionally high across East Asian middle income countries, ranging from 8.2 months of imports in Indonesia to 23 months in China. As a result, the region

Figure EAP.4 Exposures in manufactures exports are high



Source: World Bank WITS- Comtrade Database.

Figure EAP.5 East Asia & Pacific export markets show declining trends, auguring poorly for rapid trade recovery

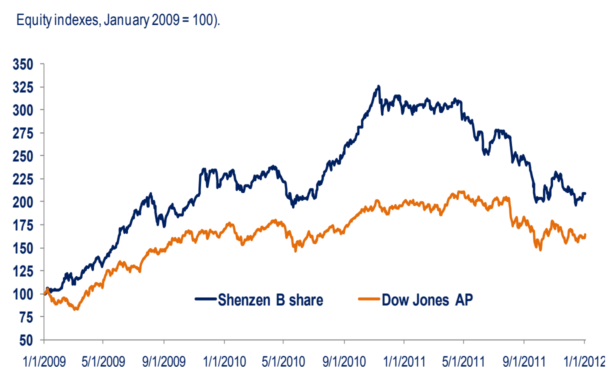


Source: National Agencies through Thomson/Reuters Datastream.

would not be particularly vulnerable should external finance begin to dry-up in 2012 or 2013. Again, lower-income and island economies may be in a different position, as external financing needs remain high and reserves to finance deficits are more limited.

In September 2011 a spurt of capital flight toward "safe haven" assets in the United States tied to the unfolding events in Europe, caused the currencies of a number of developing countries to depreciate vis-à-vis the dollar. In general, East Asian declines were modest compared with those of other large middle-income countries such as South Africa (the rand fell 22 percent against the dollar) and Brazil (the real dropped 18 percent). For East Asia, only the Indonesia rupiah and the Malaysian ringgit came under moderate pressure, falling 5.8 and 5.4 percent respectively during the second half of the year (figure EAP.7).

Figure EAP.6 Equity markets turned down in 2011, with evidence of some recovery in January



Source: Thomson/Reuters Datastream.

Easing inflation is now the watchword in East Asia. Inflation problems in the region have moderated substantially reflecting stable and even falling food and fuel prices, the modest slowing of the regional economy and policy measures taken to rein in CPI gains. For China, the ASEAN countries and others in the region, underlying momentum in headline CPI is now diminishing: China to 2.8 percent over the three months to November (saar); for countries excluding China to 4 percent. The increase in the East Asian CPI reached a recent peak of 8 percent in January 2011 under increasing food and fuel price pressures, as well as still strong

Table EAP.3 Net capital flows to East Asia and the Pacific

Net capital flows to EAP
$ billions

	2004	2005	2006	2007	2008	2009	2010	2011e	2012f	2013f
Current account balance	83.5	143.2	271.0	399.9	438.5	361.8	352.6	268.8	261.6	262.7
as % of GDP	3.2	4.7	7.4	8.7	7.5	5.8	4.8	3.1	2.6	2.3
Financial flows:										
Net private and official inflows	**127.0**	**209.0**	**238.6**	**301.3**	**209.4**	**235.3**	**448.2**	**411.6**		
Net private inflows (equity+private d	**132.2**	**212.3**	**247.9**	**304.7**	**210.4**	**231.7**	**444.8**	**408.1**	**350.4**	**426.2**
..Net private inflows (% GDP)	5.0	7.0	6.8	6.6	3.6	3.7	6.0	4.7	3.4	3.7
Net equity inflows	89.7	168.1	207.9	234.0	206.8	166.3	268.2	264.2	258.4	285.2
..Net FDI inflows	70.4	142.4	151.7	198.9	214.1	137.5	227.7	243.7	234.8	258.7
..Net portfolio equity inflows	19.3	25.7	56.2	35.1	-7.3	28.9	40.5	20.5	23.6	26.5
Net debt flows	37.3	40.9	30.7	67.3	2.6	69.0	180.0	147.4		
..Official creditors	-5.2	-3.3	-9.3	-3.4	-1.0	3.7	3.4	3.5		
....World Bank	-1.9	-0.6	-0.4	-0.3	1.2	2.2	2.7	1.2		
....IMF	-1.6	-1.6	-8.5	0.0	0.0	0.1	0.0	0.0		
....Other official	-1.7	-1.1	-0.4	-3.1	-2.1	1.3	0.8	2.3		
..Private creditors	42.5	44.2	40.0	70.7	3.6	65.3	176.6	143.9	92.0	141.0
....Net M-L term debt flows	9.1	9.3	14.9	18.7	15.0	1.9	35.1	43.9		
......Bonds	9.6	10.1	4.0	1.2	1.2	8.4	20.8	33.8		
......Banks	1.7	1.6	12.2	17.8	16.1	-6.6	13.1	10.0		
......Other private	-2.1	-2.3	-1.3	-0.3	-2.3	0.0	1.1	0.1		
....Net short-term debt flows	33.4	34.8	25.1	52.1	-11.4	63.5	141.5	100.0		
Balancing item /a	26.6	-134.5	-214.1	-160.0	-215.7	-62.2	-249.8	-270.2		
Change in reserves (- = increase)	-237.1	-217.7	-295.4	-541.2	-432.2	-535.0	-551.0	-410.2		
Memorandum items										
Migrant remittances /b	38.5	48.8	55.9	71.5	84.9	85.3	94.0	101.1	108.5	117.2

Source: The World Bank

Note:

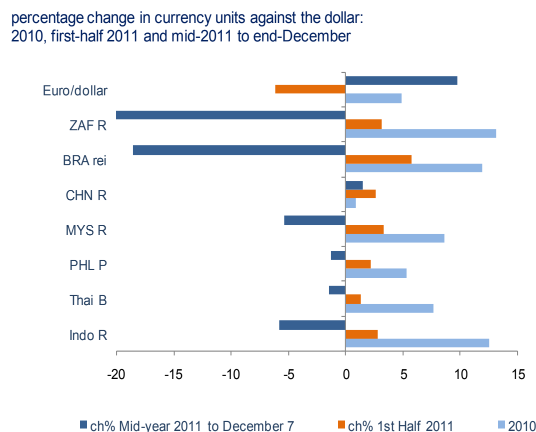
e = estimate, f = forecast

/a Combination of errors and omissions and transfers to and capital outflows from developing countries.

/b Migrant remittances are defined as the sum of workers' remittances, compensation of employees, and migrant transfers

Source: World Bank.

Figure EAP.7 Capital outflows are affecting several Brics fex-rates and reserves-- EAP largely spared



Source: World Bank.

domestic demand, and is now running at a rate below 3 percent thanks to developments in China. With economic activity now anticipated to continue fairly strong, accompanied by lower commodity prices, we may expect a continuing softening trend in inflation through 2012 at a minimum.

Partly reflecting diminished inflationary pressures, but also slowing growth–notably in China—monetary policy in the region has begun to ease. Since August 2011, policy rates have been cut 75 basis points in Indonesia; they had been raised 25 basis points in Thailand prior to the flooding, then reduced once more[2], while Malaysia and the Philippines have kept policy rates stable since a second-quarter increase. In China, the PBOC reduced the reserve requirement ratio by 50 basis points on November 30, the first time the central bank has moved to ease credit supply since 2009. But overall policy remains fairly tight, mainly because inflation rates have declined by more than policy interest rates – implying rising real interest rates— and the potential for additional rate reductions if desired.

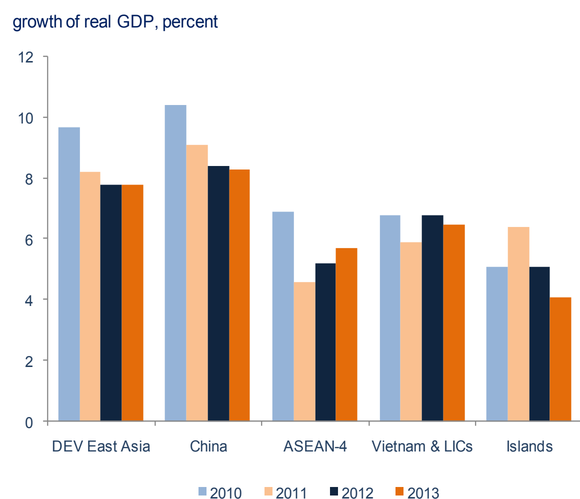
Fiscal policy in the region loosened significantly with the global recession of 2008/9. The region's overall government deficit widened by 3.6 percent of GDP between 2007 and 2009 for both cyclical and policy reasons. The Institute of International Finance estimates that fiscal measures in China could have amounted to as much as 12.5 percent of that country's GDP over two years, though its recorded deficit increased by only 3 percentage points from a surplus of 0.9 percent of GDP in 2007 to deficit of 2.1 percent in 2009.[3] Since then a combination of stronger growth and normalization of fiscal policy has seen China's deficit decline to an estimated 1.7 percent of GDP in 2011, with most of that improvement (1.5 percentage points according to World Bank estimates) the result of better cyclical conditions.

For the remainder of the region the decline and subsequent rebound in public deficits was less pronounced, with the government balance deteriorating 2.6 percentage points of GDP between 2007 and 2009 and recovering 0.8 percentage points since, to come to a deficit of 2.6 percent in 2011. Fiscal shortfalls differ substantially across countries across the year, from 5.5 percent of GDP in Malaysia to 1.6 percent in Indonesia. Most middle income countries carry some fiscal space for a relaxation of policy (assuming financing is forthcoming—or sufficient international reserves are available for backup), though on average they have 1.5 percentage points less available compared with 2007.

Medium-term outlook

Despite the increasingly cloudy global environment, growth in the East Asia and Pacific region is projected to slow by only 0.4 percentage points to 7.8 percent in 2012 (under base case assumptions) and stabilizes at 7.8 percent for 2013 as well, as the effects of a modest easing in China's growth is counterbalanced by a pickup in GDP gains in the remainder of the region, to yield 7.8 percent growth for 2013 (figure EAP.8). The slowdown of 2012 reflects an expected continuation of strong domestic demand (already in some evidence in third-quarter 2011 GDP data and high-frequency indicators), as export growth is anticipated to slow by almost 2 percentage points due to turmoil in Europe and sluggish

Figure EAP.8 Baseline view for moderate decline



Source: World Bank.

OECD demand, contributing nil to overall regional growth (see table EAP.1, earlier).[4]

In China, the lagged effects of monetary policy tightening (both in terms of interest rates and regulatory adjustment) are expected to combine with weak external demand to slow GDP growth from 9.1 percent in 2011 to 8.3 percent by 2013. The bulk of activity is expected to come from domestic demand—with private consumption and fixed investment contributing 3-and-4 percentage points to GDP in 2012—while net exports afford only a modest 0.2 point addition to growth. Inflation is anticipated to decline; and monetary policy relaxation could be in the cards during 2012. Key domestic risks for China are the property sector, local government borrowing, and bank balance sheets; but the baseline scenario envisages that policy will focus closely on these aspects, with efforts sufficient to stem systemic effects on the economy.

Prospects for the ASEAN-4 countries are mixed, but in a "baseline view" are likely to achieve a pick-up in growth despite the 2012 global slowdown. Following a sharp deceleration from 6.9 percent to 4.6 percent gains for the group in 2011, softening export volumes and mixed terms-of-trade movements are anticipated to be offset by the strong momentum of domestic demand for a number of countries, to produce a fillip to GDP gains in 2012. Growth in Malaysia is likely to sustain rates near 5 percent over the coming two years, as recent upward revisions to GDP complement a view for strong domestic demand grounded in government consumption and a substantial pickup in public investment. Indonesia is expected to see growth ease from 6.4 percent in 2011- to a still very strong 6.2 percent in 2012- before picking up to 6.5 percent by 2013, with domestic demand the prime mover for GDP.

Both Thailand and the Philippines may be able to avert a slowing of GDP in 2012. In the former, reconstruction spending to repair the extensive damage from flooding may provide a boost to output growth in 2012; while in the latter economy the continued strength of remittance inflows and renewed public spending is projected to boost growth to 4.2 percent from 3.7 percent in 2011. That the tenor of domestic demand in most countries will remain resilient may be attributable to policy decisions regarding monetary accommodation (now coming on stream) and fiscal support (potentially forthcoming). On balance, GDP gains of 4.6 percent registered in 2011 for the ASEAN-4 are anticipated to be followed by advances of 5.2 and 5.7 percent through 2013.

Growth in low-income Cambodia together with lower-middle income Vietnam and Laos PDR, slowed from 6.8 percent in 2010 to 5.9 percent in 2011. Looking forward, growth in Vietnam and Cambodia is projected to strengthen somewhat further during 2012 and 2013 due to the ability to utilize hydrocarbon windfalls to sustain spending in the former, and improved macroeconomic stability in the latter, while a lack of strong financial linkages should mute that transmission channel from the disturbance among high-income countries for both. Vietnam's fiscal stance remains accommodative, though tightening of monetary policy to stem high inflation is helping to reduce the country's macroeconomic instability gradually. Vietnam's exports have expanded at double digit rates for some time, though this is likely to give way for all economies in the group over 2012-13. GDP for the group is anticipated to achieve a robust

6.8 percent pace in 2012 (in part due to new large-scale mining and hydropower operations coming on stream in Lao PDR), before easing to 6.5 percent in 2013. Current account deficits remain at high levels, however, given the heavy import content of manufactures exports, while fiscal deficits are a continuing concern.

Risks and vulnerabilities

For the majority of middle income countries in East Asia, the health of the global economy and high-income Europe in particular, represents the key risk at this time. An acute financial crisis in Europe could reduce East Asian GDP gains in 2012 substantially compared to 7.8 percent growth in the baseline depending on the severity of the crisis – reflecting trade effects, potential terms of trade changes, a drying up of international capital and increases in regional precautionary saving by firms and households (see main text for description of a potential low case scenario).

Trade. Despite global recession in 2009, exports of developing East Asia to the world amounted to $1.8 trillion, representing 30 percent of regional GDP. Of that total, trade within the geographic region has advanced to $840 billion on growth of almost 50 percent over the last decade. Just as international and intra-region trade has proved a powerful engine of growth for a good number of East Asian countries, so can the intricate trade links among economies in the region, and generalized exposures to conditions in final destination markets serve as fairly powerful means of transmission of adverse trade effects to- and within East Asia (see figures EAP.4 and EAP.5, earlier, and table EAP.4).

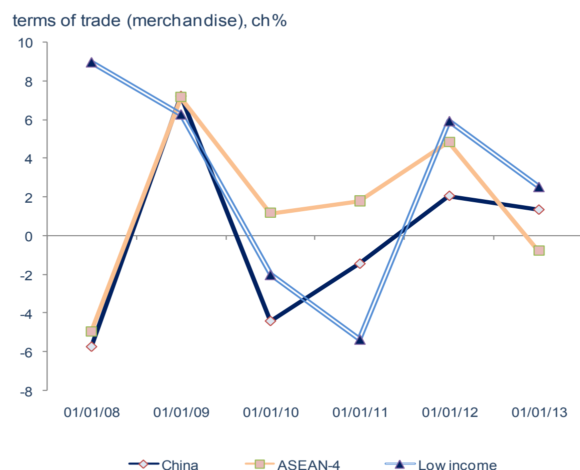
Model simulations[5] for the base case scenario suggest that a fall of GDP growth in the euro-zone from 0.5 percent postulated for 2012 to zero would be sufficient to reduce East Asia's export volume growth by 2-tenths of a percentage point in the year—and broadly (dependent on export shares in GDP), cut economic growth by 1-to-2 tenths of a percentage point. Slower OECD demand echoes quickly through East Asian production and trade networks, such that a larger number of middle income countries are affected. And under an assumption of an acute European crisis, "second-round" trade effects could take an additional toll on trade growth as more countries globally experience depressed growth and dampened imports.

Terms of trade developments can have a powerful influence on trade positions, on the purchasing power of export revenues (income gains/losses for the population) and on fiscal balances. East Asia represents a highly mixed set of countries in terms of oil and natural gas exporters (Indonesia, Malaysia and Vietnam), oil importers, and countries whose export baskets reflect a complex mix of commodities and manufactures (electronic components, auto parts and finished goods of all kinds) which include China, Indonesia, Malaysia, Indonesia and Thailand. Other countries are more dependent on a single commodity (e.g. Papua New Guinea, copper).

For the developing region as a whole, the food and energy price spikes of 2010-2011 carried negative terms of trade effects on balance, with the index dropping 1.9-and-0.6 percent respectively. Under baseline conditions, terms of trade should be moving positively for the region over 2012-2013 (plus 2.2 and 0.5 percent respectively), notably for China, the low income countries, as well as several middle income ASEAN-4 economies (figure EAP.9).

East Asia is well prepared for yet another potential bought of *strong capital inflows*, should international investors in search of yield (returns in the high single digits in local currency vis-à-vis low single digits in the high-income financial markets) turn once more to emerging markets. Reserve levels are high, interest rates are starting to be reduced; growth is likely to slow moderately and fiscal space is abundant in the middle income countries of the region. Exchange rates have—on average—weakened slightly against the greenback, but strengthened appreciably versus the euro, which may create a "win-win" situation for equity and bond flows toward East Asia, with expectations of returns

Figure EAP.9 Terms of trade move with East Asia in 2012 before relapse



Source: World Bank.

plus capital gains on the exchange rate transaction to boost overall income receipts.

The potential for a ramp-up in capital flows under emerging global conditions has increased, exposing those East Asian countries, notably, China, Indonesia, Malaysia and Thailand to the possibility of market disruption and exchange rate volatility. Reserves will serve to provide some underpinning to economies, but under worse-case scenarios, those countries which experience large amounts of capital inflow will be more vulnerable to these "stop-go" effects. These could occur under the base case, as financial workouts in Europe and the United States get underway; but could be much amplified under a low case scenario.

Consumer and business confidence appears to be holding up well, suggesting that a spate of precautionary savings behavior on the part of households and firms may not characterize conditions in East Asia in the current world conjuncture. Only under a serious crisis scenario might these effects take a meaningful toll on economic activity.

Finally, the region itself is exposed to the sort of economic landing that will characterize China's future in its efforts to quell growth in select segments of its economy- and to follow-on effects passing to the remainder of the region. Expansionary policies that supported strong growth during the "great recession" also fed a real estate boom in China. And rapid credit growth may have weakened the portfolio quality of the banking system. Attempts to cool parts of the economy were successful; monetary policy and regulations were notched up earlier, and growth in formal bank lending was tightened. However, because real estate is often used as collateral or as an investment, it is a growing risk for the banking system and for informal creditors. Should conditions worsen, the government has ample policy space, especially now that inflation appears to be on the wane. While further adjustments in property markets present a downside risk, the prospects for a soft landing for China remain high.

Policy. Although government deficits in the region have deteriorated relative to their pre-crisis levels of 2007, there remains scope for a pro-active policy response in a number of middle income countries–assuming financing is forthcoming, an important element in defining the range of operations feasible. Monetary policy may have some leeway as well to become more accommodative as inflation eases and real interest rates rise, opening the potential for lower policy interest rates—already in train in several countries.

To the extent that external finance becomes very tight, countries would have to rely on domestic sources – which are less likely to be available in the low-income and island nation groups where domestic capital markets remain underdeveloped and reserve levels may be inadequate to cover additional financing requirements.

For the longer term, however, under the premise that growth in the OECD economies slips from average rates of 2.7 percent of the last decade to 2-2.25 percent (particularly given the need to improve fiscal sustainability), there may be a set of policies worthwhile for authorities in East Asia to consider. These might include means to keep domestic demand advancing at a sustainable, non-inflationary pace, to replace some of the impetus to growth lost to weaker

OECD demand. And here lies longer-term efforts at improving education and human capital, and the productivity of investment. Moreover, a strengthening of social welfare nets and reforms of their distributional characteristics could help to support domestic demand more fully during times of economic downturn. Though such policies have been in progress for many years, in several some cases, the current episode of slower growth may provide an auspicious time to implement these with more vigor.

Table EAP.4 East Asia and the Pacific country forecasts

(annual percent change unless indicated otherwise)	98-07 [a]	2008	2009	Est. 2010	Forecast 2011	2012	2013
Cambodia							
GDP at market prices (2005 US$) [b]	8.8	6.7	0.1	6.0	6.0	6.5	6.5
Current account bal/GDP (%)	-4.2	-10.2	-9.8	-10.4	-12.7	-11.5	-10.4
China							
GDP at market prices (2005 US$) [b]	9.1	9.6	9.2	10.4	9.1	8.4	8.3
Current account bal/GDP (%)	4.1	9.1	6.0	5.2	3.5	3.0	2.6
Indonesia							
GDP at market prices (2005 US$) [b]	4.1	6.0	4.6	6.1	6.4	6.2	6.5
Current account bal/GDP (%)	3.1	0.0	2.0	1.1	0.4	-0.2	-0.5
Lao PDR							
GDP at market prices (2005 US$) [b]	6.4	7.6	7.5	8.6	7.9	7.5	7.4
Current account bal/GDP (%)	-10.6	-18.7	-12.2	-9.1	-14.0	-16.2	-18.6
Malaysia							
GDP at market prices (2005 US$) [b]	5.1	4.7	-1.6	7.2	4.8	4.9	5.3
Current account bal/GDP (%)	12.5	17.5	16.7	10.1	9.7	9.0	8.5
Mongolia							
GDP at market prices (2005 US$) [b]	6.4	8.9	-1.3	6.4	14.9	15.1	15.0
Current account bal/GDP (%)	-2.9	-12.9	-9.0	-5.8	-15.1	-13.6	-14.0
Papua New Guinea							
GDP at market prices (2005 US$) [b]	1.7	6.7	5.5	7.6	9.0	7.0	5.0
Current account bal/GDP (%)	3.3	8.8	-8.8	-0.4	-24.0	-18.0	-18.8
Philippines							
GDP at market prices (2005 US$) [b]	4.2	4.2	1.1	7.6	3.7	4.2	5.0
Current account bal/GDP (%)	0.6	2.1	5.6	4.2	2.0	2.3	2.0
Thailand							
GDP at market prices (2005 US$) [b]	4.5	2.5	-2.3	7.8	2.0	4.2	4.9
Current account bal/GDP (%)	4.7	0.8	8.3	4.6	0.7	-0.7	1.3
Vanuatu							
GDP at market prices (2005 US$) [b]	2.5	6.3	3.5	3.0	3.9	4.0	4.2
Current account bal/GDP (%)	-9.3	-9.0	-8.6	-7.6	-6.7	-6.9	-7.4
Vietnam							
GDP at market prices (2005 US$) [b]	6.6	6.3	5.3	6.8	5.8	6.8	6.5
Current account bal/GDP (%)	-8.6	-18.4	-6.6	-3.9	-4.9	-3.5	-3.5

World Bank forecasts are frequently updated based on new information and changing (global) circumstances. Consequently, projections presented here may differ from those contained in other Bank documents, even if basic assessments of countries' prospects do not significantly differ at any given moment in time.

Samoa; Tuvalu; Kiribati; Korea, Democratic People's Republic; Marshall Islands; Micronesia, Federate States; Mongolia: Myanmar; N. Mariana Islands; Palau; Solomon Islands; Timor-Leste; and Tonga are not forecast owing to data limitations.

a. Growth rates over intervals are compound average; growth contributions, ratios and the GDP deflator are averages.

b. GDP measured in constant 2005 U.S. dollars.

c. Estimate.

d. Forecast.

Source: World Bank.

Notes:

1. The developing East Asia region presented in the projections (countries with sufficient economic data for compilation of a small econometric model) include: China (mainland); the larger ASEAN members: Indonesia, Malaysia, Philippines and Thailand; Cambodia (low-income country), and lower middle income economies Vietnam and Lao PDR; and a subset of smaller island economies: Fiji and Papua New Guinea are also part of the model system. Several high-income countries are projected as part of the "geographic region", (not the headline "developing East Asia" region) including Hong Kong SAR, China; the Republic of Korea, Singapore and Taiwan, China.

2. Thailand's policy rate was raised by 25 basis points on August 24—but in the wake of the serious flooding throughout most of the country, the rate hike was rescinded on October 24 in a move to stimulate the economy and lower costs for construction financing.

3. "Global Economic Monitor". November 22, 2011. The Institute of International Finance Inc. Washington DC.

4. For the developing region, the contribution of net exports continues to be a drag on growth from 2011 through 2012, before reviving to a 0.6 point fillip to GDP.

5. World Bank, Development Economics, Prospects Group, iSIM modeling system, December 2011.

Europe and Central Asia Region

GDP growth in developing Europe and Central Asia remained stable at 5.3 percent in 2011 despite the disruptive effects of the turmoil in global financial markets since August 2011 and weakening external demand, especially from the Euro area (box ECA.1). The disruptions and global slowdown caused by the Tohoku disaster in Japan caused second quarter GDP to slow. In the third quarter, however, robust domestic demand led to strong growth in several middle-income countries—Russia, Romania and Turkey.

Nevertheless, a projected recession in high-income Europe, still troublesome inflationary pressures in the region and reduced capital inflows due to the deepening Euro Area debt crisis are projected to slow regional GDP to 3.2 percent in 2012, before a modest recovery begins in 2013 with growth of 4 percent (table ECA.1). These aggregate figures hide significant variations across countries within the region. While resource-rich economies benefit from still high commodity prices, other countries have been more adversely affected by the turmoil in high-income Europe (figure ECA.1).

There are considerable downside risks to the region's economic outlook. The baseline forecast presented here assumes that efforts to-date and those that may follow prevent the sovereign-debt stress of the past months in Europe from deteriorating further, but fail to completely eradicate market concerns. Several countries in the region are particularly reliant on high-income European banks and are vulnerable to a sharp reduction in wholesale funding and domestic bank activity. Deleveraging of banks in high-income countries could result in a forced sell-off of foreign subsidiaries, and affect valuations of foreign and domestically owned banks in countries with large foreign presence. And slower growth and deteriorating asset prices could rapidly increase non-performing loans (NPLs) throughout the region.

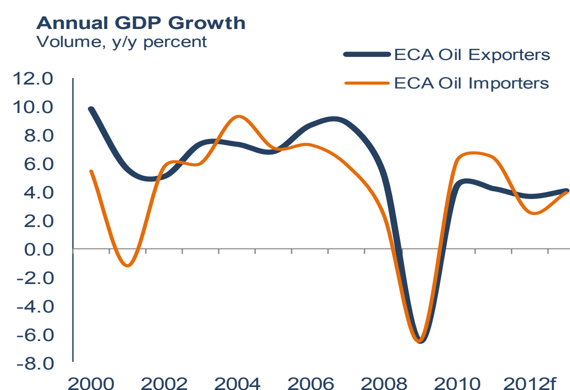
Box ECA.1 Country coverage

For the purpose of this note, the Europe and Central Asia region includes 21 developing countries with less than $12,276 GNI per capita in 2010. These countries are listed in the Table ECA.5 at the end of this note. This classification excludes Croatia, the Czech Republic, Estonia, Hungary, Poland, Slovakia, and Slovenia. The list of countries for the region may differ from those contained in other World Bank documents.

Should conditions in global financial market deteriorate and crisis in the Euro Area deepen, as highlighted in the risk section of this annex, several Central European countries will be particularly affected through financial and trade linkages. Commodity exporters in the region could also run into difficulties if deterioration in the global situation results in a major decline in commodity prices.

Based on simulations highlighted in the main text (see box 4 in the main text for details), the real-side consequences of a much deeper crisis might be significant for the region. A scenario which assumes that one or two small Euro zone economies face a serious credit squeeze may reduce the growth in the developing Europe and Central Asia by 1.9 percent in 2012 and 2.2 percent in 2013. The impact might reach as high as 5.4 percent for 2012 and 6.6 percent for 2013 if the freezing up of credit spreads to two larger Euro Zone economies.

Figure ECA.1 Significant variation across countries within the region



Source: World Bank.

Recent developments

Third quarter growth was strong in large middle income countries…

Economic growth in several countries in the Europe and Central Asia region remained robust in the third quarter of 2011, as favorable domestic factors offset the weakening external environment. Domestic consumption was strong in the third quarter in Lithuania, Ukraine, Russia, and to a lesser degree in Latvia and Romania (figure ECA.2). Robust domestic demand also supported growth in Turkey that remained high even after declining from its first quarter level. A bumper harvest contributed to strong economic performance in Romania, Ukraine, and Russia in the third quarter. Bulgaria and Serbia, on the other hand, continued to suffer from weak consumption and investment.

Industrial production has rebounded since September...

Industrial production (IP) in developing Europe and Central Asia expanded at close to a 20 percent annualized rate (3m/3m saar) early in the year, but weakened sharply beginning in the second quarter and declined during much of the third quarter. The contraction was reversed since September, and the region's IP growth reached

Figure ECA.2 Mixed economic performance in the third quarter

Source: World Bank.

Table ECA.1 Europe and Central Asia forecast summary

(annual percent change unless indicated otherwise)

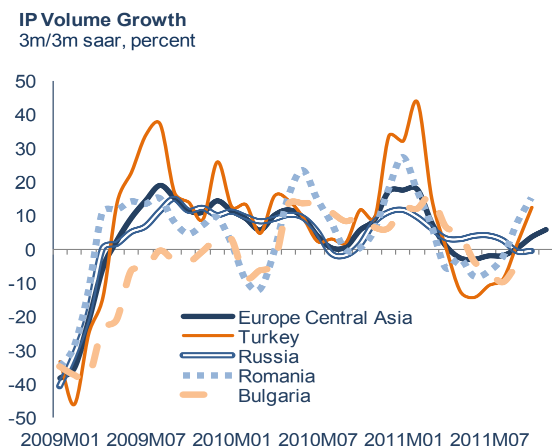
	98-07[a]	2007	2008	2009	2010	Est. 2011	Forecast 2012	Forecast 2013
GDP at market prices (2005 US$) b	5.4	7.5	3.9	-6.5	5.2	5.3	3.2	4.0
GDP per capita (units in US$)	5.4	7.4	3.9	-6.6	5.2	5.2	3.1	3.9
PPP GDP c	5.6	7.8	4.3	-6.6	5.0	5.0	3.3	4.0
Private consumption	6.3	10.8	6.6	-6.3	7.1	7.7	5.0	5.3
Public consumption	2.5	4.2	3.3	2.3	0.6	2.3	2.4	2.0
Fixed investment	8.8	15.4	6.0	-18.0	3.5	7.9	3.5	4.3
Exports, GNFS d	7.2	7.5	3.1	-7.1	5.9	6.7	4.4	6.2
Imports, GNFS d	10.1	19.6	8.3	-23.9	12.7	9.9	6.7	7.6
Net exports, contribution to growth	-0.3	-3.7	-1.9	6.5	-1.9	-0.9	-0.8	-0.5
Current account bal/GDP (%)	2.4	-0.7	0.4	0.8	0.8	0.6	-0.4	-0.7
GDP deflator (median, LCU)	10.0	12.5	13.2	2.2	9.5	6.7	6.2	5.0
Fiscal balance/GDP (%)	-2.1	2.9	1.1	-5.9	-4.0	-1.4	-2.2	-2.1
Memo items: GDP								
Transition countries e	6.2	8.6	5.2	-7.2	3.7	4.1	3.5	4.3
Central and Eastern Europe f	4.7	7.1	5.3	-8.1	-0.4	2.7	1.8	3.2
Commonwealth of Independent States g	6.5	8.9	5.2	-7.0	4.5	4.3	3.5	4.1
Russia	6.3	8.5	5.2	-7.8	4.0	4.1	3.5	3.9
Turkey	3.7	4.7	0.7	-4.8	9.0	8.2	2.9	4.2
Romania	4.3	6.3	7.3	-7.1	-1.3	2.2	1.5	3.0

Source: World Bank.
a. Growth rates over intervals are compound average; growth contributions, ratios and the GDP deflator are averages.
b. GDP measured in constant 2005 U.S. dollars.
c. GDP measured at PPP exchange rates.
d. Exports and imports of goods and non-factor services (GNFS).
e. Transition countries: f + g below.
f. Central and Eastern Europe: Albania, Bosnia and Herzegovina, Bulgaria, Georgia, Kosovo, Lithuania, Macedonia, FYR, Montenegro, Romania, Serbia.
g. Commonwealth of Independent States: Armenia, Azerbaijan, Belarus, Kazakhstan, Kyrgyz Republic, Moldovia, Russian Federation, Tajikistan, Turkmenistan, Ukraine, Uzbekistan.
h. Estimate.
i. Forecast.

Source: World Bank.

to a 5.9 percent annualized rate during the three months ending November 2011. Industrial activity at the country level has been mixed. After the sharp contraction in earlier months reflecting both a global slowing and a sharp slowdown in domestic spending, industrial production growth rebounded strongly in Romania, Ukraine, and Turkey in October. In contrast, industrial production in Russia (50 percent of regional GDP) slowed down despite persistently high oil prices, and it has contracted in Bulgaria since May (figure ECA.3).

Figure ECA.3 IP growth has rebounded in October



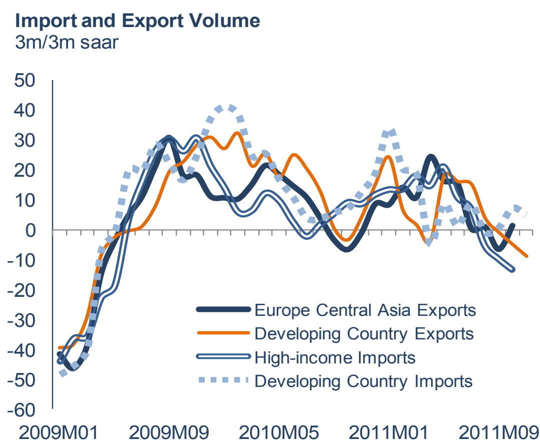
Source: World Bank.

...after being depressed by the sharp fall in export growth since the first quarter.

After strong growth in the first half of the year, export growth slowed during the second quarter and then contracted at a 6.7 percent annualized pace during the third quarter. The decline in export growth was reversed in October to 1.1 percent annualized rate supported by strong export growth in Turkey and Romania. Other countries continue to suffer from a loss of momentum, with the sharpest slowdowns experienced by Russia and Ukraine.

Activity in the region is being affected by the anemic growth in high-income Europe—where economies grew almost zero percent in 2011 (figure ECA.4). High-income European import demand declined at a 13 percent annualized rate during the three months ending November 2011. In 2008-10 these countries accounted for more than 50 percent of the region's exports. Romania, Lithuania, Latvia, FYR Macedonia, and Bulgaria are particularly dependent on demand from high-income Europe, while more distant countries are less so. The October rebound in exports was likely supported by the robust import demand from developing countries that grew at 7 percent annualized during the three months ending October 2011.

Figure ECA.4 The regions' export growth fell in tandem with the slow-down in world trade



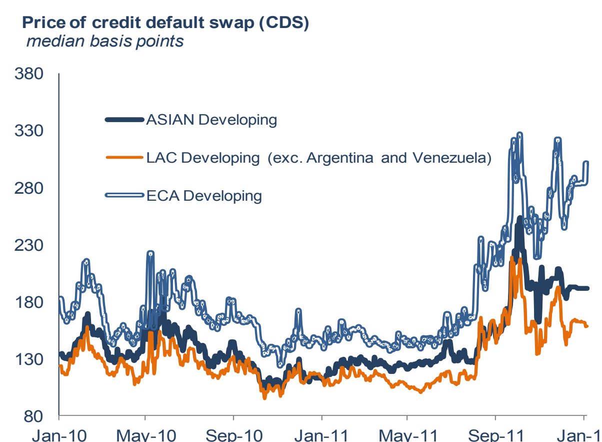
Source: World Bank.

Signs of contagion from the European debt crisis have appeared...

A sharp decline in risk appetite triggered by the Euro Area debt crisis has led to an abrupt decline in capital inflows (particularly in portfolio investment flows), a jump in risk premia and a collapse in stock prices in developing countries since August (See the Main Text and Finance Annex for further discussion). The widening in risk premia for Europe and Central Asia—proxied by median CDS spreads—was the highest among developing countries (figure ECA.5). The largest jumps in the spreads since July were in Ukraine, Romania, Bulgaria and Kazakhstan, which are particularly vulnerable to a possible downturn (see the risk section of this annex). Political uncertainty ahead of parliamentary or presidential elections also seem to have played a role in some countries.

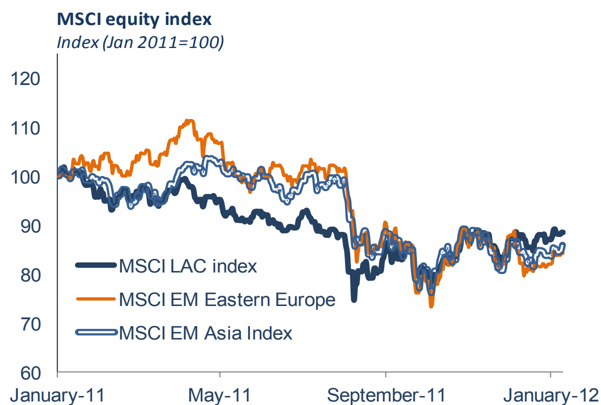
Increased risk aversion also led to significant sell -offs from developing country equity markets. Emerging market MSCI stock index lost 12 percent since July (figure ECA.6). Stock market declines were steepest in Eastern Europe, down around 20 percent since July, with Ukraine, Serbia, Bulgaria and Lithuania experiencing the sharpest falloffs. Portfolio investment flows to Turkey registered net outflows of $4.7 billion in August and September. Russia also experienced large capital outflows despite high oil prices.

Figure ECA.5 Largest increase in risk premia was in Eastern Europe and Central Asia



Source: Datastream.

Figure ECA.6 Sharp reversal in emerging countries equity markets



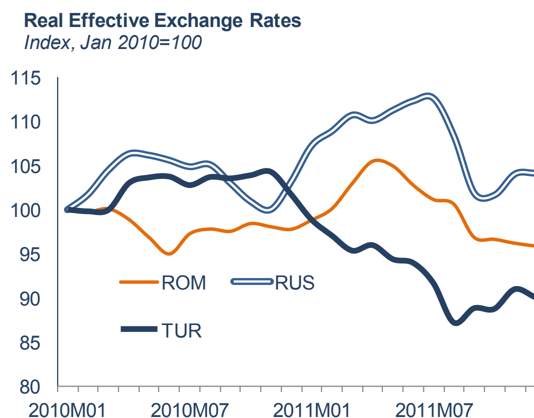
Source: Bloomberg.

Exchange rates have weakened sharply in several countries.

Several countries' dollar exchange rates weakened sharply in 2011 (figure ECA.7). Depreciation was gradual until July, and then accelerated sharply during September and October as portfolio equity inflows reversed. The currencies gained some of their lost values in October but have continued their depreciation since November. The value of the Turkish lira declined more than 15 percent against dollar between June and early January 2012, prompting the authorities to use foreign exchange reserves to the tune of $10 billion to defend the currency.

Despite high oil prices and a current account surplus, the Russian ruble has dropped by more than 10 percent against its $0.55/€0.45 basket since July. The depreciation came on the heels of large outflows from equity markets, large repayments of foreign debt that Russian borrowers were unable to refinance, and a sharp acceleration in resident lending abroad. Overall, capital outflows are estimated to have reached $80 billion in 2011, partly reflecting political uncertainty ahead of the March presidential elections and growing worries about the adverse and deteriorating business environment. The central bank has allowed the ruble to adjust faster than in past episodes of ruble weakness, limiting exchange market interventions only to smoothing excessive volatility. Under similar

Figure ECA.7 Exchange rates begin to depreciate



Source: Datastream.

pressures, Ukraine had to sell $3.5 billion of FX reserves during September and October to keep the hryvnia to its target peg (UAH 8.0) to the dollar.

Strong fiscal adjustment and prudent monetary policy in Romania have limited the fallout from the shift in market sentiment. The leu has weakened only around 2 percent against the euro since July, partly reflecting the absence of large inflows earlier in the year.

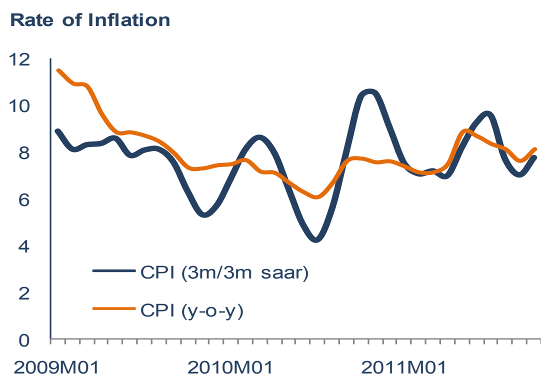
Fiscal and monetary policy: worries shift from inflation to growth

Concerns about the deteriorating global outlook and its potential adverse impact on output growth caused a shift in monetary policies. Earlier this year, reflecting concerns about inflation, a monetary tightening trend was gaining strength in the region, via both increases in interest rates (Belarus and Russia—twice in the case of the latter) and in reserve requirements (Turkey). Starting in August, however, several countries surprised the markets by lowering rates, including Turkey (by 50 bps on August 4th), Serbia (by 50 bps on October 6th), and Romania (by 25 bps on November 2nd). Russia has stopped tightening since May 2011. The central bank of Turkey has also cut reserve requirements on FX liabilities and raised its overnight borrowing rate to attract short-term capital inflows.[1]

After losing momentum in the third quarter reflecting a fall in oil prices from record high levels, year-over-year inflation picked up again in November (figure ECA.8). At 7.6 percent median for the region in November, inflation remains a major concern for more than half of the countries in the region, particularly as sharp currency devaluations and high oil prices may yield further increases.

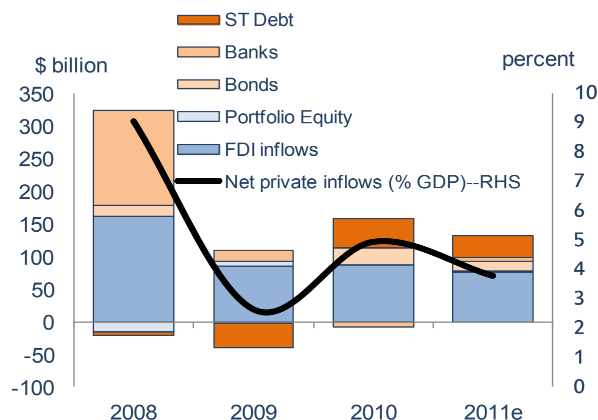
Although budget balances continued to improve in 2011 (with the exception of Azerbaijan—due to increase in non-oil sector deficit, and Kyrgyzstan), there is limited fiscal space to support growth, particularly if commodity prices fall in response to a global slowdown. While the region's cyclically adjusted budget balance improved from –3.5 percent of GDP in 2007 to 0.1 percent in 2011, this was mostly due to improvements in commodity exporters. The increase in commodity prices since 2005 has improved government balances for oil exporting developing countries by an average of 2.5 percent of GDP, among metal exporters the improvement has been of the order of 2.9 percent of GDP. Going forward however if commodity prices were to fall, then fiscal conditions in exporting countries would deteriorate rapidly. Simulations suggest that if commodity prices were to fall as they did in the 2008/09 crisis, fiscal balances in oil exporting countries could deteriorate by more than 5 percent of GDP. Impacts in metals exporting countries could also be large, with some regional impacts exceeding 7 percent of GDP.

Figure ECA.8 Inflationary pressures appears to be easing



Source: World Bank.

Figure ECA.9 International capital flows fell in 2011



Source: World Bank.

Table ECA.2 Net capital flows to Europe and Central Asia

Net capital flows to ECA
$ billions

	2004	2005	2006	2007	2008	2009	2010	2011e	2012f	2013f
Current account balance	36.7	44.9	30.7	-31.2	-5.3	13.4	26.6	23.5	-14.2	-26.6
as % of GDP	2.8	2.9	1.8	-0.5	0.4	0.6	0.8	0.6	-0.4	-0.6
Financial flows:										
Net private and official inflows	**104.1**	**135.3**	**248.9**	**424.1**	**313.0**	**104.0**	**172.8**	**135.0**		
Net private inflows (equity+private debt)	**111.6**	**163.8**	**279.3**	**426.4**	**301.0**	**68.4**	**150.2**	**122.1**	**76.3**	**129.1**
..Net private inflows (% GDP)	8.4	9.7	13.5	15.9	9.1	2.7	5.0	3.6	2.0	2.9
Net equity inflows	44.4	58.6	106.6	163.2	146.9	92.3	85.4	77.1	71.3	112.1
..Net FDI inflows	42.6	52.0	94.3	136.2	162.2	85.9	86.3	76.1	70.5	108.1
..Net portfolio equity inflows	1.8	6.7	12.3	27.0	-15.3	6.4	-0.8	1.0	0.9	4.0
Net debt flows	59.7	76.6	142.2	260.9	166.0	11.7	87.4	57.9	5.0	17.0
..Official creditors	-7.6	-28.5	-30.4	-2.3	12.0	35.7	22.6	12.9		
....World Bank	1.0	-0.7	0.2	0.2	0.7	3.0	3.5	2.1		
....IMF	-5.9	-9.8	-5.8	-5.0	7.0	20.5	9.4	3.8		
....Other official	-2.7	-18.0	-24.8	2.6	4.3	12.2	9.8	7.0		
..Private creditors	67.2	105.1	172.6	263.3	154.1	-23.9	64.7	45.0	5.0	17.0
....Net M-L term debt flows	53.5	84.4	128.4	190.7	160.9	14.6	19.2	11.0		
......Bonds	14.6	16.8	34.0	60.0	16.4	-1.8	27.1	16.0		
......Banks	40.2	68.9	95.2	131.8	145.1	16.8	-7.7	5.0		
......Other private	-1.3	-1.3	-0.8	-1.0	-0.6	-0.4	-0.2	0.0		
....Net short-term debt flows	13.7	20.8	44.3	72.5	-6.9	-38.5	45.5	34.0		
Balancing item /a	-71.4	-92.8	-105.6	-165.4	-365.5	-90.8	-133.2	-115.7		
Change in reserves (- = increase)	-69.3	-87.3	-174.0	-227.5	57.9	-26.6	-66.2	-42.8		
Memorandum items										
Migrant remittances /b	12.7	19.7	24.9	38.7	45.0	36.1	36.0	40.0	43.5	47.9

Source: The World Bank

Note:

e = estimate, f = forecast

/a Combination of errors and omissions and transfers to and capital outflows from developing countries.

/b Migrant remittances are defined as the sum of workers' remittances, compensation of employees, and migrant transfers

Source: World Bank.

Despite strong performance in the first half, net private capital flows declined in 2011

After a strong recovery in 2010, net private capital flows[2] to the region declined to an estimated $122 billion (3.6 percent of GDP) in 2011 from $150.2 billion (5.0 percent of GDP) in 2010 (table ECA.2, figure ECA.9). Almost all types of capital flows have contracted, but the largest decline was in international bond, and short-term debt flows.

Overall, short-term flows for the year as a whole declined despite their strong performance in the first half of the year. This year's fall in short-term debt flows is in sharp contrast with last year's surge, when these flows led the recovery in net capital inflows.

FDI inflows declined by an estimated 10 percent in 2011 despite high inflows in the first half of the year, with significant differences across countries. FDI inflows fell sharply in Bulgaria following large repayments on intra-company loans in the first quarter of the year, and considerably in Ukraine. In contrast, flows to Latvia almost tripled and increased significantly in Kazakhstan and Turkey.

The outlook for 2012 has become more challenging as the world economy has entered a very difficult period. The likelihood that the sovereign debt crisis in Europe deteriorates further resulting in a freezing up of capital markets and a global crisis similar in magnitude to the Lehman crisis remains very real. As discussed in the risk section, the Europe and Central Asia region has very close financial and trade ties with the high-spread Euro Area countries generating uncertainty for the region's economic outlook. Europe is the main source of cross-border bank-lending and other flows such as FDI. Increased risk aversion and banking-sector deleveraging have been cutting into

capital inflows to the region, which are projected to decline further by 40 percent to $76 billion (2.0 percent of GDP) in 2012, with sharp contraction in cross-border debt flows.

Under the assumption that the ongoing turbulence in Europe will be resolved to market's satisfaction by the end of 2012, net capital flows to the region are expected to rebound in 2013 in tandem with the growth in the global economy. Net private capital flows are projected to reach $129 billion in 2013 around 2.9 percent of region's GDP. By 2013, all flows are expected to increase. Bond issuance is expected to level down slightly as bank lending picks up the pace supported by South-South flows.

Migrant Remittances

Migrant remittances are a very importance source of both foreign currency and domestic incomes for several countries in the developing Europe and Central Asia region. Overall, they represent about 1.3 percent of regional GDP, but rise to 10 or more percent of GDP for countries like Albania, Armenia and Bosnia and Herzegovina, and between 20 and 35 percent of GDP for the Kyrgyz Republic, Moldova and Tajikistan.

After falling by almost a quarter between 2008 and 2009, and stagnating in 2010, remittances to the Europe and Central Asia region grew by an estimated 11 percent to $40 billion in 2011 in tandem with the global trend (table ECA.3). The recovery was supported by the increase in remittance outflows from Russia—which contributes almost one-third of remittances to the region (figure ECA.10). Outflows from Russia, mainly to Central Asian countries, have increased with the recovery of oil prices but appear to have become more volatile in the post-crisis period (figure ECA.11).

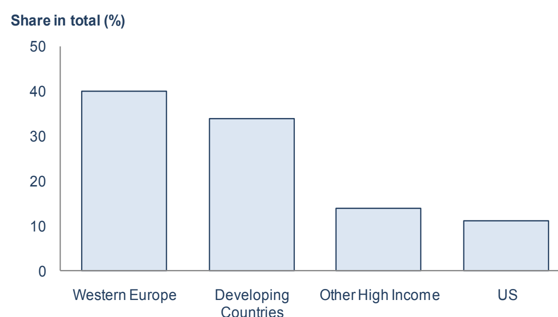
Table ECA.3 Workers' remittances, compensation of employees, and migrant transfers, credit (US$ billion)

	2008	2009	2010	2011e	2012f	2013f	2014f
All developing countries	**324**	**307**	**321**	**351**	**377**	**406**	**441**
Europe and Central Asia	45	36	36	40	44	48	53
Growth rate (%)							
All developing countries	**16.4%**	**-5.3%**	**4.6%**	**9.3%**	**7.4%**	**7.7%**	**8.6%**
Europe and Central Asia	16.3%	-19.8%	0.0%	11.1%	10.0%	9.1%	10.4%

Source: World Bank Migration and Development Brief #17.

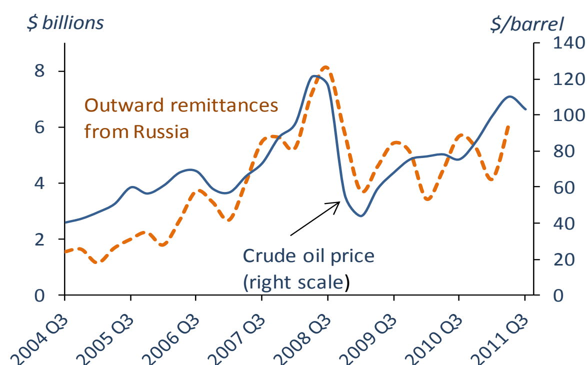
Even though remittances to developing countries grew in 2011, they are vulnerable to uncertain global economic prospects. Remittance flows to the region are expected to grow at a slower pace of 8.8 percent in 2012 to reach $44 billion. However, with global growth expected to resume in 2013, remittances are projected to grow at higher rates of 10.1 percent to reach $48 billion by 2013 (see Migration and Development Brief 17).

Figure ECA.10 Sources of remittances for ECA in 2010



Source: World Bank Migration and Development Brief #17.

Figure ECA.11 Oil prices remain a key driver of remittances to Central Asia



Source: World Bank Migration and Development Brief #17.

These rates of growth are considerably lower than those seen during the 2002-2007 period. This is partly because the ongoing debt crisis in Europe and other high-income OECD countries has been adversely affecting the economic and employment prospects of migrants. Persistently high unemployment rates have also created political pressures to reduce the current levels of immigration, which could depress remittance flows to developing regions. While buoyant oil revenues and increased spending on infrastructure development could make Russia and other destinations even more important for migrants from developing countries, volatile exchange rates and uncertain oil prices present further risks to the outlook.

Medium-term Outlook

GDP growth in Europe and Central Asia is projected to slow to 3.2 percent in 2012 from 5.3 percent in 2011, before firming to 4.0 percent in 2013. Growth rates remain well below the boom-period average of 7.5 percent recorded during 2003-07. While these growth rates are close to estimates of the region's potential growth rate, they will have limited impact in reducing spare capacity generated by the crisis. As a result regional unemployment, albeit falling, is expected to remain a challenge throughout the projection period. The deceleration in 2012 mainly reflects weaker exports due to slower growth in export markets (notably high-income Europe), and domestic demand being held back by high unemployment and banking sector deleveraging.

Projected growth paths vary significantly across countries (table ECA.5). For example, after two years of strong growth in 2010 and 2011, GDP growth in Turkey is projected to slow down to 2.9 percent in 2012 due to the weak global economy and the implications of recent market turmoil for consumer and investor confidence. Assuming that global conditions do not deteriorate further, we forecast that economic growth will pick up to an average of 4.2 percent in 2013. With its strong performance in the third quarter, growth rate in Romania is estimated to have reached 2.2 percent in 2011 from –1.3 percent in 2010. Growth is expected to be held back by the deleveraging and the euro crisis next year. It is forecasted to slow down to 1.5 percent in 2012 but later rebound to 3 percent in 2013. Similarly, growth in Serbia is expected to ease to 1.5 percent in 2012 from 2 percent in 2011, recover to 4 percent in 2013. In contrast, the Commonwealth of Independent States is projected to post somewhat stronger real GDP growth of 3.5 percent and 4.1 percent in 2012 and 2013, respectively. Most of the commodity exporters—with the exception of Azerbaijan due to the temporary interruption in oil production—had robust growth in 2011. All of these countries are expected to have robust growth for the forecast period.

The region's current account balance is projected to shift to a deficit of 0.7 percent of GDP in 2013 from a surplus of 0.6 percent of GDP in 2011, as domestic demand is expected to strengthen faster than exports. The current account surplus of commodity-rich exporters is expected to fall from 5.9 percent of GDP in 2011 to 2.8 percent in 2013 despite high commodity prices, as additional revenues are projected to leak into spending and imports relatively quickly. Current account deficits among oil importers are estimated to reach over 7.7 percent of GDP in 2011 and only gradually improve to around 5.7 percent of GDP in 2013.

High commodity prices should boost government revenues in resource-rich countries, turning the government deficit of 2.3 percent of GDP in 2010 to a slight surplus of 1.2 percent by 2013. At the same time, slowly improving activity levels and ongoing fiscal consolidation measures are projected to reduce government deficits in oil importers from 4.5 percent of GDP in 2010 to about 2.8 percent of GDP in 2013.

Risks and vulnerabilities

As emphasized in the main text, the primary risk facing the global economy is a deterioration of the situation in high-income Europe, which could result in a significantly weaker external environment for Europe and Central Asia's main trading partner but also a significant

exacerbation of negative confidence effects. Such deterioration would magnify a number of pre-existing vulnerabilities in the region, including those arising from direct trade and banking-sector exposures, as well as more indirect effects running through both financial and real channels, including possibly sharp reductions in global external financing conditions, weaker remittances and lower commodity prices.

Very strong financial linkages…

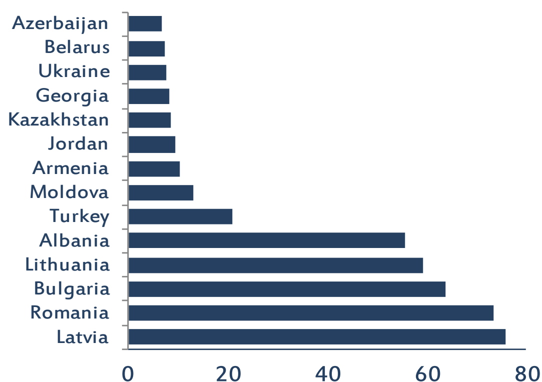
The region has unusually strong banking-sector linkages with high-income Europe, both in terms of ownership links and day-to-day financing. As European banks are required to raise their capital positions, they have been forced to deleverage and tighten credit conditions. So far deleveraging has been relatively orderly, and although accompanied by a sharp slowing of credit growth in Eastern Europe, cross-border capital flows have not dried up. But in case of a further acceleration of the process, transmission to the financial markets in developing Europe and Central Asia would likely be swift and potentially very damaging.

As of the second quarter of 2011, total foreign claims by European banks reporting to BIS were $0.6 trillion in the region (figure ECA.12). Key European banks also account for large shares of domestic bank assets in several of the region's economies, generating considerable vulnerability to any repatriation of funds (figure ECA.13).

The nature of European banks' holdings in the region underscores its vulnerability to deleveraging. Banks in the region have relied heavily upon cross-border lending from their parents to support their loan portfolios, with loan–to–deposit ratios well over 100 percent in several countries: Latvia (240%), Lithuania (129%), Romania (127%), and Russia (121%). As a result, banks are extremely vulnerable to a cut-off of lending, let alone to an active effort by parent banks to recover funds either by selling assets or calling loans where possible. Indeed, in a worrying sign that such risk is actually being realized, Austrian bank supervisors have instructed Austrian banks to limit future lending in their central and eastern European subsidiaries.

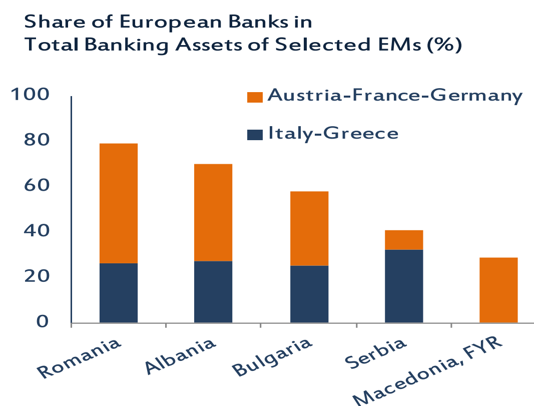
Funding pressures will add to the stress in the domestic banking sectors that are already at risk to a sharp increase of NPLs in the event of a slowdown in growth (figure ECA.14). In some countries, NPLs and provisioning are already an issue. The share of NPLs in outstanding bank lending in the Europe and Central Asia region jumped t 12 percent in 2011 from 3.8 percent in 2007. Available data indicates that NPL ratios have continued to deteriorate in 2011 in Kazakhstan (32.8%) and Romania (14.2%).

Figure ECA.12 Strong banking sector linkages



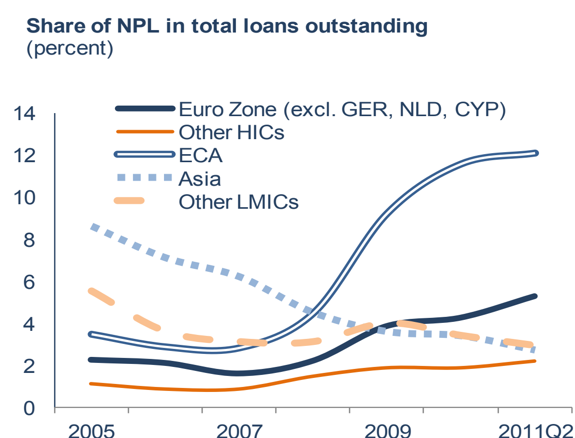
Source: BIS.

Figure ECA.13 Significant reliance on foreign banks



Source World Bank staff calculation based on data from Central Banks and Bankscope

Figure ECA.14 Possible resurgence in NPLs



Source: IMF Financial Soundness Indicators

…and other worrisome vulnerabilities

In addition to financial linkages to high-income European countries, several countries in the region are also vulnerable to generalized risk aversion, when both foreign and domestic investors will retreat from risky assets. Should conditions deteriorate substantially, international capital flows could weaken much further and borrowing costs rise sharply. To a limited degree, increased risk aversion has already reduced portfolio equity flows since July. Countries with high levels of short-term debt or maturing long-term debt and those with large current account deficits are particularly vulnerable to such a tightening in financial conditions. Overall, Europe and Central Asia is seriously exposed to such risks, with ex ante external financing needs totaling some $279 billion (16.9 percent of GDP) for 2012.

Should external financing conditions worsen, short-term debt and bond financing could dry up relatively quickly[3]—potentially forcing countries to cut sharply into reserves (or reduce imports) in order to make ends meet.

On this basis, Turkey is the among the most vulnerable of developing countries, with its projected current account deficit in 2011 set to be six times larger than its FDI inflow. The country also carries short-term debt equal to 80 percent of its reserves. Heavy reliance on short-term debt makes Albania, Belarus, Montenegro, Romania, and Serbia vulnerable to a tightening of international bank-lending conditions – even if these were not associated with a wider crisis.

The region would be particularly affected by weaker activity in the European Union, which buys more than half the region's exports. The countries most likely to suffer from a sharp downturn in EU demand include Romania, Lithuania and Latvia because of their large exposure to Europe in general, and Albania, Macedonia FYR, and Bulgaria because they rely particularly on the high-spread European economies that are likely to be hardest hit (table ECA.4). In addition, the region is also quite vulnerable to second, third and fourth-round trade effects (Main Text figure 15).

A sharp downturn in high-income Europe would also reduce remittances to the region (40 percent

Table ECA.4 ECA's trade linkages with the EU

Merchandise Exports to the EU, Share of total, 2008-2010 averages (percent)		
Country	EU27 (Total)	High-spread EA economies
Europe & Central Asia	52	10
Romania	71	19
Lithuania	70	5
Latvia	70	4
Macedonia, FYR	69	24
Bulgaria	65	21
Azerbaijan	61	32
Bosnia and Herzegovina	61	16
Russian Federation	53	8
Moldova	50	13
Kazakhstan	47	12
Turkey	47	14
Armenia	45	4
Albania	44	37
Belarus	39	2
Georgia	38	6
Ukraine	28	7
Turkmenistan	25	5
Tajikistan	17	9
Kyrgyz Republic	15	0
Uzbekistan	10	4

Source: COMTRADE and World Bank.

of the region's remittances come from high-income Europe). In the aftermath of 2008 crisis, migrant remittances declined by 20 percent. High unemployment levels have already generated political pressures to reduce immigration in many high-income countries. In addition, as discussed earlier, remittances outflows from Russia, which also accounts for a large share of remittances in the region, would decline considerably with a fall in oil prices.

Table ECA.5 Europe and Central Asia country forecasts

(annual percent change unless indicated otherwise)

						Est.	Forecast	
	98-07[a]	2007	2008	2009	2010	2011	2012	2013
Albania								
GDP at market prices (2005 US$) [b]	5.5	5.9	7.7	3.3	3.5	3.0	2.0	3.5
Current account bal/GDP (%)	-6.3	-10.8	-15.6	-15.3	-12.4	-11.7	-9.7	-9.9
Armenia								
GDP at market prices (2005 US$) [b]	9.6	13.7	6.9	-14.1	2.1	4.6	4.3	4.2
Current account bal/GDP (%)	-8.6	-6.4	-11.9	-15.5	-14.5	-12.7	-11.1	-9.6
Azerbaijan								
GDP at market prices (2005 US$) [b]	14.2	25.0	10.8	9.3	5.0	0.2	3.1	3.0
Current account bal/GDP (%)	-7.2	27.3	35.6	23.7	28.3	26.6	19.1	17.1
Belarus								
GDP at market prices (2005 US$) [b]	6.9	9.8	11.3	0.2	7.6	5.0	0.5	3.5
Current account bal/GDP (%)	-3.9	-6.7	-8.6	-13.0	-15.5	-10.9	-6.0	-4.1
Bulgaria								
GDP at market prices (2005 US$) [b]	4.8	6.4	6.2	-5.5	0.2	1.9	1.2	3.3
Current account bal/GDP (%)	-8.7	-27.3	-22.9	-8.7	-1.0	2.0	-1.0	-2.2
Georgia								
GDP at market prices (2005 US$) [b]	6.6	12.3	2.3	-3.8	6.4	6.5	5.0	5.2
Current account bal/GDP (%)	-9.8	-20.9	-22.8	-11.2	-11.5	-12.7	-11.1	-9.3
Kazakhstan								
GDP at market prices (2005 US$) [b]	8.3	8.9	3.3	1.2	7.3	6.6	5.5	5.8
Current account bal/GDP (%)	-2.7	-7.9	4.7	-3.7	3.1	6.3	3.9	3.6
Kosovo								
GDP at market prices (2005 US$) [b]		6.3	6.9	2.9	3.9	5.3	5.0	4.7
Current account bal/GDP (%)		-17.4	-22.8	-25.0	-16.3	-24.0	-20.9	-18.9
Kyrgyz Republic								
GDP at market prices (2005 US$) [b]	4.2	8.5	7.6	2.9	-1.4	7.0	5.5	5.7
Current account bal/GDP (%)	-8.4	-0.2	-8.1	0.7	-7.2	-6.9	-6.6	-7.2
Lativa								
GDP at market prices (2005 US$) [b]	7.8	10.0	-4.2	-18.0	-0.3	4.5	2.0	3.7
Current account bal/GDP (%)	-11.6	-22.3	-13.1	8.6	3.6	-0.4	-1.1	-2.0
Lithuania								
GDP at market prices (2005 US$) [b]	6.7	9.8	2.9	-14.8	1.4	5.8	3.2	3.5
Current account bal/GDP (%)	-8.5	-14.4	-12.9	4.4	1.5	-2.3	-3.1	-3.6
Moldova								
GDP at market prices (2005 US$) [b]	4.1	3.1	7.8	-6.0	6.9	6.0	4.0	4.3
Current account bal/GDP (%)	-8.4	-16.5	-17.3	-9.9	-8.3	-12.1	-11.3	-11.4
Macedonia, FYR								
GDP at market prices (2005 US$) [b]	2.6	6.1	5.0	-0.9	1.8	3.0	2.5	3.5
Current account bal/GDP (%)	-5.2	-7.4	-12.5	-6.4	-2.2	-5.1	-5.3	-4.9
Montenegro								
GDP at market prices (2005 US$) [b]		10.7	6.9	-5.7	2.5	2.5	1.8	2.5
Current account bal/GDP (%)		-40.2	-51.3	-30.1	-25.0	-20.9	-20.3	-19.7
Romania								
GDP at market prices (2005 US$) [b]	4.3	6.3	7.3	-7.1	-1.3	2.2	1.5	3.0
Current account bal/GDP (%)	-7.0	-13.7	-11.4	-4.2	-4.2	-4.5	-4.7	-5.3
Russian Federation								
GDP at market prices (2005 US$) [b]	6.3	8.5	5.2	-7.8	4.0	4.1	3.5	3.9
Current account bal/GDP (%)	9.5	6.0	6.2	4.0	4.7	5.1	2.7	2.2
Serbia								
GDP at market prices (2005 US$) [b]	3.1	5.4	3.8	-3.5	1.0	2.0	1.5	4.0
Current account bal/GDP (%)	-7.4	-17.6	-21.4	-7.1	-7.2	-7.5	-8.4	-7.7
Tajikistan								
GDP at market prices (2005 US$) [b]	7.9	7.8	7.9	3.9	6.5	6.0	6.0	5.0
Current account bal/GDP (%)	-4.2	-8.6	-7.7	-5.9	2.1	-4.1	-6.5	-7.0
Turkey								
GDP at market prices (2005 US$) [b]	3.7	4.7	0.7	-4.8	9.0	8.2	2.9	4.2
Current account bal/GDP (%)	-2.4	-5.9	-5.7	-2.3	-6.4	-9.8	-7.5	-6.3
Ukraine								
GDP at market prices (2005 US$) [b]	5.9	7.9	2.1	-14.8	4.2	4.5	2.5	4.0
Current account bal/GDP (%)	3.2	-3.7	-7.1	-1.6	-2.1	-5.4	-4.9	-4.3
Uzbekistan								
GDP at market prices (2005 US$) [b]	5.6	9.5	9.0	8.1	8.5	8.3	8.0	6.5
Current account bal/GDP (%)	4.9	7.3	8.7	2.2	6.7	8.1	7.0	6.0

World Bank forecasts are frequently updated based on new information and changing (global) circumstances. Consequently, projections presented here may differ from those contained in other Bank documents, even if basic assessments of countries' prospects do not significantly differ at any given moment in time.

Bosnia and Herzegovina and Turkmenistan,are not forecast owing to data limitations.

a. Growth rates over intervals are compound average; growth contributions, ratios and the GDP deflator are averages.

b. GDP measured in constant 2005 U.S. dollars.

c. Estimate.

d. Forecast.

Source: World Bank.

Source: World Bank.

As highlighted by the simulations outlined in the main text, a small, sustained crisis scenario could lead to declines in remittances flows in the Europe and Central Asia region in the order of 3 to 4 percent in 2012 and 2013 with the largest effects in Tajikistan, Kyrgyz Republic, and Moldova. The contraction might reach as high as 9.1 percent in 2012 and 7.4 percent in 2013 in an event of a severe crisis when two larger Euro Zone economies are squeezed from the credit markets.

Finally, a substantial faltering of global growth may disproportionately impact commodity exporters through a possible reduction in commodity prices. Following the 2008 crisis, energy prices fell by 60 percent and metals prices by 57 percent by 31 percent between August 2008 and their first-quarter 2009 lows. Simulations suggest that a sharp slowdown in global growth could result in more than 20 percent decline in energy prices. Based on current export volumes, in an event of a sharp fall in oil prices the hardest hit economies in the region are likely to include Russia and Azerbaijan.

Notes:

1 In addition, the central bank recently raised its emergency lending rates sharply and dropped its easing bias, paving the way for future hikes in its key policy rate, the one-week repo rate.

2 Net private capital flows comprise net debt flows (incoming disbursements less principal repayments) and net equity inflows (FDI and portfolio inflows net of disinvestments).

3 Historically, these capital flows are more volatile than Foreign Direct Investment – although in 2008/9 there was a global 40 percent decline in FDI, it was more gradual than the still larger cuts to other flows.

Latin America & the Caribbean Region

Recent developments

Growth in the Latin America and the Caribbean region is slowing after robust growth in the first half of 2011

The economies of Latin America expanded at a pace near or above potential through the first half of 2011. Growth was particularly strong in South America, lifted by strong domestic demand, accommodative external financing conditions in the case of countries integrated with the global financial system, and high commodity prices in the case of commodity exporters. In many of these economies the output gaps were positive. Growth in Central America was more subdued, but accelerating supported by recovery in domestic demand, while stronger agricultural performance gave an additional impetus to growth in Mexico. In the Caribbean economies growth remained weak with the output gap still negative.

Monetary, credit and fiscal policy tightening in countries where signs of overheating were apparent caused domestic demand growth to moderate. The slowing in domestic demand has coincided in some of the economies in the region with the softening in external demand causing sharper than expected deceleration in growth. Although through the first half of the year there have been little spillovers from the sovereign debt tensions in the peripheral Euro Area, the increased likelihood that the further deterioration in Euro Area's sovereign debt crisis could freeze up capital markets has started to affect the financially integrated economies of Latin America, as reflected by developments in the equity and currency markets. Heightened uncertainty about the short-term economic outlook and increased financial market volatility have started to take their toll on consumer and business sentiment, dampening further domestic demand. Retail sales and import data show that the moderation in domestic demand is broadly-based across the region.

...with momentum for both imports and exports slowing markedly...

The strong performance in export revenues in the first part of the year, when a combination of strong external demand and high commodity prices boosted growth to more than 25 percent year-on-year, gave way to a marked slowdown in the third quarter on account of softer external demand from major trade partners, and declines in commodity prices. Oil and metals exporters, including Mexico, Ecuador, and Chile, saw some of the sharpest declines in export revenues growth on a quarter-on-quarter seasonally adjusted annualized rate or momentum basis (saar).[1] The marked slowdown in Brazil's GDP growth has also affected export revenues in countries that trade heavily with Brazil. Meanwhile Colombia benefitted from the partial recovery in external demand from Venezuela, and an improvement in bilateral relations.

Against the backdrop of increased global uncertainty, the apparent soft-landing in China, weak performance in the Euro area, and relatively subdued demand in the United States external demand for the region's exports has indeed weakened, with export volumes momentum decelerating to 1.4 percent in the third quarter (saar) from the 14 percent in the second quarter, before reaccelerating slightly into the year end.

The contribution of net exports to growth has been less negative than the sharp deceleration in export volumes would suggest, due to a 4.6 percent quarter-on-quarter (saar) contraction in imports in the third quarter, following rapid growth in the first two quarter of the year (18.7 and 15.6 percent respectively), which attests to the marked moderation in domestic demand, in particular in investment. In the fourth quarter the contribution of net exports was positive as imports continued to decline at an accelerated pace (10.5 percent decline (saar) in the three-month to November) while export performance

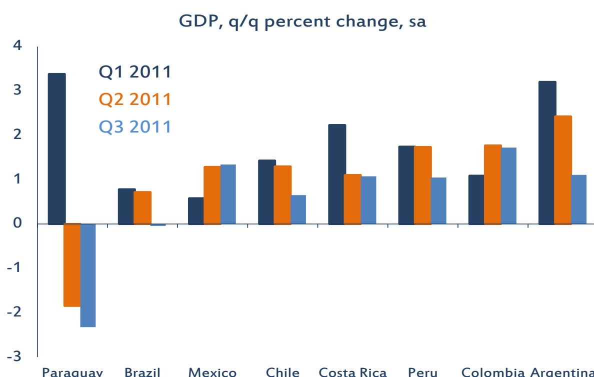
improved modestly. Notwithstanding declining commodity prices and weak external demand trade balances in the region have improved in recent months, as import growth decelerated more sharply than export revenue growth.

Reflecting moderating domestic demand, and to a some extent also weaker external demand, industrial production declined 2 percent and 1.8 percent (saar) in the second and the third quarter after a robust 9.2 percent expansion in the first quarter. In Brazil, the policy-induced moderation in domestic demand in conjunction with a stronger currency and weaker external demand have caused industrial production to decline more than 8 percent from the peak reached in February 2011. In Mexico, the region's second largest economy, growth in industrial sector eased in the third quarter to 2 percent quarter-on-quarter (saar) from robust 7.8 percent expansion pace in the first quarter, as growth in manufacturing has moderated. Industrial output, which is highly synchronized with developments in the U.S. industrial output, has dipped into negative territory in the three months to October, and output was 1.2 percent lower than the peak recorded in May. In other economies in the region domestic demand continues to expand at a robust pace as indicated by strong retail sales supporting industrial output growth. In the case of Colombia industrial production accelerated to 5.6 percent in the three months to October (saar), up from 1.8 percent in the second quarter.

Third quarter GDP data for some of the financially integrated economies in the region reveals the effects of policy-induced moderation in domestic demand as well as of weaker external demand (figure LAC.1). Brazil's economic growth came to a halt in the third quarter, after growth decelerated to 0.7 percent quarter-on-quarter (sa) in the second quarter -- down from 0.8 percent in the first quarter. The mild decline in GDP in the third quarter reflects the combined effects of fiscal and monetary policy tightening in the first part of 2011, the impact of a still strong real, and the impacts of the international financial turmoil since August 2011. Weaker retail sales and a drop in business and consumer confidence in recent months suggest that domestic demand is slowing, due to the lagged effects of policy tightening in the first half of 2011.

In Chile economic performance is also showing signs of moderating, with both domestic and external demand contributing to this moderation. Quarterly GDP growth slowed to 0.6 percent (sa) in the third quarter, from 1.4 percent in the first quarter. In contrast Peru's economic performance remained robust through the third quarter, suggesting that there have been limited spillover from increased global uncertainty and softer external demand, in particular from China. Growth eased down marginally, to 1 percent sa in the third quarter, down from a very strong 1.7 percent in the second quarter, fueled by robust growth in domestic-demand related sectors such as retail and housing, and despite weak performance in the industrial sector which suffered from weaker demand for Peru's textiles from Europe and the United States. Domestic demand is starting to show signs of moderate deceleration, however, reflected in weakening import momentum. Similarly growth in Colombia has seen little impact from a more adverse external environment so far, with growth moderating only marginally in the third quarter to 1.7 percent quarter-on-quarter from a very strong 1.8 percent expansion in the second quarter. Growth has been supported by very robust domestic demand and very rapid credit growth. Unlike in other countries in the region, both industrial production and export volumes have held up in the third quarter expanding at a

Figure LAC.1 Growth in Latin America and Caribbean is decelerating



Source: World Bank.

3.8 and 9.4 percent annualized rate despite the disruptions to global demand and investment caused by the turmoil beginning in August. Rising housing prices, lower unemployment and acceleration in inflation indicate that the economy is at risk of overheating.

Growth in commodity exporters that are less integrated financially with the global financial system was very strong in the first half of the year, boosted by high commodity prices and expansionary policies, but they too show signs of moderating growth. Favorable terms of trade, significant monetary and fiscal stimulus, and strong external demand supported above-trend growth in Argentina in the first part of the year. GDP growth started to decelerate in the second quarter recording a still very robust 2.4 percent growth (seasonally adjusted), down from 3.2 percent quarter-on-quarter (sa) growth in the first quarter, before easing more markedly in the third quarter to 1.1 percent. Venezuela's economy is finally staging a recovery from a protracted recession, with GDP up close to 4.0 percent in 2011, supported in part by strong government spending. Meanwhile Ecuador's economy grew strongly in the second quarter of 2011, on strong public spending financed from the oil windfall and Chinese loans, as well as stronger private consumption before moderating slightly to 1.7 percent in the third quarter. Economic performance deteriorated markedly in Paraguay in the second and third quarter of 2011, with GDP contracting 1.8 and 2.3 percent quarter-on-quarter (seasonally adjusted), respectively, after growing 3.4 percent in the first quarter.

In Mexico growth surprised on the upside in the third quarter, and the economy expanded at a relatively robust pace of 4.0 percent in the first three quarters of 2011, notwithstanding tepid growth in the United States. Growth accelerated to 1.3 percent (sa), bolstered by strong performance in the agriculture sector, and robust growth in the service sector. In part the strong performance also reflects a bounce back from the impacts of the Tohoku which have negatively affected growth in industrial output in the second quarter. Private consumption growth surprised on the upside in the third quarter, expanding 2.2 quarter-on-quarter (sa), up from 0.8 percent the previous quarter, while investment growth decelerated to 1.9 percent from 3.3 percent. In Central America the recovery strengthened in the first half of the year, bolstered by solid domestic demand. Growth in Panama was strong, fueled by construction work related to the expansion of the Panama Canal. Growth in El Salvador was dampened by weak external demand and the worst flooding in recent history that occurred in October. Subdued expansion in all sectors, except utilities, have kept growth below 2 percent in the first half of the year. Meanwhile the Caribbean region struggles to recover from a protracted recession, with growth weighed down by high debt levels, fiscal consolidation, high oil prices and weak performance in the tourism sector, and a series of natural disasters. For example, in the case of St Vincent and the Grenadines torrential rains in April 2011 caused major flooding and landslides that severely damaged the country's infrastructure. This came on the heels of hurricane Tomas, which only six month earlier had destroyed roads, bridges, houses, and battered the agriculture sector. The combined effect of these two natural disasters is estimated at 3.6 percent of GDP.

Despite moderation in domestic demand inflation remains high

Despite the recent moderation in domestic demand inflation remained elevated in the economies that are continuing to grow at or above potential and have positive output gaps. Marked currency depreciations have also started to fuel inflation via the import cost channel. At regional level, inflation momentum (3m/3m saar) stayed above 8 percent for most of the year. In Brazil inflation momentum continued to accelerate through October, and annual inflation barely met the upper inflation target limit of 6.5 as still robust domestic demand and a relatively tight labor market put upward pressure on service prices. In Argentina consumer price inflation remains stubbornly high, with momentum in excess of 8 percent for most of the year, and little signs of easing. Meanwhile in Peru and Colombia, strong economic expansion

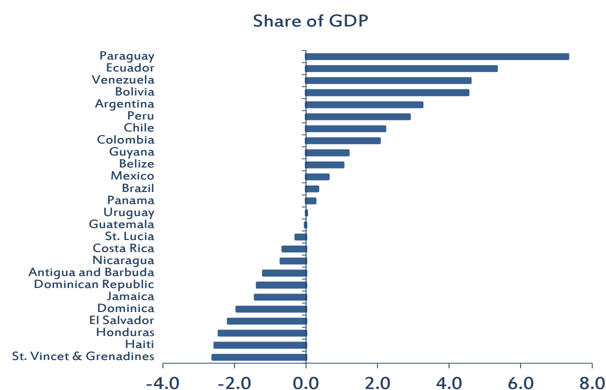
contributed to higher inflationary pressures. In contrast inflation is less of a concern in other economies in the region such as Mexico, Chile, and some of the slow-growing Central American economies.

Strong commodity prices lifted trade balances in commodity exporters while tourism-dependent economies still hurt

Strong commodity prices in the earlier part of 2011, and in particular strong oil and metals and mineral prices have benefited commodity exporters in the region. Notwithstanding recent correction in prices triggered by concerns about the strength of global expansion, cumulative terms of trade gains remain sizeable so far this year. Gains are among largest in oil and natural gas exporters such as Ecuador, Venezuela, and Bolivia, but higher prices for commodities such as maize, wheat, soybeans, and beef have helped countries such as Argentina and Paraguay. In contrast oil importers recorded the largest terms of trade losses as a share of GDP, exceeding 2 percent of GDP in some cases (figure LAC.2).

Meanwhile soft growth in high-income countries has constrained growth in tourism revenues in the Caribbean and Central America. In the first eight months of the year tourist arrivals were up 4 percent in Central America and the Caribbean, following growth of 4 and 3 percent in 2010. Performance in these two regions has been weaker than the rest of the world and than in South America were tourist arrivals grew 13 percent in the first eight months of the year, following a 10 percent expansion in 2010.[2] Growth in tourist arrivals to South America has benefited in part from strong income growth in Brazil, where expenditure on travel abroad surged 44 percent, following on the heels of a more than 50 percent expansion in 2010. By contrast spending by the United States on travel abroad, grew at a much weaker 5 percent pace.

Figure LAC.2 Terms of trade gains for commodity exporters in 2011



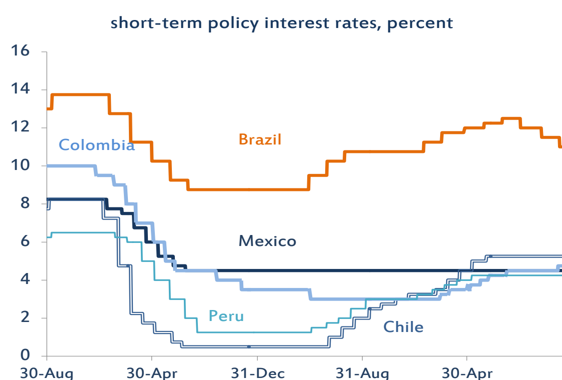
Source: World Bank.

Migrant remittances have performed slightly better, expanding an estimated 7 percent in the region this year, with growth in countries most dependent on migrant remittances (El Salvador, Jamaica, Honduras, Guyana, Nicaragua, Haiti, Guatemala) growing at a 7.6 percent pace, following growth of 6.3 percent in 2010. More than two thirds of the migrants from these countries are in the United States (67 percent, simple average).

Overall current account positions for commodity exporters have benefitted from strong commodity prices and solid external demand in the first part of the year but they are likely to deteriorate following corrections in commodity prices that occurred in recent months, and notwithstanding deceleration in import growth. Meanwhile oil importers which have been hit by higher energy prices have seen some relief in recent months.

Most policy makers are on hold for now but easing is expected going forward. Many central banks in the region tightened monetary policy in the first half of the year due to concerns about inflation and overheating, but have now adopted a wait-and-see attitude in the face of heightened global uncertainties (figure LAC.3). Facing a marked slowdown in growth and inflation of more than 3 percentage points above the upper level of the target range, Brazil is the only major central bank in the region to have cut the policy rate (by 50 basis points in each of the last three meetings, for a total reduction from 12.5 percent to 11 percent), due to concerns that a deteriorating external environment will contribute to a sharper deceleration in growth. By contrast, open economies like Chile and Peru, which are more vulnerable to the external

Figure LAC.3 Most central banks in Latin America on hold



Source: National Agencies through Datastream.

environment should the crisis worsen, have yet to cut rates. In Chile the central bank kept rates unchanged as rising external uncertainties were offset by tight labor markets and strong credit growth. Given weaker global growth prospects countries that have well anchored inflation expectations and that are more exposed to the deceleration in global demand are likely to stat easing monetary conditions early next year. Colombia is the first central bank to raise interest rates (25 basis points to 4.75 percent) on concerns about rising inflationary pressures, rapid housing prices increases, on the backdrop of robust domestic demand.

Other policies to support growth. Brazil's central bank has started to reverse some of the macroprudential tightening policies implemented during the course of 2010, in a bid to bolster demand for durable goods. Brazil also imposed an IPI tax (Imposto Sobre Produtos Industrializados, sales tax on industrial goods) for cars that are using less than 65 percent of locally-produced parts, in a bid to bolster output. Colombia and Panama signed free-trade agreements with the United States, which should boost exports going forward. In the case of Panama the FTA will benefit mostly the services sector, as Panama already had preferential access to the United States market for various exports.

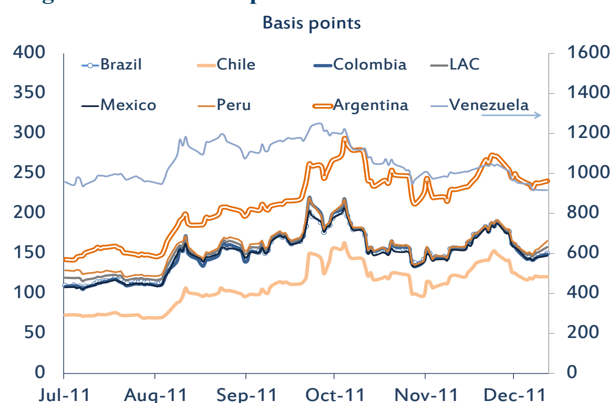
Signs of contagion. The sovereign debt crisis in the Euro periphery had only a limited impact on the region's financial markets in the first half of the year. However, the US credit rating downgrade in August and the subsequent deterioration of market confidence in Europe has resulted in a generalized increase in risk aversion and contagion to the risk premia of countries in the region. Regional equity markets suffered substantial capital outflows in September, forcing the depreciation vis-à-vis the US dollar of several currencies and causing Central Banks to rapidly switch from being concerned about the volatility and competitiveness effects caused by unwarranted appreciations to the risks that might be associated with an uncontrolled depreciation. The Mexican peso, Chilean peso, and the Brazilian real lost more than 10 percent of their value, and the Colombian peso nearly 8 percent, between September 1st and December 13th. The largest depreciations of the nominal effective exchange rate in September were in Brazil (close to 7.4 percent, month on month) and Mexico (9 percent), and Chile (5 percent). Several countries (including Brazil and Peru) dipped into their foreign currency reserves in order to limit depreciations.

Regional equity markets fell close to 18 percent between the end of July and the end of October, as compared with 19.6 percent for the broader emerging market index, and although they have retraced some of those losses remain nearly 15 percent below their July level. Paper losses for the region are estimated at more than $530 billion between July and the end of September.[3] Brazilian and Mexican equity markets were among the worst affected. Foreign selling of fixed-income assets was particularly acute in Latin America, with Brazil posting record level of outflows through September (see the Finance Annex). In the case of Brazil the decline in the first part of the year was linked to the increase of the IOF tax to 6 percent in April, although the crisis in the Euro Area was behind the declines in recent months. Reflecting these developments, EMBIG sovereign bond spreads also widened markedly between July and September, with the sharpest deterioration occurring in the second half of September. Spreads narrowed somewhat in October only to approach September highs again in November. The benchmark five-year sovereign CDS spreads also rose, with the

largest increases occurring in countries with close trade and financial linkages with the euro area (figure LAC.4).

Overall net capital inflows decline an estimated 12.6 percent in 2011, to reach 5 percent of GDP, with net private inflows down 10.1 percent to 4.8 percent of GDP. Of note is the large decline in portfolio inflows (down 60 percent) which is partly the result of the increased global market volatility of the second half of 2011, and associated equity-market sell-offs. Overall, short -term debt flows for the year as a whole also declined 46.4 percent – partly because of slower trade growth (and therefore less trade finance). Meanwhile FDI flows grew a robust 29.2 percent exceeding the levels recorded in the pre-2009-crisis. The Latin America and Caribbean region recorded the strongest FDI growth among developing regions due to relatively robust growth, rich natural resources and a large consumer base. (table LAC.1)

Figure LAC.4 CDS spreads continue to widen



Source: Datastream, World Bank.

Medium-term outlook

Weaker global growth, in particular in the advanced economies, and increased uncertainty regarding the impact of the euro area debt crisis are weighing on growth prospects in the Latin America and Caribbean region. The weakening in external demand coincides with a deceleration in domestic demand in some of the economies in the region as the business cycle matures, while in others it is complemented by policy-induced moderation in growth. On the positive side, commodity exporters will continue to benefit from robust demand from emerging Asia, although incomes will be affected by lower

Table LAC.1 Net capital flows to Latin America & the Caribbean

	2004	2005	2006	2007	2008	2009	2010	2011e	2012f	2013f
Current account balance	20.2	32.3	44.2	10.0	-36.8	-22.8	-58.0	-71.7	-110.3	-139.6
as % of GDP	0.9	1.2	1.4	0.3	-0.9	-0.6	-1.2	-1.3	-1.9	-2.2
Financial flows:										
Net private and official inflows	**57.9**	**93.8**	**68.7**	**207.9**	**181.5**	**173.2**	**319.8**	**279.5**		
Net private inflows (equity+private d	**68.0**	**125.2**	**88.6**	**208.9**	**174.9**	**155.3**	**298.4**	**268.3**	**240.9**	**278.7**
..Net private inflows (% GDP)	3.1	4.8	2.9	5.7	4.1	3.9	6.0	4.8	4.1	4.3
Net equity inflows	66.3	85.8	83.0	139.3	120.4	119.9	153.9	162.0	153.9	173.7
..Net FDI inflows	66.8	73.5	72.0	110.4	130.0	78.3	112.6	145.5	134.4	151.7
..Net portfolio equity inflows	-0.6	12.2	11.0	28.8	-9.7	41.6	41.3	16.5	19.5	22.0
Net debt flows	-8.1	0.8	-16.8	79.2	59.0	51.5	70.5			
..Official creditors	-10.1	-31.3	-19.9	-1.1	6.5	17.9	21.4	11.2		
....World Bank	-1.0	-0.7	-3.4	-0.1	2.4	6.6	8.3	2.0		
....IMF	-6.3	-27.6	-12.1	0.0	0.0	0.4	1.3	2.7		
....Other official	-2.9	-3.0	-4.4	-1.0	4.1	10.9	11.8	6.5		
..Private creditors	1.7	39.4	5.6	69.7	54.6	35.4	144.5	106.3	87.0	105.0
....Net M-L term debt flows	1.1	19.0	5.1	46.7	48.9	39.9	77.3	70.3		
......Bonds	2.5	21.6	-11.2	12.6	9.0	40.7	48.8	46.3		
......Banks	-1.2	-2.3	16.9	34.6	40.4	-0.3	27.4	24.0		
......Other private	-0.1	-0.3	-0.6	-0.4	-0.5	-0.5	1.1	0.0		
....Net short-term debt flows	0.6	20.4	0.5	23.0	5.7	-4.5	67.2	36.0		
Balancing item /a	-52.7	-91.8	-57.4	-80.0	-94.5	-96.3	-171.6	-118.2		
Change in reserves (- = increase)	-25.4	-34.4	-55.5	-137.8	-50.1	-54.1	-90.2	-89.6		
Memorandum items										
Migrant remittances /b	43.4	49.8	58.9	63.0	64.4	56.6	57.3	61.3	66.0	71.2

Note :
e = estimate, f = forecast
/a Combination of errors and omissions and transfers to and capital outflows from developing countries.
/b Migrant remittances are defined as the sum of workers' remittances, compensation of employees, and migrant transfers

Source: World Bank.

commodity prices.

Following several years of above average growth that have successfully closed output gaps opened up by the global financial crisis and even generating signs of overheating in several economies, growth in Latin America and the Caribbean is expected to decelerate to 3.6 percent in 2012 from 4.2 percent in 2011, before picking up once again to 4.2 percent in 2013 (table LAC.2). Softer global growth, and in particular weaker demand from high-income countries but also slower growth in China, will hurt exports, and increased risk aversion, tighter external financing conditions, and negative confidence effects are projected to slow investment and private consumption demand.

GDP in Brazil is projected to accelerate slightly in 2012 to 3.4 percent from 2.9 percent in 2011, roughly in line with estimates of its underlying potential growth rate, before picking up in 2013 to a 4.4 percent pace (table LAC.3). The slight acceleration in growth reflects the reversal in fiscal and monetary policies which are expected to bolster domestic demand, although persistent global uncertainties will continue to weigh on investment. Despite recent signs of moderation, household demand is expected to remain strong over the forecasting horizon supported by an emerging middle class, an expanding labor force, rising real wages , and solid credit expansion – growing faster than overall GDP -- suggesting limited relief from inflationary pressures and a further deterioration in the current account which is projected to reach a deficit of 3.4 percent of GDP in 2013. The 13.6 percent increase in the minimum wage at the beginning of 2012 should boost income and support private consumption. Investment growth is expected to decelerate slightly in 2012, in part due to confidence effects stemming from the Euro area financial crisis, before picking up again in 2013, boosted by fiscal spending ahead of the 2014 presidential elections, investments in infrastructure, including in preparation for the World Cup, and by investments to develop the pre-salt oil reserves and in refineries. In Mexico, GDP is

Table LAC.2 Latin America and the Caribbean forecast summary

(annual percent change unless indicated otherwise)				Est.	Forecast		
	98-07[a]	2008	2009	2010	2011	2012	2013
GDP at market prices (2005 US$) [b]	2.9	4.1	-2.0	6.0	4.2	3.6	4.2
GDP per capita (units in US$)	1.6	2.8	-3.2	4.7	2.9	2.3	2.9
PPP GDP [c]	2.9	4.3	-1.6	6.1	4.3	3.6	4.2
Private consumption	3.2	5.1	-0.4	5.5	4.4	3.7	4.1
Public consumption	2.2	3.0	3.9	2.5	2.8	3.3	3.3
Fixed investment	3.4	8.7	-9.7	10.5	6.3	6.1	8.1
Exports, GNFS [d]	5.2	1.4	-10.1	13.6	6.7	5.6	6.4
Imports, GNFS [d]	5.5	7.7	-15.0	19.0	8.1	7.5	8.3
Net exports, contribution to growth	-0.1	-1.7	1.6	-1.4	-0.5	-0.7	-0.8
Current account bal/GDP (%)	-0.9	-0.9	-0.6	-1.2	-1.3	-1.9	-2.2
GDP deflator (median, LCU)	5.8	8.7	4.2	5.2	5.8	6.3	5.8
Fiscal balance/GDP (%)	-2.9	-0.9	-4.0	-2.6	-2.6	-2.7	-2.4
Memo items: GDP							
LAC excluding Argentina	3.1	3.9	-2.2	5.7	3.9	3.6	4.1
Central America [e]	3.5	1.8	-5.5	5.3	4.0	3.3	3.8
Caribbean [f]	4.4	3.6	0.6	3.7	4.0	3.9	4.0
Brazil	2.6	5.2	-0.2	7.5	2.9	3.4	4.4
Mexico	3.4	1.5	-6.1	5.5	4.0	3.2	3.7
Argentina	3.0	6.8	0.9	9.2	7.5	3.7	4.4

a. Growth rates over intervals are compound average; growth contributions, ratios and the GDP deflator are averages.
b. GDP measured in constant 2005 U.S. dollars.
c. GDP measured at PPP exchange rates.
d. Exports and imports of goods and non-factor services (GNFS).
e. Central America: Costa Rica, Guatemala, Honduras, Mexico, Nicaragua, Panama, El Salvador.
f. Caribbean: Belize, Dominica, Dominican Republic, Haiti, Jamaica, St. Lucia, St. Vincent and the Grenadines.
g. Estimate.
h. Forecast.

Source: World Bank.

also projected to slow by around 0.8 percentage points reflecting weaker exports and investment as global demand for Mexico's imports slows by about 1.4 percentage point. Notwithstanding some trade diversification lately, Mexico's economic fortunes are closely tied to developments in domestic demand in the United States. Given the United States super-committee's failure to agree a deficit reduction plan, substantial short-term fiscal tightening is likely, with negative consequences for domestic demand that will feed through to affect Mexican exports. Weak consumer confidence, moderate job growth, and limited real-wage increases will limit the gains in private consumption to about 3.5 percent. Lower transport cost and rising wages in China should make Mexico a more attractive investment destination over the forecasting horizon, with evidence that some Chinese firms are setting up factories in Mexico. Furthermore the ongoing re-industrialization in the U.S. is likely to benefit Mexico's manufacturing industry. Restructuring of the U.S. automotive industry expected to take place over the forecasting horizon is also expected to benefit Mexico's manufacturing sector.

In Argentina growth will decelerate markedly in 2012 on weaker external demand along with an expected deterioration in the terms of trade, the withdrawal of policy stimulus in the wake of the presidential and congressional elections, and weaker private consumption growth due to continued decline in consumers' purchasing power. Furthermore large capital outflows and monetary tightening will constrain growth in private consumption and investment. The AR$4.7 billion cut in subsidies of gas, water and electricity indicates that fiscal tightening will be pursued in 2012. Growth is projected to decelerate to 3.7 percent in 2012, from 7.5 percent in 2011, and to rise only moderately in 2013, as high inflation is taking a toll on competitiveness and high interest rates stifle investment.

Relatively subdued demand in the United States on account of high unemployment and weak consumer confidence will weigh on growth in the Caribbean and Central America. Migrant remittances to the sub-region are projected to increase about 7.6 percent and tourism revenues can expect to remain relatively weak. In Central America (excluding Mexico) strong growth in Panama, and the reconstruction-led expansion in Haiti will support growth of around 3.7 percent in 2012, as relatively subdued performance in the United States and a high debt burden will affect private consumption and investment. Growth in El Salvador is expected to accelerate only marginally to 2 percent in 2012, on the back of reconstruction spending in the wake of the massive flooding in October while growth in the agriculture sector will be very weak as a result of the heavy losses suffered during the recent flooding. Growth is expected to accelerate to 3.1 in 2013, on the back of stronger domestic and external demand, and an improved external environment, however El Salvador will continue to have among the weakest economic performance in Central America. Confidence effects and soft growth in the United States will also weigh on growth in Costa Rica, where GDP growth is expected to inch down to 3.5 percent in 2012. Domestic demand will be one of the main engine of growth in 2012 before stronger external demand and a pick-up in investment associated with the DR-CAFTA free trade agreement, particularly in the high-tech sector and business services, will boost growth to 4.5 percent in 2013. Growth in the Caribbean will hover around 4 percent over the forecasting horizon supported by sustained growth in the Dominican Republic. Growth in the Organization of Eastern Caribbean States will remain weak over the forecasting horizon, with high public debt burdens crowding out private investment and constraining growth. Slightly higher remittances should provide some relief to private consumption, while continued high unemployment in the United States will limit the recovery in the tourism sector. Increased risk aversion internationally and the confidence effects associated with the Euro area financial crisis will weigh on foreign direct investment (FDI) inflows, which account for a particularly large share of the national income in the OECS. In Saint Vincent and the Grenadines the construction of the Argyle International Airport and terminal building is expected to bolster

growth somewhat over the forecasting horizon.

Softer growth and lower commodity prices should help bring down inflation, notwithstanding the depreciation of many currencies in the region. Inflation will remain however close to the upper limit of the target range in some of the larger economies, although with growth moderating overheating is less of a concern, reflected also in the more dovish stance of most central banks in the region. In Brazil labor markets will remain relatively tight despite the marked moderation in growth, but continued moderation in credit, lower commodity prices, and a lower pass-through of the currency depreciation to local prices will help bring consumer price inflation towards the upper bound of the target range of the central bank. Furthermore a downward trend in manufacturing operating rates should help ease inflation pressures in goods prices. Inflation in Argentina will continue to run high, as expected currency devaluation over the forecasting horizon will raise prices of imported goods. Inflation should begin to slow in the second half of 2012 however, as economic growth eases.

Weak external demand and declines in the terms of trade will result in deterioration in the balance of payments, which in some cases will reverse BOP surpluses into BOP deficits. Current account should deteriorate to an estimated 1.9 percent of GDP in 2012 in Latin America and the Caribbean on account to negative terms of trade, and weaker external demand, deteriorating further to 2.2 percent of GDP in 2013.

Fiscal positions are also likely to deteriorate slightly to 2.7 percent of GDP in 2012 as weaker growth will work through the automatic stabilizers, improving slightly in 2013 as economic growth accelerates.

Net private inflows are expected to decline a further 10.2 percent to 4.1 percent of GDP, as net FDI inflows are expected to decline 7.6 percent respectively, while debt flows from private creditors are projected to decline close to 20 percent in 2012. In contrast portfolio inflows are expected to partially recover this year, rising close to 20 percent, after having plunged 60 percent in 2011. Net private inflows are expected to recover in 2013, rising 15.7 percent to 4.3 percent of GDP, still below the levels recorded in 2010. before recovering in 2013. Net FDI and private debt flows are expected to recover in 2013, rising 12.8 percent and 20.7 percent respectively.

Transmission channels, vulnerabilities & risks

The region enters the current global downturn with still relatively strong fundamentals. However, should conditions in Europe deteriorate sharply countries in the region would be adversely affected –potentially exposing vulnerabilities that have so far remained latent. As is the case in other regions, countries have less fiscal space available now than they had at the onset of the 2008/9 crisis, while the kind of sharp deterioration in commodity prices that might accompany the kind of small or large crisis outlined in the main text would further reduce fiscal space in commodity exporting countries (notably Venezuela, Ecuador, and Argentina) – while at the same time placing their current account and external financing needs under stress. Bolivia's fiscal revenues would also be affected by lower commodity prices,[4] however the country has fiscal savings in excess of 20 percent of GDP following 6 years of fiscal surpluses.

As compared with other regions, monetary authorities in Latin America & the Caribbean do have some room to ease, having tightened monetary policy in the first half of the year. Furthermore inflation expectations in most inflation-targeting economies are well anchored and monetary policy rates are close to neutral in most of these economies. However, inflation remains a problem in selected economies in the region, suggesting that even if global growth weakens – monetary policy may have to remain relatively tight to bring inflation back down to acceptable levels.

The region is also exposed to deterioration in the global climate through trade linkages. Although

most at risk economies in Europe account for only a small 4.2 share of regional exports, the larger Euro Area – which could become embroiled in a crisis if conditions worsen -- accounts for 14.8 percent of total Latin American and Caribbean exports. Exports to the euro area amount to nearly 20 percent of the total in Brazil and Chile, and almost 15 percent in Argentina and Peru, and these countries could see sharper deceleration in growth on account of weaker export performance in a scenario in which demand from Euro area contracts as a result of the deterioration in the financial crisis. The second and third round effects would be markedly larger for the region in the case of a sharp slowdown in import demand, which is very likely in a scenario of market-induced credit -event in high-income Europe. Nevertheless the region will still have one of the smallest overall impacts relative to other developing regions.

The region is perhaps more vulnerable to deterioration in terms of trade, which would be particularly pronounced in a scenario involving a major credit event in high-income Europe. In such a scenario incomes of countries heavily reliant on commodity exports would be hit hardest, while gains for commodity importing countries would be of lesser magnitude. Given that oil demand is relatively demand inelastic incomes would be hit harder than GDP in oil producing countries. Oil exporting countries like Venezuela, Ecuador, and gas exporting countries like Bolivia[5] could see the largest hits, while exporters of agricultural commodities that have a high correlation with oil prices (Argentina, Brazil) could also be negatively affected. Metal exporters (Brazil, Chile) would suffer losses from sharply lower metal prices. Government balances in commodity exporting countries are also likely to be negatively affected by large swings in commodity prices. Among the countries where government balances are hit the most are Bolivia, Argentina, Ecuador, and Venezuela.

Migrant remittances, although expected to remain more stable relative to other flows, are also likely to suffer, putting pressure on current account position in countries that rely heavily on remittances (Central America). In an adverse scenario of a contained Euro area crisis remittance growth to the region would decline by 3.5 percent relative to the baseline. Countries where remittances represent a large share of GDP like El Salvador, Jamaica, Honduras, Guyana, Nicaragua, Haiti and Guatemala would be at risk (the impact of the decline in migrant remittances could be as large as 0.6 percentage points relative to the baseline on average in these economies), with the risk more pronounced in countries that rely on remittances from the Euro are countries.

Another possible transmission mechanism is that of consumer and business confidence effects on private consumption and investment. These confidence effects could be quite large as indicated by previous financial crisis episodes, with countries at the epicenter of the financial crisis experiencing median declines in private consumption of 7 percentage points and declines in investment of 25 percentage points. High volatility in financial markets would increase the cost for firms, directly, through higher borrowing costs, and indirectly through budget uncertainty. Increased financial market volatility will also translate into increase volatility in exchange rates, with additional negative consequences for trade. The presence of significant foreign exchange structured or derivative products could lead to overshooting of currencies, as was the case with the Brazilian real and the Mexican peso in 2008, although more restrictive regulatory policies have markedly reduce their volumes in these two countries since then.

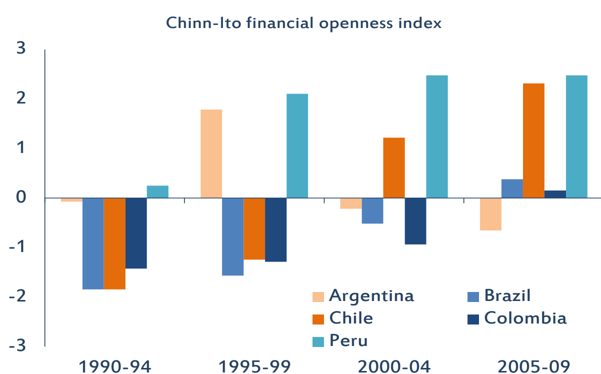
Should financial conditions deteriorate markedly with any deepening of financial stress in the euro area countries with relatively high external financing needs are more vulnerable to sudden reversal in capital flows, a drying up in credit or substantially higher interest rates. Countries like Guyana, Jamaica, Nicaragua and Panama have estimated external financing needs in excess of 15 percent of GDP in 2012. In the event of sharp contraction in capital flows these countries may be forced to sharply reduce their external financing gap by adjustments in the current

account, and/or close the external financing gap through depletion of foreign exchange reserves and increased reliance on foreign aid. Argentina is perhaps also vulnerable. The cost of four-year credit default swaps has almost tripled since 2007 (reaching 1,025 basis points), and insurance against a default within the next five years has risen 423 basis points to 1033 (suggesting a 51percent chance of non-payment). The expected large financing gap in 2012 will be difficult to meet, since the country's access to international markets is limited and the available options for garnering more resources domestically have mostly been utilized: the government has already relied on nationalizing the pension funds to raise financing and on the central bank reserves to pay debt, and has recently increased requirements on oil, gas, and mining exporters to repatriate export revenues from as little as 30 percent to 100 percent of export receipts in order to increase foreign exchange liquidity. Most other countries should not have great difficulties in meeting external financing requirements through FDI, remittances and official aid flows, which tend to be more stable.

Financial vulnerabilities are not negligible. Over the past decade the region has become more financially open (figure LAC.5). Capital controls have been relaxed, foreign ownership expanded – including in the banking, insurance and pensions sectors, while foreign investors are increasingly active in local debt and equity markets. Here, potential transmission channels are complex. Spanish banks have one of the most significant presence and highest levels of foreign claims in Latin America. However the Spanish banks are mostly decentralized in their cross-border operation with independently managed affiliates in the region. Their claims are mostly in local currency/locally funded with some exceptions.[6] Indeed, average loan to deposit ratios in the region are at or below 100 percent, with few exceptions including Chile (107 percent). As a result, the financial systems in these countries would not be excessively exposed to a sharp reduction of inflows of funding from European banks (except through the trade finance channel). As long as this kind of deleveraging occurs gradually, domestic banks and non-European banks should be able to take up the slack – as appears to be taking place in Brazil (see the Finance Annex). If parents are forced however to liquidate their assets to recapitalize parent banks or offset losses elsewhere in their portfolio, they could be forced to sell off assets in Latin America with potentially significant impacts on equity valuations – which in turn could affect capital adequacy of regional banks – generating a credit crunch even among otherwise health local banks that have strong local deposit bases (figure LAC.6).

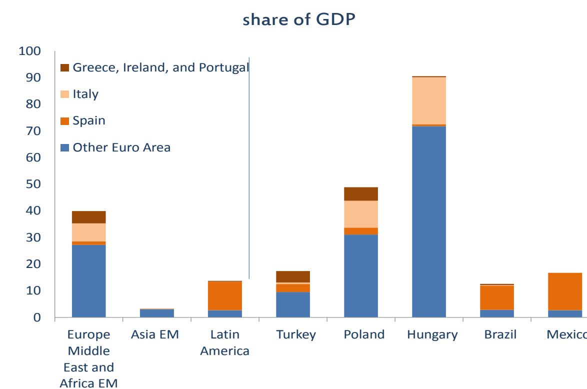
Countries with highly dollarized financial systems could also be exposed through currency risks. These risks are somewhat mitigated in countries that have large stocks of international reserves, which would allow central banks to

Figure LAC.5 Financial openness in Latin America and the Caribbean



Source: Chinn-Ito 2009.

Figure LAC.6 Foreign claims of Euro area banks on the rest of the world



Source: World Bank.

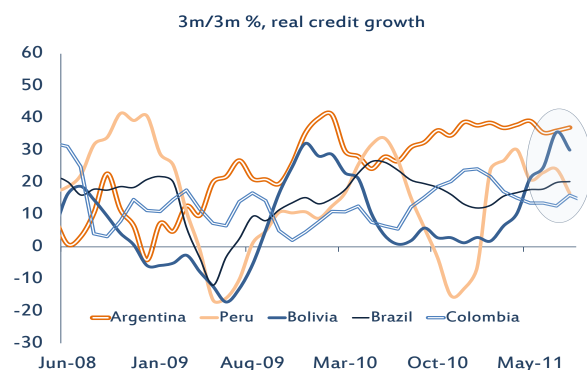
inject liquidity into the banking system in the event of a credit crunch and to stabilize the currency in the event of excessive exchange rate volatility.

Foreign bank ownership in the Caribbean is also high and banks there could be vulnerable – especially given the specialization of some banks in high-risk and relatively weakly regulated hedging and derivatives activities. Financial sector indicators in the Eastern Caribbean Currency Union are deteriorating, having been hit hard by the 2008-2009 crisis and the slow economic recovery, with some banks already facing solvency issues that could require further intervention.

Although the region is now relying less on external debt, increased foreign participation in local currency debt markets represents a potential source of vulnerability. Increased risk-aversion from the part of international investors could lead to increased borrowing costs in the domestic debt markets, should large withdrawals from foreign investors occur. Countries with deeper and more liquid markets are better able to address these vulnerabilities.

The rapid growth in domestic credit from the beginning of the global recovery through the first half of 2011 is an additional source of financial vulnerability. Real domestic credit growth remains high in most countries (figure LAC.7). It expanded more than 20 percent saar in Argentina, Bolivia, Ecuador, and Panama in the three month to September, and remains in the

Figure LAC.7 Real domestic credit growth remained robust in Latin America



Source: World Bank and IMF.

double digits in Brazil, Colombia, and El Salvador. Credit growth has eased in Peru and Chile due to the recent tightening of lending standards and other prudential measures, but the level of real domestic credit remains above the pre-crisis level. In the case of Brazil, medium and small banks have increased lending aggressively, without matching this by higher deposit base, increasing their vulnerability to a situation of tighter liquidity. Regional banks increasingly rely on wholesale funding (rather than deposits) to finance their lending operations, which could spell trouble if financing conditions tighten suddenly. On the bright side, nonperforming loans remain at low levels, although they have risen modestly of late, and banks have maintained conservative provisions. However, in the event of a sharp slowdown in growth the nonperforming loan ratio could rise sharply.

In light of these risks countries in the region should evaluate their vulnerabilities and prepare contingencies to deal with both the immediate and longer-term effects of an economic downturn.

Most countries in the region have less fiscal space available for counter-cyclical policies to cope with a sharp deterioration in global conditions as compared with 2008/09. In such eventuality, where fiscal space exists, governments could use countercyclical policy to support growth, by increasing spending on social safety nets that would limit poverty impacts, and on infrastructure projects that would benefit growth. Countries with limited fiscal space could increase the effectiveness of countercyclical fiscal policy, improving the targeting of social safety nets and prioritizing infrastructure programs necessary for longer-term growth. In such situation, monetary policy could also become more accommodative provided that inflation expectations remain anchored.

Financial oversight should continue to be improved, building on the progress made so far in many countries in the region. The countries could also benefit from further financial deepening, increased maturities of fixed-income debt, and increased local currency debt issuance.

Countries where credit has increased rapidly in recent years should engage in stress testing of their domestic banking sectors. A much weaker external environment could result in sharply lower domestic growth and falling asset prices that could result in a rapid increase in the number of non-performing loans and domestic banking stress.

Countries with large external financing needs should pre-finance these needs to avoid abrupt and sharp cuts in government and private sector spending.

With growth in high-income countries likely to remain subdued for an extended period, countries in the region may need to identify new drivers of growth and to address structural problems that negatively affect competitiveness.

Table LAC.3 Latin America and the Caribbean country forecasts

(annual percent change unless indicated otherwise)				Est.	Forecast		
	98-07[a]	2008	2009	2010	2011	2012	2013
Argentina							
GDP at market prices (2005 US$) [b]	2.2	6.8	0.9	9.2	7.5	3.7	4.4
Current account bal/GDP (%)	1.3	2.1	2.7	0.8	0.2	-0.4	-0.5
Belize							
GDP at market prices (2005 US$) [b]	5.4	3.8	0.0	2.7	2.1	2.3	2.9
Current account bal/GDP (%)	-13.1	-10.7	-6.1	-3.2	-3.3	-3.3	-4.1
Bolivia							
GDP at market prices (2005 US$) [b]	2.8	6.1	3.4	4.2	4.8	4.1	3.8
Current account bal/GDP (%)	0.8	12.0	4.7	4.4	5.8	5.0	3.8
Brazil							
GDP at market prices (2005 US$) [b]	2.8	5.2	-0.2	7.5	2.9	3.4	4.4
Current account bal/GDP (%)	-1.2	-1.7	-1.5	-2.3	-2.5	-3.2	-3.4
Chile							
GDP at market prices (2005 US$) [b]	3.4	3.7	-1.7	5.2	6.2	4.1	4.4
Current account bal/GDP (%)	0.3	-1.9	1.6	1.9	-0.4	-0.9	-1.4
Colombia							
GDP at market prices (2005 US$) [b]	3.1	3.5	1.5	4.3	5.6	4.4	4.2
Current account bal/GDP (%)	-1.4	-2.8	-2.2	-3.1	-3.1	-3.2	-3.3
Costa Rica							
GDP at market prices (2005 US$) [b]	4.7	2.6	-1.5	4.2	3.8	3.5	4.5
Current account bal/GDP (%)	-4.6	-9.4	-2.0	-4.0	-5.2	-5.1	-5.4
Dominica							
GDP at market prices (2005 US$) [b]	1.6	7.8	-0.7	0.3	0.9	1.6	2.2
Current account bal/GDP (%)	-19.0	-25.6	-21.3	-21.7	-21.9	-20.5	-18.9
Dominican Republic							
GDP at market prices (2005 US$) [b]	4.9	5.3	3.5	7.8	4.9	4.4	4.5
Current account bal/GDP (%)	-1.4	-9.9	-4.6	-8.7	-8.2	-7.5	-7.4
Ecuador							
GDP at market prices (2005 US$) [b]	3.1	7.2	0.4	3.6	6.1	3.3	3.4
Current account bal/GDP (%)	-0.1	2.0	-0.5	-3.4	-2.5	-3.5	-4.4
El Salvador							
GDP at market prices (2005 US$) [b]	2.5	1.3	-3.1	1.4	1.5	2.0	3.1
Current account bal/GDP (%)	-3.2	-7.1	-1.5	-2.3	-3.8	-3.6	-2.7
Guatemala							
GDP at market prices (2005 US$) [b]	3.4	3.3	0.5	2.6	2.8	3.1	3.5
Current account bal/GDP (%)	-5.4	-4.5	-0.1	-2.1	-2.2	-3.5	-4.2
Guyana							
GDP at market prices (2005 US$) [b]	0.6	2.0	3.3	4.4	4.6	5.1	5.6
Current account bal/GDP (%)	-8.7	-10.0	-7.7	-9.1	-10.6	-15.8	-19.2
Honduras							
GDP at market prices (2005 US$) [b]	4.0	4.0	-1.9	2.6	3.4	3.3	4.0
Current account bal/GDP (%)	-6.7	-15.3	-3.6	-6.2	-6.4	-5.9	-5.1
Haiti							
GDP at market prices (2005 US$) [b]	0.6	0.8	2.9	-5.1	6.7	8.0	8.3
Current account bal/GDP (%)	-22.4	-11.9	-9.7	-12.0	-13.4	-10.6	-11.0
Jamaica							
GDP at market prices (2005 US$) [b]	1.6	1.7	-2.5	-1.0	1.3	1.8	2.2
Current account bal/GDP (%)	-7.8	-19.8	-8.9	-7.4	-9.8	-9.1	-8.6

(annual percent change unless indicated otherwise)	98-07[a]	2008	2009	Est. 2010	Forecast 2011	2012	2013
Mexico							
GDP at market prices (2005 US$) [b]	2.8	1.5	-6.1	5.5	4.0	3.2	3.7
Current account bal/GDP (%)	-1.9	-1.5	-0.7	-0.5	-0.8	-1.4	-1.6
Nicaragua							
GDP at market prices (2005 US$) [b]	3.5	2.8	-1.5	4.5	4.1	3.3	4.0
Current account bal/GDP (%)	-21.3	-24.6	-13.4	-14.8	-16.3	-18.3	-18.4
Panama							
GDP at market prices (2005 US$) [b]	4.8	10.1	3.2	7.5	8.1	6.1	6.3
Current account bal/GDP (%)	-5.5	-11.8	-0.2	-11.0	-12.3	-10.5	-9.3
Peru							
GDP at market prices (2005 US$) [b]	4.1	9.8	0.9	8.8	6.3	5.1	5.6
Current account bal/GDP (%)	-1.1	-4.2	0.2	-1.5	-2.7	-3.1	-3.1
Paraguay							
GDP at market prices (2005 US$) [b]	1.9	5.8	-3.8	15.3	4.8	3.9	4.5
Current account bal/GDP (%)	-0.1	-1.8	0.3	-3.3	-3.1	-2.5	-2.0
St. Lucia							
GDP at market prices (2005 US$) [b]	2.0	5.8	-1.3	4.4	2.7	2.7	3.5
Current account bal/GDP (%)	-18.5	-28.4	-12.7	-12.5	-21.4	-21.9	-20.4
St. Vincent and the Grenadines							
GDP at market prices (2005 US$) [b]	4.2	-0.6	-2.3	-1.8	-0.2	1.9	3.3
Current account bal/GDP (%)	-20.5	-32.9	-29.4	-31.1	-29.1	-26.5	-25.5
Uruguay							
GDP at market prices (2005 US$) [b]	0.8	7.2	2.9	8.5	5.5	4.0	5.1
Current account bal/GDP (%)	-1.0	-5.7	-0.4	-1.2	-2.0	-2.2	-3.4
Venezuela, RB							
GDP at market prices (2005 US$) [b]	2.8	4.8	-3.3	-1.9	3.8	3.1	3.4
Current account bal/GDP (%)	8.5	12.0	2.6	4.9	9.7	6.6	5.1

World Bank forecasts are frequently updated based on new information and changing (global) circumstances. Consequently, projections presented here may differ from those contained in other Bank documents, even if basic assessments of countries' prospects do not significantly differ at any given moment in time.
Barbados, Cuba, Grenada, and Suriname are not forecast owing to data limitations.
a. Growth rates over intervals are compound average; growth contributions, ratios and the GDP deflator are averages.
b. GDP measured in constant 2005 U.S. dollars.
c. Estimate.
d. Forecast.

Notes:

1 Ecuador has entered into forward oil sales contracts with China. Therefore, some of the oil shipped to China in the third quarter were actually recorded as exports in the previous quarters.

2 United Nation World Tourism Organization, World Tourism Performance 2011 and Outlook 2010, November 2011 Volume9, Issue 2.

3 Calculations based on World Federation of Exchanges data.

4 Banks controlled by Europeans (largely through equity investment in domestic banks, but also through affiliates) account for 18.5 percent of the banking system's net worth, 25.7 percent of total lending, and 14.1 percent of total assets.

5 In the case of Bolivia the lagged moving average formula used to price gas export prices to Brazil and Argentina may cushion to some extent revenues.

6 Brazil depends on substantial cross-border lending from European banks, and some European affiliates fund a substantial portion of loans from foreign, rather than domestic, deposits (IMF 2011).

References:

International Monetary Fund, 2011, *Regional Economic Outlook:Western Hemisphere,* September 2011.

United Nation World Tourism Organization, World Tourism Performance 2011 and Outlook 2010, November 2011 Volume9, Issue 2.

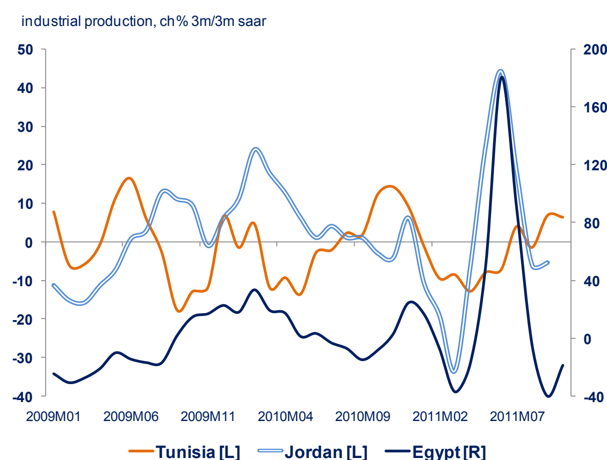
Middle East and North Africa Region

Overview

The dramatic political changes in the Middle East and North Africa of the last year have disrupted economic activity substantially, but selectively across the region. The area is now facing two sets of tensions and uncertainties—the more important of which is continuing domestic disturbance and local challenges affecting countries already taking steps toward political and economic reform (and for countries in internal conflict). At the same time a deteriorating external environment (largely in Europe) is amplifying adverse effects on goods trade, commodity prices, tourism and other critical export receipts. Though several countries in the region—including Tunisia, Morocco, and Jordan—appeared to be on the cusp of positive or improved growth in late 2011, the onset of financial crisis in the high-income countries may come to delay that event.

For the developing net-oil importing countries as a group, initial conditions going into the current period of turmoil are weak: including a lack of meaningful fiscal space, dampened economic activity, depletion of reserves and continuing social tensions in several countries. Developing oil exporters (if not in internal conflict) are better situated to withstand the brunt of the crisis, on the assumption that oil prices do not fall substantially in the face of declining demand.

Figure MNA.1 "Snap-back" dynamics affect industrial production in Egypt and Tunisia



Source: National Agencies through Thomson-Reuters Datastream

Domestic challenges are difficult and widespread. Ten months after the Arab Spring, political unrest and political economy issues continue to determine in good part economic policies and prospects for growth. Though elections held in Egypt, Tunisia and Morocco went smoothly, a degree of underlying dissension remains. A failure to achieve political and macroeconomic stability would extend uncertainties, keeping investment and economic activity at low levels for several countries, potentially for an extended period of time. Underlying demographic pressures remain unabated as well, and with prospects of slower gains in employment ahead, this becomes another area of uncertainty and vulnerability.

The Middle East and North Africa is prospectively entering a "third" crisis episode in succession, following on the "great recession", and importantly for the region, the "food price" crisis of 2007-08, under which substantial hikes in grains prices took a toll on terms of trade for all countries in the region. To a degree, today's weak fiscal positions in a number of oil importing countries, which will play a role in developments over the next two years, have their source in that period.

The region will feel the bulk of effects of slower European—and global—growth largely through the trade channel, notably oil but also manufactured goods, rather than the financial channel, given relatively weak links in this area. On balance, with the already difficult conditions being experienced by many countries in the region because of recent output disruptions, a global downturn will be felt more severely now than in 2008-09, when economic growth in the region was relatively robust.

GDP for the developing countries of the Middle East and North Africa region[1] is estimated to have increased 1.7 percent in 2011, down from the 3.6 percent gain of 2010 (table MNA.1). Growth is likely to remain subdued in 2012 (2.3 percent), as external conditions join uncertain or adverse developments on the domestic side to make recovery more difficult—in particular constraining a needed pick-up in investment outlays. Growth is expected to rise to 3.2 percent by 2013, as FDI and investment finally revive, traditional revenue streams (tourism and remittances) begin to normalize, and civil unrest in several countries is assumed to be resolved. Growth in 2012 is projected to be subdued in both oil exporters (partly reflecting weaker oil prices) and oil importers – many of which (Morocco, Tunisia, Egypt) have very close economic ties to high-income Europe, and others (Jordan and Lebanon) with closer links to the Gulf Cooperation Council (GCC) GCC economies.

Recent developments

One source of strength in the broader Middle East and North Africa economy is the large oil and natural gas windfalls being generated by the region's exporters. This has provided substantial funding for exporters to support subsidies and job creation programs as well as infrastructure-related projects which have served to quell a good portion of social uncertainty in these countries as a group. The developing oil exporters and the high-income GCC economies benefitted substantially from the rise in oil prices of 2010 and the first half of 2011, and several (e.g. Saudi Arabia, Kuwait) have increased production on the margin to cover for the earlier loss of Libyan crude oil on the market.

Overall Middle East and North Africa hydrocarbon revenues totaled $785 billion in 2011 with the developing oil economies (Algeria, Iran, Syria and Yemen) absorbing $50

Table MNA.1 Middle East and North Africa forecast summary

(annual percent change unless indicated otherwise)				Est.	Forecast		
	98-07[a]	2008	2009	2010	2011	2012	2013
GDP at market prices (2005 US$) [b]	4.2	4.1	4.0	3.6	1.7	2.3	3.2
GDP per capita (units in US$)	2.7	2.4	2.3	1.9	0.1	0.7	1.6
PPP GDP [c]	4.3	4.1	4.0	3.7	1.6	2.2	3.2
Private consumption	4.4	5.2	5.0	3.8	1.7	2.8	3.6
Public consumption	3.2	8.6	7.0	4.0	9.7	7.8	6.2
Fixed investment	6.0	7.6	2.9	1.8	-0.4	3.0	5.0
Exports, GNFS [d]	5.2	4.6	-6.3	3.0	-1.4	1.3	3.0
Imports, GNFS [d]	7.1	11.4	-1.8	2.7	1.1	4.2	5.8
Net exports, contribution to growth	-0.2	-2.2	-1.7	0.1	-0.9	-1.0	-1.0
Current account bal/GDP (%)	7.5	7.4	-0.7	2.8	3.7	2.4	1.1
GDP deflator (median, LCU)	4.7	14.6	2.0	9.6	7.5	8.5	6.0
Fiscal balance/GDP (%)	-1.0	-0.3	-3.4	-2.9	-2.6	-2.3	-2.1
Memo items: GDP							
MENA Geographic Region [e]	3.8	4.7	1.9	3.3	2.4	3.2	3.8
Resource poor- Labor abundant	4.1	6.6	5.9	4.5	1.8	3.4	4.6
Resource rich- Labor abundant	4.2	2.6	2.3	2.1	0.1	2.2	3.0
Selected GCC Countries [f]	3.4	5.3	-0.5	3.3	4.6	3.7	4.5
Egypt [g]	4.3	7.5	4.9	5.1	1.8	3.8	0.7
Iran	4.9	2.3	3.5	3.2	2.5	2.7	3.1
Algeria	3.5	2.4	2.4	1.8	3.0	2.7	2.9

a. Growth rates over intervals are compound average; growth contributions, ratios and the GDP deflator are averages.
b. GDP measured in constant 2005 U.S. dollars.
c. GDP measured at PPP exchange rates.
d. Exports and imports of goods and non-factor services (GNFS).
e. Geographic region includes high-income countries: Bahrain, Kuwait, Oman and Saudi Arabia.
f. Selected GCC Countries: Bahrain, Kuwait, Oman and Saudi Arabia.
g. Egypt growth presented on Fiscal Year basis.

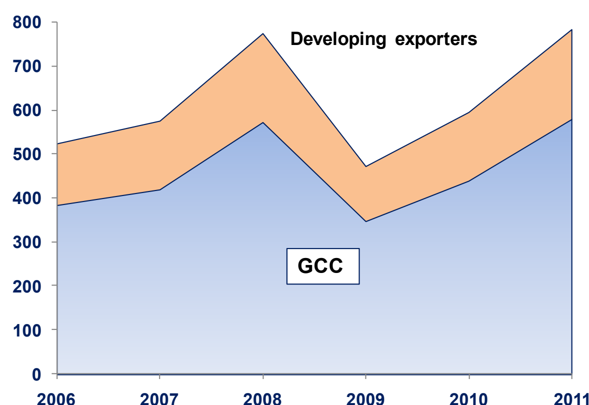
Source: World Bank.

billion of the $200 billion increase in the year (figure MNA.2). While fiscal positions in these countries remain sustainable (0.6 percent of GDP for developing oil exporters and 12 percent for the GCC economies), should oil prices decline sharply, governments could be forced to cut into spending in a pro-cyclical manner.

Several of the net oil-importing developing countries—Egypt, Tunisia, Jordan and Morocco—saw declines in industrial output or GDP during the first quarter of 2011, which impaired business and household sentiment after a period of greater ebullience. These led to a near-collapse in investment and sharp falloff in consumer and government spending. GDP contracted by more than 6 percent in the first quarter of 2011 (q/q) (25.8 percent annualized pace in Egypt and 24.2 percent in Tunisia) due in large measure to dislocations and disturbances of the initial weeks of protests. As the situation on the ground began to stabilize, GDP snapped back, placing Egypt's decline for the first three quarters of 2011 at a much more moderate 1.2 percent (saar), with similar outturns for Tunisia.

GDP declines were less dramatic for countries not experiencing large protest movements. In Jordan for example, GDP dropped by 1.3 percent (q/q) in the first quarter and 0.7 percent in the second (or 5.2 and 2.7 at an annual rate). Morocco's GDP advanced at a strong 4.2 percent clip during the second quarter (saar). And through Lebanon does not publish quarterly GDP, coincident indicators dropped 12 percent between late 2010 and August 2011.

Figure MNA.2 Oil exporters enjoy windfall $785 billion in 2011 revenues



Source: U.N COMTRADE, IEA, OPEC.

Data on industrial production suggest that Tunisia and Egypt have taken a very hard hit from residual domestic unrest, uncertainties over political outcomes and the onset of financial turmoil in Europe. In Jordan, after an initial post-crisis spurt, production dropped from a 44 percent annual gain in the three-months ending June to decline of 5 percent in the third quarter. In Egypt production snapped back sharply to 180 percent annualized during the second quarter, only to fall to a 40 percent decline in the following quarter. And in Tunisia, developments have been similar, though much less volatile, with production standing some 6 percent higher during the third quarter vis-à-vis the second (figure MNA.1 earlier).

Unemployment in Egypt jumped from 8.9 percent in December 2010 to 11.8 percent by June 2011. Economic turbulence has taken a toll on confidence within and outside of the region, in particular increasing the already high risk aversion of international investors. Indeed, spreads on regional sovereign debt stand higher than those of any other developing region at the moment.

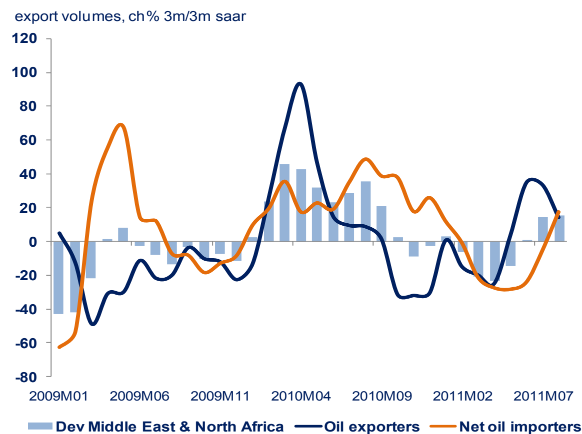
Merchandise export volume growth was weak all year (particularly for the oil-importing countries of the region), reflecting the influence of the broader disruptions linked to the Arab Spring, the less direct influence of the Tohoku earthquake in Japan; and most recently the financial turmoil in Europe and associated weak import demand. Still, recent export performance shows improvement, on the grounds of stronger oil exports, up 14 percent as of August (saar) as well as a fillip for net oil importers, pushing goods exports to a 17 percent annual pace in the same month, led by strong gains in phosphates from Morocco and Jordan (figure MNA.3).

The net oil importers are particularly vulnerable to changes in European import demand. Tunisia ships fully 80 percent of its manufactured goods exports to the EU-25, Morocco more than 65 percent and Egypt almost 40 percent. In contrast

Jordan has a sizeable share of trade destined for the United States (under a FTA signed in the 1990s) (figure MNA.4).[2] But average data on export volumes masks varying conditions across countries, where stronger performance in dollar-based trades for Morocco and Jordan has been grounded in phosphates and fertilizers (facing robust global demand), while Egypt and Tunisia have been subject to more substantial volatility and decline in demand from Europe and the United States.

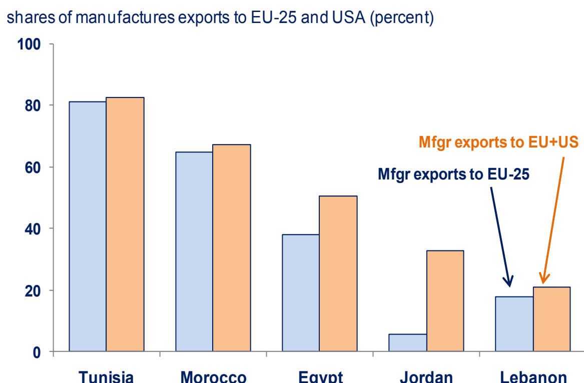
Economic growth of economies in internal conflict deteriorated in 2011, both as armed confrontations denied firms access to export markets (notably Libya), but also because violence disrupted day to day economic business. Not only has there been substantial loss of life and property in these encounters, but also uncertainty concerning the region has been amplified on account of these situations. In Libya, private sector analysts suggest that GDP may have fallen by a cumulative 30-50 percent during the course of the conflict, with non-oil output declining 20 percent. Reconstruction, un-freezing of the regime's assets and resumption of oil production will be the priorities of the transition government—likely over-shadowing the formation of economic policy in the near term. Resolution to the conflict and improvements in overall security conditions, could generate a rebound in activity. In particular, the possible return of migrant workers could help restore production and demand within the country, while also reestablish remittance flows to varying countries of origin. In Syria, the United Nations estimates that 2,200 people have died since violence broke out, but public dissent seems unabated, prompting segments of the international community to call for regime change. New sanctions may begin to bite shortly, with the Arab League having joined bilateral parties in demands for various measures of change in late November 2011.

Figure MNA.3 Oil importing economies' exports hit hard in 2011, but signs of rebound accruing



Source: National Agencies through Thomson-Reuters Data-stream

Figure MNA.4 Oil importers carry elevated exposures to European demand



Source: U.N COMTRADE.

In Yemen, negative growth in 2011 is likely, despite a recent step up in hydrocarbons output. The outlook for countries in conflict is dependent on the speed and efficiency with which protests, disruptions to civil life and larger scale conflict can be resolved and new plans and reforms put in place. This is clearly a challenging and lingering uncertainty for the region.

Developing oil exporters (considering here just Algeria and Iran, as Syria and Yemen are occupied with their respective internal conflicts) and the GCC benefitted from a sharp rise in crude oil prices (World Bank average) toward the end of 2010 and into 2011. Prices peaked near $120/bbl in April, when the loss of 1.4mb/d of Libyan oil exports significantly tightened light/sweet crude markets, particularly for Europe where much of Libya's crude was sold.

Subsequently prices eased, mainly because of slowing global growth (global oil consumption increased only 1/mbd in 2011), but also reflecting a drawdown on International Energy Association strategic reserves and rising production outside of OPEC.

GDP in Algeria is estimated to have increased by 3 percent in 2011, on high oil prices and strong advances in the non-oil sector. Oil and gas revenues jumped 25 percent, reaching $44 billion (or 26 percent of GDP), part of which the government used to raise public-sector wages, support employment and housing, and to mitigate the pressure on living standards from escalating food and fuel prices. The increased expenditures amounted to some 0.6 percent of GDP in 2011, and with a fiscal deficit of 1.1 percent of GDP are unlikely to be sustainable unless the price of oil remains at today's high levels.

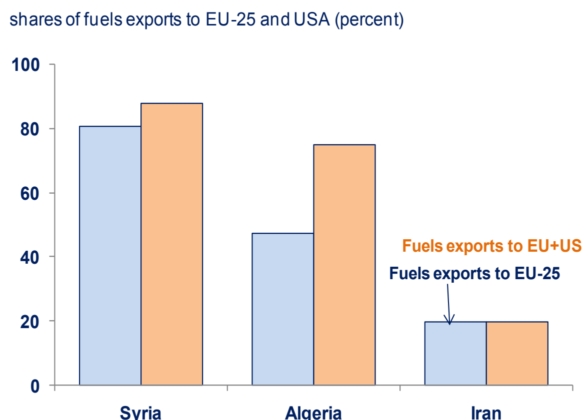
In Iran, despite the introduction of international sanctions, rising oil prices and a good crop helped to support growth of about 2.5 percent in calendar year 2011. A revision to the system of subsidies and cash transfers to better balance reimbursements and fiscal accounts has been looked upon favorably by outside analysts. But severe difficulties in the non-oil sector (manufacturing and services) persist.

As is the case with the oil-importing economies, the developing oil exporters (Iran excluded) have strong export links with the European Union, notably Syria, with 80 percent of fuels shipments destined for the EU-25, and Algeria, where substantial movements of natural gas and oil through pipeline and ships comprise 48 percent of hydrocarbons shipments; the United States absorbs another 30 percent of the country's output (figure MNA.5).

Figure MNA.6 highlights the sources of the 2010 and 2011 increase in revenues for oil exporters in the larger geographic region (including the GCC countries): in 2010 production increased moderately and the global oil price rose by $18/bbl; and in 2011, regional production increased by about 28kbl/d, together with a $24/bbl rise in price. Still, fiscal vulnerability has increased as a consequence of the substantial buildup in spending packages implemented in the last three years. In particular, the fiscal break-even oil price—price levels that ensure that fiscal accounts are in balance at a given level of spending—have been trending up for most countries, and are gradually approaching the spot market price.

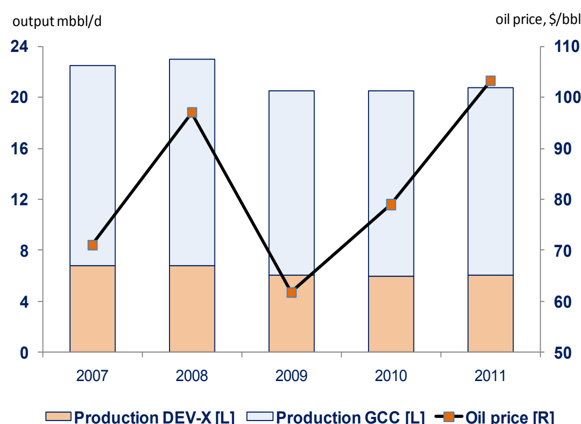
Tourism, migrant remittances and capital flows are important sources of income and foreign currency in the region, particularly for the net oil importers. In Egypt for example, during 2010 (before the "Arab Spring"), tourism revenues amounted to about $12.2 billion or 5.6 percent of

Figure MNA.5 Dev oil exporters reliant on Europe and USA



Source: U.N COMTRADE.

Figure MNA.6 Oil output gains and higher prices lead to 2011 windfall



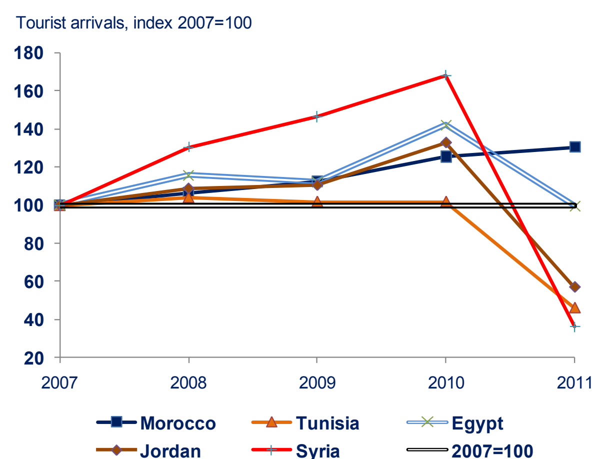
Source: International Emergy Agency, World Bank.

GDP; for Tunisia and Jordan the figures were $2.6 billion (5.7 percent of GDP) and $4 billion (14.8 percent), respectively.

The decline in tourism arrivals to the region has been unprecedented, according to estimates from the United Nation's World Tourism Organization (UNWTO). Syria was hardest hit (figure MNA.7), with the number of visitors dropping by 80 percent in 2011, followed by Jordan (57 percent), Tunisia (55 percent) and Egypt (30 percent).[3] UNWTO estimates that arrivals to Morocco increased as visitors chose it over some of its less stable neighbors. Once more, the underlying cause of the falloff in tourism is deep uncertainty about the set of domestic conditions across the region.

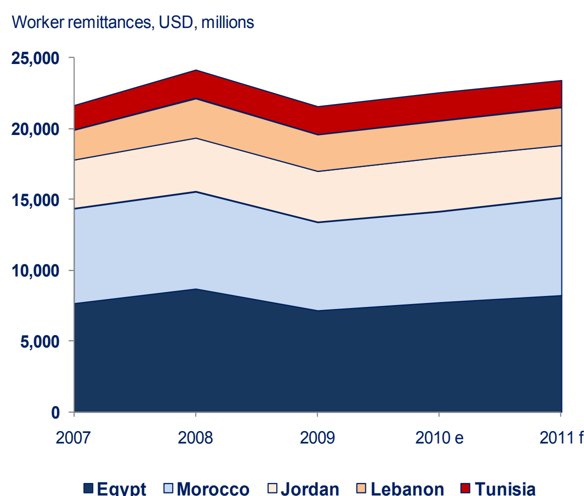
In contrast, migrant remittances held up relatively well in 2011, increasing by some 2.6 percent. While weaker conditions in European labor markets would have been expected to reduce income transfers to home countries notably in the Maghreb) data suggest that the dollar value of these flows increased by $500 million for Morocco, a like amount in Egypt, and $100 million in Lebanon. Jordan and Tunisia suffered only moderate declines. The increase in flows likely reflects a conscious effort by expatriates to increase support during the political difficulties faced by these countries. At the same time oil revenues have powered the GCC economies to robust GDP gains in 2011, helping to underpin activity, employment and remittance outflows (figure MNA.8).

Figure MNA.7 The falloff in tourism--key factor in lower growth



Source: U.N. World Tourism Organization; World Bank estimates.

Figure MNA.8 Remittances have held up better than expected



Source: World Bank.

Table MNA.2 Foreign Direct Investment flows, 2007 through 2011(e)

	2007	2008	2009	2010e	2011f
FDI Inflows $bn					
Egypt	11.57	9.50	6.71	6.38	2.22
Lebanon	3.37	4.33	4.80	4.98	3.96
Tunisia	1.62	2.78	1.69	1.51	1.12
Morocco	2.80	2.48	1.95	1.30	1.09
Jordan	2.62	2.83	2.43	1.70	1.16
Total	**22.00**	**21.90**	**17.59**	**15.86**	**9.56**
ch%	*-2.1*	*-0.4*	*-19.7*	*-9.8*	*-39.7*
FDI outflows $bn					
Saudi Arabia	-0.1	3.49	2.18	3.91	4.10
Kuwait	9.78	9.09	8.64	2.07	1.00
UAE	14.58	15.82	2.72	2.01	1.81
Qatar	5.16	6.03	11.58	1.86	1.49
Bahrain	1.69	1.62	-1.79	0.33	-0.1
Total	**31.12**	**36.54**	**23.40**	**10.51**	**8.64**
ch%	*52.3*	*17.4*	*-36.0*	*-55.1*	*-17.8*

Source: UNCTAD, International Investment database (update November 2011).

Box MNA.1 FDI links and aid flows: developing MENA and the GCC

This year's fall off in FDI extends a medium-term trend that began in 2009. Flows to developing Middle East and North African (MENA) economies dropped by 40 percent in 2011, on the heels of a cumulative 25 percent decline over 2009 and 2010—notably for Egypt (65 percent in 2011) and Jordan (30 percent). On the "investor side", from GCC members UAE, Qatar and Kuwait investment abroad has fallen sharply, by 18 percent during 2011, on the heels of a 70 percent retrenchment over 2009-10. Part of this earlier decline is related to the restructuring of balance sheets in the wake of the financial crisis in Dubai (table MNA.2).

A downward trend is in force for both inflows and outflows –increasing amounts of which had been directed at the developing MENA region from the GCC. This development will take some time to turn around, as though GCC economies are enjoying strong oil windfalls and boosting non-oil growth through government outlays, recovery in FDI will require a rebuilding of confidence in FDI destination countries, so that for the near-term, investment outlays in the region may be difficult to restart.

A counterpoint to this trend is recent GCC actions in Morocco. Despite the uncertain domestic and external environments facing countries in the region, Morocco (the economy is experiencing solid growth of late), has been the beneficiary of several GCC investment proposals related to development projects (Qatar and Kuwait), and notably in new tourism facilities (UAE and others at $2.5 billion).

Following several years of reduced aid flows during the early 2000s, 2011 saw a surge in donor flows from Arab nations. Saudi Arabia and other GCC members stepped up aid to the developing countries of MENA in an effort to ensure that transitioning and other economies in the region are able to respond to demands for change.

Overall, aid from Saudi Arabia and the GCC for developing MENA is expected to reach $15 billion for 2012-2015, with the bulk to be furnished by Saudi Arabia. The aid should enable Egypt, Jordan, and to a lesser degree, Morocco, to shore up balance sheets and increase subsidies to ameliorate food price and other pressures on the population. Jordan is likely to benefit the most, having already been recipient of a $400 million cash grant from Saudi Arabia; and another $1 billion came through on July 28, 2011.

The GCC has also established a new Development Program to support Bahrain and Oman, the two GCC countries which experienced protests and popular calls for reform. The program should provide $10 billion in investment funding over ten years, focused on housing and infrastructure, and akin in function to earlier EU Cohesion Funds.

External capital flows to developing countries in the region declined sharply during the course of the year, with FDI (mainly from the GCC) down nearly 40 percent, while equity and bond flows are estimated to have dropped in the third and fourth quarters to levels only half as high as in 2010. However, official aid from the GCC and others is restoring a good portion of (and in some cases more than 100 percent of) lost liquidity to several economies in the region – and helping some of the transitioning economies to meet fiscal shortfalls (box MNA.1).

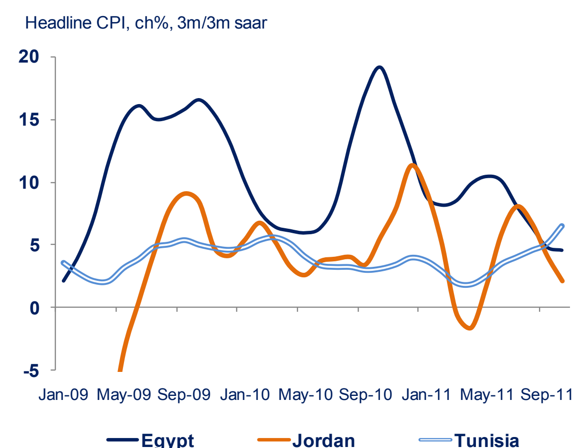
Capital flows, aside from foreign direct investment, have traditionally been small in the developing Middle East and North Africa region, though equity inflows into Egypt, Lebanon and Morocco, and bond issuance by Tunisia and Lebanon had built some momentum before the global financial crisis of 2009. Accompanying the notable decline in FDI during 2010 and 2011, net portfolio equity investment dropped effectively to nil in 2010 and $500 million during 2011 (table MNA.3). However, net private debt flows rose from $2.3 billion in 2010 to $4.8 billion in 2011 due to increased bank borrowing.

Moreover, bond spreads for Tunisia, Lebanon and Egypt have widened, and banking sector balance sheets in some countries are expected to deteriorate. It is likely that under baseline conditions, the transitioning economies will require extensive external financing in 2012, which the International Monetary Fund places at some $50 billion.[4]

Inflation eases on international developments and government intervention A stabilization, and subsequent modest decline in world food prices contributed to ease inflationary pressures in the region over the course of 2011. Regional food

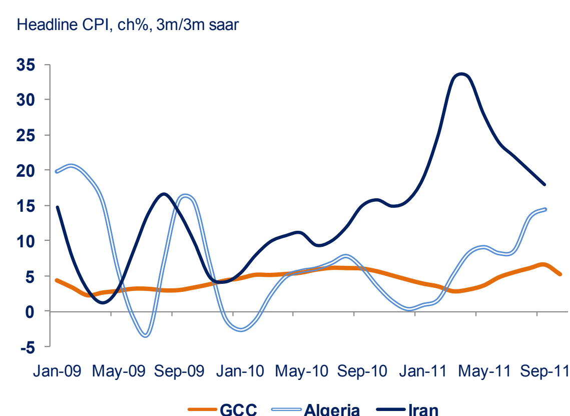
prices were rising at a 20 percent annualized pace in the first quarter – pushed by rising international food prices. However, as global prices stabilized and even declined, the pace of regional food inflation eased to an 8 percent annualized pace as of July (latest data available). Inflation is a particular worry for developing oil exporting countries, where for Algeria and Iran it exceeds 10 percent (at seasonally adjusted annualized rates, or "saar").[5] In net oil importing countries a combination of very weak growth and food and fuel subsidies have attenuated inflationary pressures, although at large budgetary cost in most cases (figure MNA.9). Inflation has fallen in Egypt from a peak of 20 percent in October 2010 to 4.6 percent as of October 2011, and in Jordan from 11.3 percent during the final quarter of 2010 to 2 percent by October. Iran has made important efforts to reform its income support system away from subsidies and toward better targeted social safety nets, and this has brought down the pace of price

Figure MNA.9 Subsidies work to reduce inflation for oil importers



Source: World Bank.

Figure MNA.10 Iran's reform program dominates oil-exporter CPI landscape



Source: World Bank.

Table MNA.3 Net capital flows to Middle East and North Africa

Net capital flows to MENA
$ billions

	2004	2005	2006	2007	2008	2009	2010	2011e	2012f	2013f
Current account balance	0.1	19.9	30.6	24.3	19.2	-20.8	-9.6	39.8	27.8	13.6
as % of GDP	0.0	3.6	4.8	3.2	2.1	-2.3	-0.9	3.4	2.2	1.0
Financial flows:										
Net private and official inflows	**12.9**	**19.4**	**14.5**	**28.5**	**19.7**	**28.3**	**25.4**	**24.6**		
Net private inflows (equity+private deb	**16.4**	**22.5**	**25.7**	**27.4**	**21.5**	**25.9**	**24.2**	**23.3**	**15.1**	**22.2**
..Net private inflows (% GDP)	3.4	4.1	4.0	3.6	2.3	2.8	2.4	2.0	1.2	1.6
Net equity inflows	10.4	19.2	28.2	25.5	29.6	27.3	22.7	19.0	13.9	19.9
..Net FDI inflows	9.7	16.8	27.2	27.6	29.2	26.1	22.7	19.0	13.9	19.9
..Net portfolio equity inflows	0.7	2.4	1.0	-2.1	0.4	1.2	0.0	0.5	0.6	1.0
Net debt flows	-8.1	0.8	-16.8	79.2	59.0	51.5	70.5			
..Official creditors	-3.4	-3.2	-11.3	1.1	-1.8	2.4	1.2	1.3		
....World Bank	-0.6	0.0	-0.8	1.0	-0.3	0.9	0.8	0.5		
....IMF	-0.5	-0.7	-0.2	-0.1	-0.1	-0.1	0.0	0.0		
....Other official	-2.3	-2.4	-10.3	0.2	-1.4	1.6	0.4	0.8		
..Private creditors	6.0	3.4	-2.5	1.9	-8.2	-1.4	1.5	4.3	1.2	2.3
....Net M-L term debt flows	2.7	3.1	-1.7	-1.6	-4.0	-3.0	0.4	2.3		
......Bonds	2.8	2.5	0.8	0.7	-0.8	0.1	3.2	1.8		
......Banks	0.0	1.3	-1.3	-1.3	-1.8	-2.1	-1.9	0.5		
......Other private	0.0	-0.8	-1.2	-1.1	-1.3	-0.9	-0.8	0.0		
....Net short-term debt flows	3.2	0.3	-0.8	3.5	-4.2	1.6	1.1	2.0		
Balancing item /a	1.7	-0.3	-7.2	-4.8	4.5	16.7	8.3	-65.8		
Change in reserves (- = increase)	-14.7	-38.9	-37.8	-48.0	-43.4	-24.2	-24.1	1.4		
Memorandum items										
Migrant remittances /b	23.2	25.1	26.5	32.1	36.0	33.6	34.7	35.6	37.4	39.4

Source: The World Bank

Note:

e = estimate, f = forecast

/a Combination of errors and omissions and transfers to and capital outflows from developing countries.

/b Migrant remittances are defined as the sum of workers' remittances, compensation of employees, and migrant transfers

Source: World Bank.

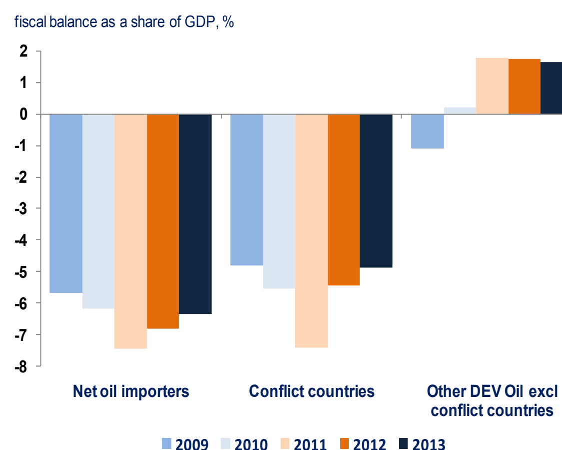
changes into a range of 15-20 percent. Further pursuance of these reforms will need to be made to bring Iran's inflation solidly into single digits (figure MNA.10).

Policy developments

Fiscal policy has been strongly expansionary in much of the region; for example, fiscal deficits of the net oil importers rose to 7.3 percent of GDP in 2011 from 6.2 percent in 2010 and 4.4 percent in 2007, before the financial crisis (figure MNA.11 and table MNA.4). In several countries with declining fiscal space, including Jordan and Morocco, expansion of social programs in response to popular demand has occurred at the expense of public investment programs. A sharp decline in revenues among the oil importing countries is mainly cyclical in nature, but the increase in social spending and transfers has a large permanent (structural) component and will be difficult to maintain. And the fiscal deficit of countries in conflict ballooned in 2011 to 6.5 percent of GDP, exacerbated by the need to procure supplies, weapons and etc., for armed forces involved in the conflicts.

There is a clear medium term shift in monetary policy toward loosening, as evidenced by reductions in policy rates across all groups for which data exist. The more impressive compression of interest rates has occurred among the oil importers (150 basis points (bps) between 2007 and 2011), with larger countries averaging closer to 200 bps. GCC rates are exceptionally low, but have also registered a reduction of some 165 bps. Lower inflation (regardless how measured), weaker growth and a

Figure MNA.11 Fiscal costs are substantial



Source: World Bank.

Table MNA.4 Economic outturns and policy developments 2011

	Fiscal balance %GDP		Reserves in months of imports		Policy interest rate (basis points)		Headline CPI, ch% 3m/3m saar		CAB %GDP	
	2007	*2011*	*2007*	*2011 /**	*2007*	*2011 /**	*2007*	*2011 /**	*2007*	*2011*
Net oil importers	**-4.4**	**-7.3**	**8.3**	**8.4**	**7.50**	**6.00**	**12.5**	**2.5**	**-5.2**	**-5.6**
Egypt	-7.8	-9.5	10.0	5.5	10.28	8.25	18.3	4.8	0.5	1.8
Tunisia	-0.7	-5.1	4.6	4.7	5.25	3.50	4.9	5.1	-3.8	-5.8
Jordan	-4.1	-5.7	5.3	7.0	6.70	4.50	13.9	4.1	-9.3	-8.5
Morocco	0.2	-5.5	8.8	6.0	3.32	3.25	3.8	-3.0	-0.1	-6.7
Lebanon	-9.6	-5.5	12.7	18.6	12.00	10.00	3.4	-1.8	-9.1	-20.6
Conflict	**-0.3**	**-6.5**	**10.6**	**5.2**	**....**	**....**	**....**	**....**	**-2.0**	**1.5**
Syria	2.7	-7.1	9.6	7.3	.....	.....	.....	.....	0.1	-2.2
Yemen	-3.2	-8.0	11.5	3.1	.....	.....	.....	.....	-4.1	9.6
DEVOil-X	**4.5**	**0.9**	**23.1**	**25.2**	**....**	**....**	**15.9**	**15.8**	**14.3**	**8.5**
Algeria	9.1	-1.1	35.0	37.9	.....	.....	4.4	14.5	20.2	10.8
Iran	0.0	2.8	11.2	12.5	.....	.....	25.6	17.0	8.5	8.9
GCC	**19.3**	**8.5**	**12.0**	**10.0**	**3.00**	**1.35**	**10.0**	**6.8**	**26.2**	**24.4**
Saudi Arabia	35.4	11.7	31.9	27.3	5.07	2.00	9.9	7.6	27.8	20.6
Kuwait	19.9	17.2	5.3	7.0	1.00	0.75	10.6	4.2	40.5	33.5
Bahrain	4.9	-2.4	4.1	3.5	2.19	0.50	3.5	6.0	10.2	5.9
Oman	17.2	7.6	6.4	5.7	3.70	2.00	12.5	6.2	8.3	11.0

Source: World Bank.

foreseen need to loosen financial conditions with tougher economic times on the horizon has yielded an acceleration in policy interest rate cuts within the region. A notable exception, once more, is Egypt, which on November 30, 2011 raised its benchmark policy rate by a full 100 basis points to 9.25 percent, the first tightening move for the country since 2008, to ease pressure on the pound amid tense political conditions.

In aggregate, developing countries of the region saw an increase in current account surplus positions from $27 billion in 2010 to $41 billion in 2011, due in the main to higher revenues for oil exporters. This enabled a modest build up of reserves of some $2.4 billion (Iran not included in this tally). In contrast, the oil importers saw their reserves fall by 17 percent ($13 billion) to $67 billion, though at 6.4 months of imports and 200 percent of short-term capital and maturing debt, they remain ample at present. The notable exception is Egypt, where capital outflow and pressure on the exchange rate compelled authorities to draw some $11 billion of the $13 total in reserves for the oil-importing group to support the pound. This represents 4.5 percent of Egypt's GDP leaving reserves representing just 4.8 months of imports.

On balance, with the already difficult conditions being experienced by many countries in the region because of recent uprisings, a global downturn will be felt more severely now than in 2008-09, when economic growth in the region was relatively robust.

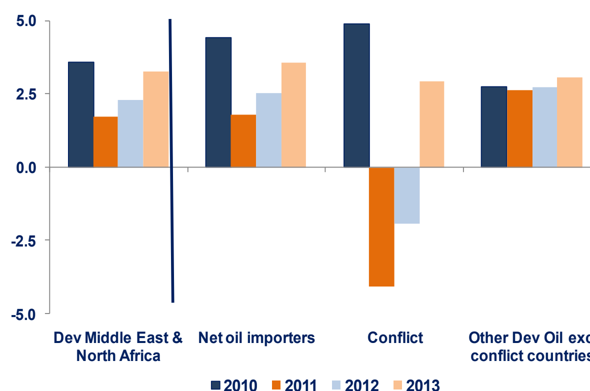
Medium-term outlook

Even if the external environment for growth were not as sobering as it is, the ongoing political tensions in the region would likely have constrained outturns over the next few years. Though the negative economic effects of the acute phase of transition may have begun to pass for Egypt, Tunisia, and Libya, they may continue to weigh on growth in Syria and Yemen. In the projections outlined below, intra-country conflicts are assumed to stabilize in one form or another during the course of 2012, so that the impact of this year's disruptions on economic activity begins to wane by 2013. Reduced political instability could be accompanied by an improved business climate, higher investment and stronger FDI flows– all contributing to improved economic conditions.

However, that recovery will be less marked and buoyant than otherwise because European economic turmoil will reduce demand for the region's exports, diminish the availability of commercial finance and lower commodity prices. Thus while domestic conditions would point to a relatively strong rebound in activity by 2013, actual outturns and the baseline forecast is for more muted improvement, with growth in oil importing countries accelerating from 1.8 percent in 2011 to 2.5 and 3.6 percent in 2012 and 2013 (figure MNA.12 and table MNA.1 earlier). Recovery is anticipated to be slower among countries still in conflict, but nevertheless a rebound should be more vigorous by 2013 given the extent of output losses anticipated over 2011 and 2012.

The region will feel the bulk of effects of slower European—and global—growth through the trade channel, especially oil, but also in manufactured goods rather than the financial channel, given relatively weak links in this area. Oil exporters will face reduced demand and lower prices. Oil importers with EU links will feel the weakness mainly through goods trade, and in some case through remittances. And oil

Figure MNA.12 By 2013 reforms should be bearing fruit



Source: World Bank

importers with GCC links (Jordan, Lebanon) will be more shielded, but will still feel indirect effects from lower activity in the GCC.

Prospects for a return to the growth rates that Egypt and Tunisia experienced in the previous decade are slim over the period through 2013, with weak European demand and necessary fiscal consolidation (given weak external financing conditions) expected to weigh on growth. Nonetheless, GDP gains for these countries are expected to improve from 0.3 percent in 2011 to 3.1 percent by 2013—still well below potential and trend growth rates, implying an output gap of close to 5 percent of GDP in 2013. Morocco and Jordan have been less affected by protest. Implementation of select reforms in both countries, and the holding of parliamentary elections (Morocco) have been important elements in tying social fabric tighter. Growth in Morocco is projected to slow to 4 percent in 2012 from a 4.3 percent gain in 2011, reflecting weaker European demand; but gains are expected to strengthen to 4.2 percent by 2013 as global recovery emerges. Jordan is anticipated to follow a similar growth path, but at a slower pace, with GDP expanding 1.7 percent in 2012, and accelerating to 3 percent by 2013, restrained to a degree by still lackluster exports to the United States, offset by stronger conditions among the GCC economies at that time (table MNA.5).

For developing countries in conflict, here Syria and Yemen, ongoing social and military disruptions are expected to continue to weigh on activity during 2012, but as conditions stabilize, growth should pick up to a 2.9 percent pace by 2013. And for the remaining developing oil exporters, Algeria and Iran, growth is projected to pick-up modestly from 2.7 percent in 2011 to 3 percent by 2013. Slow growth reflects in part moribund export market growth, weakening revenues as oil prices ease and continued high leakage in the form of imports as populations continue to spend oil revenues in the form of government transfers or subsidies. Offsetting external drag, stronger developments in non-oil sectors should help to underpin GDP gains—on outlays of planned large-scale social and infrastructure projects with lifespan extending 3 to 5 years.

Risks and vulnerabilities

Extreme uncertainties face the region, in having to address both the continuing threats of protest and slower movement on political economy reforms, at the same time as facing a real crisis in the Euro Area. Within the Middle East and North Africa, an important risk is that armed violence in countries– notably Syria and Yemen – is not resolved in 2012. A differentiating factor between Yemen and Syria at this juncture is the existence of a 'road map' for the former in the form of the GCC-inspired Transition Agreement of November 23, with which a large part of society appears to be willing to work with. But, should unsettled conditions extend for a longer period despite bilateral and multilateral diplomatic efforts to bring conflicts to closure, uncertainty will continue to cloud the region, likely restraining an anticipated rebound in activity in 2013.

The Middle East and North Africa is highly exposed to an exacerbation of the European crisis, with strong and broad links through trade, tourism arrivals, migrant remittances, and to a lesser degree, finance.[6] With the advent of the "Arab Spring", policy decision making had become exceptionally more difficult. And policies may now have to shift once more to fend off the adverse effects stemming from the situation in Europe and potential alternate courses toward eventual closure of the crisis there—though room for maneuver is slim for oil-importers (and some oil exporters) in the region.

As a major trading partner for Europe, exports would be directly affected, while a serious crisis in Europe would likely also be accompanied by a significant tightening of global financial conditions and importantly a drop in commodity prices – potentially placing strains on countries with large fiscal and current account deficits (though the distinct mix of oil exporters and oil and food importers in the region would yield mixed results for terms of trade and fiscal effects—positive for the transitioning

economies, not favorable for the developing oil exporters).

On the fiscal side, oil-importers within the region might see fiscal shortfalls increase substantially in the case of a significant slowdown; while oil exporters would be affected by both weaker demand but also lower revenues due to lower prices. Assuming that financial shortfalls can be met through international capital markets GDP impacts could range between -0.8 and -1.2 for oil importers and -0.2 and -0.6 percent for oil exporters. If financing is not forthcoming, countries where current accounts and government deficits are expected to deteriorate most sharply could be forced to cut more deeply into spending (additional fiscal shortfalls could exceed 3 percent of GDP in Egypt, Jordan and Tunisia).

And countries with high-levels of indebtedness would be particularly vulnerable to a tightening of international credit conditions. Lebanon could be exposed to this channel because of relatively high external financing needs (reflecting short- and medium-term debt repayments and and/or large current account deficits).

On balance, risks are to the downside for the region, given the extensive exposures of so many

Table MNA.5 Middle East and North Africa forecast summary

(annual percent change unless indicated otherwise)				Est.	Forecast		
	98-07[a]	2008	2009	2010	2011	2012	2013
Algeria							
GDP at market prices (2005 US$) [b]	3.5	2.4	2.4	1.8	3.0	2.7	2.9
Current account bal/GDP (%)	28.9	20.0	0.1	8.1	10.8	8.9	6.3
Egypt, Arab Rep.							
GDP at market prices (2005 US$) [c]	4.3	7.5	4.9	5.1	1.8	3.8	0.7
Current account bal/GDP (%)	0.9	-0.9	-2.0	1.6	1.8	1.8	1.6
Iran, Islamic Rep.							
GDP at market prices (2005 US$) [b]	4.9	2.3	3.5	3.2	2.5	2.7	3.1
Current account bal/GDP (%)	10.3	15.2	4.6	6.5	8.9	6.6	4.2
Iraq							
GDP at market prices (2005 US$) [b]		9.5	4.2	0.8	9.6	12.6	10.2
Current account bal/GDP (%)		19.2	-13.8	-3.2	-1.5	-4.5	6.0
Jordan							
GDP at market prices (2005 US$) [b]	5.6	7.6	5.5	2.3	2.5	1.7	3.0
Current account bal/GDP (%)	-2.3	-9.0	-4.4	-4.8	-8.5	-6.9	-5.2
Lebanon							
GDP at market prices (2005 US$) [b]	2.8	9.3	8.5	7.0	3.0	3.8	4.4
Current account bal/GDP (%)	-17.5	-13.6	-19.7	-20.9	-20.6	-17.2	-14.6
Morocco							
GDP at market prices (2005 US$) [b]	3.7	5.6	4.8	3.7	4.3	4.0	4.2
Current account bal/GDP (%)	1.4	-5.2	-5.4	-4.3	-6.7	-7.3	-6.7
Syrian Arab Republic							
GDP at market prices (2005 US$) [b]	3.3	4.5	6.0	3.2	-3.0	-1.5	2.5
Current account bal/GDP (%)	3.0	0.1	-2.3	5.1	-2.2	-5.0	-7.0
Tunisia							
GDP at market prices (2005 US$) [b]	4.5	4.6	3.1	3.0	-0.5	2.5	3.2
Current account bal/GDP (%)	-2.8	-4.2	-2.7	-4.6	-5.8	-5.8	-6.0
Yemen, Rep.							
GDP at market prices (2005 US$) [b]	3.5	3.6	3.8	8.0	-6.0	-2.6	3.6
Current account bal/GDP (%)	2.5	-4.6	-8.3	7.6	9.6	5.5	2.4

World Bank forecasts are frequently updated based on new information and changing (global) circumstances. Consequently, projections presented here may differ from those contained in other Bank documents, even if basic assessments of countries' prospects do not significantly differ at any given moment in time.
Djibouti, Libya, West Bank and Gaza are not forecast owing to data limitations.
a. Growth rates over intervals are compound average; growth contributions, ratios and the GDP deflator are averages.
b. GDP measured in constant 2005 U.S. dollars.
c. Egypt growth presented on Fiscal Year basis.

Source: World Bank.

countries to Europe and a dependence on commodity prices. Countries will need to take decisive action to formulate a broad reform agenda—aimed at fostering inclusive growth—while maintaining economic stability, to build confidence, anchor expectations and reap the longer- term benefits of the historical transformation.

Notes:

1 The low and middle income countries of the region included in this report are Algeria, the Arab Republic of Egypt, the Islamic Republic of Iran, Jordan, Lebanon, Morocco, the Syrian Arab Republic, Tunisia and Yemen. Data is unfortunately insufficient for the inclusion of Djibouti, Iraq, Libya and the West Bank and Gaza. The high-income economies included here are Bahrain, Kuwait, Oman and Saudi Arabia. Data is insufficient for the inclusion of Qatar and the United Arab Emirates. The group of developing oil exporters includes Algeria, the Islamic Republic of Iran, the Syrian Arab Republic and Yemen. The diversified economies of the region (net oil importers—with Egypt included in this group due to the smaller share of hydrocarbons in its export mix), can be usefully segmented into two groups: those with strong links to the GCC (Jordan and Lebanon), and those with tight ties to the European Union (the Arab Republic of Egypt, Morocco and Tunisia). Further groups of interest are the Resource-poor-labor abundant countries: Egypt, Jordan, Lebanon, Morocco and Tunisia; and Resource-rich labor abundant economies: Algeria, Iran, the Syrian Arab Republic, and the Republic of Yemen.

2 It should be noted, that in contrast with, for example, the East Asia and Pacific region, the share of exports in GDP for the oil importing economies of the MENA region is quite small, which would have the effect of mitigating adverse impacts on growth attendant with slower goods shipments to Europe.

3 "UNWTO Tourism Barometer". United Nations World Tourism Organization. November, 2011. Madrid.

4 Regional Economic Outlook. "Middle East and Central Asia". World Economic and Financial Surveys. October, 2011. Washington DC. The International Monetary Fund.

5 Inflation rates are here expressed at seasonally adjusted annualized rates or "saar". That is, a ratio of rolling three-month moving averages of consumer price indexes is raised to the fourth power (so at "quarterly rates"). This provides a clearer view of current developments and potential turning points for the data series contrasted with "year over year' growth rates—especially avoiding biases of exceptionally high or low base period values. A warning that readers may find the CPI figures as "out of line" with the more-broadly used y/y measure.

6 In 2008 roughly half of oil importer's merchandise exports were sent to EU markets, contrasted with 65 percent in 1998. And migrant remittances from expatriate workers in Europe are much larger for Morocco and Tunisia than for other MENA countries—data for 2000 suggests that about 75 percent of Morocco and Tunisia's immigrants settle in the EU, contrasted with 10 percent for Egypt.

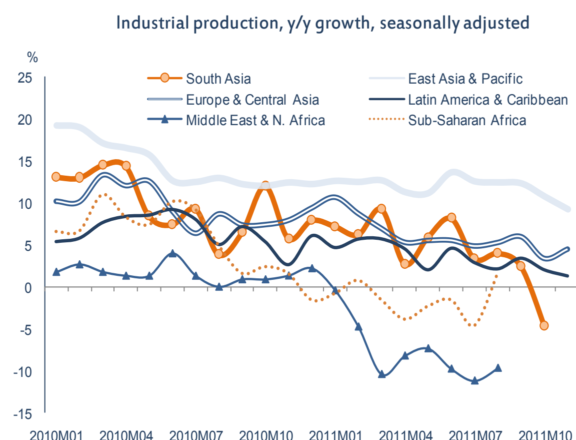
South Asia Region

Recent developments

Following a vibrant 9.1 percent growth rate in 2010 (calendar year), South Asia's real GDP growth decelerated to an estimated 6.6 percent in 2011 (table SAR.1). A slowdown in activity became strongly apparent late in the year with a pronounced fall-off in industrial production, well below most other developing regions. (figure SAR 1). The slowdown reflects numerous headwinds, both internal and external. Nevertheless, growth is estimated to have exceeded the long-term average of 6 percent (1998-2007), led by above trend activity in Bangladesh, India and Sri Lanka. On the domestic front, more restrictive macroeconomic policy stances—aimed at reducing stubbornly high inflation and unsustainably large fiscal deficits—have contributed to weaker domestic demand growth. Consumer spending for durables has been constrained by higher interest rates, and real disposable incomes have been eroded by sustained high food and fuel prices that, along with administered price increases, have contributed to slower private consumption growth. Higher borrowing costs, elevated inflation, moderating economic activity and some local factors (e.g., policy uncertainty, stalled reforms, and deteriorating political and security conditions) contributed to a fall-off in investment growth. While there's been some slippage on fiscal consolidation efforts, the impulse from the fiscal-side has been generally less expansionary than in 2010.

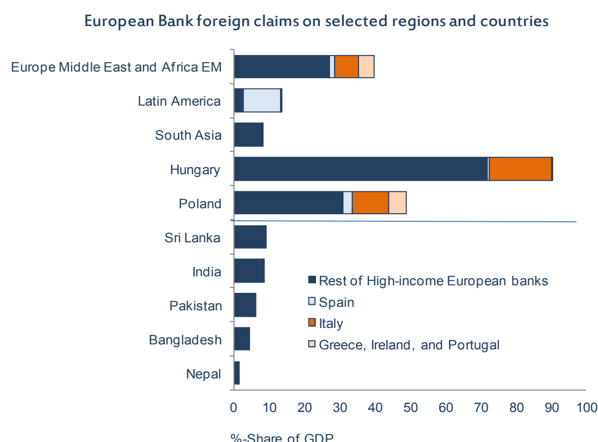
Aside from domestic factors contributing to a slowdown in South Asia's real GDP growth in 2011, the external environment had become increasingly challenging and uncertain. While direct financial linkages, such as exposures to Euro Area banks, are limited compared with other regions, contagion from Euro Area debt woes has contributed to the fall-off in South Asian investment growth. (figure SAR 2). In particular, equity finance has been hit, with regional stock markets retreating in concert with the rest of the world during the second half of the year. Deteriorating international bank funding conditions have also led to a fall-off in foreign bank lending, beginning mid-2011. Reflecting these developments, local currencies depreciated sharply against the dollar in the second half of 2011, as investors retreated into safe-haven assets, prompting some monetary authorities in the region to defend their

Figure SAR.1 Activity in South Asia decelerated sharply in late-2011



Sources: Thomson Datastream and World Bank

Figure SAR.2 South Asia's exposure to a sudden withdrawal of European bank assets is relatively small, and limited to 'core' countries

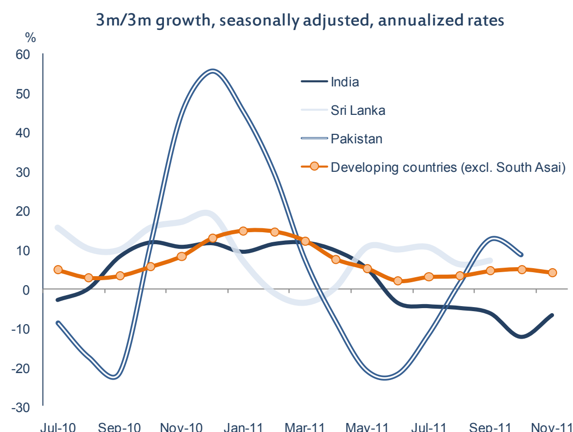


Sources: BIS, JP Morgan and World Bank

currencies and draw down international foreign exchange reserves. In particular, India, which had benefitted from strong inflows, saw pronounced depreciation as foreign investors reduced exposures in countries with twin deficits (as witnessed in Turkey, among other more financially integrated developing countries). Slack growth in Europe and the United States contributed to a fall-off in export growth that became strongly evident in October. This followed relatively strong export growth in the first half of the year, which partly reflected a continued reorientation of export markets toward dynamic developing East Asia (underway at least since early-2000). Worker remittances inflows to South Asia proved relatively resilient in 2011, buoyed in part by a revival in job growth in the high-income Arabian Gulf economies (important host countries for South Asian migrants), supported by high energy prices and related fiscal spillovers. Nevertheless, the pace of remittances growth moderated viz-a-viz 2010, especially in the second half of 2011. Despite tighter macroeconomic policy and strong exports, the regional current account deficit is expected to widen in 2011 to an estimated 3.0 percent of GDP in 2011 from 2.6 percent in 2010, due to higher import prices (notably sustained high fuel prices), continued strong import demand and currency depreciation.

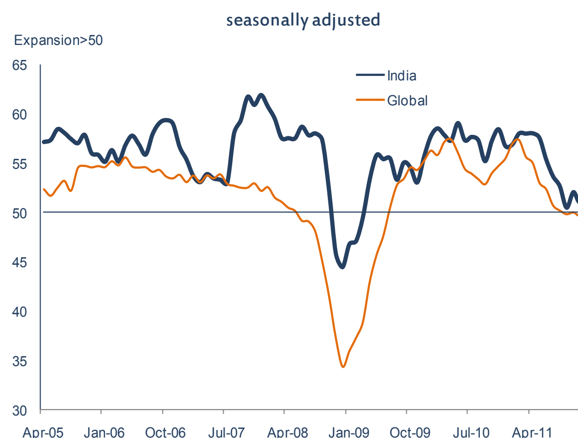
The deceleration in regional economic growth in 2011 to a large extent stems from slowing growth in India, which accounts for about 80 percent of South Asia's GDP. Overall, GDP growth at market prices for the fiscal year (ending March 2012) is expected to have slowed 2.2 percentage points from 8.7 percent in FY2010/11. On a calendar year basis, India's GDP growth slowed to an estimated 7.0 percent in 2011 from 10 percent in 2010.[1] The weakening in activity reflects a significant moderation in domestic demand, led by a deceleration in investment activity that has faced headwinds of rising borrowing costs, high input prices, slowing global growth and heightened uncertainty. Delays and uncertainty surrounding the implementation of policy reforms have also hindered investment. Household spending has been curbed by persistently rising prices cutting into real incomes and higher borrowing costs. A tightening of monetary policy and some reduction in the fiscal deficit contributed to the slowdown. On the supply-side, an improved 2011 monsoon supported stronger agricultural output in the second-half of 2011 (coming in the aftermath of a weak base tied to low rainfall in 2010). Industrial output, however, significantly decelerated from mid-2011, in part reflecting a sharp fall-off in capital goods output and moderating domestic demand. (figure SAR 3). Producer sentiment was down markedly in the second half of the year, albeit a pick-up was evident in December. (figure SAR 4). Indian merchandise export volume growth was vibrant through most of 2011—recording gains as much

Figure SAR.3 Deceleration in South Asia's industrial production has been led by India, while Pakistan recovered after flooding



Sources: Thomson Datastream and World Bank

Figure SAR.4 Purchasing manufacturers index for manufacturing output



Sources: Haver Analytics and World Bank

as 54 percent above year-earlier levels in July (seasonally adjusted)—supported by resilient external demand from developing countries and emerging East Asia, in particular. However, export volume growth slowed sharply to 0.5 percent (y/y) in October—despite real trade-weighted depreciation of the rupee of 6.5 percent in October (real effective exchange rate, y/y). Robust merchandise import growth (from a higher base level than exports) and a deterioration in the terms of trade contributed to an expansion of the current account deficit, which is projected to have reached 3.4 percent of GDP in 2011, up from 3.2 percent in 2010.

Economic activity in Pakistan, South Asia's second largest economy (representing about 15 percent of regional GDP), continues to markedly lag outcomes elsewhere in the region. Nevertheless, it firmed in the second half of 2011. Industrial production surged to grow at a robust 32.1 percent annualized pace during the three months ending in October (3m/3m, at seasonally adjusted annualized rates), after falling at 9.1 and 10.1 percent rates during the first and second quarters, respectively. Part of the strengthening in growth reflects base effects due to the widespread flooding that had hampered activity in the second half of 2010. Indeed, because the floods occurred in July and August 2010, GDP growth on a fiscal year basis (ending June-2011) slowed to 2.4 percent from

Table SAR.1 South Asia country forecasts

(annual percent change unless indicated otherwise)				Est.	Forecast		
	98-07[a]	2008	2009	2010	2011	2012	2013
Calendar year basis [b]							
Bangladesh							
GDP at market prices (2005 US$) [c]	5.0	6.3	6.0	5.9	6.5	6.1	6.3
Current account bal/GDP (%)	0.2	1.4	3.5	2.6	0.7	0.5	-0.2
India							
GDP at market prices (2005 US$) [c]	6.4	6.2	6.8	10.0	7.0	6.0	7.5
Current account bal/GDP (%)	-0.3	-2.7	-2.0	-3.2	-3.4	-2.4	-2.3
Nepal							
GDP at market prices (2005 US$) [c]	3.4	4.8	5.3	4.5	4.0	3.5	3.8
Current account bal/GDP (%)	-1.7	3.2	-1.8	-2.9	-2.9	-2.7	-2.3
Pakistan							
GDP at market prices (2005 US$) [c]	5.0	3.7	1.7	3.8	3.1	4.0	4.2
Current account bal/GDP (%)	-0.8	-9.6	-2.5	-0.9	0.5	-0.2	-0.7
Sri Lanka							
GDP at market prices (2005 US$) [c]	4.4	6.0	3.5	8.0	7.7	6.8	7.7
Current account bal/GDP (%)	-3.2	-9.8	-0.7	-3.0	-3.8	-3.9	-4.2
Fiscal year basis [b]							
Bangladesh							
Real GDP at market prices	5.0	6.2	5.7	6.1	6.7	6.0	6.4
India							
Real GDP at market prices	6.2	4.9	9.1	8.7	6.5	6.5	7.7
Memo: Real GDP at factor cost	-	6.8	8.0	8.5	6.8	6.8	8.0
Nepal							
Real GDP at market prices	3.1	6.1	4.4	4.6	3.5	3.6	4.0
Pakistan							
Real GDP at market prices	4.7	1.6	3.6	4.1	2.4	3.9	4.2

World Bank forecasts are frequently updated based on new information and changing (global) circumstances. Consequently, projections presented here may differ from those contained in other Bank documents, even if basic assessments of countries' prospects do not significantly differ at any given moment in time.
Afghanistan, Bhutan, Maldives are not forecast owing to data limitations.
a. Growth rates over intervals are compound average; growth contributions, ratios and the GDP deflator are averages.
b. National income and product account data refer to fiscal years (FY) for the South Asian countries with the exception of Sri Lanka, which reports in calendar year (CY). The fiscal year runs from July 1 through June 30 in Bangladesh and Pakistan, from July 16 through July 15 in Nepal, and April 1 through March 31 in India. Due to reporting practices, Bangladesh, Nepal, and Pakistan report FY2009/10 data in CY2010, while India reports FY2009/10 in CY2009. GDP figures are presented in calendar years (CY) based on quarterly history for India. For Bangladesh, Nepal and Pakistan, CY data is calculated taking the average growth over the two fiscal year periods to provide an approximation of CY activity.
c. GDP measured in constant 2005 U.S. dollars.

Source: World Bank

4.1 percent in FY2009/10.

Pakistan's weak growth outturns are also tied to worsening security conditions, accompanied by greater political uncertainty and a breakdown in policy implementation. Infrastructure bottlenecks, including disruptions in power delivery, remain widespread. A notable bright spot has been a strengthening of exports, evident particularly in the first half of 2011, led by textiles that surged 39 percent in the first half of the year (y/y). However, like India, Pakistan's export volume growth saw a sharp fall-off in October. Indeed, Pakistan's export volumes fell to a minus 46 percent rate in the three-months ending October (3m/3m, at seasonally adjusted annualized rates). Along with an upswing in worker remittances inflows, robust exports have supported Pakistan's external positions and contributed to an improvement in the current account from a deficit of 0.9 percent of GDP in 2010 to a surplus of close to 0.5 percent of GDP in the 2011 calendar year.

GDP growth in Bangladesh strengthened to a projected 6.7 percent in FY2010/11 (ending June 2011), firming from the 6.1 percent outturn in FY2009/10. Growth has been supported by an expansion in private consumption, buoyed by an upswing in government subsidies and transfer payments. While export activity surged, strong import growth (from a higher base), contributed to a deterioration in the trade deficit and the current account surplus narrowed markedly. Elevated oil prices led to a widening of the trade deficit as well, and weighed on fiscal balances through increased fuel subsidies to the private power plants. CPI inflation remained close to 10 percent during much of the year, tied to rapid credit expansion, administered price increases and depreciation of the Bangladeshi taka. The combination of high import demand, elevated international oil prices and taka depreciation (against the dollar) over recent months has led to a significant drawdown in international reserve holdings to below the equivalent of three months import cover (a threshold of comfort for liquidity). While worker remittances inflows continued to expand in 2011, disruptions in the Middle East and North Africa, where many Bangladeshi migrant workers are based, led to a slowdown in the pace of growth. At the sectoral level, rising agricultural output reflected good harvests, which also supported household spending. Strengthened industrial production has been buoyed by booming garment exports, which represent over two-thirds of Bangladesh's merchandise exports.

Despite a waning of the post-conflict rebound effects, GDP in Sri Lanka is estimated to have grown 7.7 percent in the 2011 calendar year, slightly below the 2010 pace of 8 percent. Domestic demand growth has been vibrant, supported by strong credit expansion. Strong export growth, led by a surge in textile exports, was more than offset by the rise in imports, and the trade deficit rose. Remittances, tourism and port services grew strongly, which helped to contain the deterioration of the current account balance. While growth was strong at the start of 2011, a deceleration became apparent in the second half of the year, on heightened uncertainty and weakening external demand, as reflected in a modest slowdown in industrial production growth.

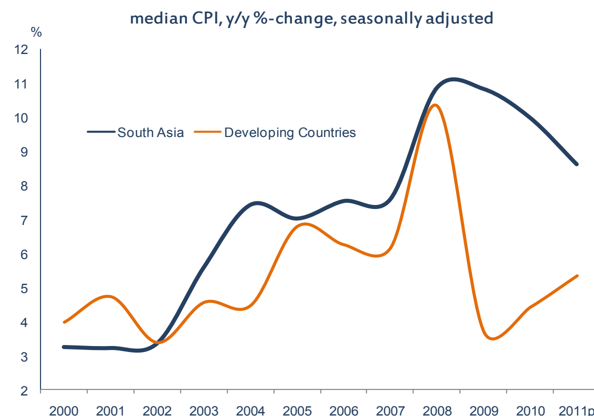
Afghanistan's real GDP growth (on a fiscal year basis) slowed markedly from an unsustainable 20 percent in FY2009/10 to 8.4 percent in FY2010/11 (ending March 2011).[2] Economic activity in Afghanistan remains highly dependent on donor aid inflows and reconstruction efforts, as the ongoing fighting continues to impede private sector economic activity. The still strong FY2010/11 outturn reflected the continued expansion of foreign assistance and spending on security. On the supply side, both services and mining showed strong growth. Activity has remained relatively strong in the early months of FY2011/12, on sustained reconstruction (transport services and construction activity remain buoyant). Inflationary pressures rose sharply, reaching 13.3 percent for the fiscal year, reflecting an upswing in international oil and food prices.

Nepal has also experienced a slowdown in activity, given ongoing political uncertainty as the post-conflict transition to a new government

has extended well into its fourth year since the comprehensive peace agreement was reached in November 2006. Law and order problems, and persistent and extensive infrastructure bottlenecks (electrical shortages are reflected in widespread load-shedding and unreliable delivery), reduced real GDP growth to 3.5 percent in FY2010/2011 (ending June-2011) from 4.6 percent in FY2009/10. Despite some moderation in domestic demand, inflation remains elevated (averaging 8.7 percent in the first four months of the fiscal year—July through October). The upswing in prices reflects high international food and fuel prices, and imported inflation from India (as Nepal's local currency is pegged to the Indian rupee). Tourism arrivals remained strong, which, along with strengthened growth of remittances inflows, largely offset a rise in the trade deficit tied to deterioration in the terms of trade. The current account deficit remained steady as a share of GDP of close to 2.9 percent.

Among the smaller South Asian economies, GDP growth decelerated slightly in Bhutan to a still buoyant 8.1 percent in FY2010/11 (ending June-2011), down from 8.7 percent in FY2009/10, supported by ongoing construction of additional hydropower projects, and to a lesser extent by largely sustained strong tourism activity. The Maldives posted a strong recovery in GDP growth to 9.9 percent in 2011, following a contraction of 6.5 percent in the previous year.

Figure SAR.5 While easing in South Asia, inflationary pressures remain sharply elevated compared with other developing countries



Source: World Bank

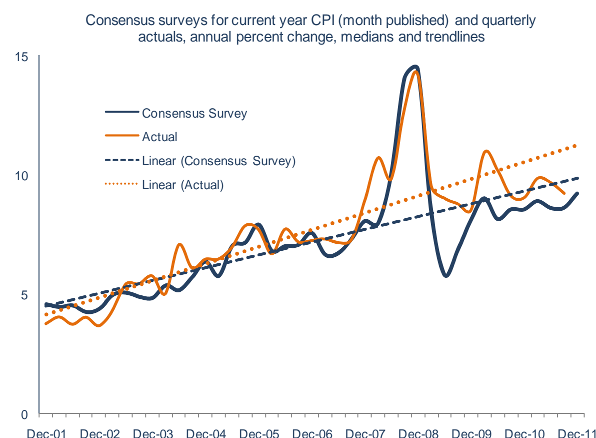
Activity has been buoyed by strong growth in tourism arrivals, led by vibrant growth of arrivals from Asia—as China surpassed the U.K. in 2010 as the largest country of origin for tourists in the Maldives. Reflecting high international commodity prices and strong GDP growth, inflationary pressures have become more elevated in both Bhutan and the Maldives.

Inflation remains a serious regional challenge**.** Although inflation eased in South Asia during 2011, it has fallen less than in other developing regions and remains very high (figure SAR 5). Headline inflation rates were close to or exceeded double-digit levels throughout much of the region in 2011. Rather than being a one-off event, current high inflation reflects years of rising inflation that has contributed to a gradual entrenchment of high inflation expectations that is complicating efforts to bring inflation under control.

As elsewhere, high international fuel and food prices contributed significantly to price pressures in late 2010 and early 2011, but their influence was fading by the second quarter of 2011 when international prices were stabilizing or even falling. Food prices are of particular importance, as food represents about 40 percent of the regional household consumption basket. International prices are particularly relevant for Afghanistan and the Maldives—where 30 percent to 50 percent of domestic consumption of grains (including rice, wheat, pulses) is projected to be imported for the 2011/2012 crop year.

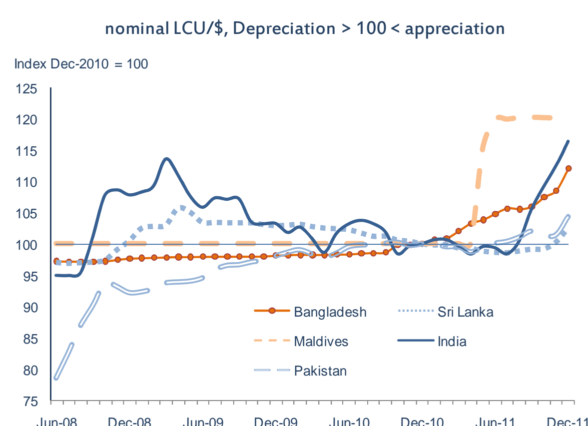
For India, Pakistan, Bhutan and Bangladesh, however, domestic crop conditions and price controls are more important determinants of domestic food price inflation. These factors have contributed to inflationary pressures in the region in 2011, including floods in Sri Lanka early in the year and increases in the minimum domestic support prices in India for rice, wheat, pulses and oil-seed to bring them more in line with costs and international prices (to reduce fiscal outlays and market distortions).[3] Administered fuel price increases in Bhutan, India, the Maldives, Nepal and Pakistan have

Figure SAR.6 Actual and expected short-run inflation in South Asia



Sources: Consensus and World Bank

Figure SAR.7 Exchange rates depreciated across much of South Asia since end-2010



Sources: IMF and World Bank

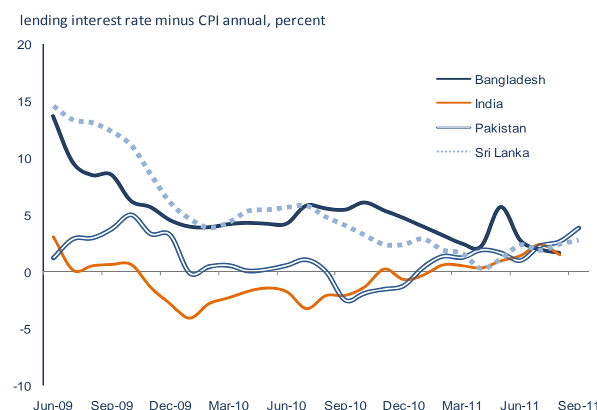
also contributed to price pressures, although pass through of international price increases has been incremental and partial, such that some targeted local food and fuel prices remain subsidized to varying degrees (and below international levels). For Bhutan and Nepal, with local currencies pegged to the Indian Rupee, sustained high inflationary pressures in India have been an important driver of local inflation. Sustained elevated inflationary pressures have also led to a rise in inflation expectations (figure SAR 6).

Regional monetary policy authorities face several challenges in reducing inflation. More recently, currency devaluation has contributed to inflation as well (figure SAR 7). In Bangladesh and Pakistan, monetary authorities have also been monetizing the deficit, complicating the efficacy of other monetary policy efforts to reduce inflation. A key factor working against monetary policy efforts is the overall stance of fiscal policy, which despite some consolidation, remains very loose.

Monetary authorities in Bangladesh, India, Pakistan, and Sri Lanka have responded to persistent price pressures by raising policy interest rates and/or introducing higher reserve requirements. The Reserve Bank of India was among the first developing countries to begin tightening after the global crisis, and has hiked it key policy rate by a cumulative 375 basis points since March 2010 to 8.5 percent as of end-October 2011. As a result, implicit real lending interest rates in India shifted into positive territory from early-2011, although at about 1.5 percentage points they are not particularly high (compared with about 4 percentage points in Brazil). Monetary tightening in Pakistan brought about positive real lending rates in early 2011 as well, the first time since late 2009 (figure SAR 8).

South Asia's general government fiscal deficit—projected at 8.3 percent of GDP in 2011 and significantly higher than in most other regions—is down only slightly from 8.8 percent in 2010.

Figure SAR.8 Real lending rates became positive again in India and Pakistan, reflecting monetary policy tightening

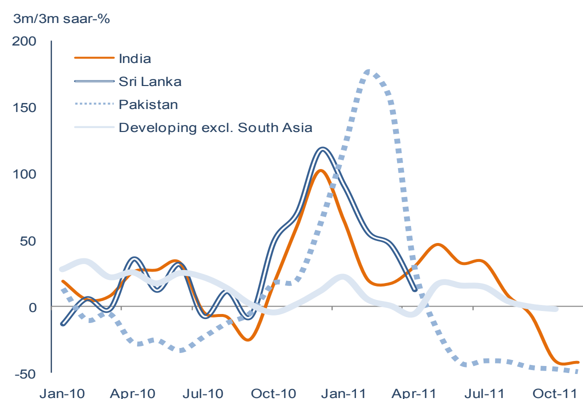


Sources: Thomson Datastream, EIU and World Bank

Targeted reductions in budget deficits were missed in a number of countries in the region for a variety of reasons in 2011. In India, privatization proceeds have been markedly below target (reflecting equity market volatility and poor returns) and subsidy outlays have exceeded targets (particularly due to an upsurge in oil subsidies tied to the sharp devaluation of the rupee since mid-2011 and sustained high oil prices). With the slowdown in activity, tax receipts have failed to meet expected levels. The shortfall prompted the government to announce an increase in borrowing for the second half of the fiscal year (ending March 2012), which in turn led to a rise in government bond yields, raising the burden of interest payments. Slower revenue growth has contributed to larger fiscal deficits in Bhutan, Nepal and Pakistan. On the expenditure side, fertilizer, food and fuel subsidies (on and off-budget) remain a significant burden on regional fiscal coffers. In Bhutan, a rise in capital expenditures was a key factor behind the expansion of the fiscal deficit. Other structural factors are at play across the region, including rising debt-servicing charges in a number of countries, while the region's low tax base makes consolidation especially challenging.

Trade faltered late in 2011 following an upsurge. Regional export volumes grew by roughly one-fourth in 2011, buoyed by healthy textile exports and tourism receipts in particular. External demand firmed, supported especially by a shift in export market composition in recent years toward higher-growth developing countries (China) and away from traditional export markets in slower-growing Europe and the United States. While export activity was especially robust in the first half of 2011, as demand from abroad faltered it lost significant momentum later in the year. (figure SAR 9). Regional merchandise import volume growth remained robust as well, reflecting strong domestic demand, which combined with deterioration in the terms of trade increased the regional current account deficit. Terms of trade losses are estimated at about 1.9 percent of GDP for the region in aggregate, led by a 4.3 percent of GDP decline for Nepal, while Bangladesh and Sri Lanka saw a smaller negative impact of close to 1.5 percent of GDP, and India and Pakistan saw negative impacts of close to 1.8 percent of GDP (estimated January through September 2011 terms of trade impacts relative to 2010).

Figure SAR.9 The pace of export volume growth fell-off sharply in late-2011



Sources: Thomson Datastream, IMF and World Bank

Worker remittances remain a critical source of foreign exchange in South Asia.[4] Remittances inflows rose in US-dollar terms by 10.1 percent in 2011 to an estimated $90 billion, which helped to offset large trade deficits. This is a slight acceleration from the 9.5 percent expansion of remittances inflows in 2010, reflecting strengthened activity in host countries, particularly in the high-income oil exporting countries of the Arabian Gulf, where high petroleum prices have supported strengthened GDP outturns (through fiscal expenditures and increased social spending). While India and Nepal are estimated to have recorded a slowing in the pace of growth in remittances inflows, remittance inflows to Pakistan rose by an estimated 25 percent in 2011, partly in response to the widespread flooding in the second half of 2010. When measured in local currency terms, given the appreciation of the dollar, remittances inflows to the region grew by a more vibrant 13 percent in 2011 (median rate). Adjusting for inflation, worker remittances inflows to the region grew by a less robust 5.8 percent (median rate) in local currency terms.

Table SAR.2 Net capital flows to South Asia

$ billions

	2004	2005	2006	2007	2008	2009	2010	2011e	2012f	2013f
Current account balance	-1.0	-14.8	-16.5	-17.1	-49.3	-26.9	-52.7	-64.7	-54.8	-65.2
as % of GDP	-0.1	-1.5	-1.4	-1.2	-3.3	-1.7	-2.6	-3.0	-2.3	-2.5
Financial flows:										
Net private and official inflows	**21.2**	**28.6**	**77.1**	**116.4**	**64.8**	**86.2**	**111.5**	**90.4**		
Net private inflows (equity+private debt	**21.5**	**25.7**	**73.5**	**111.9**	**55.9**	**75.2**	**101.9**	**83.9**	**78.2**	**99.2**
..Net private inflows (% GDP)	2.4	2.5	6.4	7.6	3.7	4.6	5.0	3.9	3.3	3.7
Net equity inflows	16.8	23.6	36.5	66.7	35.2	59.9	67.4	43.9	45.2	53.2
..Net FDI inflows	7.8	11.2	26.1	32.7	51.1	39.4	28.0	34.9	32.2	35.2
..Net portfolio equity inflows	9.0	12.4	10.4	34.0	-15.8	20.5	39.4	9.0	13.0	18.0
Net debt flows	4.4	4.9	40.2	49.3	28.5	18.8	21.1			
..Official creditors	-0.3	2.9	3.5	4.4	8.8	11.0	9.6	6.5		
....World Bank	2.3	2.3	2.0	2.0	1.4	2.4	3.3	2.0		
....IMF	-0.3	0.0	-0.1	-0.1	3.2	3.6	2.0	0.5		
....Other official	-2.3	0.6	1.7	2.5	4.2	5.0	4.4	4.0		
..Private creditors	4.7	2.1	37.1	45.2	20.7	15.2	34.5	40.0	33.0	46.0
....Net M-L term debt flows	4.0	-0.2	20.2	32.3	12.8	12.6	22.8	30.0		
......Bonds	3.9	-2.8	6.4	10.7	1.7	1.9	10.1	5.0		
......Banks	0.5	2.8	13.6	21.5	11.2	10.8	12.8	25.0		
......Other private	-0.3	-0.2	0.2	0.1	0.0	-0.1	-0.1	0.0		
....Net short-term debt flows	0.7	2.3	16.8	12.9	7.9	2.6	11.7	10.0		
Balancing item /a	7.5	-7.0	-18.9	4.5	-41.8	-20.0	-36.5	-5.2		
Change in reserves (- = increase)	-27.6	-6.8	-41.7	-103.8	26.3	-39.3	-22.3	-20.5		
Memorandum items										
Migrant remittances /b	28.7	33.9	42.5	54.0	71.6	75.1	82.2	90.5	97.2	105.0

Note: Only for Afghanistan, Bangladesh, Bhutan, India, Maldives, Nepal, Pakistan and Sri Lanka.

e = estimate, f = forecast

/a Combination of errors and omissions and transfers to and capital outflows from developing countries.

/b Migrant remittances are defined as the sum of workers' remittances, compensation of employees, and migrant transfers

Source: World Bank.

Capital flows

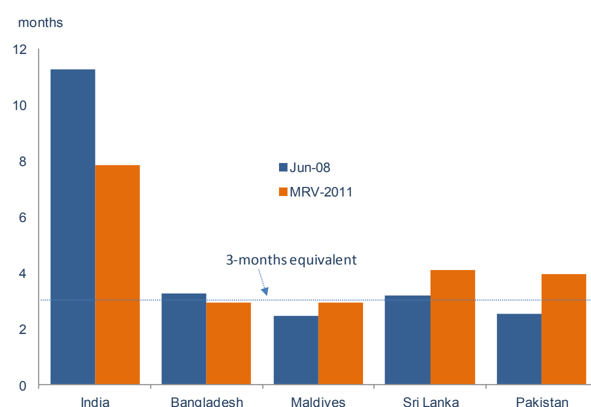
As witnessed in most developing regions in 2011, net private capital inflows (excluding official inflows) to South Asia declined in 2011 to $83.9 billion, largely driven by declines in net portfolio equity inflows to $9 billion and in net international private bond issuance to $5 billion (table SAR.2). The retreat in portfolio flows from the high level of 2010 reflects a general heightened degree of risk aversion by international investors in the second half of the year.

In contrast, FDI inflows to South Asia strengthened markedly in 2011, to a projected $34.9 billion from $28 billion in 2010. The rise in net FDI inflows was largely due to a recovery of inflows to India, which accounts for the lion's share of FDI in the region and had recorded a sharp fall-off in 2010. Despite the rebound in India, FDI inflows to the region in aggregate remain down by nearly one third from the 2008 peak of $51.1 billion.

International reserve positions in South Asia have generally improved since mid-2008. Latest readings of foreign currency holdings were equivalent to at least three-months of merchandise imports in India, Pakistan and Sri Lanka, and rose in all cases with the exceptions of Bangladesh (where they have fallen in recent months to bellow three months import-cover) and India (where they remain comfortably high at close to eight months). (figure SAR 10). External liquidity positions, however, are relatively more exposed than other developing countries when measured against short-term debt. In India, short-term external debt has risen significantly since late-2010, likely reflecting a rise in trade finance with the rapid trade growth witnessed in the first half of 2011. However, the build-up in short-term debt has coincided with monetary policy interest rate hikes, and Indian corporations have also apparently sought external financing to avoid higher domestic borrowing costs. Measured as a share of foreign exchange reserves, many countries in South Asia report significantly higher ratios of short-term

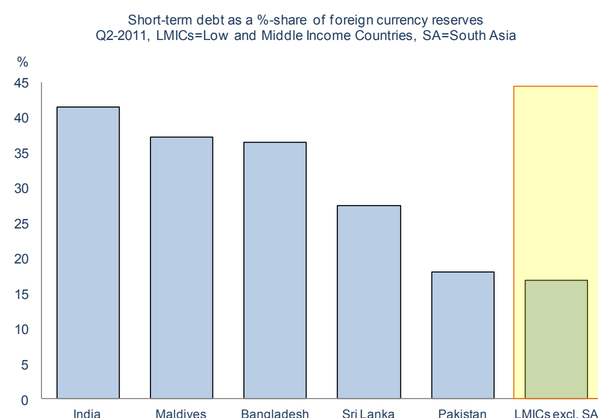
debt than other developing countries (which averaged 17 percent in the second quarter of 2011). Short-term debt in India represented 41 percent of foreign exchange reserves in the second quarter of 2011, followed by 37 percent in the Maldives and 36 percent in Bangladesh (figure SAR 11). To the extent that short-term debt obligations are not tied to trade finance, countries with elevated levels could face challenges in rolling over debt, should global financial conditions suddenly deteriorate.

Figure SAR.10 Reserves in months import cover have generally improved since mid-2008, but latest readings dipped below 3-months in Bangladesh and Maldives



Sources: IMF, Thomson Datastream and World Bank

Figure SAR.11 South Asia's short-term debt relative to reserves is elevated compared with other developing countries



Sources: Bank for International Settlement and World Bank

Medium-term outlook

South Asian GDP growth is projected to ease to 5.8 percent in 2012 from an estimated 6.6 percent in 2011, before strengthening to 7.1 percent in 2013 (in calendar year terms). The slowdown in growth in 2012 reflects continued deceleration in investment growth tied to a variety of factors, including domestic policy paralysis and uncertainty about regulatory reforms, deterioration in international investor sentiment, heightened uncertainty and weaker external demand from high-income Europe and developing countries.

The projected deceleration in economic activity also reflects the anticipated deepening traction of the more restrictive monetary policy conditions introduced over the course of 2011 and continued progress (albeit gradual) toward programmed fiscal consolidation. Higher interest rates and increases in regulated prices are projected to induce a slowing in consumer demand, while high interest rates and a more somber business outlook are expected to slow investment growth—contributing to significantly weaker imports during 2012. Meanwhile demand for the region's exports is projected to slow in 2012 and lead to a near halving of export growth to 11.6 percent in 2012 from 21 percent in 2011, due to stagnant GDP in the European Union and the projected global slowdown—including the influence of tighter monetary policy in China and fiscal consolidation in Europe (which will particularly hit South Asia's tourism receipts).

Regional inflationary pressures are projected to come down over the forecast horizon, assuming continued expansion of crop production (India, Pakistan, Sri Lanka) and a decline in international fuel prices (reflecting weaker global activity in 2012). A good crop year (2011/2012) in much of the region and sustained high regional stocks are providing a buffer for grain prices and import demand in 2012.[5] (table SAR.3) Lower inflation should provide a relatively limited impetus to household spending because the deceleration in price pressures is expected to be halting and incremental. A projected slow moderation in inflation reflects

Table SAR.3 South Asia's grain supply and demand balances

1,000 metric tons, unless otherwise noted

	2004/2005	2005/2006	2006/2007	2007/2008	2008/2009	2009/2010	2010/2011	2011/2012p
Production	280,608	286,947	296,253	315,659	323,189	325,141	345,942	357,831
y-o-y % growth	-2.4	2.3	3.2	6.6	2.4	0.6	6.4	3.4
Ending stocks	18,710	20,729	23,117	26,134	40,767	45,391	48,608	49,233
y-o-y % growth	-20.6	10.8	11.5	13.1	56.0	11.3	7.1	1.3
% share of use	7.4	8.1	8.8	9.5	15.0	16.8	16.9	16.6
Domestic consumption *	251,320	255,843	262,345	274,532	272,303	270,787	287,354	295,888
y-o-y % growth	-0.2	1.8	2.5	4.6	-0.8	-0.6	6.1	3.0

Countries = Bangladesh, India, Nepal, Pakistan, Sri Lanka.

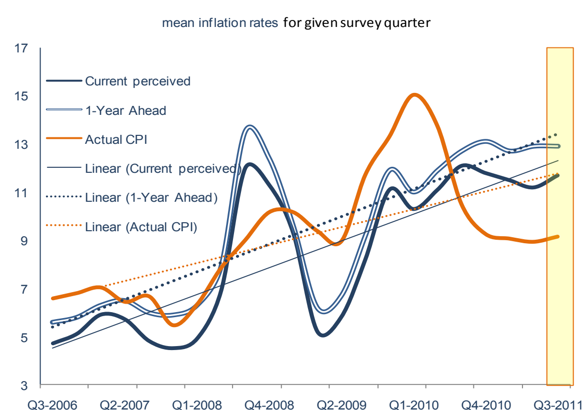
*Excluding feed consumption.
Sources: United States Department of Agriculture (1 November 2011) and World Bank.

the still incomplete pass-through of higher international commodity prices and entrenched inflationary expectations. With respect to the latter, inflation expectations in India have remained at double digit rates since the fourth quarter of 2009—with 'one-year ahead' expected rates at 12.9 percent in the third quarter of 2011.[6] This 3.8 percentage point wedge above the actual 9.1 percent rate reported for the quarter underscores the degree to which higher price pressures have become entrenched. (figure SAR 12).

Despite slowing exports (see above), lower import demand and lower import prices should reduce the region's current account deficit to an estimated 2.3 percent of GDP in 2012 from 3.0 percent in 2011. Nevertheless, while oil prices are projected to moderate over the forecast horizon, they are expected to remain relatively high—falling incrementally only to $100.8/bbl in 2013[7]—and thus the regional oil import bill is expected to remain a significant burden on external balances.

Remittances inflows to South Asia are projected to rise 7.4 percent in 2012 in US dollar terms and continue to represent significant support to regional current account positions. This deceleration in the pace of growth from an estimated 10.1 percent rise in remittances inflows in 2011 reflects a projected slowing in host country activity, particularly in high-income Europe and the Gulf Cooperation Council (GCC) countries (Saudi Arabia, the U.A.E, Kuwait, Qatar, Bahrain and Oman). Worker transfers to

Figure SAR.12 India's household inflation expectations increased mid-2011, despite fall in the actual inflation rate



Sources: Reserve Bank of India and World Bank

South Asia from the GCC, where most of the region's estimated 9 million migrants are based (3.3 million in Saudi Arabia and 2.9 million in the U.A.E.), are projected to remain fairly resilient however, tied to Arab Spring related stimulus measures (social spending).[8] For example, Saudi Arabia's increased non-hydrocarbon spending (on public employment, unemployment benefits, etc.) is estimated to equal about 11 percent of GDP in FY2011/12. This is likely to be reflected in higher remittance outflows, particularly to Pakistan, India and Bangladesh. Saudi Arabia is host to 21.5 percent, 12.8 percent, and 8.3 percent of the total emigrant population, respectively, from Pakistan, India and Bangladesh.[9] The countries facing ongoing political upheaval in the Middle East (Egypt, Libya, Syria, Tunisia, and Yemen)

do not represent large migrant host countries for South Asia.[10]

GDP growth in South Asia is projected strengthen in 2013 to 7.1 percent from a projected 5.8 percent in 2012 (in calendar year terms), led by firming private sector activity, as inflationary pressures recede sufficiently to allow monetary authorities to pursue less restrictive stances (table SAR.4). In particular, acceleration of investment growth is forecast to be supported by lower inflation and some improvement in fiscal balances, which will support cheaper access to credit. Additionally, programmed large investment and reconstruction projects in Afghanistan, Bangladesh, Bhutan, India and Sri Lanka should contribute to stronger growth outturns in 2013, boosting productivity and potential output. External demand is expected to revive in 2013, which along with improved international investor sentiment is expected to support stronger regional growth.

Net foreign private capital inflows to South Asia are forecast to support investment activity in 2013, rising by a projected 26.8 percent following a projected contraction of 6.8 percent in 2012 (reflecting continued relatively high investor uncertainty in 2012 tied to ongoing deleveraging in high-income countries).

Risks and vulnerabilities

As discussed in the main text, the risk of a serious downturn in the global economy is high. Downside scenarios suggest the possibility of much lower growth outturns globally and for the region. Should external demand falter appreciably, South Asia's capacity to respond with countercyclical measures has been greatly reduced, with government deficits in 2011 at 8.3 percent of regional GDP versus 4.1 percent in 2007 before the onset of the crisis in 2008 (figure SAR 13). Given high inflation, the scope for monetary policy easing is also limited, although this could be tempered by easing inflationary pressures should the external situation deteriorate sharply, as the downside scenarios described in the main text would also result in a significant decline in oil prices.

Table SAR.4 South Asia forecast summary

(annual percent change unless indicated otherwise)				Est.	Forecast		
	98-07[a]	2008	2009	2010	2011	2012	2013
GDP at market prices (2005 US$) [b,f]	6.0	6.0	6.1	9.1	6.6	5.8	7.1
GDP per capita (units in US$)	4.4	4.5	4.7	7.7	5.3	4.5	5.8
PPP GDP [d]	6.0	6.0	6.1	9.1	6.6	5.8	7.1
Private consumption	4.9	7.2	6.5	8.2	5.3	4.9	5.7
Public consumption	3.8	16.9	12.3	3.6	7.1	7.1	5.2
Fixed investment	8.9	5.7	3.5	12.1	6.0	5.6	11.1
Exports, GNFS [e]	14.0	14.9	-7.1	12.8	21.0	11.6	17.6
Imports, GNFS [e]	9.2	25.8	-6.5	10.4	13.4	8.5	16.3
Net exports, contribution to growth	-0.1	-3.3	0.3	-0.2	0.8	0.3	-0.4
Current account bal/GDP (%)	-0.4	-3.3	-1.7	-2.6	-3.0	-2.3	-2.5
GDP deflator (median, LCU)	5.7	7.8	6.9	11.3	9.9	8.9	7.7
Fiscal balance/GDP (%)	-7.0	-9.9	-9.4	-8.8	-8.3	-7.9	-7.2
Memo items: GDP at market prices [f]							
South Asia excluding India	4.5	4.8	3.9	5.1	5.1	4.8	4.8
India	6.2	4.9	9.1	8.7	6.5	6.5	7.7
at factor cost	-	6.8	8.0	8.5	6.8	6.8	8.0
Pakistan	5.0	1.6	3.6	4.1	2.4	3.9	4.2
Bangladesh	5.0	6.2	5.7	6.1	6.7	6.0	6.4

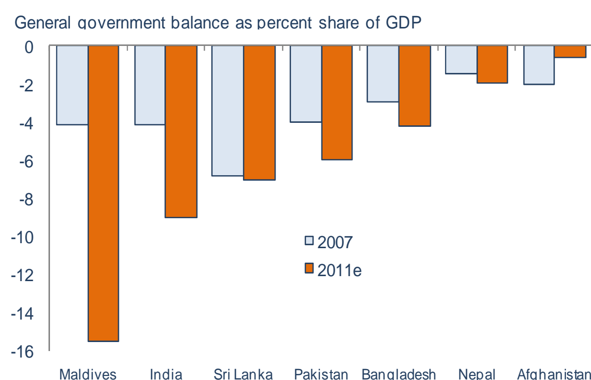
a. Growth rates over intervals are compound average; growth contributions, ratios and the GDP deflator are averages.
b. GDP measured in constant 2005 U.S. dollars.
c. GDP figures are presented in calendar years (CY) based on quarterly history for India. For Bangladesh, Nepal and Pakistan, CY data is calculated taking the average growth over the two fiscal year periods to provide an approximation of CY activity.
d. GDP measured at PPP exchange rates.
e. Exports and imports of goods and non-factor services (GNFS).
f. National income and product account data refer to fiscal years (FY) for the South Asian countries, while aggregates are presented in calendar year (CY) terms. The fiscal year runs from July 1 through June 30 in Bangladesh and Pakistan, from July 16 through July 15 in Nepal, and April 1 through March 31 in India. Due to reporting practices, Bangladesh, Nepal, and Pakistan report FY2009/10 data in CY2010, while India reports FY2009/10 in CY2009.

Source: World Bank

(figure SAR 14). A sharp fall in fuel prices would also help reduce pressure on fiscal balances, given remaining administered price controls and fuel subsidies.

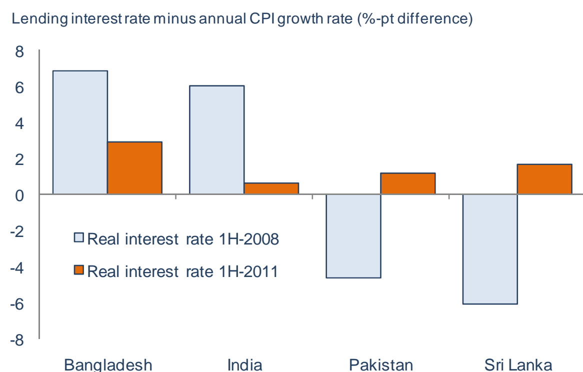
A deepening of the Euro Area crisis would lead to weaker exports, worker remittances and capital inflows to South Asia. The EU-27 countries account for a significant share of South Asia merchandise export markets, although not as much as for some developing regions. (figure SAR 15). The Euro Area represents about one-fourth of South Asia's merchandise export market, of which Germany and France account for 40 percent and 20 percent, respectively. Moreover, export financing from Europe, an important component of the region's trade credit, is particularly vulnerable to drying up, as was the experience during the 2008 financial crisis. At the country level, Bangladesh, the Maldives and Sri Lanka are particularly exposed to a downturn in European demand for merchandise. (figure SAR 16). With respect to services, tourism sectors could be especially hard hit in Sri Lanka and the Maldives, although greater diversification (with booming arrivals from Asia) should provide a buffer. However, there could be some countercyclical benefits for goods exporters ("Walmart effect") for some sectors (e.g., for Bangladesh's garment industry). Additionally, a slowdown in global activity would likely translate into lower oil prices that

Figure SAR.13 Fiscal space has diminished across most of South Asia compared with 2007



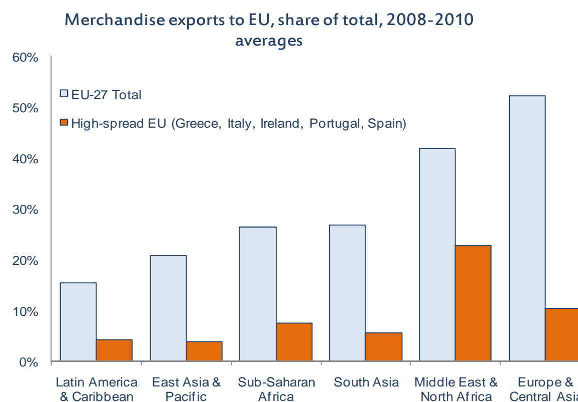
Sources: IMF and World Bank

Figure SAR.14 Real interest rates indicate some scope for easing, and much improved positions in Pakistan and Sri Lanka since 2008



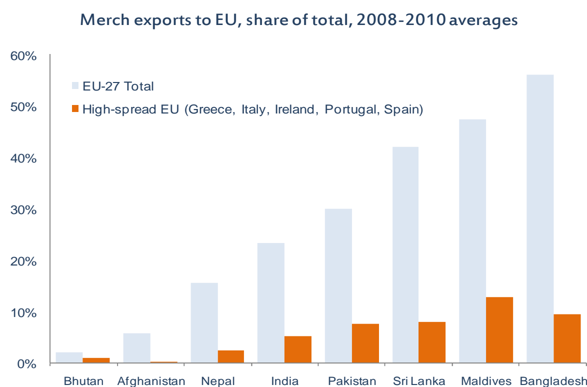
Sources: EIU, Thomson Datastream and World Bank

Figure SAR.15 The EU-27 countries represent over one-fourth of South Asia's export market



Sources: World Bank and UN COMTRADE (WITS)

Figure SAR.16 Maldives and Bangladesh have highest exposure to EU-27



Sources: World Bank and UN COMTRADE (WITS)

would ease pressures on current account and fiscal balances for the oil import-dependent region.

Worker remittances inflows—which were equivalent to 5 percent or more of GDP in 2010 in Nepal (20 percent as of 2010) Bangladesh (9.6 percent), Sri Lanka (7 percent) and Pakistan (5 percent)—could slow markedly through second round effects of weakened domestic demand in migrant host-countries, largely located in the Arabian Gulf.

The rise in South Asia's financing needs (current account financing and debt repayment)—projected at 8.4 percent of GDP in 2012, up from 5 percent in 2007 (the only region to post an increase over the period)—increases the region's vulnerability to a rise in global risk aversion. India is particularly vulnerable within South Asia, as it is the most integrated with global financial markets. India's short-term external debt (with remaining maturity of less than one-year, according to the Bank of International Settlements) rose to $128 billion (6.8 percent of GDP) in the second quarter of 2011, and total external financing needs are projected to reach 9.8 percent of GDP in 2012. The Maldives and Sri Lanka, with external financing needs projected at 18 percent and 7.0 percent of GDP in 2012, respectively, are also highly exposed. Countries heavily reliant on foreign assistance, such as Afghanistan, Nepal and Pakistan, could be hit hard if fiscal consolidation in high-income countries were to result in cuts to overseas development assistance.

Other risks are also prominent in South Asia. Continued large inflation differentials with other countries would put upward pressure on real effective exchange rates, undermining competitiveness, discouraging foreign investment and slowing productivity growth. International commodity prices—albeit easing from early-2011 highs—also remain elevated and continue to represent an important negative risk factor for South Asia. Given political resistance to reducing subsidies, governments have postponed the pass-through of higher international prices over the past couple of years. The delay in adjusting prices has resulted in some slippage in fiscal consolidation and will require monetary policy to maintain a restrictive posture for a longer period than otherwise might have been required (had pass-through been more immediate). Sustained higher policy interest rates could hinder investment activity, attract large capital inflows and complicate monetary policy—further emphasizing the need for fiscal consolidation—although in the current environment (favoring low-risk assets and a flight-to-safety) this is less of a risk.

While there has been some progress toward fiscal consolidation, large regional fiscal deficits continue to pose important downside risks to growth, by crowding out private investment (particularly given shallow domestic financial markets) and contributing to excess demand that has translated into sustained high import growth and expanded regional current account deficits. In other words inadequate progress in fiscal consolidation focused on recurrent expenditures reduces the capital stock over time, undermining growth prospects. Reductions in fiscal deficits have been less than programmed. Additional fiscal slippage could trigger higher than projected inflationary pressures and constrain policy options further in the event of future crises. At one extreme, the Maldives' general government fiscal deficit is unsustainably high (projected at 15.5 percent of GDP in 2011), which has led to an upsurge in public debt and requires vigilant fiscal consolidation. While much less severe, India's fiscal deficit, and the concomitant rise in short-term external debt, appears to be placing continued pressure on domestic financial intermediation and increasing the country's vulnerability to a sudden tightening of international credit markets.

Policy options

While South Asia is relatively insulated from international financial market turbulence compared to other more integrated regions, the weak global economic trajectory will nonetheless likely have an adverse impact on the region. Given the lack of fiscal space in South Asia, inflationary pressures and consequent

limited room for monetary policy easing, fiscal consolidation through greater revenue mobilization (particularly in Pakistan, Sri Lanka, Bangladesh, and Nepal) and expenditure rationalization (especially in India) could play a key role in helping to protect critical social programs. Governments should also look at further improving the targeting of its safety nets and capacity to respond to a crisis to improve efficiency of social safety net programs.

Expanding the drivers of growth also holds potential. With markets in the United States and Europe expected to experience prolonged weakness, South Asian countries have the opportunity to re-think and pursue new sources of growth for their countries. Unlike East Asia, which has depended greatly on developed country markets for its export-led growth, South Asia faces less adjustment costs from rebalancing demand sources, and can more readily look for new growth drivers in both domestic and external markets. This may include focusing on export growth toward faster growing emerging markets, as well as internal market enhancements through structural and governance reforms. Such actions would help boost export demand, help raise investment, provide better jobs and generate an environment for more inclusive growth.

Notes:

1 See Global Economic Prospects, June 2010 "Box SAR 1 GDP reporting practices—market price versus factor cost and calendar year versus fiscal year", p. 116: http://siteresources.worldbank.org/INTGEP/Resources/335315-1307471336123/7983902-1307479336019/SA-Annex.pdf.

2 The exceptionally strong FY2009/10 outturn reflected a record harvest and rebound from a severe and extended period of drought. Additionally, aid inflows rose sharply in the year.

3 In the event that domestic market prices fall below the government's minimum price, the government provides payments to producers.

4 Nepal, Bangladesh, and Sri Lanka, were among the top 15 recipients of remittances in 2010—with inflows representing the equivalent of 20 percent of GDP in Nepal, 9.6 percent in Bangladesh, 6.9 percent in Sri Lanka, 5.0 percent in Pakistan and 3 percent in India.

5 U.S. Department of Agriculture, PSD (Production, Supply, Demand) database.

6 The public's expectations for inflation, based on surveys conducted by the Reserve Bank of India.

7 World Bank crude oil price, which is a simple average of the prices for Brent, Dubai and West Texas Intermediate.

8 Institute of International Finance, Global Economic Monitor, November 2011.

9 World Bank, Development Economics, Migration and Remittances, Prospects Group (see http://go.worldbank.org/JITC7NYTT0).

10 The net impact of the Arab Spring on external demand for labor appears positive, with the main migrant host countries in the GCC benefitting from production stoppages that have contributed to elevated oil prices. The related increase in social spending has also buoyed local activity.

Sub-Saharan Africa Region

Recent developments

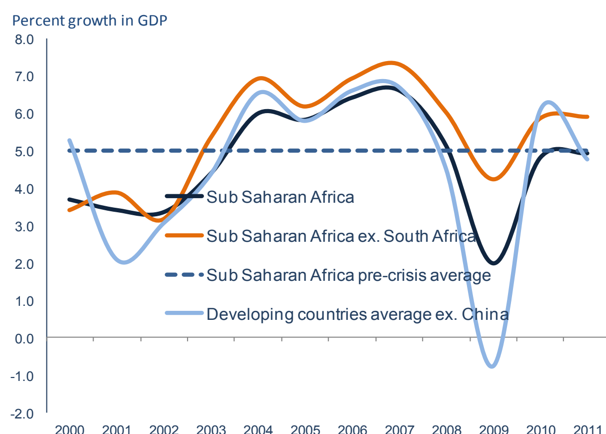
Despite multiple shocks - heightened uncertainty and slowdown in the global economy, volatile and high fuel and food prices, disruptions to supply chains from the Tohoku earthquake, and bad weather conditions for some countries in the region - growth in Sub-Saharan Africa continued briskly in 2011.

Continuing on its post-crisis recovery trajectory, GDP in Sub-Saharan Africa is estimated to have expanded 4.9 percent in 2011, slightly faster than the 4.8 percent recorded in 2010, and just shy of its pre-crisis average of 5 percent (2000-2008, (figure SSA.1). Excluding South Africa, which accounts for over a third of the regions GDP, growth in the rest of Sub Saharan Africa was stronger at 5.9% in 2011. Indeed, growth in 2011 was more than a percentage point higher than the developing country average excluding China (4.8%), making it one of the fastest growing developing regions in 2011. Overall, over a third of countries in the region attained growth rates of at least 6%, with another forty percent of countries in the region growing between 4-6% (figure SSA.2 and table SSA.3).

As has been the case in recent years, domestic demand was the main source of growth, with external demand - supported by higher commodity prices - also providing a strong impetus, notwithstanding the perturbations to the global economy.

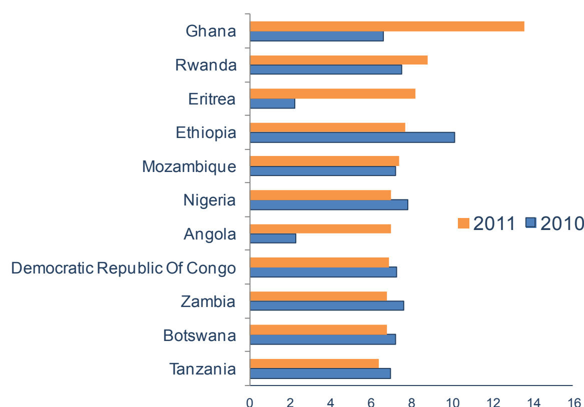
The rebound in merchandise exports was supported by higher commodity prices. Export values in the region were up some 38 percent for the first seven months of 2011 compared with the same period in 2010. In recent years, trade growth has been supported by the increasing diversification of trading partners (box SSA.1) and commodity prices. In 2011, much of the increase was due to higher commodity prices. With commodities dominating their exports, most Sub-Saharan Africa countries, benefitted from the surge in commodity prices in the earlier half of 2011, particularly oil exporters (figure SSA.3). Metal and mineral exporters in the region also benefitted from the recovery in industrial production at the global level and cotton exporters were also net gainers. However, not all Sub-Saharan Africa economies benefitted from a positive terms of trade. Indeed, several predominantly agricultural exporters and oil importers saw a deterioration in their terms of

Figure SSA.1 Growth in Sub Saharan Africa closes in on pre-crisis average…



Source: World Bank.

Figure SSA.2 Fastest Growing Sub Saharan Africa economies in 2011



Source: World Bank

Box SSA.1 Changing dynamics of trading partners

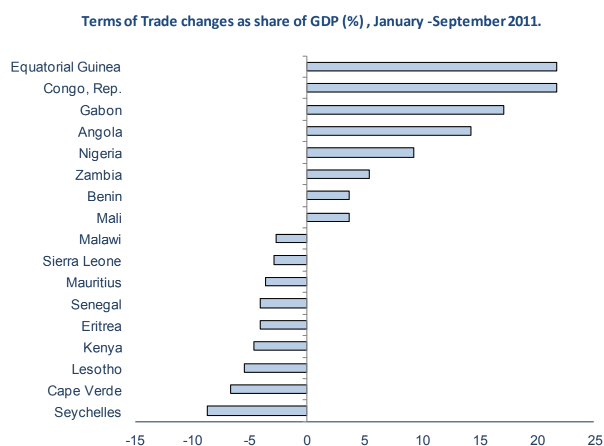
Growth in Sub-Saharan Africa exports has been supported by strong demand from other developing countries, in particular China, given its relatively high resource intensity in production and its fast growth rate. Though high-income countries are the destination for some 57 percent of the exports originating from Sub-Saharan Africa, weak growth means that their contribution to the total growth of the sub-continent's exports is much smaller. As a result, the share of high-income countries in total Sub-Saharan exports is falling. For instance in 2002, the EU accounted for some 40 percent of all exports from Sub-Saharan Africa, but by 2010 that share had fallen to about 25 percent – while China's share has increased from about 5 percent to 19 percent over the same period. For the first seven months of 2011, growth in exports destined for China from Sub-Saharan Africa was 10 percentage points higher than those destined for high-income countries.

Further, even though intra-regional trade in Sub-Saharan Africa remains well below potential due to weak infra-structure, lack of harmonization of trade policies and cumbersome border procedures, recent efforts to address these deficiencies are beginning to bear fruit. In East Africa where trade integration is more advanced, intra-regional trade has been expanding relatively rapidly. According to data from the Central Bank of Kenya, exports to other East African Community members (Uganda, Tanzania and Rwanda), during the first seven months of 2011, exceeded its combined exports to traditional trading partners such as the U.K, Netherlands, Germany, France, as well as the US.

trade. For a number of countries, these shocks compromised the relatively stable macroeconomic environment they had hitherto enjoyed (e.g. Ethiopia and Kenya).

Though commodity prices were the main driver of the increase in export values, thanks to increased exploratory activities, new mineral exports continue to come on stream in several countries, augmenting volumes and boosting growth. Ghana, the region's fastest growing economy in 2011, benefitted from the commencement of oil exports. Mozambique also began exporting coal from its large Moatize mine, and Liberia and Sierra Leone commenced iron-ore exports.

Figure SSA.3 Oil Exporters benefit the most from Terms of Trade changes



Source: World Bank

Services exports, mainly tourism, also picked up. According to the World Tourism Organization, international tourist arrivals were up 7 percent in Sub-Saharan Africa for the first eight months of 2011, compared with the same period in 2010. The slower growth in Europe does not appear to have limited tourism arrivals, in part because tourist arrivals to competing destinations in North Africa were hurt by the Arab Spring uprisings. In addition, a number of tourist destinations in the region were successful in attracting new tourists from Asian countries. For example, in Mauritius, where European tourists account for some 64 percent of tourist arrivals, arrivals from Europe grew at 3.8 percent, whereas arrivals from Asia increased by 21.7 percent (53.6 percent increase from China) during the first half of 2011.

Increased export earnings provided the needed foreign exchange to boost capital goods imports. The value of capital goods imports increased by 32.2 percent during the first seven months of 2011, compared with the same period in 2010. With infrastructure a binding constraint and obsolete machinery impairing productivity, the ability to obtain capital goods is critical for growth over the long term. Indeed, several studies on the determinants of long-run growth

in Sub-Saharan Africa countries find infrastructure investment to be a robust determinant.[1]

Foreign direct investment flows to Sub-Saharan Africa picked up in 2011. According to World Bank estimates (table SSA.1), FDI flows to Sub-Saharan Africa increased by 25 percent in 2011 following two years of decline (declines were concentrated among the region's three largest economies - Angola, Nigeria, and South Africa - with the rest of the region experiencing gains). Supported by high commodity prices and regulatory improvements, the extractive sector has attracted much of the increase in the value of FDI flows to Sub-Saharan Africa. For many countries in the region, FDI in the oil, base metals, and minerals sectors underpins much of the strong GDP growth in recent years (e.g. Angola, Congo Republic, and Niger).

Unfortunately, the enclave nature of extractive activities, means that such FDI flows to the sector have generated fewer linkages to the rest of the economy, and with the capital intensive nature of investments, this likely means limited job creation.

However, foreign investment (mainly private equity—see box SSA.2) in the non-extractive sector has also picked up in recent years – reflecting opportunities opened up by strong growth in the region, improved regulation, a growing middle class with higher discretionary income ($275 billion by one estimate), the fast pace of urbanization which makes it easier to reach consumers, and one of the highest rates of return globally (UNCTAD, World Investment Report, 2008).

Government public investment projects, sometimes in partnership with others, continued to support Sub-Saharan Africa growth in 2011. With weak infrastructure identified as one of the main binding constraints and with an estimated infrastructural funding gap of some $32 billion p.a (World Bank 2009), recent public investments have focused on power,

Table SSA.1 Net capital flows to Sub-Saharan Africa

$ billions

	2004	2005	2006	2007	2008	2009	2010	2011e	2012f	2013f
Current account balance	2.2	19.4	19.8	-0.9	-11.9	-28.1	-37.7	-5.8	-11.1	-13.0
as % of GDP	0.4	3.1	2.7	-0.1	-1.2	-3.0	-3.5	-0.5	-0.9	-0.9
Financial flows:										
Net private and official inflows	**24.2**	**33.6**	**38.4**	**52.6**	**42.6**	**47.2**	**53.5**	**62.8**		
Net private inflows (equity+private debt	**21.9**	**34.5**	**40.4**	**49.8**	**37.6**	**37.4**	**40.5**	**48.2**	**45.8**	**60.0**
..Net private inflows (% GDP)	4.0	5.4	5.4	5.8	3.8	4.0	3.7	3.9	3.5	4.4
Net equity inflows	17.8	26.6	33.0	38.4	31.8	43.0	36.5	39.5	40.3	52.0
..Net FDI inflows	11.2	18.6	16.2	28.3	37.5	32.8	28.5	35.6	35.8	47.0
..Net portfolio equity inflows	6.7	8.1	16.8	10.1	-5.7	10.2	8.0	3.9	4.5	5.0
Net debt flows	6.4	6.9	5.4	14.6	10.0	5.1	16.3			
..Official creditors	2.3	-0.9	-1.9	2.8	4.9	9.8	13.0	14.6		
....World Bank	2.5	2.4	2.2	2.4	1.9	3.1	4.0	4.2		
....IMF	-0.1	-0.4	-0.1	0.1	0.7	2.2	1.2	1.0		
....Other official	0.0	-2.9	-3.8	0.3	2.3	4.5	7.9	9.4		
..Private creditors	4.0	7.9	7.4	11.3	5.9	-5.6	3.9	8.7	5.5	8.0
....Net M-L term debt flows	2.7	4.9	-2.0	7.1	1.4	4.3	2.5	10.7		
......Bonds	0.6	1.3	0.3	6.5	-0.7	1.9	1.4	7.2		
......Banks	2.4	3.8	-1.7	1.3	2.2	1.6	0.7	3.5		
......Other private	-0.3	-0.3	-0.7	-0.8	-0.1	0.8	0.4	0.0		
....Net short-term debt flows	1.4	3.0	9.4	4.3	4.5	-9.9	1.5	-2.0		
Balancing item /a	-4.7	-33.1	-25.8	-24.8	-19.8	-16.4	-17.6	-40.2		
Change in reserves (- = increase)	-21.6	-20.0	-32.4	-26.9	-10.9	-2.7	1.8	-16.7		
Memorandum items										
Migrant remittances /b	8.3	9.6	12.8	18.8	21.7	20.2	21.1	22.7	24.1	25.7

Source: The World Bank

Note :

e = estimate, f = forecast

/a Combination of errors and omissions and transfers to and capital outflows from developing countries.

/b Migrant remittances are defined as the sum of workers' remittances, compensation of employees, and migrant transfers

Source: World Bank.

Box SSA.2 Recent private equity activity in Sub-Saharan Africa

In 2010, ECP Africa Fund raised the then record amount of $613m for an Africa focused fund, however in 2011, the London-based Helios Investment Partners announced that it had succeeded in raising $900 million (the fund was oversubscribed by a $1 billion) for its Africa dedicated fund. Several other Africa dedicated funds continue to be launched, including from the Carlyle Group – the second largest private equity fund globally - which plans on raising a reported $750 million fund.

Further evidence of increased private equity investment in the region is the 21.9 percent increase in cross-border mergers and acquisitions during the first nine months of 2011, according to estimates from UNCTAD. Significant transactions in 2011 included the $2.4 billion purchase of the South African retail giant Massmart (which has operations in over a dozen countries in the region) by Walmart – the world's largest retailer.

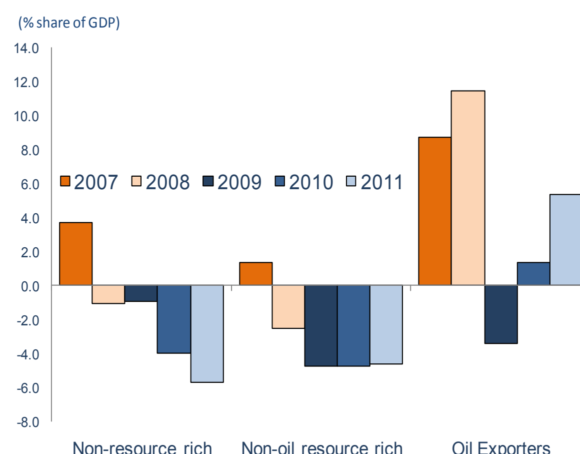
Firms from Sub-Saharan Africa are also participating in cross-border equity investments. In the retail sector South African mega retailers (Massmart, Shoprite etc) have been very active in carrying out acquisitions or greenfield investment in several countries in the region; Nigerian bankers have set up branches across West Africa and are increasing their foot prints elsewhere; and in East Africa firms can now cross-list across the different bourses in the region.

transportation, and port infrastructure facilities. Though a past legacy of low returns on public investment raises questions on its efficacy, a recent study (Gupta and others, 2011) suggests that the productivity of public capital in low and middle income countries is significantly improved once adjustments are made for shortcomings in the investment process (e.g. bidding processes). Thus, given recent improvements in governance that have occurred in recent years, the productivity and ultimately the social benefits of public capital spending in Sub-Saharan Africa may have improved.

Increasingly, in addition to development finance institutions and donor-supported programs, Sub-Saharan Africa governments are issuing long-term debt instruments (mainly local and foreign sovereign bonds). For example, Namibia made its first entry into the offshore bond market in October 2011, issuing $500 million in 10-year bonds. And in Ghana, which has already issued Euro bonds, the government is extending the yield curve of its local bonds by planning on issuing 10-year fixed rate bonds to finance infrastructure projects contained in its 2012 budget. Further, governments in many resource rich Sub-Saharan Africa countries are leveraging their resources in support of infrastructural projects. Some prominent reported loan agreements at various stages of ratification involving China in 2011 include: a $5.8 billion agreement with the Governments of Guinea (alumina refinery, power plants, port); $3 billion agreement with the Government of Ghana (gas pipeline, mineral processing, agro-industrial ventures); and a $1 billion agreement with the Tanzanian Government (gas pipeline). The Forum on China-Africa Cooperation estimates that since 2000, some 2000 Chinese companies have built 60,000km of road in Africa and 3.5 million KW in power generation.

Changes in fiscal balances depended on the composition of exports. The direction of shifts in fiscal balances in 2011 depended on the composition of exports (figure SSA.4). Prudent macroeconomic management over the past decade has underpinned the robust growth performance in Sub-Saharan Africa. However,

Figure SSA.4 Fiscal balances deteriorate for non-resource rich and improve for oil exporters



Source: IMF WEO database and World Bank

the implementation of countercyclical fiscal policy by some countries in the region in response to the financial crisis, and the rise in fuel and food prices in 2011 (which was mitigated in some Sub-Saharan Africa countries by increased subsidies) has reduced their fiscal buffers in the event of a significant downturn in the global economy. The situation however differs by country. On the one hand, oil exporters had a fiscal surplus of 5.4 percent of GDP in 2011, up from 1.3 percent in 2010, thanks to the higher oil prices. However, non-oil exporter's fiscal balances deteriorated further in 2011 to a deficit of 5.3 percent from 4.3 percent in 2010. Even among the non-oil exporters there were differences in performance; with resource rich non-oil exporters, mostly metal and mineral exporters keeping their deficits steady, while for other non-oil and non-mineral exporters the deficits widened by 1.7 percentage points to 5.7 percent in 2011, thus giving them limited fiscal space to maneuver in the event of another significant global downturn.

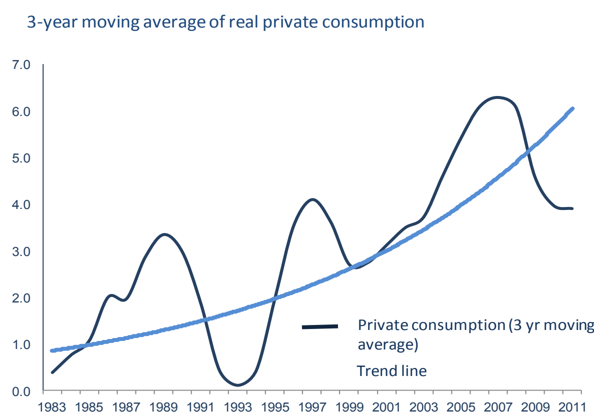
Private consumption expenditures, which accounts for some 60 percent of Sub-Saharan Africa GDP, has picked up in recent years. This rise in consumption has been supported by recent robust GDP growth rates (box SSA.3). Using three-year moving averages to smooth the volatility in data, private consumption growth has picked up from a low of 0.1 percent in 1994 to a pre-crisis peak of 6.3 percent in 2007 (figure SSA.5). It fell with the 2008/9 crisis and has averaged 4.2 percent during 2009-2011 and is projected to pick-up over the forecast horizon.

Survey data on retail spending are unavailable for many countries in the region, making it difficult to gauge recent developments in private consumption. Data on car imports (excluding trucks and buses) suggest strong growth, at least among wealthier consumers. Imports of cars rose by 31.2 percent in the first seven months of 2011 compared with the same period of 2010. The strength of consumer spending in 2011 was supported by a variety of factors, including rising incomes, improved access to credit, real wage increases and historically low interest rates (e.g. South Africa).

Inflation picked up in a number of Sub-Saharan Africa countries. Median headline inflation in the region rose from 4.3 percent by the end of 2010 to 7.0% within the first five months of 2011, and after a few months of slow down in inflationary pressures picked up again in September to 7.2 percent (figure SSA.6). However, the situation across countries in the region reflects significant differences.

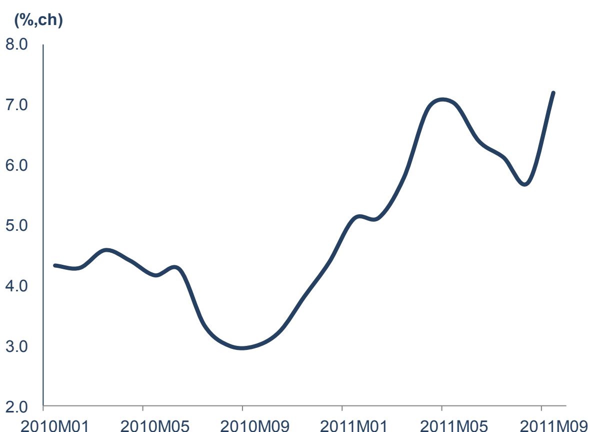
Median inflation in Sub-Saharan Africa oil exporters remained unchanged during the first six months of 2011. However, due to the escalation in oil and food prices during this period, inflation picked up among non-oil exporters in the region, with land-locked non-oil

Figure SSA.5 Growth of Private Consumption in Sub Saharan Africa



Source: World Bank

Figure SSA.6 Inflationary pressures pick-up in Sub Saharan Africa…



Source: World Bank

Box SSA.3 Consumer demand in Sub-Saharan Africa rises

Improved economic governance, a more stable political environment, and increased investments in infrastructure and human capital has supported growth, and rising employment opportunities in Sub-Sahara Africa over the past decade. The robust growth and job creation is thereby supporting consumer spending. A recent study by the African Development Bank (2011) finds that between 1990 and 2008, the number of people in Sub-Saharan Africa with incomes between $2-$20 per day almost doubled (rising from 109 million to 206 million).

Typically, middle income consumers demand better governance and are more active in civil society. They also have the means to demand better services including financial services (e.g mortgages), telecommunication (mobile phone subscriptions), education and healthcare, and discretionary incomes to purchase durable consumer products (Banerjee, A and Duflo, 2008).

Notwithstanding recent gains, the African Development Bank study shows that for Sub-Saharan Africa, some 33 percent of the middle class ($2-$20) remain vulnerable to slipping back in to poverty in the event of exogenous shocks, because the bulk of these households have per capita incomes just above the $2 poverty line (between $2 and $4). Further, World Bank projections show that by 2015 between 38.0 percent and 43.8 percent of Sub-Saharan Africa's population will still be living below the $1.25 poverty line – a shortfall of 9 to 14 percent above Millennium Development Goals, but an improvement from the 2005 level of 50.9 percent.

exporters experiencing the highest increase in headline inflation (from 8.7 percent in 2010 to 13.8 percent). East African economies were particularly hard hit, not only because of the rise in food and fuel prices but also due to the very poor rains and harvest earlier in the year. In Ethiopia, inflation peaked at 40.1 percent (in September) from 14.5 percent at the beginning of the year; in Kenya, it reached 19.7 percent in November; and in Uganda, it hit 30.5 percent in October. High levels of inflation, particularly above the 10% threshold are noted in a number of studies to be inimical to the growth process (IMF, 2005). Hence, the recent episodes of high inflation in these economies, if not reined in, threatens to curtail the robust growth that has occurred in these countries. In this regard, the moderate decline in inflation in Kenya (18.9 percent) and Uganda (27.0 percent) in December 2011 is a step in the right direction.

Medium-term outlook

The underlying factors supporting growth dynamics in Sub-Saharan Africa are expected to continue over next several years. However, considerable headwinds from slower growth in the global economy, lower commodity prices, heightened uncertainty in global financial markets, and monetary policy tightening in some countries, could dampen prospects. Moreover, as emphasized in the main text, the global outlook is particularly precarious at this time and much worse outcomes could arise if conditions in high-income Europe deteriorate.

Assuming a muddling through in the high-income world, GDP in Sub-Saharan Africa should expand by around 5.3 percent in 2012 and by 5.6 percent in 2013 (table SSA.2). However, excluding South Africa, the largest economy in the region, GDP growth would be much higher in 2012 (6.6 percent) and 6.4 percent in 2013. This anticipated acceleration in 2012 reflects new oil and mineral capacity coming on stream in 2012 and increased investments in these sectors in several countries including: Congo, Guinea, Lesotho, Liberia, Madagascar, Mauritania, Mozambique, Niger, and Sierra Leone; as well as the projected robust bounce back in Cote d'Ivoire, which contracted by 6 percent in 2011. Under our baseline scenario, in 2012, a third of countries in the region will grow by at least 6 percent (similar to 2011), another third will grow between 4.7 percent and below 6 percent, and the remaining third will grow by less than 4.7 percent (table SSA.3).

Growth prospects in the largest economies.

Supported by historically low interest rates, and above-inflation wage increases, the *South African* consumer will continue to remain the dominant driving force for GDP growth. However, the contribution of consumer spending

to GDP growth is projected to wane over the forecast horizon as household debt remains high and the recent pick-up in inflation reduces purchasing power. The boost to growth from increased government spending will remain strong in 2012, but is likely to wane as stimulus gives way to consolidation. Private investment growth, which picked up in 2011, is projected to ease due to the uncertain global recovery, low business confidence, low capacity utilization in manufacturing, labor disputes, and the strong rand. Reflecting many of these same factors, net exports will continue to drag on GDP growth. As a result, GDP in South Africa is projected to expand a modest 3.1 percent in 2012 before strengthening somewhat in 2013 at a relatively subdued level of 3.7 percent, as the global economy picks up.

Growth prospects in *Nigeria*, the region's second largest economy, remain robust (7.1 percent and 7.4 percent for 2012 and 2013 respectively). As has been the case in recent years, growth will be largely driven by the non-oil sector. The consumer services sector (financial, telecommunication, wholesale and retail) one of the main targets of private equity investors in Sub-Saharan Africa's most populous economy, will continue to provide a strong impetus to growth and job creation. Favorable weather conditions and targeted interventions in the agricultural sector should also support growth there. However, uncertainty in the global economy and domestic production challenges in its oil sector, which accounts for some 15% of GDP, will continue to limit the sector's contribution to GDP growth.

Angola's growth prospects continue to hinge on its fortunes in the oil sector. Though Angola benefitted from higher oil prices in 2011, technical glitches prevented any significant expansion in output. These problems should be resolved by 2012, paving the way for an increase

Table SSA.2 Sub-Saharan Africa forecast summary

(annual percent change unless indicated otherwise)	98-07[a]	2008	2009	Est. 2010	Forecast 2011	2012	2013
GDP at market prices (2005 US$) [b]	4.2	5.1	2.0	4.8	4.9	5.3	5.6
GDP per capita (units in US$)	1.9	3.1	0.0	2.8	2.9	3.3	3.6
PPP GDP [c]	4.4	5.6	2.5	5.1	5.2	5.6	5.9
Private consumption	2.2	3.7	1.6	5.3	5.0	4.3	4.7
Public consumption	5.4	7.5	5.8	6.6	5.6	4.2	4.9
Fixed investment	8.0	11.6	4.3	12.0	7.7	6.2	10.0
Exports, GNFS [d]	4.0	4.2	-6.4	6.3	10.3	9.7	9.5
Imports, GNFS [d]	6.5	6.6	-3.8	7.9	10.4	5.8	8.8
Net exports, contribution to growth	-0.7	-1.1	-0.7	-0.9	-0.6	0.9	-0.2
Current account bal/GDP (%)	-0.8	-1.5	-3.7	-3.3	-0.3	-0.7	-0.8
GDP deflator (median, LCU)	6.1	11.0	4.6	6.9	5.5	6.2	6.2
Fiscal balance/GDP (%)	-0.6	1.0	-5.5	-4.4	-3.4	-2.9	-2.3
Memo items: GDP							
SSA excluding South Africa	4.5	6.0	4.2	5.9	5.9	6.6	6.4
Oil exporters [e]	4.9	6.7	4.7	5.7	5.8	6.7	6.9
CFA countries [f]	3.5	4.1	2.7	4.0	2.8	4.8	4.9
South Africa	3.7	3.7	-1.8	2.8	3.2	3.1	3.7
Nigeria	5.0	6.0	7.0	7.8	7.0	7.1	7.4
Angola	9.7	13.8	2.4	2.3	7.0	8.1	8.5

Source: World Bank.
a. Growth rates over intervals are compound average; growth contributions, ratios and the GDP deflator are averages.
b. GDP measured in constant 2005 U.S. dollars.
c. GDP measured at PPP exchange rates.
d. Exports and imports of goods and non-factor services (GNFS).
e. Oil Exporters: Angola, Cote d Ivoire, Cameroon, Congo, Rep., Gabon, Nigeria, Sudan, Chad, Congo, Dem. Rep.
f. CFA Countries: Benin, Burkina Faso, Central African Republic, Cote d Ivoire, Cameroon, Congo, Rep., Gabon, Equatorial Guinea, Mali, Niger, Senegal, Chad, Togo.
g. Estimate.
h. Forecast.

Source: World Bank.

in output from 1.65 million bpd to 2.1 million bpd over the forecast horizon – reflecting both new wells and increased production from the Pazflor deepwater field. Gas output is also likely to rise as the $9 billion liquefied natural gas project gets underway. However, developments in the hydrocarbons sector have limited linkages with the rest of the economy. Government efforts to support the non-oil sector, will continue to be hindered by high transactions cost and a difficult business environment. GDP growth is projected to reach 8.1 percent and 8.5 percent in 2012 and 2013 respectively.

Risks and vulnerabilities

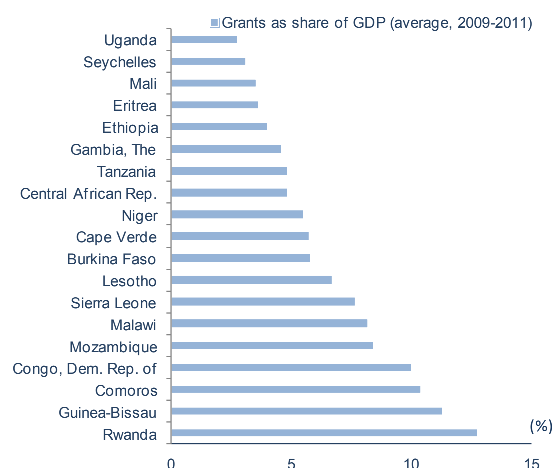
Slowdown in global economy. In the current global context, the risk of a serious downturn in the global economy is very real and would carry with it serious implications for Sub-Saharan Africa, reducing global demand for the region's exports, yielding potentially sharp declines in commodity prices and ,therefore, government revenues, and potentially large declines in remittance and tourism flows.

In the small contained European crisis outlined in the main text, growth in Sub-Saharan Africa could decline by 1.3 percentage points compared to the current forecasts for 2012, with oil and metal prices falling by as much as 18 percent and food prices by 4.5 percent. Indeed, the fiscal impact of commodity price declines could be as high as 1.7 percent of regional GDP (see main text). In 2008, several Sub-Saharan Africa countries had the fiscal buffers to make up these shortfalls. Governments in the region had much healthier fiscal balances in 2007 and thus could undertake expansionary fiscal policies (e.g. in Kenya, Tanzania and Uganda) to compensate for the fall in external demand. In 2011, however, the aggregate fiscal deficit in Sub-Saharan Africa is estimated at 3.4 percent of GDP, and not many countries in the region are well placed to carry out countercyclical fiscal policies, if the global downturn worsens significantly. The situation could become even more difficult if donors cut aid flows to low-income countries receiving high levels of budget support (e.g. Burundi, São Tomé and Príncipe, Rwanda), though Lesotho and Cape-Verde, both middle-income economies, also remain vulnerable to sharper than anticipated aid cuts (figure SSA.7).

With fiscal space much more restricted, and in a context where external financing may well not be available, governments may be forced to cut deeply into spending – thereby exacerbating the downturn. However, reduced fiscal space during a downturn need not translate into higher poverty levels if mechanisms are already in place to help protect targeted spending on the most vulnerable groups. One such successful program in Sub-Saharan Africa is Ethiopia's Productive Safety Net Program, which delivers social transfers through public work activities (food for cash, cash for work etc), as well as direct support to households that are labor constrained. Besides fiscal policy, in economies that have inflationary expectations under control and that have monetary policy space, loosening policy rates to stimulate domestic demand could support aggregate demand in the face of declining external demand. However, given structural rigidities and limited links between interest rates and credit in low-income Sub-Saharan African economies, monetary policy tends to be less effective than fiscal policies in these economies.

Fall in trade. The trade impacts of a sharp slowdown in Europe could significantly impact

Figure SSA.7 SSA economies with the highest budgetary support (grants) as a share of GDP.

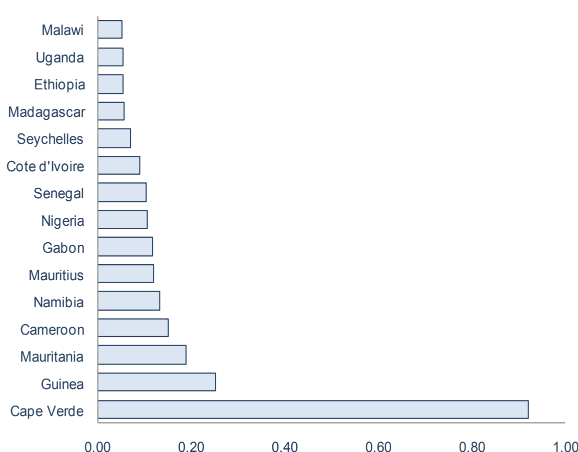


Source: IMF WEO database and World Bank Staff calculations

Sub Saharan African economies given that European Union member states account for 37 percent of the regions non-oil exports. And for tourism dependent economies in the region (e.g. Cape Verde, Gambia, Kenya, Tanzania, Mauritius, Seychelles, etc), arrivals from Eurozone member states constitute the bulk of total tourist arrivals. Impacts will differ, though, depending on individual countries' exposure to the hardest hit European economies as well as the composition of exports. While merchandise exports to the high-spread Euro Area economies account for only 9 percent of total Sub-Saharan African non-oil merchandise exports, in Cape Verde some 92 percent of merchandise exports are destined for these economies (figure SSA.8). However, for Cape Verde's service-oriented economy outturns from tourism flows will be of more importance than merchandise exports. Other economies with high exposure export demand from high-spread Euro Area economies include Guinea and Mauritania where some 25 percent and 19 percent respectively of their non-oil exports are destined.

Indeed, if the current concerns were to escalate and encompass some of Sub-Saharan Africa's major trading partners in the Euro Area, this would significantly dampen Sub-Saharan Africa exports. Further diversification of export composition and trading partners (including with other countries in the region) should, over the longer term, help Sub-Saharan Africa economies become less vulnerable to shocks originating from specific regions (see Trade Annex).

Figure SSA.8 SSA economies with the highest share of exports destined to Portugal Greece, Ireland, Italy and Spain



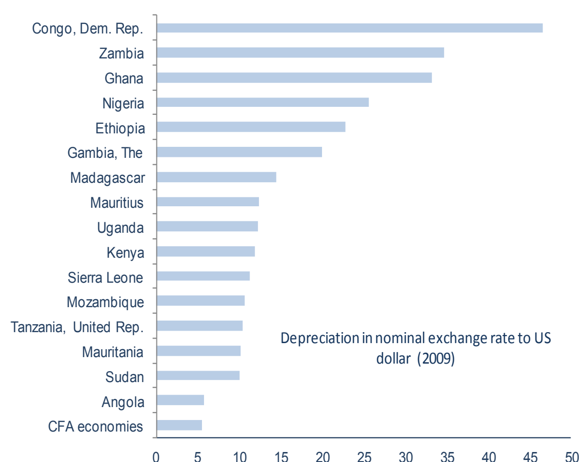
Source: UN Comtrade database and World Bank staff

Fall in commodity prices. A fall in commodity prices is likely to reduce incomes and slow investment flows to the resource sector—an important growth sector for many economies. The slowdown in export revenues is likely to be stronger in the lesser diversified economies in the region, and in particular in those whose exports are dominated by oil, minerals and metals, since, during a slow down in the global economy these commodities are more likely to be negatively impacted than agricultural exports. Indeed, some 70 percent of Sub-Saharan Africa export revenues come from agricultural products, oil, metals and minerals. In Angola and the Republic of Congo, where the oil sector accounts for over 60 percent of GDP, a 10 percent decline in oil prices could translate into a 2.7 percent and 4.4 percent decline in GDP, respectively. In Nigeria, where the oil sector accounts for 15.9 percent of GDP, a similar decline in oil prices could reduce its GDP by 1.8 percent.

Further, for many economies in the region that operate a flexible exchange rate regime, adverse terms of trade shocks translate to depreciation in their currencies, with potential for increased macroeconomic instability. For instance, during the downturn in 2009, a third of local currencies in the region depreciated by over 10% (figure SSA.9). However, on the upside, a more pronounced decline in oil prices would provide a welcome relief for the region's oil importers that were hard hit by the spike in oil prices earlier in 2011 (Ethiopia, Kenya, Malawi, Mauritius, Swaziland, Sudan, and Uganda).

Fall in capital flows. With financial markets underdeveloped in many Sub-Saharan Africa countries, the region is the least integrated with global financial markets. As a result, the direct impact on the region's banking sector, in the event of a worsening of the Euro Area debt crisis would be rather limited in terms of the deterioration in asset quality, non-performing

Figure SSA.9 A fall in commodity prices, as occurred in 2009, could contribute to significant depreciation of local currencies in the region.



Source: World Bank.

loans etc. Nonetheless, there are other sub-channels through which countries in the region could be affected in a non-trivial way.

Heightened uncertainty in global financial markets will adversely impact short-term portfolio equity and investment in bonds. Indeed, between April and October 2011, while the MSCI World Index fell by 23%, indices in the three most liquid stock exchanges in the region fell sharply: South Africa by 24%, Nigeria by 21%, and Kenya by 43%. Hence for economies in the region with more liquid financial markets (stock and bond markets), the downturn could lead to destabilizing capital flows with negative consequences on exchange rate volatility. Indeed, in the aftermath of the turmoil in financial markets in August 2011, the South African rand was one of the currencies to have depreciated the most globally.

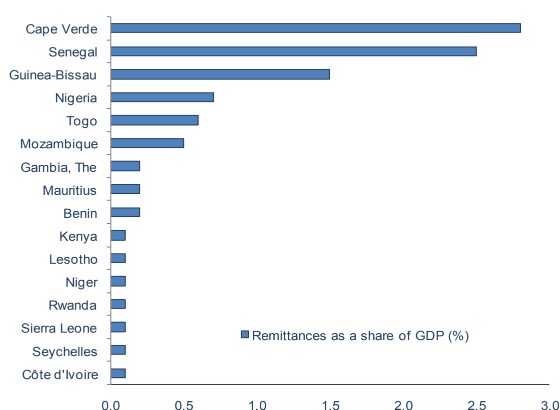
However, for most countries in the region, private capital flows are in the form of foreign direct investment, which is less volatile than other types of capital flows and hence are somewhat shielded from sudden capital flights. Nonetheless, an intensification of the Euro Area debt crisis could well result in a fall in foreign direct investment as occurred during the 2008/09 financial crisis when foreign direct investment fell by a cumulative 24% over the 2008-2010 period.

Heightened financial market uncertainty could affect participation in bond issuance– both local and foreign. For instance, plans by a number of Sub-Saharan African countries (Kenya, Tanzania, Zambia) to issue international bonds may be further postponed if the premiums required remain high due to elevated investor risk averseness related to the Euro debt situation. This could therefore delay the prospect of addressing some of the binding infrastructural constraints to growth in these countries.

Fall in remittances. Another channel of transmission that a slowdown in the global economy could engender is a fall in remittance inflows. With remittance flows supporting household spending and local currencies, a sharp decline in remittances could dampen growth prospects. World Bank estimates that remittances to Sub-Sahara Africa will rise to $24 billion and $26 billion in 2012 and 2013 respectively. Given that remittance flows were resilient during the 2008/09 crisis (falling by only 4.6% in 2009), they are likely to hold steady in the medium term. However, in the event of a sharper slowdown than anticipated in the baseline, remittances could deviate from current projections by declining between 2.8% to 6.2%, depending on the severity of the downturn. The effects among Sub-Saharan Africa countries would however differ. As a share of GDP, Cape Verde, Senegal and Guinea-Bissau are the most dependent on remittance flows from the high-spread Euro Area countries (figure SSA.10), thus likely to be the most vulnerable through this channel.

Internal risks. While external risks are most prominent – a number of domestic challenges could also cause outturns to sour. Indeed, disruptions to productive activity in the aftermath of elections are important potential downside risks, as investment, merchandise trade and tourism receipts, all important growth drivers, are likely to suffer. The 6 percent contraction in output in Cote d'Ivoire in 2011 was due to the civil unrest following the

Figure SSA.10 Sub Saharan Africa countries with high remittances from high-spread Euro Area countries



Source: World Bank

elections in 2010. In 2012 about a sixth of Sub-Saharan Africa countries have scheduled presidential elections.

Another downside risk stems from adverse weather conditions. With the agricultural sector accounting for about 20 percent to 40 percent of GDP in most Sub-Sahara African countries, and with much of it dependent on good rains, the impact of poor rains on GDP growth in the region can be significant, not just to the agricultural sector but also for services and industries as they depend on the generation of power from hydroelectric sources. In 2011, lower food production in parts of Kenya, due to poor rains led, to an escalation of food prices and a contraction in the electricity and water supply sector (by 12.1%, y/y, in the third quarter); and in Tanzania extensive power rationing due to lower water levels cut into manufacturing output.

Notes:

1. Estache et. al (2006) demonstrate that infrastructure investments accelerated growth convergence in Africa by over 13 percent. And Calderon (2008) estimates that infrastructure contributed 0.99 percentage points to per capita economic growth during the 1990-2005 period.

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Table SSA.3 Sub-Saharan country forecasts

(annual percent change unless indicated otherwise)				Est.	Forecast		
	98-07[a]	2008	2009	2010	2011	2012	2013
Angola							
GDP at market prices (2005 US$) [b]	9.7	13.8	2.4	2.3	7.0	8.1	8.5
Current account bal/GDP (%)	-0.9	8.5	-10.0	-1.8	7.0	8.0	9.2
Benin							
GDP at market prices (2005 US$) [b]	3.8	5.1	2.7	2.6	3.4	4.3	4.8
Current account bal/GDP (%)	-7.7	-9.3	-9.2	-10.2	-14.2	-11.8	-6.9
Botswana							
GDP at market prices (2005 US$) [b]	4.7	2.9	-4.9	7.2	6.8	6.2	5.0
Current account bal/GDP (%)	9.2	3.5	-4.5	-6.0	-2.9	2.5	11.4
Burkina Faso							
GDP at market prices (2005 US$) [b]	4.8	5.0	3.5	7.9	5.8	5.2	5.4
Current account bal/GDP (%)	-14.0	-24.8	-19.4	-10.6	-6.1	-6.8	-5.5
Burundi							
GDP at market prices (2005 US$) [b]	1.8	4.5	3.5	3.9	4.4	4.7	4.9
Current account bal/GDP (%)	-20.5	-30.2	-12.3	-10.8	-13.4	-13.0	-12.9
Cape Verde							
GDP at market prices (2005 US$) [b]	5.9	6.2	3.6	5.4	5.8	6.4	6.6
Current account bal/GDP (%)	-10.8	-13.3	-15.1	-18.1	-16.7	-15.6	-14.4
Cameroon							
GDP at market prices (2005 US$) [b]	3.4	2.9	2.0	2.6	3.8	4.1	4.6
Current account bal/GDP (%)	-2.4	-1.9	-5.0	-3.8	-2.9	-3.3	-3.2
Central African Republic							
GDP at market prices (2005 US$) [b]	0.8	2.0	1.7	3.3	4.0	3.0	3.5
Current account bal/GDP (%)	-4.6	-9.7	-8.0	-8.8	-7.8	-7.8	-6.9
Chad							
GDP at market prices (2005 US$) [b]	8.0	-0.4	-1.6	5.1	6.0	5.5	4.0
Current account bal/GDP (%)	-36.5	-19.8	-28.9	-24.3	-14.4	-13.0	-5.5
Comoros							
GDP at market prices (2005 US$) [b]	1.9	1.0	1.8	2.1	2.3	2.5	2.8
Current account bal/GDP (%)	-4.0	-10.5	-5.9	-8.2	-8.7	-9.6	-9.9
Congo, Dem. Rep.							
GDP at market prices (2005 US$) [b]	1.9	6.2	2.8	7.3	6.5	6.0	8.0
Current account bal/GDP (%)	-3.6	-17.5	-10.5	-6.8	-2.8	-0.7	0.6
Congo, Rep.							
GDP at market prices (2005 US$) [b]	2.9	5.6	7.5	8.8	5.1	5.5	5.0
Current account bal/GDP (%)	1.2	-18.3	-10.6	3.9	10.2	7.1	6.5
Cote d Ivoire							
GDP at market prices (2005 US$) [b]	0.0	2.3	3.8	2.4	-5.8	4.9	5.5
Current account bal/GDP (%)	0.7	1.9	7.2	6.9	2.3	0.6	-0.8
Equatorial Guinea							
GDP at market prices (2000 USD) [2]	20.7	10.7	5.3	0.9	2.8	4.1	4.5
Current account bal/GDP (%)	6.7	10.2	-18.0	-5.9	-9.4	-7.5	-6.0
Eritrea							
GDP at market prices (2005 US$) [b]	-0.1	-9.8	3.9	2.2	8.2	6.3	7.0
Current account bal/GDP (%)	-18.9	-6.2	-6.5	-2.7	-3.0	-3.4	-3.6
Ethiopia							
GDP at market prices (2005 US$) [b]	6.5	10.8	8.8	10.1	7.7	7.2	7.8
Current account bal/GDP (%)	-5.3	-6.8	-6.8	-9.6	-10.6	-11.6	-12.4

(annual percent change unless indicated otherwise)				Est.	Forecast		
	98-07[a]	2008	2009	2010	2011	2012	2013
Gabon							
GDP at market prices (2005 US$) [b]	0.4	2.3	-1.4	5.7	6.0	5.1	4.1
Current account bal/GDP (%)	10.9	22.2	13.5	11.4	15.0	12.1	11.3
Gambia, The							
GDP at market prices (2005 US$) [b]	3.4	5.4	6.2	5.6	5.3	5.4	5.8
Current account bal/GDP (%)	-9.4	0.4	4.0	2.1	1.9	1.3	0.8
Ghana							
GDP at market prices (2005 US$) [b]	4.6	8.4	4.7	6.6	13.6	9.0	8.0
Current account bal/GDP (%)	-6.4	-12.4	-3.6	-7.2	-7.0	-5.9	-4.4
Guinea							
GDP at market prices (2005 US$) [b]	2.8	4.9	-0.3	1.9	4.3	4.5	5.0
Current account bal/GDP (%)	-6.1	-11.6	-10.1	-13.1	-14.2	-12.2	-13.6
Guinea-Bissau							
GDP at market prices (2005 US$) [b]	1.8	3.2	3.0	3.5	4.8	4.7	5.0
Current account bal/GDP (%)	-7.3	-11.0	-8.5	-11.1	-11.4	-10.6	-10.3
Kenya							
GDP at market prices (2005 US$) [b]	3.4	1.6	2.6	5.6	4.3	5.0	5.5
Current account bal/GDP (%)	-4.9	-6.6	-5.7	-7.7	-10.0	-6.6	-5.9
Lesotho							
GDP at market prices (2005 US$) [b]	2.9	4.7	3.1	3.3	3.1	5.1	4.9
Current account bal/GDP (%)	-3.5	9.0	-0.1	-19.7	-24.5	-17.8	-13.5
Madagascar							
GDP at market prices (2005 US$) [b]	3.2	7.1	-4.6	1.6	2.6	3.0	4.5
Current account bal/GDP (%)	-9.5	-17.5	-15.4	-8.1	-8.5	-8.3	-8.3
Malawi							
GDP at market prices (2005 US$) [b]	2.8	8.6	7.6	6.7	5.6	5.0	5.6
Current account bal/GDP (%)	-4.7	-7.1	-9.6	-2.7	-4.7	-5.1	-5.5
Mali							
GDP at market prices (2005 US$) [b]	5.1	5.0	4.5	4.5	5.4	5.1	5.9
Current account bal/GDP (%)	-7.9	-12.2	-7.3	-7.6	-8.0	-8.1	-7.8
Mauritania							
GDP at market prices (2005 US$) [b]	4.1	3.5	-1.2	5.2	5.1	5.7	6.0
Current account bal/GDP (%)	-5.8	-12.6	-13.2	-10.1	-11.2	-11.7	-12.2
Mauritius							
GDP at market prices (2005 US$) [b]	3.6	5.5	3.0	4.0	4.1	3.3	4.3
Current account bal/GDP (%)	-1.2	-10.1	-7.4	-8.2	-11.1	-11.2	-10.2
Mozambique							
GDP at market prices (2005 US$) [b]	6.8	6.8	6.4	7.2	7.4	7.6	8.5
Current account bal/GDP (%)	-14.6	-11.9	-11.8	-15.4	-13.6	-12.4	-11.1
Namibia							
GDP at market prices (2005 US$) [b]	4.4	4.3	-0.8	6.6	3.9	4.2	5.1
Current account bal/GDP (%)	4.0	0.5	-1.2	-0.7	-0.5	-1.5	-2.4
Niger							
GDP at market prices (2005 US$) [b]	2.7	8.7	-1.2	8.8	6.0	8.5	6.8
Current account bal/GDP (%)	-7.4	-12.1	-19.3	-18.8	-19.2	-16.7	-14.4
Nigeria							
GDP at market prices (2005 US$) [b]	5.0	6.0	7.0	7.8	7.0	7.1	7.4
Current account bal/GDP (%)	11.0	13.6	7.8	1.5	14.3	13.3	11.4

(annual percent change unless indicated otherwise)				Est.	Forecast		
	98-07[a]	2008	2009	2010	2011	2012	2013
Rwanda							
GDP at market prices (2005 US$) [b]	6.8	11.2	4.1	7.5	8.8	7.6	7.0
Current account bal/GDP (%)	-6.0	-5.3	-7.2	-6.0	-6.1	-4.3	-2.1
Senegal							
GDP at market prices (2005 US$) [b]	4.0	3.3	2.2	4.2	4.2	4.4	4.4
Current account bal/GDP (%)	-7.0	-14.3	-12.9	-13.2	-13.4	-14.1	-14.6
Seychelles							
GDP at market prices (2005 US$) [b]	2.1	-1.3	0.7	6.2	4.0	4.7	5.0
Current account bal/GDP (%)	-16.4	-44.2	-32.1	-51.6	-25.4	-17.6	-15.4
Sierra Leone							
GDP at market prices (2005 US$) [b]	7.5	5.5	3.2	4.9	5.6	44.0	13.0
Current account bal/GDP (%)	-12.2	-15.3	-15.7	-13.1	-12.6	-12.2	-11.9
South Africa							
GDP at market prices (2005 US$) [b]	3.7	3.7	-1.8	2.8	3.2	3.1	3.7
Current account bal/GDP (%)	-2.1	-7.1	-4.1	-2.8	-3.0	-3.7	-4.1
Sudan							
GDP at market prices (2005 US$) [b]	5.9	6.8	4.0	4.5	5.3	5.8	5.8
Current account bal/GDP (%)	-7.1	-2.3	-7.7	-1.9	-7.2	-7.3	-7.4
Swaziland							
GDP at market prices (2005 US$) [b]	3.1	2.4	0.4	2.0	-2.1	0.6	1.5
Current account bal/GDP (%)	-1.3	-8.1	-14.4	-15.2	-15.8	-13.1	-12.1
Tanzania							
GDP at market prices (2005 US$) [b]	5.9	7.4	6.0	7.0	6.4	6.7	6.9
Current account bal/GDP (%)	-5.8	-12.9	-9.0	-8.6	-9.1	-10.4	-11.8
Togo							
GDP at market prices (2005 US$) [b]	1.9	2.4	3.2	3.4	3.7	4.0	4.1
Current account bal/GDP (%)	-9.5	-6.9	-5.6	-5.9	-4.6	-4.9	-4.9
Uganda							
GDP at market prices (2005 US$) [b]	6.4	8.7	7.2	6.4	6.3	6.2	7.0
Current account bal/GDP (%)	-5.4	-9.1	-6.7	-10.1	-12.1	-15.3	-11.2
Zambia							
GDP at market prices (2005 US$) [b]	4.2	5.7	6.4	7.6	6.8	6.7	6.0
Current account bal/GDP (%)	-13.7	-9.3	1.9	2.5	3.5	2.4	2.1

Source: World Bank.

World Bank forecasts are frequently updated based on new information and changing (global) circumstances. Consequently, projections presented here may differ from those contained in other Bank documents, even if basic assessments of countries' prospects do not significantly differ at any given moment in time.

Liberia, Somalia, Sao Tome and Principe are not forecast owing to data limitations.

a. Growth rates over intervals are compound average; growth contributions, ratios and the GDP deflator are averages.

b. GDP measured in constant 2005 U.S. dollars.

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