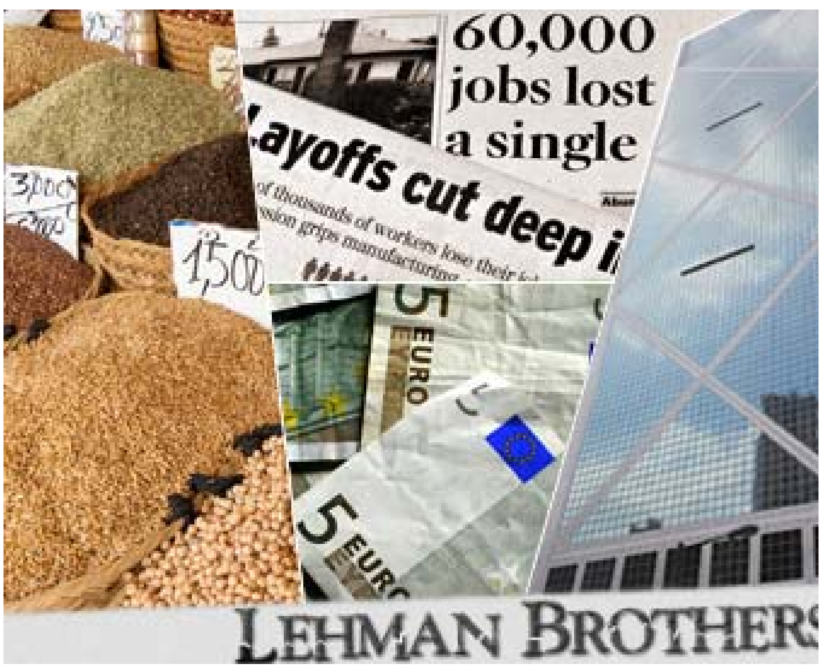
Volume 5 | June 2012

Global Economic Prospects



Managing growth in a volatile world

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Acknowledgments

This report is a product of the Prospects Group in the Development Economics Vice Presidency of the World Bank. Its principal authors were Andrew Burns and Theo Janse van Rensburg.

The project was managed by Andrew Burns, under the direction of Hans Timmer and the guidance of Justin Yifu Lin. Several people contributed substantively to the report. The modeling and data team was led by Theo Janse van Rensburg assisted by Irina Magyer, Sabah Zeehan Mirza and Muhammad Adil Islam. The projections, regional write-ups and subject annexes were produced by Dilek Aykut (Finance, Europe & Central Asia), John Baffes & Shane Streifel (Commodities) Sanket Mohapatra (South Asia and Exchange Rates), Allen Dennis (Sub-Saharan Africa and International Trade), Eung Ju Kim (Finance), Theo Janse van Rensburg (High-Income Countries), Elliot (Mick) Riordan (East Asia & the Pacific, Middle-East & North Africa, and Inflation), Cristina Savescu (Latin America & Caribbean, Industrial Production). Regional projections and annexes were produced in coordination with country teams, country directors, and the offices of the regional Chief Economists and PREM directors. The short-term commodity price forecasts were produced by John Baffes, Betty Dow, and Shane Streifel. The remittances forecasts were produced by Dilip K. Ratha and Ani Silwal. Simulations were performed by Theo van Rensburg, Irina Magyer and Sanket Mohapatra.

The accompanying online publication, Prospects for the Global Economy, was produced by a team comprised of Sarah Crow, Sanket Mohapatra, Sabah Mirza, Muhammad Adil Islam, Betty Dow, Vamsee Krishna Kanchi, and Katherine Rollins with technical support from David Horowitz, Ugendran Machakkalai, and Malarvishi Veerappan.

Roula I. Yazigi and Sabah Zeehan Mirza were responsible for the cover artwork.

Indira Chand, Cynthia Case-McMahon and Merrell Tuck-Primdahl managed media relations and the dissemination. Hazel Macadangdang managed the publication process.

Several reviewers offered extensive advice and comments. These included Inger Andersen, Ulrich Bartsch, Maria Teresa Benito-Spinetto, Fabio Bittar, Zeljko Bogetic, Otaviano Canuto, Shubham Chaudhuri, Jeff Chelsky, Punam Chuhan-Pole, Tito Cordella, Jorg Decressin, Augusto de la Torre, Shantayanan Devarajan, Tatiana Didier, Pablo Fajnzylber, Manuela V. Ferro, Caroline Freund, Bernard G. Funck, David Michael Gould, Marcelo Giugale, Bert Hofman, Zahid Hussain, Elena Ianchovichina, Kalpana Kochhar, Auguste Tano Kouame, Roumeen Islam, Jeffrey D. Lewis, Philippe H. Le Houerou, Jose R. Lopez Calix, Ernesto May, Alexey Morozov, Antonio M. Ollero, Samuel Pienknagura, Bryce Quillin, Christine M. Richaud, Sudhir Shetty, Vijay Srinivas Tata, Phil Suttle, Anthony G. Toft, Yvonne M. Tsikata, Willem van Eeghen, Jan Walliser.

Table of Contents

The cut off date for information included in this edition of the Global Economic Prospects reflects data as of June 8, 2012.

Global Economic Prospects June 2012:
Managing growth in a volatile world

Overview & main messages

Economic developments of the past year have been volatile, punctuated by natural disasters, large swings in investor sentiment, and periods of relative calm and improving prospects. Output in the second half of 2011, was particularly weak, buffeted by flooding in Thailand, the delayed impact of earlier policy tightening and a resurgence of financial market and investor jitters.

In contrast, economic news during the first four months of 2012 was generally positive. Significant structural, fiscal and monetary policy steps in high-income Europe during the fourth quarter of 2011 and the first quarter of 2012 contributed to a significant improvement in market sentiment, and less constraining financial conditions. This combined with monetary policy easing in developing countries was reflected in a strengthening of real-side economic activity in both developing and high-income countries. Annualized growth rates for industrial production, import demand and capital goods sales returned to positive territory with developing countries leading the rebound.

Increased Euro Area jitters have reversed earlier improvements in market sentiment

Most recently, market tensions have jumped up again, sparked by fiscal slippage, banking downgrades, and political uncertainty in the Euro Area. The renewed market nervousness has caused the price of risk to spike upwards globally. In the Euro Area, measures of financial market tension, such as Credit Default Swap (CDS) rates, have risen to levels close to their peaks in the fall of 2011. In other high-income countries, CDS rates have risen somewhat less sharply. Among most developing countries, CDS rates are currently about 65 to 73 percent of peak levels, and between 77 and 90 percent for countries in the Europe & Central Asia region.

Other financial market indicators have also deteriorated, with developing– and high-income country stock markets losing about 10 percent (at their recent trough) since May 1st, giving up almost all of the gains generated over the preceding 4 months. They have since recovered about half that value. Yields on high-spread economies were also driven upwards, while those of safe-have assets declined. Virtually all developing economy currencies have depreciated against the US dollar, while industrial commodity prices such as oil and copper have also fallen sharply (19 and 14 percent respectively).

Renewed tensions will add to pre-existing headwinds to keep GDP gains modest

Assuming that conditions in high-income Europe do not deteriorate significantly, the increase in tensions so far can be expected to subtract about 0.2 percentage points from Euro Area growth in 2012. The direct effect on developing country growth will be smaller (in part because there has been less contagion), but increased market jitters, reduced capital inflows, high-income fiscal and banking-sector consolidation are all expected to keep growth weak in 2012. These drags on growth are expected to ease somewhat, and global growth strengthen during 2013 and 2014, although both developing-country and high-income country GDP will grow less quickly than during the pre-crisis years of this century.

Taking these factors into account, global GDP is projected to increase 2.5 percent in 2012, with growth accelerating to 3.0 and 3.3 percent in 2013 and 2014 (table 1). Output in the Euro Area is projected to contract by 0.3 percent in 2012, reflecting both weak carry over and increased precautionary saving by firms and households in response to renewed uncertainty. Overall, high-income GDP is expected to expand only 1.4 percent this year weighed down by banking-sector deleveraging and ongoing fiscal

Table 1 The Global Outlook in summary

(percent change from previous year, except interest rates and oil price)

	2010	2011	2012e	2013f	2014f
Global Conditions					
World Trade Volume (GNFS)	13.0	6.1	5.3	7.0	7.7
Consumer Prices					
G-7 Countries [1,2]	1.2	2.4	1.9	1.8	2.0
United States	1.6	3.1	2.6	2.4	2.5
Commodity Prices (USD terms)					
Non-oil commodities	22.5	20.7	-8.5	-2.2	-3.1
Oil Price (US$ per barrel) [3]	79.0	104.0	106.6	103.0	102.4
Oil price (percent change)	28.0	31.6	2.5	-3.4	-0.6
Manufactures unit export value [4]	3.3	8.9	0.9	1.2	1.5
Interest Rates					
$, 6-month (percent)	0.5	0.5	0.7	0.8	1.1
€, 6-month (percent)	1.0	1.6	1.0	1.1	1.4
International capital flows to developing countries (% of GDP)					
Developing countries					
Net private and official inflows	5.8	4.6	3.3	3.6	3.8
Net private inflows (equity + debt)	5.4	4.4	3.1	3.4	3.7
East Asia and Pacific	5.9	4.9	3.3	3.4	3.5
Europe and Central Asia	4.9	4.4	2.6	3.7	3.9
Latin America and Caribbean	6.1	4.8	3.9	3.9	4.0
Middle East and N. Africa	2.3	0.0	1.0	1.7	2.2
South Asia	5.2	3.7	2.8	3.0	3.5
Sub-Saharan Africa	3.6	3.4	2.6	3.3	4.3
Real GDP growth [5]					
World	**4.1**	**2.7**	**2.5**	**3.0**	**3.3**
Memo item: World (PPP weights) [6]	5.1	3.7	3.3	3.9	4.2
High income	**3.0**	**1.6**	**1.4**	**1.9**	**2.3**
OECD Countries	2.9	1.4	1.3	1.8	2.2
Euro Area	1.8	1.6	-0.3	0.7	1.4
Japan	4.5	-0.7	2.4	1.5	1.5
United States	3.0	1.7	2.1	2.4	2.8
Non-OECD countries	7.4	4.8	3.6	4.3	4.1
Developing countries	**7.4**	**6.1**	**5.3**	**5.9**	**6.0**
East Asia and Pacific	9.7	8.3	7.6	8.1	7.9
China	10.4	9.2	8.2	8.6	8.4
Indonesia	6.2	6.5	6.0	6.5	6.3
Thailand	7.8	0.1	4.3	5.2	5.6
Europe and Central Asia	5.4	5.6	3.3	4.1	4.4
Russia	4.3	4.3	3.8	4.2	4.0
Turkey	9.2	8.5	2.9	4.0	5.0
Romania	-1.6	2.5	1.2	2.8	3.4
Latin America and Caribbean	6.1	4.3	3.5	4.1	4.0
Brazil	7.5	2.7	2.9	4.2	3.9
Mexico	5.5	3.9	3.5	4.0	3.9
Argentina	9.2	8.9	2.2	3.7	4.1
Middle East and N. Africa	3.8	1.0	0.6	2.2	3.4
Egypt [7]	5.0	1.8	2.1	3.1	4.2
Iran	2.9	2.0	-1.0	-0.7	1.5
Algeria	3.3	2.5	2.6	3.2	3.6
South Asia	8.6	7.1	6.4	6.5	6.7
India [7, 8]	9.6	6.9	6.6	6.9	7.1
Pakistan [7]	4.1	2.4	3.6	3.8	4.1
Bangladesh [7]	6.1	6.7	6.3	6.4	6.5
Sub-Saharan Africa	5.0	4.7	5.0	5.3	5.2
South Africa	2.9	3.1	2.7	3.4	3.5
Nigeria	7.9	7.4	7.0	7.2	6.6
Angola	3.4	3.4	8.1	7.4	6.8
Memorandum items					
Developing countries					
excluding transition countries	7.8	6.4	5.5	6.1	6.2
excluding China and India	5.6	4.4	3.6	4.3	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 FY2010-11 are 8.4, 6.5, 6.9, 7.2, and 7.4 percent – see Table SAR.2 in the regional annex.

consolidation. As these pressures ease in 2013 and 2014, rich-country GDP growth is projected to firm to what will still be a modest 1.9 and 2.3 percent pace in each of 2013 and 2014.

GDP in developing countries is projected to expand 5.3 percent in 2012. Still weak, but strengthening high-income demand, weak capital flows, rising capital costs and capacity constraints in several large middle-income countries will conspire to keep growth from exceeding 6 percent in each of 2013 and 2014. The projected recovery in the Middle-East & North Africa is uncertain and is contingent on assumptions of a gradual easing of social unrest during 2012 and a return to more normal conditions during 2013 and 2014.

In the baseline, the slower growth in developing countries mainly reflects a developing world that has already recovered from the financial crisis. Several countries are rubbing against capacity constraints that preclude a significant acceleration in growth, and may even require a slowing in activity in order to prevent overheating over the medium run.

Should global conditions deteriorate, all developing countries would be hit — making the replenishment of depleted macroeconomic cushions a priority

The resurgence of tensions in the high-income world is a reminder that the after effects of the 2008/09 crisis have not yet played themselves out fully. Although the resolution of tensions implicit in the baseline is still the most likely outcome, a sharp deterioration of conditions cannot be ruled out. While the precise nature of such a scenario is unknowable in advance, developing countries could be expected to take a large hit. Simulations suggest that their GDP could decline relative to baseline by more than four percent in some regions, with commodity prices, remittances, tourism, trade, finance and international business confidence all mechanisms by which the tribulations of the high-income world would be transmitted to developing countries. Countries in Europe and Central Asia would be among the most vulnerable to an acute crisis in high-income Europe, with likely acceleration in deleveraging by Greek banks affecting Bulgaria, Macedonia and Serbia the most.

A return to more neutral macroeconomic policies would help developing countries reduce their vulnerabilities to external shocks, by rebuilding fiscal space, reducing short-term debt exposures and recreating the kinds of buffers that allowed them to react so resiliently to the 2008/09 crisis. Currently, developing country fiscal deficits are on average 2.5 percent of GDP higher than in 2007, and current account deficits 2.8 percent of GDP higher. And short-term debt exceeds 50 percent of currency reserves in 11 developing countries.

A more neutral and less reactive policy stance will help even if a crisis is averted

Even in the absence of a full-blown crisis, elevated fiscal deficits and debts in high-income countries (including the United States and Japan), and the very loose monetary policies being pursued in the high-income world, suggests that for the next several years the external environment for developing economies is likely to remain characterized by volatile capital flows and volatile business sentiment.

As a result, sharp swings in investor sentiment and financial conditions will continue to complicate the conduct of macro policy in developing countries. In these conditions, policy in developing countries needs to be less re-active to short-term changes in external conditions, and more responsive to medium-term domestic considerations. A reactive macroeconomic policy runs the risk of being pro-cyclical, with the impact of a loosening (tightening) in response to a temporary worsening (improvement) of external conditions stimulating (restraining) domestic demand at the same time as external conditions recover (weaken).

For the many developing economies that have, or are close to having fully recovered from the crisis, policy needs to turn away from crisis-fighting and re-prioritize the kinds of productivity-enhancing reforms (like investment in human capital and regulatory reform) that will support a durable pickup in growth rates over the longer term.

Activity and sentiment improved in early 2012

The first 4 months of 2012 started off relatively well. Greece successfully completed a major debt restructuring, and tensions in financial markets eased. Responding to a loosening of monetary policy in developing countries, and a significant improvement in sentiment, the pause in global economic growth that occurred in the second half of 2011 gave way to renewed expansion. Activity was aided by a relative absence of the kind of major shocks that characterized 2011 (earthquake and tsunami in Japan, flooding in Thailand), although geopolitical tensions and trade sanctions did initially push oil prices higher.

Progress in high-income Europe reduced financial market tensions during the first quarter of 2011

Market concerns about fiscal sustainability in Europe, although still present, declined in the first quarter of 2012, in the wake of major policy initiatives, including: cross-party agreement to fiscal consolidation plans; the passage of far-reaching structural policy reforms; the successful restructuring of Greek debt; agreement of pan-European fiscal rules and firewalls, and a significant easing of borrowing conditions by the European Central Bank (ECB) in the context of its Long-Term Refinancing Operations (LTROs).

As a result, the risk premia required of high-spread economies declined from 7.2 to 4.1 percent in the case of long-term Italian bonds and from 5.7 percent to 4.6 percent in the case of Spanish bonds. CDS rates for high-spread economies also declined, losing about 92 percent of the increases observed since July 2011.

As market concerns eased, other financial market indicators also improved. Equities in both developing and high-income countries recovered much of the value lost during the second half of 2011, rising by some 14 percent between mid-December and mid-May (figure 1) and bonds spreads declined (figure 2). European bank funding pressures also declined – in part because of access to cheap ECB money. Interbank and central bank overnight rate spreads (a measure of the perceived riskiness of private banks) declined sharply.

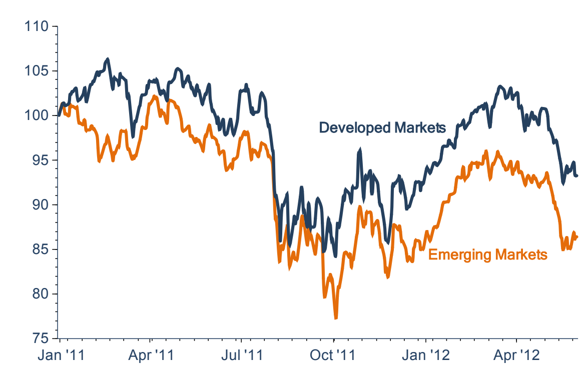
Euro Area deleveraging cut into bank-lending to developing countries

Easing risk aversion during the first quarter of 2012, and the lower borrowing costs that accompanied it led to a resurgence in developing -country bond issuance through the first four months of the year, with issuance standing 14 percent above the levels observed at the beginning of 2011 — a period of robust capital flows.

However, not all financial sector developments were so positive. Tighter regulations in the Euro Area,[1] and weak demand, contributed to a significant decline in European bank lending

Figure 1. Equity markets recovered during the first quarter of 2012, before weakening in May

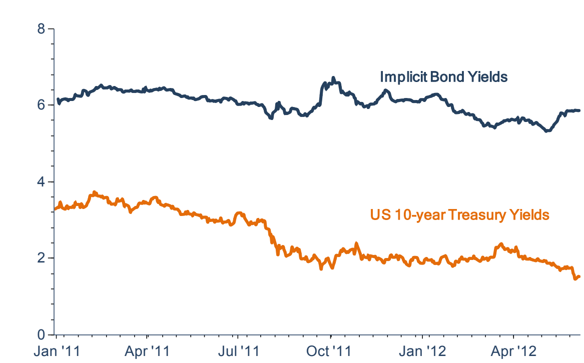
Index Jan 2011 = 100



Source: World Bank.

Figure 2. Emerging-market bond spreads were declining in the first quarter, before widening in May

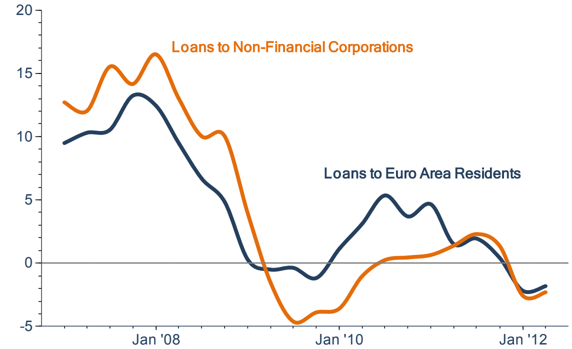
Percent



Source: World Bank.

Figure 3. Weak growth and tighter regulations contributed to a fall in European bank lending

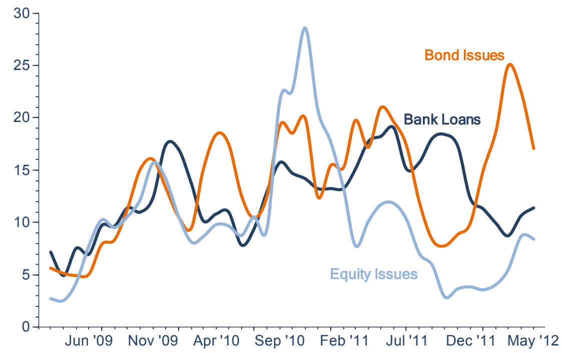
Percent change



Source: ECB via Datastream.

Figure 4. A sharp decline in syndicated bank lending was only partly offset by increased bond issuance

Percent change
Source: Dealogic, World Bank.



beginning in the third quarter of 2011 (figure 3). Deleveraging has continued into 2012, with the overall stock of loans in the Euro Area declining at a 2.3 percent annualized rate during the three months ending April 2012.

Although the impacts for developing countries are difficult to quantify, syndicated bank-lending declined markedly during the fourth quarter of 2011 and into 2012 (figure 4). This, coupled with a sharp decline in new equity offerings, more than offset the increase in bond issuance by developing countries in early 2012.

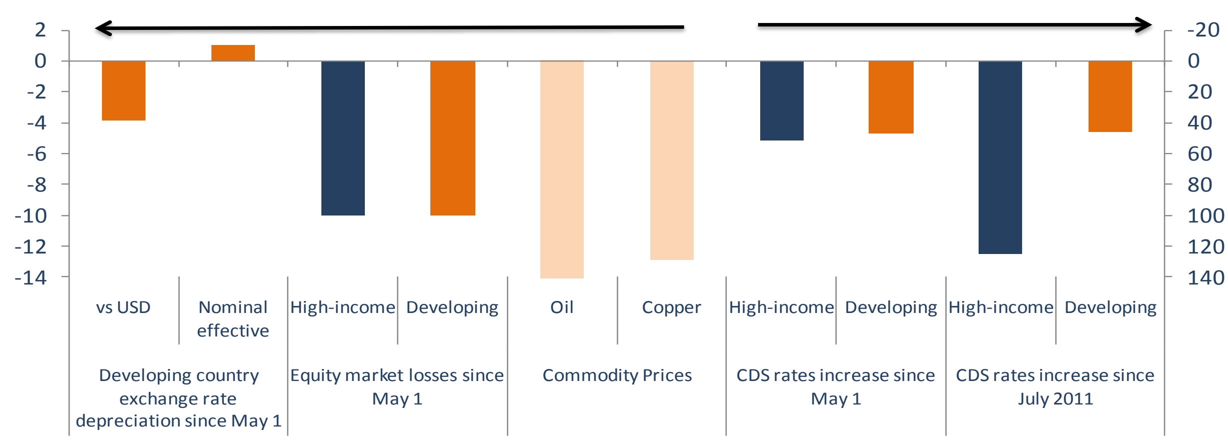
The deterioration of several high-frequency indicators in May (see following discussion of headwinds) suggest that a re-tightening of developing country financial conditions is likely underway. For example, both high-income and developing stock markets lost around 10 percent during May (though they have rebounded 2.7 percent), giving up much of their 2012 gains. Capital outflows and increased risk aversion are also likely responsible for the 10 or more percent depreciation of many developing economy currencies (somewhat less than 4 percent on average) and for the sharp drop in commodity prices since May 1st (figure 5).

Gross capital flows shrank some 44 percent in May, led by an 62 percent decline in bond issuance and a 53 percent decline in equity issuance (figure 4 shows the 3 month moving average of these flows, and therefore visually

Figure 5. Renewed financial turmoil hit a wide range of indicators in May

Percent change since May 1st

change basis points (reverse axis)



Source: World Bank, Datastream.

Table 2. Net capital flows to developing countries
$ Billions

	2008	2009	2010	2011e	2012f	2013f	2014f
Current account balance	410.2	243.3	185.9	97.8	109.7	94.9	63.1
Capital Inflows	830.9	674.2	1131.2	1038.5	818.1	994.8	1198.1
Private inflows, net	801.4	593.7	1059.9	989.0	775.4	953.2	1152.1
Equity Inflows, net	570.7	508.7	634.1	649.1	533.6	647.0	774.9
FDI inflows	624.1	400.0	506.1	624.6	517.7	593.6	684.9
Portfolio equity inflows	-53.4	108.8	128.4	24.5	15.9	53.4	90.0
Private creditors, net	230.6	85.0	425.8	339.9	241.8	306.2	377.2
Bonds	26.7	51.1	111.4	109.1	113.8	119.8	108.6
Banks	213.1	20.2	44.3	67.1	15.1	40.3	66.9
Short-term debt flows	-4.4	14.7	268.5	163.2	115.0	145.0	200.0
Other private	-4.8	-1.1	1.6	0.5	-2.1	1.1	1.7
Offical inflows, net	29.5	80.5	71.2	49.5	42.7	41.6	46.0
World Bank	7.2	18.3	22.4	12.0			
IMF	10.8	26.8	13.8	8.0			
Other official	11.5	35.4	35.0	29.5			
Capital Outflows/a	-311.7	-168.8	-291.1	-369.1	-387.0	-372.0	-417.0
FDI outflows	-214.5	-148.2	-217.2	-238.1	-220.0	-250.0	-300.0
Portfolio equity outflows	-19.8	-65.6	-24.3	-40	-45.0	-50.0	-57.0
Private debt outflows	-78.3	50.7	-57.3	-81.0	-110.0	-65.0	-54.0
Other outflows	1.0	-5.7	7.7	-10.0	-12.0	-7.0	-6.0
Net Capital Flows (Inflows+Outflows)	519.2	505.5	840.0	669.4	431.1	622.8	781.1
Net Unidentified Flows/a	-109.0	-262.2	-654.2	-571.6	-321.4	-527.9	-718.0

Source: The World Bank
Note:
e = estimate, f = forecast
/a Combination of errors and omissions, unidentifed capital inflows to and outflows from developing countries.

mutes the decline in May). Encouragingly, bank-lending was relatively resilient, declining by only 7 percent. Overall, despite the improvement in flows during the first four months, total gross flows to developing countries were down 22 percent during the first 5 months of the year. Given the further tightening of financial conditions, net capital flows (which comprise a larger set of flows) are projected to decline about 21 percent for the year as a whole (table 2).

Real-side activity strengthened in early 2012 but it shows signs of renewed weakness

Improved conditions in financial markets during the first four months of the year may have reflected (and have contributed) to a turnaround in the real side of the economy. Global industrial production, which had been very weak through much of the second half of 2011 (partly due to supply disruptions from the earthquake and tsunami in Japan and from extensive flooding in Thailand), started expanding once again in the first quarter of 2012—growing at a 9.4 percent annualized pace.

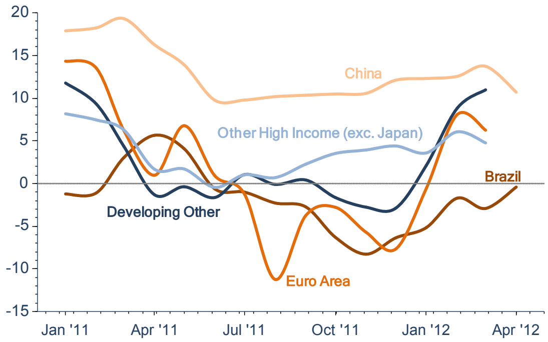
The pickup in activity was broadly based and evident in high-, middle-, and low-income countries alike (figure 6 and table 3). Even the Euro Area, which saw 6 months of declining activity in the second half of 2011, had begun to accelerate. The strengthening in industrial production data was partially reflected in first quarter GDP data for the Euro Area. Area-wide, GDP was stagnant, reflecting relatively robust growth in Germany and Greece (respectively 2 and 2.9 percent saar), and less robust growth in Belgium and France. These expansions were offset by continued contraction elsewhere, including in Italy, the Netherlands, and Spain.

Developing-country demand appears to have led the rebound in activity

The resurgence of industrial activity was strongest among developing countries. It partly

Figure 6. Industrial production picked up markedly in 2012

Industrial production growth, 3m/3m saar



Source: Dealogic, World Bank.

Table 3. Comparing regional industrial production GDP growth in 2011H2 versus Q1 (or MRV) where available.

	Industrial production (saar)	
	2011H2	2012Q1
High income	1.1	3.9
East Asia and Pacific	7.5	11.0
Europe and Central Asia	4.0	6.2
Latin America and Caribbean	-0.8	1.3
Middle East and N. Africa	3.3	10.2
South Asia	-0.8	5.4
Sub-Saharan Africa	-2.4	-3.8

Source: World Bank.

reflected steady growth in China, but also a return to expanding output among many of the larger middle-income countries that had seen activity stagnate or decline in the second half of 2011 (for example India and Turkey), and a bounce back in activity levels in Thailand following last year's flooding. Data through April are available for only a few countries, and show mixed trends. Growth in China has softened, while in Brazil the contraction shows signs of ending. Box 1 and the industrial production appendix provide additional detail regarding recent developments in each of the six developing regions.

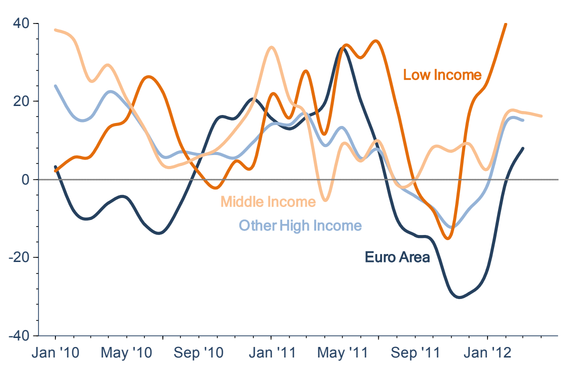
The firming of growth in the first four months of 2012 appears to have been mainly due to strengthening demand in developing countries. Developing-country import demand accelerated sharply in the fourth quarter of 2011, even as Euro Area import demand continued to decline (figure 7). And it was this boost in demand that fueled the uptick in the exports of both developing and developed economies.

The rebound partly reflects a sharp acceleration in developing country capital goods imports, which were expanding at an annualized rate of 35.6 percent (3m/3m, saar) during the three months ending January 2012 — versus a 3.7 percent rate of decline in the third quarter of 2011. The increased demand was particularly supportive of the foreign sales of capital goods exporting countries like Germany, Japan and the United States and augurs well for future activity.

Overall global trade, which was falling at a 12 percent annualized pace in November 2011 was growing at a 14 percent annualized pace during the first quarter. Even Euro Area imports, which had been falling at a 30 percent annualized pace

Figure 7. Developing countries lead rebound in imports

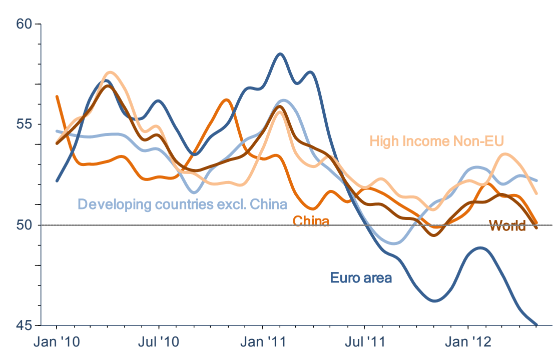
Import volume growth, 3m/3m saar



Sources: World Bank, Datastream.

Figure 8. Outside the Euro Area business sentiment picked up in early 2012.

Index, > 50 implies increased activity, < 50 slowing growth



Sources: World Bank, Markit and Haver Analytics.

Box 1. Data suggest a pickup in activity in all regions following a weak second half of 2011

Industrial activity in ***East Asia & Pacific*** has accelerated sharply, and was growing at a 14 percent annualized pace during the three months to April 2012, led by a sharp rebound of activity in Thailand following months of disruption due to flooding. Restoration of disrupted supply chains has also seen activity surge in the Philippines. Despite the recovery in activity, industrial production in Thailand has recovered year-earlier levels and is only 5 percent higher in the Philippines. Activity in China has strengthened, although most recently it slowed to an 10.7 percent annualized rate — slightly below its average rate of growth over the preceding 10 years of 13.1 percent. Regional trade has also picked up, with import volumes expanding at a 32 percent annualized pace in the first quarter and exports rising at a 8 percent annualized pace. A few countries in the region are showing signs of rising inflationary pressures but overall at 2 percent region-wide inflation remains under control.

Developing Europe and Central Asia recorded strong industrial production growth earlier in the year, but was showing signs of slowing down by April. During the first quarter, growth was concentrated in oil and gas producing regions like Russia and Kazakhstan. While Turkey and Latvia also had strong IP growth, activity in other countries in the region like Bulgaria, Romania, and Serbia was very weak or declining in sync with high-income Europe. Among the countries reporting data for April, industrial production growth slowed down in Russia, Ukraine and Kazakhstan. Regional trade also accelerated sharply in the first quarter, with import demand expanding at a 42 percent annualized pace and exports at a 17 percent annualized pace with Russia leading the way in exports and Russia and Lithuania in imports. Inflation region-wide is easing although it remains above 7 percent in Armenia, Belarus and Turkey.

After several months of weakness, ***Latin American and the Caribbean*** is benefitting from a firming of U.S. auto and other durables demand. For the region as a whole, industrial output was growing at an 4.4 percent annualized pace during the first quarter of 2012, despite weak industrial activity in Brazil and Argentina. Trade is up sharply, reflecting strong U.S. auto sales and robust demand from East Asia. Overall regional import demand was growing at a 16 percent annualized pace and exports by 14 percent (3m/3m saar). Inflation pressures are also easing in response to a stabilization in food price inflation, but prices were rising at a more-than 5 percent annualized pace (3m/3m saar) by April 2012 in several countries (Argentina, Honduras, Jamaica, Panama, Uruguay, St. Vincent, and R. B. de Venezuela).

In the ***Middle East & North Africa,*** industrial production growth turned positive toward the end of 2011, as the disruptions associated with the ongoing social unrest began to dissipate, at least in some countries. Among those countries for which data are available, industrial production was expanding at a 12 percent annualized pace in the three months to February, but nevertheless remained 6 percent below its year ago level. Through the three months to February (the most recent observation for the region) exports were still declining at an 20 percent annualized pace even as import demand was declining at an 16 percent pace, with weak domestic production playing a role in both phenomenon. Regional inflation is declining, thanks mainly to the stabilization in international food prices (the region is a major food importer), with annualized quarterly inflation in excess of 5 percent in Iran, Jordan, Syria and Tunisia.

Output in ***South Asia*** shows signs of a relatively weak pick up in 2012 after a prolonged slump. Trade and industrial production data suggest that a sharp uptick in activity in early 2012 has since faltered, with regional industrial activity slowing from an annualized pace of 18.8 percent during the three months ending January 2012 to 10.3 percent in March. Similarly, regional export (import) volumes surged 22.6 percent (40.3 percent) in February, but weakened to 13.1 percent (2.5 percent) by April. Imports in US dollar terms have outpaced exports during the last 12 months ending April (partly due to higher crude oil prices), which has put current account positions under considerable stress. Inflation pressures in the region remain strong despite easing in India in early 2012, with inflation picking up to a more-than 10 percent annualized quarterly pace in India, Pakistan and Sri Lanka by April 2012.

In ***Sub-Saharan Africa,*** high-frequency data are more sparse. For the 4 countries where monthly industrial production data are available, the extent of the slowdown in 2011 was less marked than elsewhere and so too are indications of a rebound. Data suggest that aggregate activity eased slightly most recently — mainly reflecting production declines in Nigeria through the end of 2012. More timely data for South Africa suggest a strengthening of growth to 7.7 percent annualized pace in the third quarter. Trade data for the region lag however by February 2012, exports were declining at a 12 percent annualized pace and imports was expanding at a 21 percent pace. Unlike other regions, inflation seems to be on the rise, particularly in Burundi where it has reached 23 percent and Nigeria where annualized quarterly inflation exceeded 15 percent in early 2012.

in the fourth quarter returned to positive territory.

Business sentiment also picked up through April (figure 8), suggesting that growth was likely to continue — albeit at a more modest pace than during the pre-crisis period. Data for May, however, shows a marked downturn reflecting the dampening influence of the uptick in financial market turmoil as well as evidence that the pace of expansion in the United States and China may be slowing. How durable this change in sentiment proves to be and its impact on investment expenditure will be a critical determinant of the strength of activity going forward (see following discussion of headwinds).

Lower food-price inflation has translated into a decline in headline inflation

Inflation in developing countries has eased substantially since 2011 with prices now rising at a 5.4 percent annualized pace during the 3 months ending April 2012. The decline in total inflation mainly reflecting an easing in domestic food inflation in developing countries to below 5 percent in the three months to February 2012 (3m/3m saar) (figure 9). Food price inflation is now 0.4 percentage point below headline inflation. Food price inflation decelerated in South Asia, while in Europe and Central Asia consumer food prices have actually declined. In contrast, food price inflation accelerated in Sub-Saharan Africa and Latin America and the Caribbean, and the Middle East and North Africa.

Despite the welcome normalization of domestic food price inflation, domestic food prices in developing countries remain 25 percent higher relative to non-food consumer prices than they were at the beginning of 2005. While incomes in developing countries have continued to rise, the sharp increase in food prices will have limited gains for many households, such as the urban poor, where food often represents more-than one -half of their total expenditures.

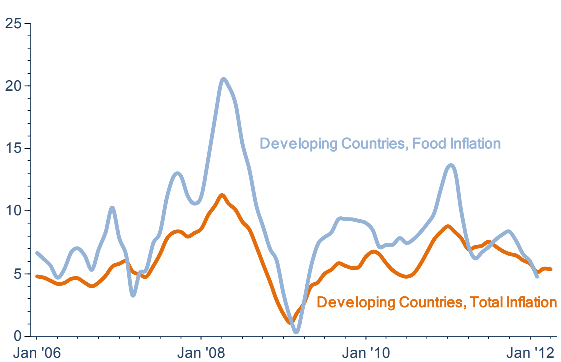
Global imbalances appear to have stabilized at new lower levels

The steady decline in global trade imbalances that has characterized the past 5 years, appears to be slowing, with the aggregate absolute value of current account balances having declined from a high of 5.7 percent to about 4 percent of global GDP in 2011 (figure 10).

Much of the decline to date reflects a fall in the U.S. trade deficit and in China's trade surplus following the financial crisis. In the United States, while cyclical factors are still at play, longer-term factors have been important as well. In particular, the bursting of the housing bubble saw spending levels fall back in-line with production and the U.S. personal savings rate move from negative territory to 4.6 percent in 2011. As a result, import growth slowed, and the U.S. current account deficit declined from 6

Figure 9. Inflation in developing countries has stabilized, due in part to a stabilization of food prices

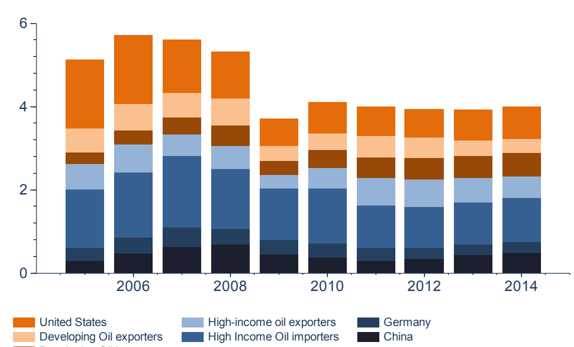
Food and overall inflation, % change 3m/3m saar



Source: World Bank, ILO.

Figure 10. Global imbalances have narrowed and are expected to remain much lower than in the mid 2000s

Percent of world GDP



Source: World Bank.

percent of GDP in 2006 to 3.1 percent of GDP in 2011.

At the same time, China's surplus narrowed from more than 10 percent of GDP in 2007 to 2.8 percent in 2011, as the country regained and even surpassed full-employment levels of output. The decline in China's surplus partly reflects reduced high-income import demand, but also a post-crisis growth strategy in China that has emphasized domestic sources of growth, notably investment, which has raised imports faster than exports.

Looking forward, global imbalances are expected to remain broadly constant. Declining surpluses among oil exporters, where windfall oil revenues are projected to continue fueling import demand growth in excess of export growth for several years (a modest projected decline in global oil prices will also play a role) are projected to be offset by an increase in deficits among high-income countries. As domestic demand recovers, their current account deficits are expected to expand through 2014 (to 3.6 percent in the case of the United States). China's surplus is projected to rise to about 3.6 percent of its GDP as efforts to reduce its current reliance on investment spending reorient demand toward less import-intensive consumer goods.

Significant headwinds imply moderate growth going forward

Notwithstanding that activity in both developed and developing countries picked up in early 2012, growth for the year is likely to be modest because of uncertainty in Europe, ongoing banking-sector deleveraging, fiscal consolidation in high-income countries, and capacity constraints in developing countries.

Renewed uncertainty in the Euro Area has resulted in a sharp deterioration in financial conditions

The situation in the Euro Area (and high government debt and deficit levels in the United States and Japan) remain central elements that will shape global prospects over the next several years. With inconclusive elections in Greece, changes of government in France and the Netherlands; banking downgrades and nationalizations elsewhere in the Area, uncertainty and financial market tensions have increased sharply yet again — with financial markets openly discussing the possibility and implications of a Greek exit from the Euro Area and the need for a bailout of some Spanish banks.

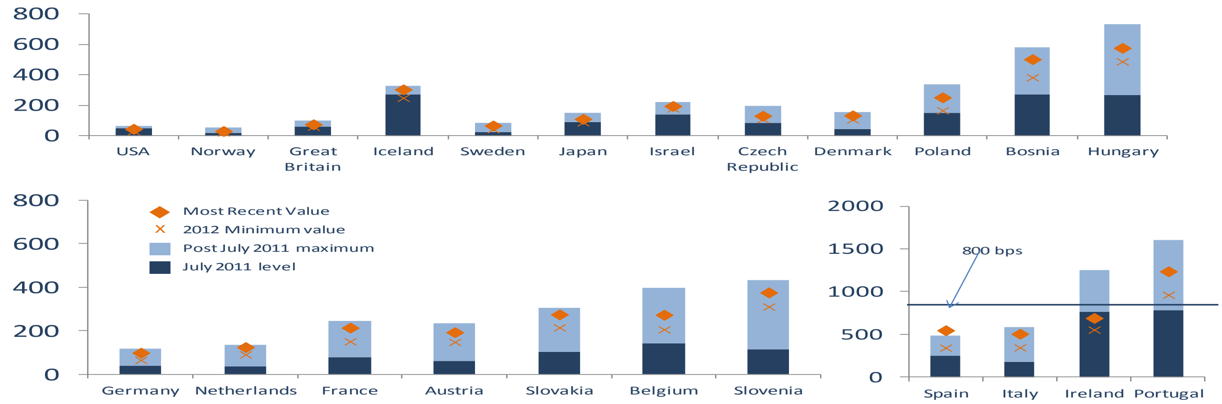
Financial indicators have deteriorated markedly. Credit Default Swap (CDS) rates throughout the Euro Area have increased, recouping almost all (90 percent) of the earlier declines (panel A, figure 11). CDS rates in most non-European high -income countries (and developing Europe and Central Asia) are also up, reaching between 60 and 90 percent of their earlier highs (panel B, figure 11). CDS rates in most developing countries have risen by about 30 and 50 percent of earlier declines. Spreads on long-term bonds of Spain have reached 555 basis points, a record high. Those of Portugal, Ireland, and Italy have also risen by 276, 158, and 68 basis points, respectively, but remain below earlier peak levels.

It is too soon to observe the impact of the recent resurgence in financial market turmoil on the real -side of the economy, but it is almost certain to be negative — particularly in high-income Europe. How negative is extremely uncertain. As of early June, financial market uncertainty in high-income Europe (as proxied by CDS rates) was about the same level as in the fall of 2011. However, because European CDS rates never fell back to their pre-crisis July 2011 levels, the deterioration in European CDS rates from their 2012 lows is only about 1/3 to 1/2 as much as it was in the fall. This suggests that the hit on activity (assuming no further deterioration) would be between 1/3 and 1/2 as large as the one endured in the fall of 2011, when Euro Area quarterly growth rates declined by about 0.8 percentage points relative to expectations in June 2011 (subtracting about 0.4 percent of annual growth). Elsewhere the extent of contagion has been less severe.

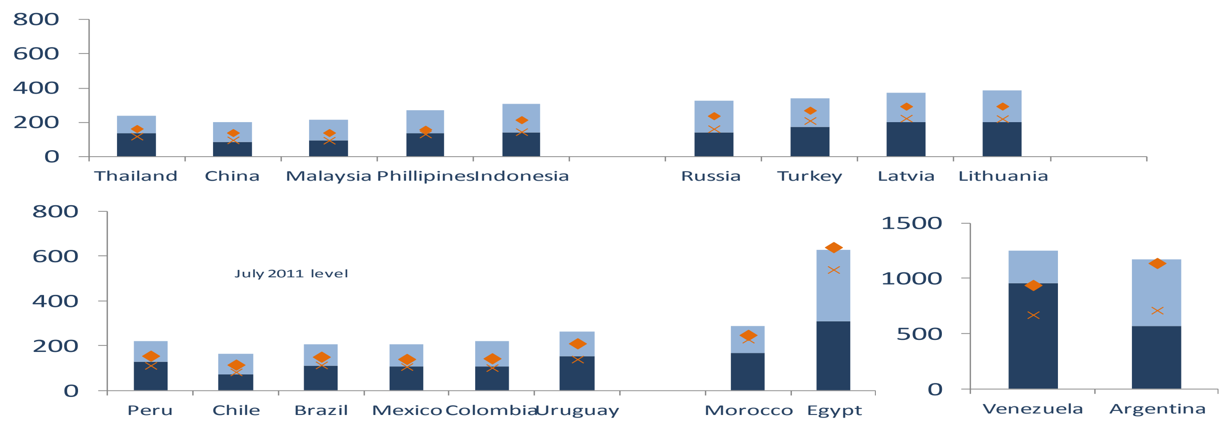
Overall, although CDS rates are as high as they were in the fall of 2011, because they did not fall all the way back to their July 2011 levels, they have increased only between 1/3 and 1/2 as much as they did in the fall of 2011 — suggesting that

Figure 11. Credit default swap rates have surged once again

A. High-income country CDS rates, basis points



B. Developing country CDS rates, basis points



Source: World Bank, Datastream.

the direct impacts of the increase in turmoil may be more muted than in 2011.

In the baseline, the recent uncertainty and market turmoil is assumed to endure for several months without precipitating a disorderly resolution of current tensions, as policymakers are assumed to succeed in re-working existing frameworks to the satisfaction of financial markets.

The increased uncertainty is expected to cause firms to delay investments and households to hold back on major expenditures. This is assumed to slow second and third-quarter growth rates in the Euro Area by some 0.4 percentage points (0.2 percent for the year as a whole), roughly similar to the impacts observed in the second half of 2011.[2] Impacts for the rest of the world are assumed to be relatively muted, with impacts for developing countries estimated to be in the range of a 0.1 percentage point reduction in growth rates in 2012.

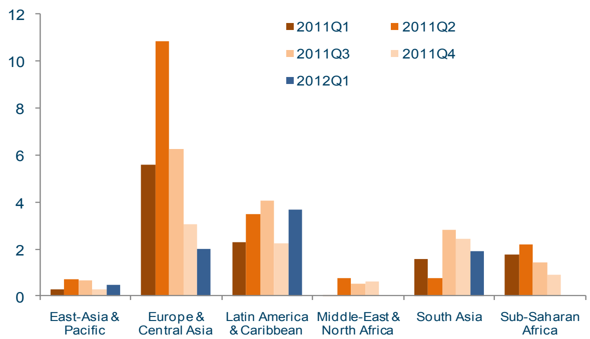
Banking-sector deleveraging is cutting into growth and developing country capital flows

Even before the latest bout of risk aversion, pressure on European banks to deleverage intensified in the second half of 2011. Faced with rising funding costs, increased counter-party risk assessments, deteriorating bank-asset-quality, and growing concerns over the adequacy of capitalization, European banks started to reduce their loan books in the second half of 2011[3] (see earlier figures 3 and 4).

For the moment, data do not permit a full accounting of the extent of spillover effects to developing countries. However, the quantity of syndicated bank loans to developing countries

Figure 12. Sharp decline in trade finance in late 2011, early 2012

Syndicated trade-finance, % of merchandise trade



Source: World Bank, Dealogic.

organized and led by European banks (not including interbank and bilateral loans) fell by almost 40 percent during the 6 month period October 2011-March 2012 compared with the same period a year earlier. Almost all developing regions were affected, with the biggest percentage declines among projects in South Asia (down 72 percent) partly reflecting a deterioration of investment conditions in India. European-led lending to Russia and Turkey plunged by 50 and 56 percent, respectively.

Partial data on mainly syndicated trade finance, suggest that trade finance delivered by European banks (major players in this market) also declined in the fourth quarter of 2011 (latest data available). However, anecdotal evidence suggests that lenders from other regions (mainly Asian financial institutions) may have partly filled the funding gap.

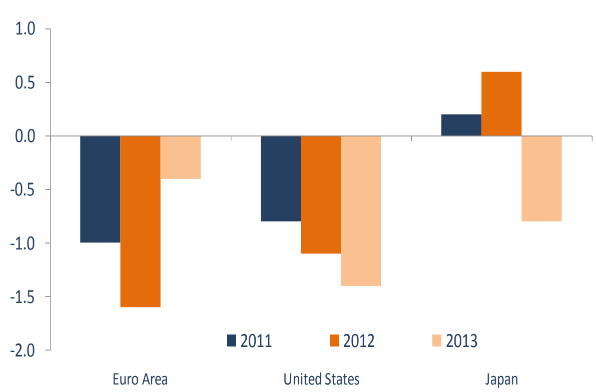
Overall, syndicated trade-finance declined from a post crisis high of 2.8 percent of developing country exports to a post-crisis low of 1.4 percent in the first quarter of 2012 (figure 12). Declines were concentrated in Europe and Central Asia, but felt everywhere. Among regions with first quarter 2012 data, there has been some recovery in East Asia & Pacific, Latin America & the Caribbean, but further compression in Europe and Central Asia and South Asia. Moreover, even in regions where losses have been made up the share of regional exports being covered by syndicated trade finance remains lower than in the third quarter of 2011.

According to the International Chamber of Commerce 2012 Survey which covers a wider-range of trade finance activities, trade finance levels started to rise again in 2012, reflecting improved trade and financial market conditions. The surveys suggest that trade finance shortfalls were sharpest for SME trading companies and low-income countries, partly because higher risk ratings under Basel III rules have reduced the attractiveness of such lending for banks. The World Bank Group has increased its support for trade finance in low income countries through the IFC's Global Trade Finance Program, and a new program to support commodity traders from low income countries.

While the pace of deleveraging is expected to slow, lending conditions are likely to remain tight in years to come. Partly because markets will demand higher interest rates for a given level of risk, but also because of tighter regulation. Market regulators indicate that many European banks have already met the new capital requirements for July 2012, and most U.S. banks passed recent stress tests. However, banks will start operating under Basel III in 2013, with a range of provisions being gradually phased in through 2019–implying continued tightening of conditions. Some European regulators have proposed more stringent capital requirements than the Basel III minimum, which may kick in earlier.

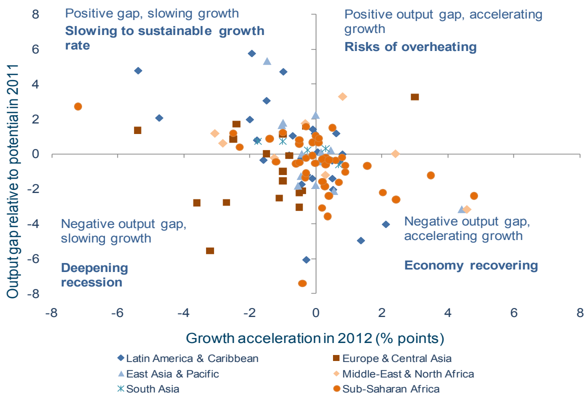
Figure 13. Fiscal consolidation to remain a drag on growth

Estimated and expected change in structural deficit, percent of GDP



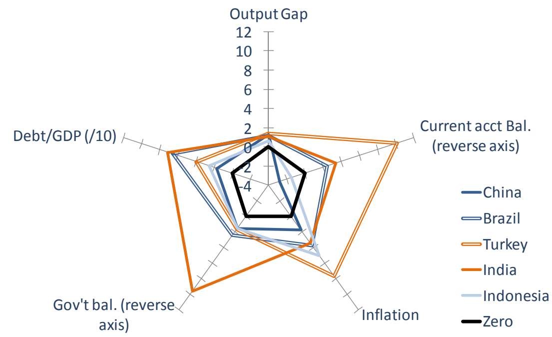
Sources: World Bank. IMF.

Figure 14. Most developing countries outside Europe & Central Asia have little spare capacity



Source World Bank.

Figure 15. Capacity constraints and limited policy space in many large middle-income countries



Source: World Bank.

Even tougher capital requirements may be imposed further down the line. In an effort to mitigate the impact on Central and Eastern European economies, officials, international financial institutions, and private banks signed the Vienna Initiative II in March 2012 ensuring supervisory and fiscal cooperation between home - and host-country authorities. Overall, bank lending for developing economies is expected to be less abundant and more expensive in coming years – with negative implications for FDI, investment and potential growth.

Fiscal consolidation in high-income countries will remain a drag on growth

Ongoing fiscal consolidation will also continue to hold back high-income growth over the forecast period. Whereas increased government spending in 2009 (up about 5½ percent of GDP) at the height of the financial crisis supported GDP growth in high-income countries, the partial withdrawal of that stimulus is estimated to have reduced GDP growth by around 1 percent in each of 2010 and 2011.

This net drag on high-income countries' growth will be even stronger in 2012. The International Monetary Fund estimates that structural deficits in the United States and the Euro Area will decline by about 1.5 percent (of GDP) during 2012 (figure 13). Although such steps are essential to put these countries' fiscal positions back on a sustainable fiscal path, they will be a drag on GDP growth in 2012.

The pace of fiscal consolidation in the Euro Area is expected to ease in 2013 and 2014 as efforts to return to pre-crisis deficits levels are well advanced in many countries. In the United States and Japan, however, the drag on growth is expected to intensify in part because disaster-related spending in Japan actually increased structural deficits in 2011, while in the United States the pace of fiscal consolidation so far has been modest.

Capacity utilization may become a binding constraint in major developing countries

Developing countries have been important motors of global growth in the post-crisis period, generating about 50 percent of the increase in global import demand and GDP growth. While they are expected to continue to play an important role, many of the larger and faster growing economies are close to or above potential (figure 14), which suggests that they will not be able to provide as much an impetus to global growth as before.

Outside of Europe and Central Asia and the Middle-East and North Africa—regions hard-hit by either the financial crisis or domestic turmoil—about 65 percent of developing countries for which data are available are operating at close to or above potential (output gaps greater than –1 percent).

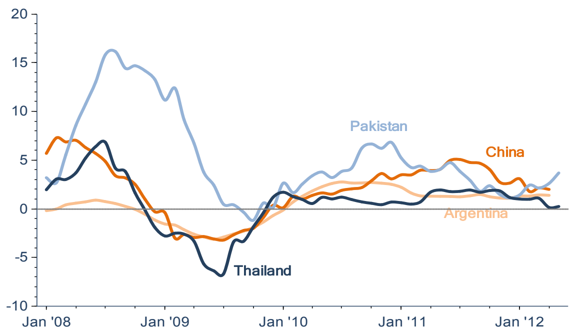
In some of these countries, capacity constraints are generating inflationary pressures in either goods or asset markets, or raising current account

Box 2. Emerging capacity constraints suggest that policy will have to tighten if medium-term inflationary pressures are to be avoided and policy buffers re-stocked

Outside of Europe and Central Asia and the Middle-East and North Africa — regions hard-hit by either the financial crisis or domestic turmoil —about half of the developing countries for which data are available are operating at or above potential. In several of these countries, macroeconomic policy is relatively loose and indicators are pointing towards developing tensions and imbalances.

Box figure 2.1 Higher than normal inflation

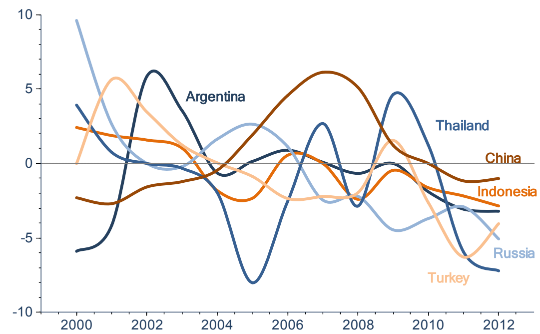
Percent



Source: World Bank.

Box figure 2.2. Deteriorating current accounts

Percent of GDP

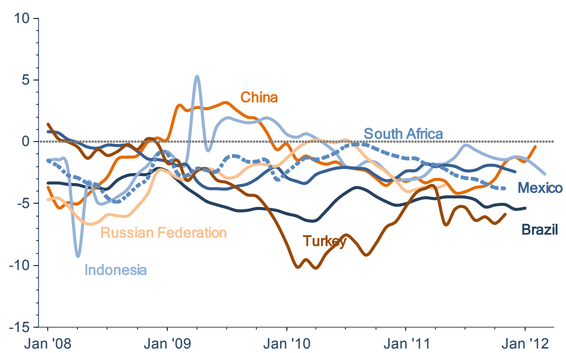


Source: World Bank.

Inflation is above long term averages in Argentina, China, Pakistan and Thailand (box figure 2.1). In many countries, domestic demand has been expanding more quickly than domestic production – resulting in **deteriorating current account balances** in Argentina, China, Indonesia, Russia, Thailand and Turkey (box figure 2.2). In the case of China, this may reflect a welcome reorientation of production toward domestic demand. Elsewhere, rising current account deficits may represent weakening competitive positions—albeit partly related to undervalued developed countries' currencies.

Box figure 2.3. Historically, low real interest rates

Percent



Source: World Bank.

In some of these developing countries, **monetary policy remains very loose** (albeit also partly reflecting low real rates elsewhere). In Brazil, China, Indonesia, Mexico, Russia, Turkey and South Africa real interest are below normal (box figure 2.3). While some of these economies are slowing, which should reduce tensions (notably in Brazil), in others output is projected to accelerate in 2012 and 2013, raising the possibility that tensions will rise further or that opportunities to rebalance policy and regenerate policy buffers that were consumed by the crisis are not being exploited.

imbalances (box 2). In some, fiscal and or monetary policy remains very loose, raising the possibility that financial tensions will intensify and suggesting that opportunities to rebalance policy and regenerate policy buffers that were consumed by the crisis are not being exploited.

Domestic tensions appear to be particularly acute in countries like Turkey and India where inflation is high, and fiscal and current account deficits elevated (figure 15).

The outlook : weak growth in 2012, a modest acceleration in 2013 and 2014

The baseline forecast projects that the global economy will expand 2.5 in 2012, before picking

Box 3. Weak growth in the second half of 2011 means that 2012 carry over is unusually low — implying slow annual growth in 2012

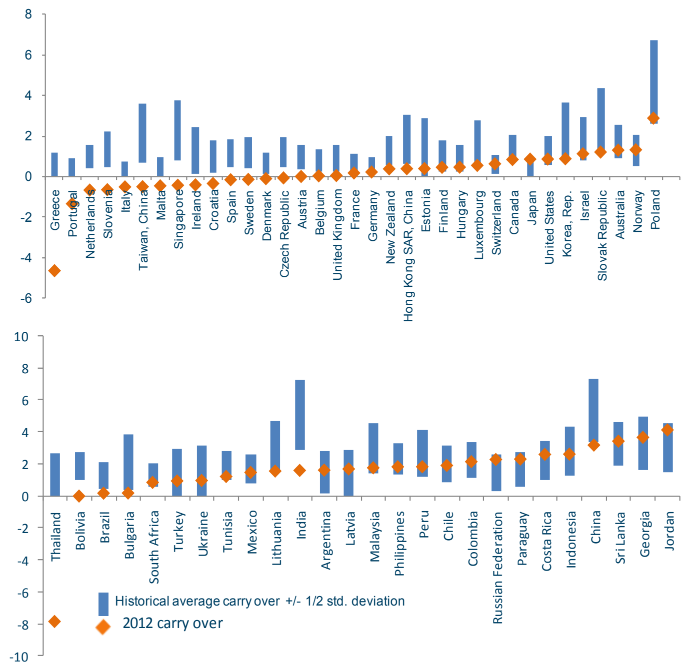
The quarterly pattern of growth in the previous year partially determines the annual growth rate of the following year. This phenomenon, called carryover by economists,[5] is of more than academic interest (see Tödter, 2010 for a derivation of this relationship). When growth is relatively steady during the course of the two years, carryover has relatively little impact. However, it can have a strong influence on annual growth in following years when quarterly growth is either unusually strong or weak at the end of the year preceding year.

Take two examples. Growth in the United States was stronger in the second half than in first half of 2011, while in Brazil the opposite was true. Thus, even though annual growth in the U.S. in 2011 was only 1.7 percent (vs 2.7 percent for Brazil), growth accelerated during the course of the year and was strongest in the third and fourth quarters. As a result, it will contribute a full 0.9 percentage point to 2012 annual GDP growth. In contrast, in Brazil, growth was strong in the first half and stagnant in the second half. As a result, the carry over into 2012 will be small, i.e. 0.18 percentage points.

Because growth in most countries followed a similar pattern to Brazil last year, the carryover for 2012 is much lower than normal—falling outside the one standard deviation range of historical experience in most high-income countries and in the lower range for most developing countries (box figure 3.1). Overall, the carryover for 2012 will be 0.5 percentage points lower than usual for developing countries, and 0.3 percentage points lower for high-income countries. Meaning for any given quarterly profile of GDP growth during 2012, annual GDP will be about 0.3 and 0.5 percentage points lower in 2012 than it would have been had growth in 2011 followed a more normal pattern.

Box figure 3.1 Poor growth in the second half implies historically low carryover for 2012

Contribution of past year's growth to next year's growth, percent



Source: World Bank.

up to 3.0 and 3.3 percent in 2013 and 2014 (3.3, 3.9 and 4.2 percent when calculated using purchasing power parity weights).

Outside of the Euro Area, the slowdown in annual growth between 2011 and 2012 (from 2.8 to 2.4 percent) is to a large extent a statistical reflection of slow growth in the second half of 2011 (box 3). Quarterly growth rates during 2012 are expected to be stronger than in 2011 for most developing and many high-income countries. By the same token, the apparent acceleration in annual growth in 2013, mainly reflects the expected strengthening of quarterly growth during 2012—which increases the contribution of carry-over to annual growth in 2013.

Weak, but strengthening growth in high-income countries

GDP in high-income countries is projected to rise 1.4 percent in 2012. As with developing countries, weak carryover will mask an expected gradual strengthening of quarterly growth in most countries in the annual numbers. In high-income Europe, 2nd and 3rd quarter growth is projected to be negative due to increased precautionary saving in the face of turmoil. Combined with weak carry over, this will result in an annual GDP decline of 0.3 percent. Annual growth in high income countries is projected to pick up to 0.7 and 1.4 percent in 2013 and 2014, partly reflecting a return of carryover to more normal levels. While headwinds are projected to ease, they will remain and continue to prevent the kind of robust growth that would see output gaps close more quickly.

Annual growth in the United States is projected to accelerate from 1.7 percent in 2011 to 2.1

percent in 2012, but quarterly growth is expected to display a somewhat different pattern. Already, quarterly GDP growth has slowed from 3 percent in the fourth quarter of 2011 to 1.9 percent in the first quarter — reflecting in part a tightening of fiscal policy. Going forward, quarterly growth in the U.S. is expected to remain relatively modest as continued fiscal consolidation cuts into government spending, which will only be partially offset by strengthening private sector demand and improving net exports. GDP growth is expected to strengthen only modestly to 2.4 and 2.8 percent in 2013 and 2014 respectively.

After the profound negative impact that the earthquake and tsunami (and the disruptions emanating from the Thai floods) had on the Japanese economy, growth is forecast to rebound to 1.5 percent over 2013-14, boosted in part by continued reconstruction-related fiscal spending.

Following a weak 2012, developing country growth is projected to pick up in 2013 before easing in 2014

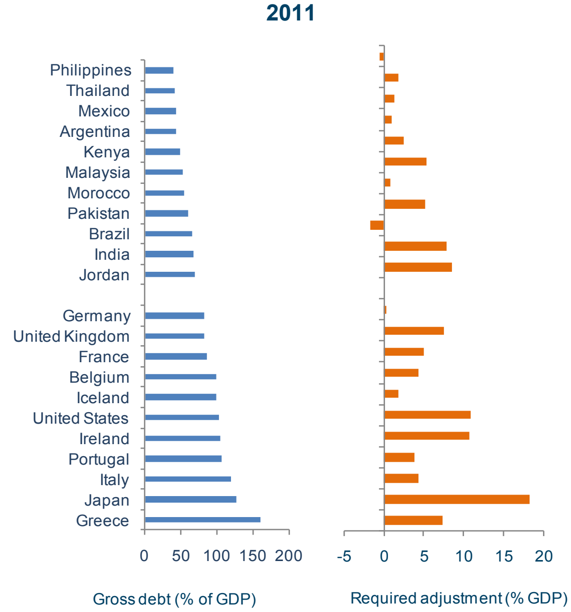
The regional annexes to this report and box 4 contain more detailed accounts of regional economic trends, including country-specific forecasts.

Developing country GDP is expected to expand by 6 percent in each of 2013 and 2014, somewhat slower than the 6.3 percent average pace during the first 7 years of this century. For 2012, weak carryover from the year before will be reflected in a deceleration of annual growth in all regions despite firming quarterly growth, but subsequent developments diverge across regions.

In South Asia, growth is anticipated to remain subdued, as growth in India settles at around 7 percent over the 2012-14 period. Elsewhere, the acceleration in 2013 and 2014 is expected to be strongest in the Middle-East & North Africa as the conflicts that are currently disrupting activity in several countries in the region are assumed to gradually resolve during the course of 2012. Growth in several large middle-income countries (notably, Brazil and China) is expected to moderate somewhat in 2014 as countries bump up against capacity constraints.

Despite the slower growth projected for developing countries, and the acceleration in high-income countries, the developing world will still account for more than half of global growth throughout 2012/14.

Figure 16. Further required deficit reductions for fiscal sustainability



Source: IMF Fiscal Monitor, 2012

The outlook remains fragile

Financial market uncertainty and fiscal consolidation associated with the high deficits and debt levels of high-income countries are likely to be recurring sources of volatility for several years to come. Given current government deficit and debt levels (figure 16), it will take years of concerted political and economic effort before debt to GDP levels of the United States, Japan and many Euro Area countries are brought down and on a path to stabilize at 60 percent of GDP (IMF, 2012).

Although debt levels in developing countries are lower, several countries (notably Jordan, India and Pakistan) would have to reduce their structural primary deficits by 5 or more percent of GDP if they are to reduce debt to 40 percent of GDP by 2020 (or prevent debt-to-GDP ratios from rising further). Others like Brazil and Philippines require little additional adjustment. The metric for high-income country debt stability is more generous (60 percent of GDP). Nevertheless, the amount of structural

Box 4. Regional outlook

The regional annexes to this report contain more detailed accounts of regional economic trends, including country-specific forecasts (for more details, www.worldbank.org/gep2012b)

GDP growth for the ***East Asia and the Pacific*** region slowed to 8.3 percent in 2011, much slower than the post-crisis recovery pace of 9.7 recorded in 2010. The slowing was more marked for those countries outside of China, whose aggregate growth rate slowed by a full 2.5 percentage points to 4.5 percent in the year, in large part due to a decline in Thailand under massive flooding conditions. East Asia is projected to slow further to growth of 7.6 percent in 2012, as domestic demand in China cools in response to earlier policy actions and relatively weak demand from high-income countries. Against this background, Chinese policy has recently turned more accommodative. Regional outturns will be boosted as global trade growth firms, regional GDP is expected to strengthen over 2013 and 2014, growing during each of the two years by about 8 percent for the region, 8.5 percent for China, and 5.8 percent for East Asia excluding China.

GDP in developing ***Europe and Central Asia*** increased an estimated 5.6 percent in 2011, despite the renewed financial turmoil and weakening Euro Area demand in late 2011. The growth in 2011 was supported by the robust domestic demand and good harvests in countries such as Russia, Romania and Turkey. Bad weather earlier this year, renewed tensions in Euro-area, capacity constraints in some countries and deleveraging by European banks are projected to slow regional GDP growth to 3.3 percent in 2012, before a modest recovery begins in 2013 and 2014 with growth of 4.1 percent and 4.4 percent, respectively. Domestic demand is expected to remain robust in most resource-rich economies benefiting from still high commodity prices, but capacity constraints will hold growth back in Russia over the medium-term. Among regional oil importers, high commodity prices will contribute to slower growth, deteriorating current accounts and fuel inflation. Upcoming elections are expected to delay progress in fiscal adjustment in several middle income countries in the region while monetary policies are likely to remain loose given still ample spare capacity in most economies.

Growth for the ***Latin America and the Caribbean*** region is projected to slow to 3.5 percent in 2012, from 4.3 percent in 2011, due to a weaker global external environment, high oil prices, capacity constraints in selected economies and weak carry-over effects following the slowdown in the second half of 2011 in some of the largest economies in the region. Renewed tensions in the global financial markets and risk aversion since May 2012 and marked declines in commodity prices and weaker capital flows means the region is facing renewed headwinds. Better financial conditions and firming growth outside the region should contribute to a modest acceleration of growth to 4.1 percent in 2013 before easing modestly in 2014. The recent volatility of international confidence and capital flows has complicated macroeconomic policy in the region, perhaps prompting policy makers to switch course more often than domestic conditions warrant as activity reacts to large swings in external conditions.

Economic developments in the ***Middle East and North Africa*** region continue to be heavily influenced by the disruptions caused by the social unrest that started more than 18 months ago. In addition to the challenges posed by societal violence in some cases and sometimes fundamental political change, the external environment for the region is weak because of its close ties with high-income Europe. GDP growth for the aggregate of the developing region eased to 1 percent in 2011 from 3.8 percent in 2010, on weaker outturns for Egypt and Tunisia; and declining output for those countries in civil conflict. Output is projected to strengthen in 2013 and 2014 on the back of increased political stability, improved conditions in Europe, portending a return of FDI and tourism flows. Nevertheless, regional GDP is projected to rise by only 2.2 and 3.4 percent in 2013 and 2014 – well below the 4.8 percent average growth recorded during 2000-2008.

GDP growth in ***South Asia*** slowed to 7.1 percent in 2011 from 8.6 percent in 2010, as headwinds from the Euro Area crisis caused a deceleration in exports and a reversal of portfolio capital. Growth in India was particularly weak due to monetary policy tightening, stalled reforms, electricity shortages, which, along with fiscal and inflation concerns, cut into investment activity. Relatively resilient remittances and good agricultural harvests have supported consumption demand in the region. Sri Lanka's growth further benefitted from reconstruction spending. Regional GDP growth is expected to slow further to 6.4 percent in 2012, reflecting weak carry over from the sharp deceleration in the second half of 2011 and the fragile external environment. Fiscal deficits, entrenched inflation, and electricity shortages continue to weigh negatively on investment activity and are expected to limit regional growth to a relatively modest 6.6 percent annual average during 2013 and 2014.

Despite the turbulent global economic environment in 2011, growth in ***Sub-Saharan Africa*** remained robust, steadying at 4.7 percent in 2011 - just shy of its pre-crisis average of 5 percent. Excluding South Africa, which accounts for over a third of the regions GDP, growth in the rest of Sub Saharan Africa was stronger at 5.6 percent in 2011, making it one of the fastest growing developing regions. Looking forward, still high commodity prices, ongoing investments in new mineral discoveries, policy loosening in some countries, and lower inflation rates, should support robust domestic demand, with GDP growth projected at 5 percent in 2012, with a pick up expected in 2013 as the global economy rebounds. Nonetheless risks to these forecasts remain tilted to the downside, as the global economy remains fragile, and weaker growth in China could curtail growth in the resource-dependent Sub Saharan economies.

adjustment required is much larger in many cases — with the United States and Japan requiring steeper cuts in spending than any Euro Area economy.

In the immediate term, tensions emanating from the Euro Area are the most serious potential risk for developing countries

Significant progress has been made in Europe on the policy front both in terms of the domestic structural and fiscal policies of high-spread European economies; and at the level of Euro Area institutions (renewed commitments to pan-European fiscal rules; enhanced Euro Area and IMF firewalls; and a more pro-active stance taken by the ECB).

Nevertheless, policy makers have yet to find the right mix of structural and macroeconomic policies to turn the vicious circle (whereby market-driven cuts in fiscal spending so dampen growth that they worsen fiscal sustainability and require even more cuts to spending) into a virtuous circle where reduced tensions yield lower interest rates — and deficits— that allow for stronger private-sector growth and even more rapid progress toward fiscal sustainability. As a result, even if the current bout of tensions pass as is assumed in the baseline, markets are likely to remain nervous and further bouts of turmoil and policy reaction may be in store.

Current conditions in the Euro Area are worrisome. Bond yields on the debt of several countries have reached levels that, in the past, have been associated with interventions by international agencies. At the same time, deposits withdrawals from banks speak to a weakening of domestic confidence in the financial systems of some countries.

As discussed in the January 2012 edition of *Global Economic Prospects* (World Bank, 2012), if conditions in high-income Europe deteriorate sharply such that one or more countries found themselves frozen out of financial markets, global economic consequences could be severe.

Box 5 updates two scenarios that were presented in the January 2012 edition of *Global Economic Prospects*. The scenarios are not meant to be predictive, but rather illustrative of the magnitude of impacts that might be envisaged if the situation in high-income Europe were to deteriorate sharply. They 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, and 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.

With these caveats in mind, these simulations suggest that if there were a major deterioration in conditions, GDP in developing countries could be much (4.0 percent) weaker than in the baseline.

Transmission channels for developing countries

Countries with strong reliance on external remittances, tourism, commodities or with high levels of short-term debt or medium-term financing requirements are likely to be hardest hit.

- Remittances to developing countries could decline by 5 percent or more, representing as much as 3 or more percent of GDP decline in incomes among countries heavily dependent on remittances.
- Tourism, especially from high-income Europe would be impacted with significant implications for countries in North Africa and the island economies of the Caribbean.
- Many countries have reduced short-term debt exposures, partly because of Euro Area deleveraging. Nevertheless, many countries continue to have high levels of short-term debt and could be forced to cut sharply into both government and public spending if global finance were to freeze up as it might do in the case of a severe crisis (see discussion below).
- In the instance of a serious recession, commodity prices could fall precipitously, cutting into government revenues. For example, a 20% fall in oil prices could reduce fiscal balances by 1.2 percent of GDP

Box 5 A downside scenario[4]

As discussed in the previous edition of Global Economic Prospects (GEP), the form that an escalation of the crisis might take in the current economic context, should one occur, is very uncertain — partly because it is impossible to predict what exactly might trigger it, and partly because the powerful forces unleashed 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 approach taken here follows closely scenarios outlined in the January GEP (World Bank, 2012).

The first scenario assumes that one or two small Euro Area economies face a serious credit squeeze (box table 5.1). An inability to access finance that extends to the private sectors of these economies causes GDP in the directly affected countries to fall (broadly consistent with what has been observed when 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 between 6 and 10 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 and uncertainty, the banking-sector stress in Europe is contained and does not spread to the rest of the high-income world. However, uncertainty and concerns about further credit squeezes induces increased precautionary savings among both firms and households worldwide.[1] While this scenario does not envisage an exit of the countries from the Euro Area, it is felt that the modeled effects would capture the bulk of impacts for developing countries should such an event occur.

Overall, GDP in the Euro Area falls by 1.6 percent relative to baseline, and by 1.1 percent 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 1.3 percent decline in middle-income GDP relative to baseline in 2012. The decline among low-income countries (0.6 percent) is less pronounced reflecting weaker financial and trade integration. Weaker global growth contributes to a 8.3 percent decline in oil prices and a 1.6 percent drop in internationally-traded food commodity prices.

In the second scenario (box table 5.2) 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

Box table 5.1 A relatively orderly crisis in a few small countries

	2012	2013	2014
World	-1.2	-1.0	-0.5
High Income countries	-1.2	-1.0	-0.5
Other High Income	-1.1	-0.9	-0.5
Euro area (17)	-1.6	-1.2	-0.4
Developing countries	-1.2	-0.9	-0.4
Low Income	-0.6	-0.5	-0.3
Middle Income	-1.3	-1.0	-0.5
Developing Oil exporters	-1.4	-1.1	-0.4
Developing Oil importers	-1.2	-0.9	-0.5
East Asia & Pacific	-1.2	-0.8	-0.4
Europe & Central Asia	-1.5	-1.1	-0.4
Latin America & Caribbean	-1.4	-1.1	-0.5
Middle East & N. Africa	-1.1	-0.8	-0.2
South Asia	-0.9	-0.9	-0.7
Sub-Saharan Africa	-1.2	-0.8	-0.3

Source: World Bank.

Box table 5.2 A disorderly crisis involving several countries

	2012	2013	2014
World	-2.0	-4.5	-3.7
High Income countries	-2.1	-4.7	-3.9
Other High Income	-1.4	-3.3	-2.9
Euro area (17)	-3.9	-8.5	-6.5
Developing countries	-1.8	-4.0	-3.2
Low Income	-1.0	-2.3	-2.0
Middle Income	-1.8	-4.0	-3.2
Developing Oil exporters	-2.0	-4.4	-3.3
Developing Oil importers	-1.7	-3.8	-3.1
East Asia & Pacific	-1.8	-3.9	-3.0
Europe & Central Asia	-2.4	-5.2	-3.9
Latin America & Caribbean	-1.7	-3.8	-3.2
Middle East & N. Africa	-1.9	-4.1	-2.9
South Asia	-1.2	-3.1	-3.2
Sub-Saharan Africa	-1.7	-3.7	-2.7

Source: World Bank.

1. The shock 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 1.0 percentage point increase in household savings and a 2.5 percent decrease in investment growth, with impacts doubled in high-income Europe, and halved in low income countries (due to weak global financial integration). Confidence effects are assumed to be relatively short-lived,

(Continued on page 20)

(Continued from page 19)

larger because the shock is about 8 times larger.[2] Euro Area GDP falls by 8.5 percent relative to the baseline in 2013, and because confidence effects are bigger. GDP impacts for other high-income countries (-3.3 percent of GDP) and developing countries (-4.0 percent) are less severe but still enough to push them into a deep recession. Overall, global trade falls by 10 percent (relative to baseline) and oil prices by 25 percent (5 percent for food).

significantly fading after 6 months.

2. Scenario 2 assumes that two larger European economies are also frozen out of capital markets and subjected to a 7 percent cut in consumer spending and a 25 percent fall in investment. Confidence effects in other countries are still 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). Confidence effects are assumed to last 12 months in this scenario.

in oil exporting countries, but help to cushion the blow among oil importing economies (see discussion below).

– A disorderly unwinding of sovereign debt obligations could force a much accelerated process of bank-deleveraging in Europe with economies in Europe and Central Asia, and to a lesser degree Latin America, among the hardest hit.

Macroeconomic buffers have been depleted since 2007, increasing developing country vulnerabilities.

Unlike 2008/09, growth in developing countries would probably not bounce back as quickly because economies enter into this crisis in much weaker positions than in 2008/09. On average developing country government deficits are 2.5 percent of GDP higher than in 2007—suggesting they will be less able to respond to a downturn with fiscal stimulus (table 4). Their external vulnerability has increased as well. Developing country current account deficits have deteriorated by an average of 2.8 percent of GDP, with most of the deterioration having been among oil importing and non-oil commodity exporters. Especially if international financial markets close up, in an acute crisis countries may find themselves unable to respond as forcefully as they did in 2008/09 and may find themselves forced to cut back on government spending and or imports in a way that they did not at that time.

Currency reserves remain elevated at the aggregate levels, suggesting that most countries

Table 4. Macroeconomic vulnerabilities have increased on balance

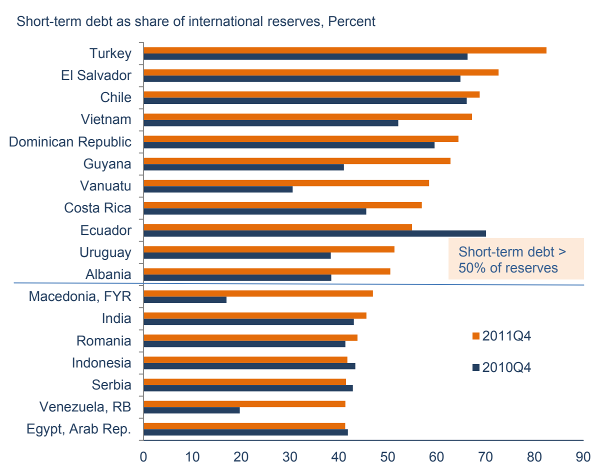
	Fiscal Balance, % of GDP			Current Account Balance, % of GDP		
	2007	2011	Change	2007	2011	Change
All Developing	0.0	-2.0	-2.0	3.2	0.5	-2.7
Oil exporters	1.3	-0.6	-1.9	4.7	3.5	-1.2
Other resouce rich	5.3	-0.3	-5.6	2.8	-2.4	-5.2
Commodity importers	-1.0	-2.8	-1.8	2.4	-0.8	-3.2

	Short-term debt to reserves ratio, %			Reserves, months of import cover		
	2007	2011	Change	2007	2011	Change
All Developing	26.4	18.4	-8.0	4.9	5.1	0.2
Commodity exporters	26.0	13.9	-12.0	6.5	6.5	0.0
Commodity importers	26.4	18.4	-8.0	4.7	4.8	0.1

Note: Fiscal Balance and Current Account Balance are GDP weighted averages. Debt data are expressed as medians of country-level data.

Source: World Bank.

Figure 17. High levels of short-term debt make countries vulnerable to a freezing of international capital flows



Note: Cross-border short-term debt stocks calculated using the BIS consolidated database. Numbers reflect short-term cross-border and local claims in foreign currency of foreign banks reporting to BIS (with an original maturity of one year or less). BIS data may differ from those reported by national authorities.

Source: World Bank and Bank for International Settlements.

Box 6. Impact of higher oil and commodity prices on GDP, current accounts and fiscal balances

Oil remains a central commodity in the world economy and outturns could be significantly affected if global supply were to be interrupted. The most notable risks currently stem from political instability in the Middle-East and North Africa and geopolitical tensions surrounding Iran.

Box table 6.1 reports results from a simulation that assumes that a significant disruption to global oil supply causes world prices to rise by about $50 per barrel beginning in the middle of this year and stay at that level for about 12 months (modeled as a $25 shock in each of 2012 and 2013). Notwithstanding the slower growth that higher oil prices would induce, metal- and food prices would also rise by 9.1 and 4.6 percent respectively above the baseline. The combined impact of this upward adjustment in commodity prices could shave off 0.5 and 0.6 percentage points from global output in 2012 and 2013 respectively, with GDP in developing oil importing countries reduced (relative to baseline) by 0.9 and 1.3 percentage points over the two years.

Commodity exporting countries see a gain in real income as the prices of their exports rise, with the income effect strongest in countries where exports represent a large share of GDP — notably oil exporting countries in the Middle-East and Sub-Saharan Africa, and metal exporters such as South Africa. Countries with significant export links to countries experiencing strong terms of trade adjustments (such as those between oil-importers countries in Europe and Central Asia and Russia) will benefit from increased import demand which attenuates the impact on their GDP.

For commodity importers, higher commodity prices reduce real-income and demand directly, but also indirectly through higher inflation and higher interest rates. Oil and food importing nations in the Middle East and North Africa region are among those hardest hit.

Current account balances of oil exporters are expected to rise by up to 4.5 percent of GDP in Sub Saharan Africa, and by about 2.8 percent in the Middle East and North Africa in 2012. In the East Asia and the Pacific region, external balances may decline by about 0.5 of GDP.

Box table 6.1. Impact of a sustained $50 increase in the price of oil

	Real GDP (% deviation from baseline)			Fiscal Balance (% GDP)			Current Account (% GDP)		
	2012	2013	2014	2012	2013	2014	2012	2013	2014
World	-0.5	-0.6	-0.2	0.0	0.0	0.0	0.0	0.0	0.0
High income	-0.5	-0.6	-0.2	-0.1	-0.1	-0.1	-0.3	-0.3	0.0
Oil importers	-0.6	-0.8	-0.3	-0.5	-0.6	-0.2	-0.7	-0.6	0.1
Oil exporters	0.2	0.4	0.4	2.1	2.3	0.6	1.8	1.3	-0.7
Developing countries	-0.5	-0.7	-0.3	0.2	0.2	0.0	0.3	0.0	-0.3
Oil importers	-0.9	-1.3	-0.5	-0.4	-0.4	0.0	-0.6	-0.6	0.1
Oil exporters	0.4	0.6	0.3	1.4	1.2	0.0	2.1	1.2	-1.2
Middle income	-0.5	-0.7	-0.3	0.2	0.2	0.0	0.3	0.0	-0.3
Low income	-0.7	-1.0	-0.4	-0.3	-0.3	-0.1	-0.7	-0.6	0.0
East Asia & Pacific	-1.0	-1.4	-0.5	-0.3	-0.4	-0.1	-0.5	-0.4	0.0
Oil importers	-1.1	-1.5	-0.5	-0.4	-0.5	-0.1	-0.6	-0.5	0.0
Oil exporters	-0.6	-0.7	-0.2	0.1	0.1	0.0	0.2	0.1	-0.1
Europe and Central Asia	-0.1	-0.1	0.0	1.4	1.0	0.0	2.1	1.4	-0.9
Oil importers	-1.0	-1.3	-0.6	-0.5	-0.6	-0.4	-0.6	-0.5	0.2
Oil exporters	0.6	1.0	0.6	2.3	1.8	0.2	3.3	2.1	-1.7
Latin America and Caribbean	0.1	0.1	0.1	0.3	0.5	0.3	0.4	0.2	-0.2
Oil importers	-0.6	-0.8	-0.4	-0.4	0.0	0.6	-0.3	-0.2	0.1
Oil exporters	0.6	1.0	0.5	1.1	1.0	0.0	1.0	0.5	-0.6
Middle East and North Africa	0.3	0.2	-0.3	1.5	1.0	-0.5	2.1	0.8	-1.4
Oil importers	-0.7	-1.1	-0.5	-0.4	-0.7	-0.5	-1.2	-1.3	-0.1
Oil exporters	0.7	0.8	-0.3	2.0	1.4	-0.6	2.8	1.1	-1.9
South Asia	-1.0	-1.3	-0.5	-0.6	-0.8	-0.3	-1.6	-1.5	0.1
Sub-Saharan Africa	-0.1	-0.2	-0.2	0.5	0.8	0.2	2.4	1.3	-1.5
Oil importers	-0.1	-0.2	-0.1	0.0	0.0	0.1	0.0	-0.1	-0.1
Oil exporters	0.0	-0.2	-0.4	1.0	1.4	0.2	4.5	2.1	-3.3

Source: World Bank.

will be able to deal with short-term fluctuations in capital flows. However, in several countries they are low both with respect to imports and short-term debt. Eleven developing countries for which data exist have short-term debt levels that exceed 50 percent of their reserves and in 10 of these short-term debt to reserve ratios have been increasing (figure 17).

But a stronger recovery in demand is also possible

While a less likely outcome than it was just a few months ago, a stronger recovery than currently embedded in the baseline forecast is of course possible. For high-income countries such a result would be unambiguously welcome, and could derive from an improvement in market sentiment, perhaps due to additional progress on the reform agenda or because of better than anticipated outturns. Improved sentiment could help create the kind of virtuous circle, where lower interest rates reduced borrowing costs, improved fiscal prospects and reduced the need for growth sapping expenditure cuts without affecting the overall improvement in the region's fiscal trajectory.

For developing countries where some post-crisis slack remains (notably many of the economies of Central and Eastern Europe and the Middle-East & North Africa), a stronger than expected recovery in demand would also be welcome and could be relatively easily absorbed and converted into improved living conditions and lower unemployment.

However, for those developing countries operating close to, or above potential output (like Brazil, China, India and Turkey), a pick up in demand (domestic or external) could intensify capacity constraints unless it is met with significant progress on the supply side. If excess demand were to build up, it could stoke inflationary pressures and/or result in a further deterioration in current account balances, which could increase the vulnerability of these economies to a future domestic or external shock. Such countries would likely have to tighten policy much more severely than in the baseline — potentially resulting in an increase in unemployment and economic disruption in the outer years of the projection period.

Geopolitical and regional tensions could disrupt oil supply with potentially serious downside risk for developing countries

The baseline scenario assumes that the recent declines in oil prices do not reverse themselves and that oil prices gradually move toward a long-term level of about $80 dollars at today's prices.

However, if international tensions (or internal tensions within an important oil exporter) intensify and a serious disruption to global supply ensues, prices could rise much higher, with potentially significant impacts on output.

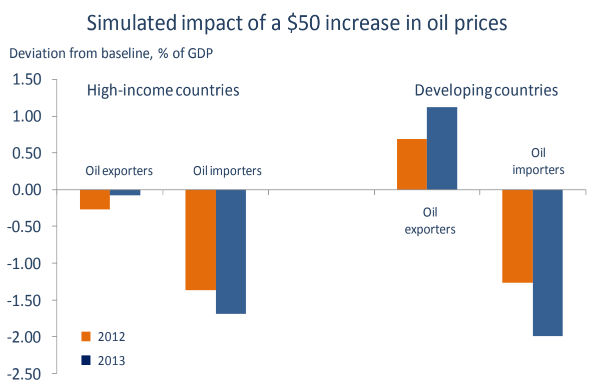
In particular, a prolonged blockage of the Strait of Hormuz, although a low probability event, could send oil prices soaring. Some 17 mb/d of crude and products transit the strait (an average 14 crude tankers daily, with another 14 returning empty). Although alternative routes for some Middle-East oil could be found and any disruption is likely to be temporary (see Commodity Annex for more details), a net 13 mb/d or 15 percent of global demand could be disrupted for several months and would likely be only partially offset by release of strategic reserves.

Evaluating what price oil might reach under such a scenario is highly uncertain, but economic impacts would be serious – even if peak prices are short-lived and adequate supply is restored. World Bank Group simulations suggest that a sustained $50 increase in oil prices could reduce global GDP by around 1.3 percent in oil-importing countries (figure 18). A more detailed discussion on the impact of higher oil prices is presented in box 6.

But lower commodity prices are also possible, with potentially serious consequences for commodity exporting countries

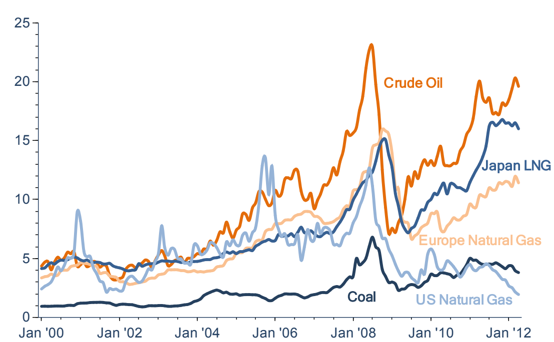
The recent decline in commodity prices (oil and metals are down 8.4 and 4.7 percent in the last month) attests to the possibility that commodity prices come down sharply in the projection period. The price rises of the past decade reflect the influence of a wide range of factors (see the 2009 edition of *Global Economic Prospects* http://go.worldbank.org/G8LVQDRH70 for a detailed

Figure 18. A major oil shock could cut sharply into global growth



Source: World Bank.

Figure 19 Falling natural gas prices have created large new arbitrage opportunities



Source: World Bank.

discussion), but may have reached unsustainable levels.

Notwithstanding the sharp declines in May, since 2000, oil prices have increased by 268 percent, metals and minerals prices by 245 percent and agricultural prices by 165 percent. While demand for these products can be inelastic in the short run, such large price swings unleash very powerful economic forces, in the form of substitution on the demand side, increased supply (via increased exploration and investment), and technological change.

All of these forces are at work currently (see box Comm.1 in the commodity annex), most obviously in the energy sector where OECD oil demand has declined 8 percent over the past 5 years, and where new technologies (such as shale gas and liquids extraction techniques) have brought large new supplies to market. These new supplies have opened up large and potentially destabilizing price differentials between natural gas and crude oil (figure 19) that could contribute to a longer-term fall in oil and other commodity prices.

Table 5. Impact of lower commodity prices on developing country GDP, current and government accounts

	Impact of a 20% fall in					
	Oil prices			Non-oil commodity prices		
	GDP	Government balance	Current account balance	GDP	Government balance	Current account balance
	(% of baseline)	(% of GDP)	(% of GDP)	(% of baseline	(% of GDP)	(% of GDP)
	No financing constraints					
Developing countries	0.9	-0.1	-0.1	0.1	-0.1	0.1
Oil exporters	-0.4	-1.2	-1.3	-0.2	-0.4	-0.1
Oil importers	1.5	0.4	0.5	0.3	0.0	0.2
East Asia & Pacific	1.6	0.4	0.3	0.5	0.2	0.2
Europe & Central Asia	0.3	-0.9	-1.4	0.5	-0.1	-0.1
Latin America & Caribbean	0.2	-0.4	-0.2	-0.6	-0.7	-0.1
Middle East & N. Africa	0.0	-0.8	-1.0	0.5	0.4	0.4
South Asia	1.4	0.8	1.3	0.3	0.2	0.4
Sub-Saharan Africa	0.0	-0.9	-1.7	-0.7	-0.5	-0.2
	Government budget financing constraint					
Developing countries	0.2	0.1	0.1	-0.8	-0.1	0.3
Oil exporters	-1.5	-0.3	-0.5	-1.3	-0.1	0.3
Oil importers	1.0	0.3	0.5	-0.6	-0.1	0.3
East Asia & Pacific	1.1	0.3	0.4	-0.4	0.0	0.3
Europe & Central Asia	-0.8	0.3	-0.7	-0.1	0.0	-0.1
Latin America & Caribbean	-0.6	-0.2	0.0	-2.1	-0.3	0.3
Middle East & N. Africa	-1.0	-0.2	-0.5	-0.5	1.0	0.9
South Asia	1.0	0.6	1.2	-0.2	0.0	0.3
Sub-Saharan Africa	-0.8	-0.9	-1.3	-1.8	-0.6	0.1

Source: World Bank.

If commodity prices were to come off their current highs there could be potentially serious consequences for the external and internal imbalances of commodity exporting economies, who depend upon commodity revenues to finance a large share of their imports and government expenditures.

Table 5 reports the simulated impact on developing country commodity exporters of a 20 percent decline in commodity prices. The first three columns of the first set of simulations show the impact on: the level of GDP (after two years); the government balance as a percent of GDP; and the current account balance as a percent of GDP, under the assumption that oil prices fall by 20 percent and that other commodity prices fall according to their own sensitivities to the fall in oil prices (oil prices are an important determinant of other commodity prices). The fourth through sixth columns report the impacts from a simulation that assumes oil prices do not change, but that other commodity prices decline by 20 percent.

In the first set of simulations, alternative financing is assumed to be found so that the government revenue shortfalls caused by the crisis are made up for via borrowing (external or domestic). In the second set of results, revenue shortfalls are assumed to be binding such that government expenditure must be cut by the decline in government revenues from the earlier simulation.

In the first scenario government deficits rise by close to 1 percent of GDP in the Middle-East and North Africa because of lower oil prices. However, GDP effects are relatively small —in part because the government is assumed to continue to maintain spending at earlier levels via increased borrowing. Impacts in the non-oil commodity price simulation are smaller because these commodities tend to be much less important sources of revenue for governments at the aggregate level.

In the second set of results, all of the lost government revenues from the first are assumed to be deducted from government spending. Here GDP effects are much larger, but because of demand compression current account effects are more muted. Impacts for individual countries are of course larger, with GDP in Paraguay, Uruguay, Argentina, Kyrgyz Republic, Belize, Chile, and Uzbekistan (all important extractive commodity exporters or countries with close links to commodity exporters) projected to decline relative to baseline by more than 2 percent in the non-oil with government budget constraint scenario.

Evolving policy challenges for developing countries

For most developing economies the crisis-management challenges of the great recession have passed and output gaps have been closed. In part, because the international environment remains volatile and high-income countries are still struggling with the aftermath of the crisis, policy in many developing countries remains focused on crisis-fighting. Given the sharp shifts in market sentiment that have been observed and developing country vulnerabilities, such a focus is understandable, but focus needs to shift toward the longer-term and policy needs to guard against maintaining a loose stance too long.

This is particularly the case for the many developing countries already operating at or above capacity. In these countries, policy should work to strengthen prudential frameworks, and avoid further stimulus. Instead the authorities should rebuild fiscal and monetary-policy space so that they can respond forcefully should a second global (or forceful domestic) crisis emerge (see earlier discussion).

Moreover, policy needs to start re-investing in human and physical capital to ensure rapid and sustainable growth in a post-crisis world where high-income fiscal and monetary policy have returned to a more sustainable stance and some of the conditions (such as inexpensive and abundant capital) that have driven the very high growth rates of the past decade may no longer hold.

Developing countries face a more constrained financial environment in the post crisis period

Independent of short-term outcomes, developing countries are likely to face a much more constrained financial environment over the next decade than they did during the pre-crisis boom period (see *Global Economic Prospects* 2010A). The current process of consolidation in high-income banking and household sectors and regulatory reform should yield a more stable and ultimately more robust global financial environment. However, it is also likely to be one characterized by less liquid and more expensive financing conditions, with important real-side implications for developing countries.

For low-income countries with relatively weak domestic financial sectors and binding capital constraints, weaker bank finance and FDI flows will be particularly challenging. In some of these countries FDI inflows represent more than 40 percent of total investment, while in middle-income countries with access to international financial markets and better developed domestic markets, the main impact is likely to be through the increased cost of borrowing over the medium term.

Simulations performed for the 2010 edition of *Global Economic Prospects* (World Bank, 2010A) suggest that if these tighter conditions result in an increase in developing country capital costs of between 30 and 310 basis points, potential growth rates in developing countries, could be reduced by between 0.2 and 0.7 percentage points for an extended period of between 5 and 7 years.

The same study showed, however, that reducing financial sector inefficiencies within developing countries could more than offset these impacts — suggesting that developing countries should redouble efforts to strengthen domestic regulatory frameworks to facilitate the expansion of a healthy domestic financial sector to partially offset the likely reduction in external capital flows.

The transition to tighter capital conditions may generate significant challenges to developing countries that have had very rapid credit growth during the recent past

While increased financial intermediation has been closely associated with increased growth and income gains, the very rapid expansion of credit in past years in some countries may have increased their vulnerability either to tighter international conditions or domestic shocks.

Loan to GDP ratios increased by more-than 10 percentage points between 2005 and 2010 in Brazil, China and Nigeria (figure 20). In these countries loan performance could deteriorate markedly in in the face of slowing growth, heightened risk aversion and restricted access to finance. For example, partly because of the severity of the growth slowdown in the Europe and Central Asia region, non-performing loans (NPLs) increased from 3.8 percent of banking assets in 2007 to 12 percent in 2010. NPLs in Vietnam have risen from 2.1 percent of banking-sector assets in 2010 to 3.4 percent last year according to official data, but the level of bad debt is believed to be 2-3 times higher if measured by international standards.

In China, concern centers around both the speed at which credit has expanded and the absolute quantity of credits relative to the size of the economy. To-date the state-owned dominated banking system has been stable. However, there is growing concern regarding the long-term viability of the banks' $1.4 trillion in loans to local government, much of which was accumulated over the past two years in the context of the country's post-crisis stimulus program. Indeed, the non-performing loans of China's third largest bank rose sharply in the first quarter of 2012. So far, however, NPL levels remain modest in part due to a central government supported policy of rolling over problem loans, plans to reduce repayment burdens, and pledges to stand behind some of the debt. The Government has the fiscal resources to support the banks if and when needed.

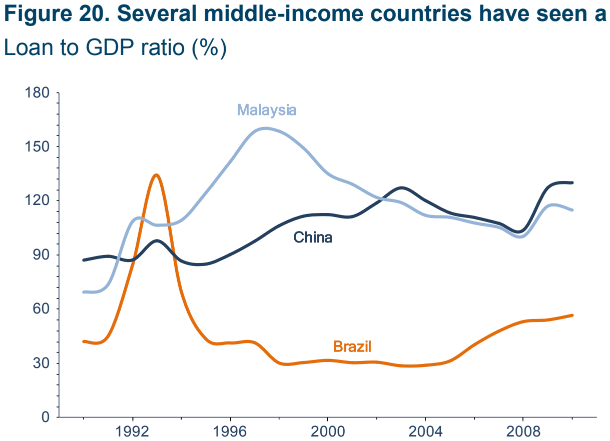
Managing macroeconomic policy and capital flow volatility is especially challenging for middle-income countries

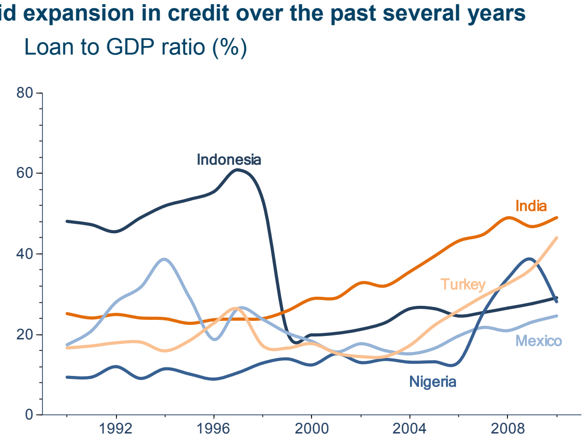
In the current volatile international environment, portfolio equity flows have fluctuated wildly in reaction to global macro developments, affecting exchange rates in middle-income countries where these markets are relatively well developed. With interest rates in high-income countries at all-time lows, corporate profits at record levels, and private balance sheets healthy, investors are both nervous and hungry for yield.

Given the sheer size of global international capital markets, changes in sentiment can, and have had, disruptive short-term impacts on the currencies of middle-income countries (impacts are mainly restricted to those middle-income countries with relatively deep markets that provide investors with some security that they will be able to exit).

While a steady inflow of external portfolio investments can be extremely beneficial to a developing economy, when they are volatile or attracted by speculative motivations, as in recent years, they can be disruptive. Of particular concern is the challenges that they can pose for the conduct of macroeconomic policy — especially when countries are operating at or close to full capacity as are most of the major recipients of portfolio flows. For these countries, the kind of sharp increase in inflows that has been associated with declines in the international

Figure 20. Several middle-income countries have seen a rapid expansion in credit over the past several years





Source: World Development Indicators

Box 7. Capital controls part of policymakers' toolkit for managing risks from volatile flows

International capital flows can be an important determinant of a developing countries exchange rate, with positive inflows pushing a currency toward appreciation and negative flows toward depreciation. International capital flows can reflect the actions of foreign investors or domestic investors. When increases (decreases) in capital flows are more or less permanent –reflecting a change in international perceptions of returns in a country, then the resulting exchange movement is part of the normal equilibrating mechanisms and probably should not be resisted. Increases in foreign direct investment or long-term bond lending might fit this category.

However, when fluctuations in flows reflect more temporary and or speculative "hot money" flows, they can be disruptive. During the inflow stage they can erode short-term competitiveness and give rise to credit and asset price booms, whose subsequent collapse during the withdrawal phase can devastate local balance sheets.

As a result, there is an emerging consensus that that when currency movements are driven by (identifiable) speculative capital flows that are temporary in nature, capital controls and prudential regulations can be used to lean against the wind. These should complement, rather than substitute for, appropriate monetary, exchange rate, and foreign reserve management (G20 2011). Capital controls can limit excessive borrowing by sovereigns and firms and prevent the buildup of risky financial structures, thereby enhancing resilience during busts when foreign capital dries up (Ostry and others 2011). Capital flow management measures should be transparent, properly communicated, and be targeted to specific identified risks.

Capital controls can be complemented by domestic macro-prudential regulations that do not discriminate on the basis of currency or residency. Such prudential measures may include limits on domestic credit growth, credit concentration in certain sectors as well as reserve requirements. Such controls should reduce the likelihood of credit booms associated with speculative inflows, and in turn the adverse consequence of rapid withdrawals.

However, identifying short-term speculative rather than more patient capital inflows is not straight forward. In commodity exporting economies, capital inflows attracted by real-side opportunities coincide with strong export revenues making it difficult to identify the relative contribution of each as opposed to more speculative flows attracted by the appreciation of the currency. Moreover, capital controls introduced to manage short-term capital flow volatility risk becoming "sticky" even when the short-term surge fades, introducing production and capital allocation distortions.

[1.] Emerging market countries with economy-wide capital controls/restrictions on inflows and foreign-exchange related prudential regulations (e.g. limits on banks' open foreign exchange positions) experienced 2.5 to 3.5 percentage points smaller decline in growth during the 2008-09 Lehman crisis (Ostry and others, 2011).

price of risk can exacerbate existing goods and asset-price inflation. In a worst-case scenario, the sudden discontinuation or withdrawal of capital from developing countries (running current account deficits) could result in a financial and/or balance of payments crisis.[6]

Orthodox policy options include allowing exchange rate appreciation, or following a sterilization policy. But both options can be neutralized in the face of large flows. If flows-induced appreciation induces further flows to take advantage of the exchange rate appreciation, a speculative exchange rate bubble can develop to the detriment of local industry (which is made uncompetitive — perhaps temporarily) and the economy as a whole when it bursts. Attempting to prevent such a bubble through conventional monetary instruments can be both very expensive and unsuccessful if interest rate hikes just fuel additional carry-trade related capital inflows.

In the context of these kinds of temporary disruptive flows, countries may wish to use some form of limited capital controls to reduce the volatility of flows (box 7). However, care must be exercised to ensure that restrictions do not impede more stable and desirable flows and to ensure that restrictions are not put in place to counteract appreciations that are due to longer-term factors such as permanent or durable terms of trade improvements, such as those enjoyed by commodity exporters.

Concluding remarks

Developments, during the first four months of 2012 were generally positive and in line with the expectations that underpinned the projections in the January 2012 edition of Global Economic Prospects (World Bank, 2012). High-income Europe appeared to be stepping back from the brink. However, the situation has soured significantly, with financial market tensions in the Euro Area approaching the levels observed in the fall of 2011, although so far there has been less contagion to developing countries.

The renewed tension compounds the headwinds facing developing countries going forward and increases the likelihood of a serious deterioration of conditions in high-income Europe, to which developing countries remain vulnerable. While countries must be prepared to react to a significant downturn should it arise, they must also be careful to ensure that policy does not become too re-active, but is directed by medium-term domestic priorities.

Even if the current phase of tensions passes, the external environment for developing countries is likely to remain volatile and challenging. Loose monetary policies, and, as yet, unresolved fiscal and banking-sector problems in high-income countries are likely to keep international capital flows and business confidence volatile.

If a close to capacity economy finds demand falling (accelerating) at an unexpectedly rapid pace due to changes in global animal spirits, macroeconomic policy can potentially find itself following a similarly volatile path of permanently trying to catch up to what for many developing countries are entirely external and largely unforeseen developments.

In such an environment, perhaps the optimal strategy is to follow a steadier course, keeping policy instruments focused on the domestic forces that policy can expect to influence, while allowing automatic stabilizers such as exchange rates and the tax system to deal with the constant changes of a still febrile international environment.

Notes

1. In October 2011, the European Banking Authority passed regulations requiring European Banks to restate the value of their sovereign bond holdings to their market value as of September 2011 and to increase risk-weighted capital adequacy ratios to 9.0 percent by July 2012.
2. Estimating the effects of recent events is fraught with error. The impacts assumed in the baseline were derived by estimating the impact of the turmoil in 2011 on Euro Area activity and scaling it by the relative size of the increase in financial uncertainty in this versus the earlier episode (proxied in this case by the ratio of the increase in CDS rates in 2012 divided by maximum increase during the second half of 2011).
3. In October 2011 the European Banking Authority required banks to value their sovereign bond holdings at September 2011 market values and raise capital ratios to 9 percent by June 2012. EBA estimates suggest that banks needed an additional €115 billion of capital to fulfill these requirements. Although most banks indicated that they would meet these objectives without reduced lending, credit growth in the Euro Area eased noticeably, and was falling at a 2.8 percent annualized pace during the three months ending February 2012.
4. The scenario underlying the simulations is similar to that outlined in the January 2012 edition of *Global Economic Prospects* (World Bank, 2012). It is assumed that current market tensions escalate, freezing Greece out of international capital markets. In the scenario, market confidence is shaken resulting and contagion to at least four other Euro Area economies ensues. The acute credit squeeze in directly affected economies denies finance that extends to the private sectors of these economies whose GDP declines sharply (broadly in line with observations during previous financial crises in high-income countries (see Abiad and others, 2011). Other, economies are affected through reduced exports (imports from the directly affected countries fall by between 6 and 10 percent), and by increased uncertainty, which raises borrowing costs and increases precautionary savings by households and firms.

   Direct trade and tighter global financial conditions plus increases in domestic savings by firms and households as a result of the increased global uncertainty impact activity worldwide, with Euro Area GDP falling by 8.5 percent relative to the baseline in 2013. GDP impacts for other high-income countries (-3.3 percent of GDP) and developing countries (-4.0 percent) are less severe but still enough to push them into a deep recession. Overall, global trade falls by about 10 percent (relative to baseline) and oil prices by 25 percent (5 percent for food.

5. A brusque halt or reversal of capital inflows can force economies to cover the outflow through reserves, placing downward pressure on the exchange rate (net reserves are a major exchange rate determinant). In turn, the depreciation will increase the value of the foreign debt stock and debt servicing costs and boost the cost of imported goods, raising inflation and current account deficits placing currencies under further pressure and cutting into external competitiveness.

6. Mathematically, the quarterly pattern of growth during the preceding year has a direct and measurable influence on the annual growth rate in the current year. This arises because annual growth rates are calculated on the basis of the levels of GDP over eight quarters, four in the preceding year and four in the current year (equation 1).

   If quarterly growth during the previous year is positive, then fourth quarter GDP will be higher than the average for the year, and annual growth in year t will be positive — even if during the four quarters year t GDP does not grow. More generally, the growth rate in any given year can be approximated by a weighted average of the quarterly growth rates over 7 quarters as in equation 3 (Tödter, 2010 provides a more detailed derivation of this relationship).

   Carry over (or statistical overhang) is defined as the rate of growth that would be observed if quarterly GDP in year t remained unchanged from the level of the fourth quarter of the previous year (equation 2). It therefore measures the contribution to annual growth in year t, of the quarterly expansion during the previous year.

$$y_t = \left(\left(\frac{q_t^{1} + q_t^{2} + q_t^{3} + q_t^{4}}{q_{t-1}^{1} + q_{t-1}^{2} + q_{t-1}^{3} + q_{t-1}^{4}} \right) - 1 \right) * 100 \quad (1)$$

$$carryover_t = \left(\left(\frac{q_{t-1}^{4} + q_{t-1}^{4} + q_{t-1}^{4} + q_{t-1}^{4}}{q_{t-1}^{1} + q_{t-1}^{2} + q_{t-1}^{3} + q_{t-1}^{4}} \right) - 1 \right) * 100 \quad (2)$$

$$\mathrm{y_t} = \frac{1}{16} * \frac{q_{t-1}^{4}}{q_{t-1}^{3}} + \frac{2}{16} * \frac{q_{t-1}^{3}}{q_{t-1}^{2}} + \frac{3}{16} * \frac{q_{t-1}^{2}}{q_{t-1}^{1}} + \frac{4}{16} * \frac{-}{q_{t-1}} + \frac{3}{16} * \frac{q_t^{2}}{q_t^{1}} + \frac{2}{16} * \frac{q_t^{3}}{q_t^{2}} + \frac{1}{16} * \frac{q_t^{4}}{q_t^{3}} \quad (3)$$

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Industrial Production

Recent economic developments

Following a weak second half of 2011

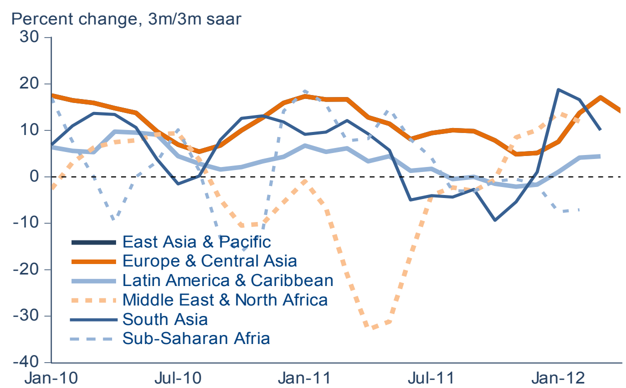
After a relatively robust first half of 2011 (global output expended 2.7 percent) that helped close or narrow significantly the gap with respect to trend, global industrial production growth weakened in the second half of 2011 to 0.9 percent. The slowdown initially reflected a policy induced slowing of demand in several middle-income countries that were pushing against capacity constraints, but was exacerbated by confidence effects and tightening financial conditions and further bouts of fiscal contraction in high-income Europe following the escalation of market turmoil in July 2011. Developments in 2011 were also deeply influenced by the earthquake and tsunami in Japan (which cut sharply into activity in Q2, but contributed to rebound effects later in the year and by flooding in Thailand (which interrupted global supply chains in the fourth quarter). More recent data point to strengthening in industrial output growth in the first months of 2012 in most developing regions as well as in high-income countries outside the Euro area, with industrial output now in line with long-term trend levels (box IP.1).

Activity has picked up in early 2012 but is once again weakening

Industrial activity accelerated markedly toward the end of 2011 and into the first quarter of 2012, reflecting strengthening demand in high-income countries outside Euro area and in large developing economies, earlier reversals in monetary policy tightening and rebound effects as Thailand's industrial production started feeding into global supply chains once again. However industrial production is once again showing signs of weakness at the beginning of the second quarter (figure IP.1).

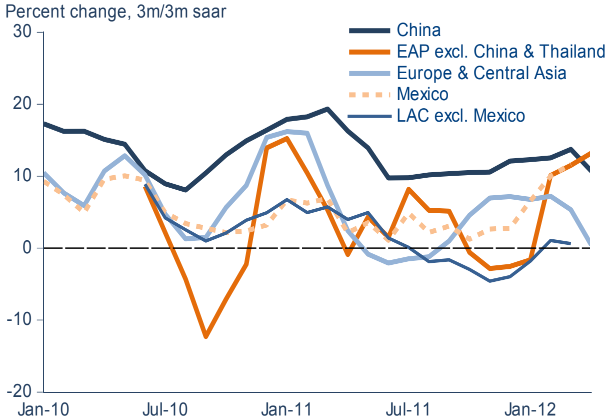
A firm recovery was underway in regions that have experienced sizeable supply or demand shocks like East Asia and Pacific and Europe and Central Asia (the Tohoku and Thai flooding effects in the case of the former and very weak domestic and external demand in the latter as a result of the European economic crisis). Indeed growth accelerated to 5.3 percent annualized pace in Europe and Central Asia in the first quarter of 2012, on very strong performance in Turkey, and it was expanding at more than 17 percent in East Asia and Pacific (figure IP.2). However the second quarter started on a much weaker note in both regions as growth in China disappointed and growth in Russia weakened. In South Asia data was suggesting a sharp acceleration in Indian industrial production in the earlier part of 2012, apparently reflecting sharp increases in food and beverages output, although growth in other industrial sectors remains muted. The marked acceleration in production observed in the first two months of 2012 is in part attributed to a temporary increase in before the anticipated increase in taxes in the March budget. Activity in the Middle East and North Africa output was growing at an 12 percent annualized pace in the three months to February 2012, as the effects of political turmoil from Arab Spring faded. Despite this rebound effect, output remained well below earlier peak levels in several countries and ongoing tensions in several countries along with weak European demand are expected to weigh on activity over the near term.

Figure IP.1 Industrial output growth has accelerated in early 2012 before softening again in April



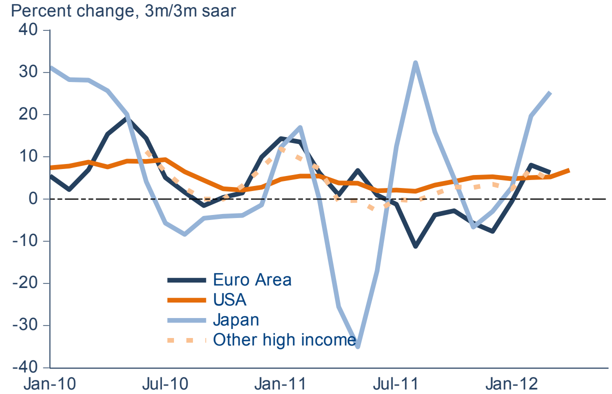
Source: Datastream, World Bank.

Figure IP.2 With growth decelerating in East Asia & the Pacific and Europe & Central Asia



Source: Datastream and World Bank.

Figure IP.3 Industrial output growth in high-income countries is also weakening, outside Japan and United States



Source: Datastream and World Bank.

Stronger demand in the United States and rapid growth in industrial production in East Asia has boosted industrial output growth in Latin America and the Caribbean, with growth in Mexico accelerating to the strongest pace in almost a year (11.7 percent annualized pace in the first quarter of 2012) – 4.4 percent annualized for the region as a whole during the same period. Growth in industrial production in Brazil has disappointed, despite government initiatives to shield domestic industries; output contracted at a 3 percent annualized pace in the first quarter of 2012, after a very weak second half of 2011. As of the end of the first quarter Brazilian industrial output was back at the levels recorded at the end of 2009. In Argentina the contraction in industrial production worsened in April.

Activity across high-income countries has strengthened in early 2012, notably in core European economies but is losing steam

In high-income countries, after a dismal performance in the Euro area in the second half of 2011, with output in the Euro area outside Germany contracting for seven consecutive months (-6.3 percent saar in the three-months to January) there were some signs of stabilization in industrial output (output expanded 0.9 percent saar in the first quarter). Industrial production for the sub-region as whole expanded at a 6.2 percent annualized pace in the first quarter of 2012 – although weather effects played a role here (figure IP.3). Industrial output, excluding construction was down 1.7 percent and manufacturing contracted at a 2.3 percent rate.[1] Activity in Germany turned strongly positive in the first months of 2012, supported by strong pick-up in construction activity, capital goods demand from developing countries, and real wage increases, but production declined markedly in April (2.2 percent month-on-month). Italy, Portugal, Ireland and Greece continued to register marked declines in industrial activity during the first quarter. However the recent deterioration in business sentiment in Euro Area in March-April and the decline in German industrial production suggest the Euro area remains on the brink of recession and that second quarter performance starts at a weak pace, with tight financial constraints weighing on activity.

Outside of Europe, the recovery in the United States has consolidated with industrial production growing at 5.2 percent (saar) in the first quarter of 2012, boosted by stronger employment growth in the last few months and improving performance in the construction sector. The March ISM manufacturing survey points to sustained growth in the first quarter of 2012, with the production index up 3 points to 58.3. Furthermore industrial production expanded at a 1.4 percent monthly pace in April.

Box IP.1 Normalization in industrial activity with respect to long-term trend levels

Most developing economies have recovered from the global economic crisis, with industrial output levels now in line with long-term trends. At the aggregate level, output was actually about 2 percent above its long-term trend in February, although high-income countries have yet to regain long-term trend levels.

Despite the severe supply chain shocks that disrupted activity in East Asia and Pacific in 2011 (Japanese earthquake and tsunami, severe and prolonged flooding in Thailand), industrial output there is currently 1.9 percent above the level consistent with long-term trends (table IP.1). In Latin America and the Caribbean, and South Asia industrial output levels are 0.3 percent and 2.2 percent above their long-term industrial output trend levels, respectively. Among Latin American countries Colombia, Mexico, Peru have recovered while industrial production in Argentina, Brazil, and Chile is yet to reach their long-term trend levels. In South Asia only Pakistan is lagging behind in the recovery and the gap with respect to long(er) term trends remains relatively large. In contrast, many countries in developing European and Central Asian and the Middle East and North Africa have yet to regain trend output levels, reflecting the severity of the demand shocks in the former and the ongoing domestic political turmoil in the latter. Among high-income countries industrial output remains below the long-term trend levels, including the United States – with the notable exceptions of Korea; Singapore; Taiwan, China; and Germany.

Industrial growth among high-income countries in East Asia remained robust and accelerated to double-digit growth in the three-month to April (saar), after a very weak performance in the second half of 2011 – partly reflecting supply-disruptions from Thailand. The timing of the Lunar New Year makes the interpretation of the strength of the manufacturing sector more difficult, with output proving very volatile in the early months of 2012. Growth in China (an important market for high-income economies in the region) has been softer since the second half of 2011, with industrial output growth weakening to 10.7 percent pace (saar) in the three months to April 2012, compared to 16.3 percent in the year-earlier period, as domestic demand starts to soften and investment growth slows.

Table IP.1 Industrial output gap relative to levels consistent with long-term growth

Developing countries	1.0
East Asia and Pacific	1.9
Europe and Central Asia	-18.1
Middles East and North Africa	-18.5
Latin America and the Caribbean	0.3
South Asia	2.1
Sub-Saharan Africa	-3.9

Source: World Bank.

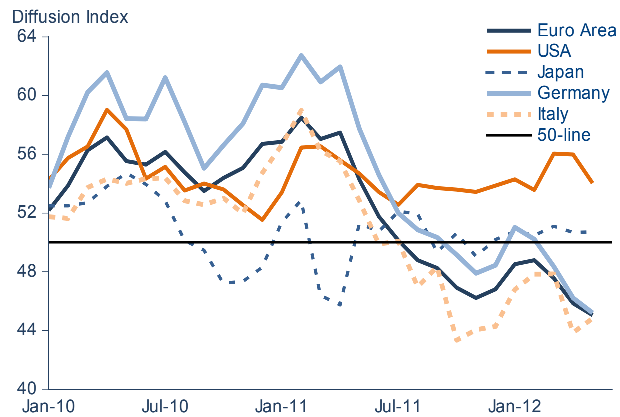
Growth expected to ease in the industrial sector before strengthening again in late 2012 and into 2013

Globally business sentiment continued to improve through April 2012, as indicated by the rise in the world JPMorgan/Markit PMI to 53.1 in April, but it has taken a turn for the worse in May, declining almost 2 points to near the weakest level since late 2011. This suggests that growth in global industrial production has softened markedly during the second quarter and that for the remainder of the year will growth will decelerate to a more sustainable pace than the above-trend growth recorded in the first quarter of 2012. Sentiment is relatively weak in a historical perspective, and remains below the levels recorded in May 2011, with the largest gaps recorded for the E.U., notably in the Euro Area, suggesting industrial sector performance there will remain lackluster (figure IP.6). Expectations for the Euro Area deteriorated further to 45.1 in May, the lowest since mid-2009, as the Euro area remains on the brink of recession. One of the largest declines in PMI was recorded in Germany (down 5 points since the February 2012) as prolonged weakness in other Euro area countries is starting to take a toll on business sentiment in the core Euro Area countries which have so far proved more resilient. Italy's PMI dropped to a depressed 43.8 in April before recovering marginally in May, while Spain's PMI slid 3 points to 42 by May. Meanwhile PMI readings for high-income countries outside the Euro Area improved through March, before weakening slightly in the following months, pointing to sustained growth in the United States and Japan but weakening growth in high-income East Asian countries (figure IP.5).

More notable however is the deterioration in business sentiment in developing and merging economies. By May PMIs readings were below the 50-no-growth mark in East Asia and Pacific and Latin America and the Caribbean, while stepping down markedly in the other regions. This suggests growth will be losing steam in the developing regions after the firming of growth observed in the first quarter of 2012. Europe and Central Asia is something of an outlier but growth prospects there remain precarious, due to weak demand in the EU. Indeed business sentiment in Turkey has deteriorated throughout the first quarter of 2012, suggesting industrial production could falter, and was only slightly above 50 by May. In contrast business sentiment in Russia has improved more in recent months. In East Asia indicators are mixed, with Markit's PMI pointing to markedly weaker growth in China. The gap between the more upbeat national survey and the Markit PMI has narrowed in May as the former moved closer to the 50 growth-no-growth mark, pointing to weakening prospects. It remains however more upbeat than the Markit PMI which dropped to 48.4 in May. Differences in methodology (weighting and questions asked) explain the difference, but recent developments on the ground point to more subdued growth compared to historical trends (figure IP.4).

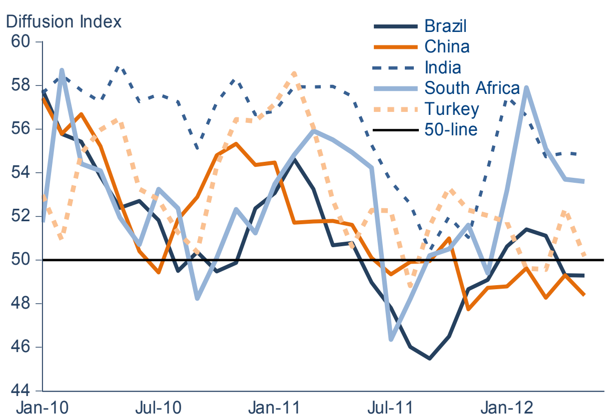
Global industrial output growth is expected to ease over the next couple of quarters, from an above-trend pace in the first quarter (10 percent saar) that was underpinned by the rebound from recent supply and demand shocks as well as relatively robust domestic demand growth in selected high-income and large developing economies. The main headwinds are high oil prices, continued banking-sector deleveraging, capacity constraints in several large emerging economies, and high borrowing costs. Weak demand in the Euro area will continue to affect countries that rely on the Euro area as a major export market. Global industrial production growth is expected to firm somewhat towards

Figure IP.5 Business sentiment in high-income deteriorated in the second quarter of 2012



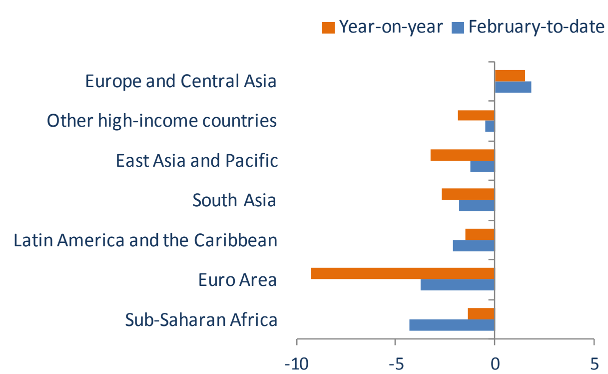
Source: World Bank and Markit.

Figure IP.4 Business sentiment is deteriorating in major emerging and developing economies



Source: World Bank and Markit.

Figure IP.6 Business sentiment is weaker than in early 2011



Source: Markit/ Haver Analytics, World Bank.

the end of 2012 as government policies in selected emerging economies, improved labor markets, and rising purchasing power should support global demand.

Industrial production growth in the Euro area is likely to stabilize towards the end of 2012, as the measures put in place by European policy makers (long term refinancing operations and fiscal consolidation programs) restore business and consumer confidence and as demand from developing countries and other high-income countries firms. In the United States industrial output will benefit from improvements in the labor markets and wealth gains, and there are signs that industrial output in East Asia outside China is also firming, supported by improved performance in the tech sector on account of stronger demand in the United States and larger developing economies, as well as normalization of supply chains. In Japan improvements in labor markets and easier financial conditions are boosting consumer demand which will further lift industrial production domestically as well as demand for imports, benefitting Japan's main trading partners.

In East Asia & Pacific in economies outside China IP growth is likely to accelerate, as they benefit from firming U.S. demand and some of the emerging economies. China's industrial production growth is likely to remain subdued by historical standards as the weaker real estate market continues to take its toll in spite of supportive government policy (structural tax cuts and targeted expenditure programs) and relatively solid private demand. Growth in countries with tight trade ties with the U.S. should benefit from firming demand there, and in particular Mexico should see sustained growth in its industrial output, with manufacturing expected to expand at an above-trend pace in 2012. Other countries in Latin America that rely more on trade with China are likely to see a deceleration in their export market growth over the short-term.

Risks and vulnerabilities

The world economy remains fragile, and risks to the downside remain. Renewed deterioration of conditions in Europe, financial flows volatility due to very loose monetary policy in high-income countries and the risk of higher oil prices, on account of geo-political tensions and supply disruptions are among the most important of these downside risks that could stall global growth.

A potential 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, in particular on sectors producing financing-sensitive items such as auto's and big-ticket items such as electronics.

For countries tightly linked to the U.S. the risk of a political impasse and/or rapid unwinding of stimulus measures represent a downside risk as it would result in a sharp weakening in domestic demand in the U.S. Mexico is particularly vulnerable as close to 80 percent of its exports are destined for the U.S.

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

A sharp deterioration in conditions in Europe, the U.S. or China would likely produce large confidence effects for developing countries that would exacerbate the decline in demand for industrial production, and for capital goods in particular.

Notes:

1. Weak private consumption in the Euro area translated into a 7.7 percent saar decline in consumer goods production in the first quarter of 2012, the worst performing category, while capital and intermediate goods production declined an annualized 0.3 percent over the same period.

Inflation

Global inflation eased substantially during the second half of 2011 and into 2012.

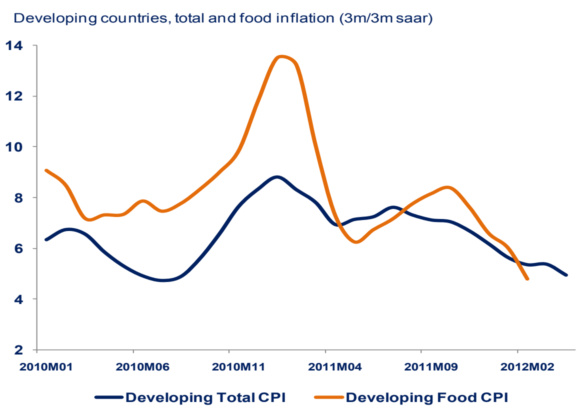
Developing country inflation, which averaged 7.2 percent in 2011 eased to a 5 percent annualized rate in the three months through April 2012 (saar). Among high-income countries inflation decelerated as well but by much less, from 2.7 to 2.5 percent in the same period. For emerging markets the decline in inflation mainly reflected a sharp falloff in local food inflation, relative stabilization of oil prices, a weakening in the pace of global growth and general firming of EM currencies (figure INF.1).

A decline in local food price inflation was the main driver of lower inflation in most developing economies.

Local food prices in developing countries increased 8.9 percent in 2011, reflecting drought conditions in several developing regions the year before (notably in Europe and Central Asia and the Horn of Africa) and a sharp 24 percent rise increase in the dollar price of international food commodities. Domestic food price inflation decelerated in South Asia, while in Europe and Central Asia consumer food prices have recently declined on the back of improved crops following drought in 2010. In contrast, food price inflation has accelerated in sharply in the Middle East and North Africa, less so in Sub-Saharan Africa and Latin America and the Caribbean (table INF.1). Despite the welcome normalization of developing country food price inflation, coming to stand at 4.8 percent over the three months through February 2012, food prices in developing countries stand some 25 percent higher (relative to non-food consumer prices) than they were at the beginning of 2005. This is a very large hit to real incomes especially among poor urban families where food often represents more-than one-half of their total expenditures.

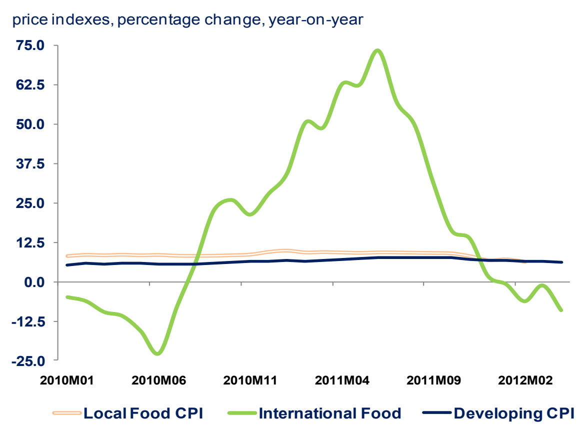
Local food price increases in developing countries (and local food price inflation) was much lower than the dollar price of internationally-trade commodities, in part because of exchange rate effects (appreciation of most developing country exchange rates –see exchange rate annex for more), but mainly because most food consumed in developing countries is produced locally, and therefore the pass-through of international prices to local prices is weak – ranging between 0.1 and 0.3 percent (World Bank and figure INF.2).

Figure INF.1 Inflation in developing countries has stabilized due in part to food prices



Source: World Bank and U.N. Food and Agricultural Organization.

Figure INF.2 Pass-through of international food prices to local food prices is small



Source: World Bank, ILO.

Regional inflation trends differ considerably

While the influence of weaker food price inflation has played an important role in many developing countries, regional (and country) developments reflect a much wider range of influences.

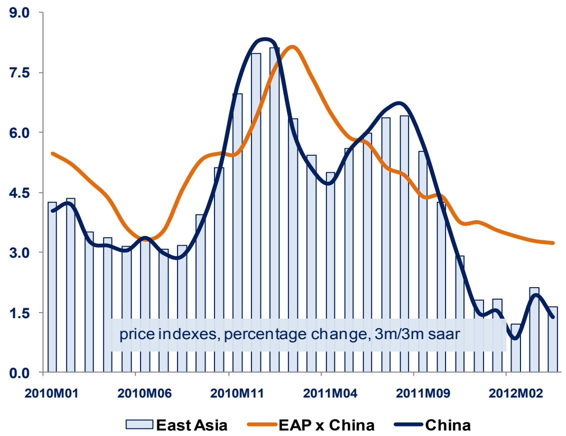
- Headline inflation in the East Asia and Pacific region decelerated from a peak of 8 percent at end-2010 to an impressive 1.6 percent by April 2012 (3m/3m saar). Most of the regional decline has been driven by a dramatic falloff in Chinese inflation (figure INF.3) – reflecting among other things, food price declines (though subject to extremes of variability at times of National Holidays and the New Year); an easing in residential rental- and home purchase prices following new regulations and prudential guidance, and more broadly, the policy of maintaining a modest rate of appreciation of the yuan vis-à-vis the dollar, averaging about 4 percent per annum, serving to pressure international prices lower in domestic terms. ASEAN-4 countries as a group have seen prices ease from a 5 percent pace to 3.5 percent during the first quarter of 2012 on this measure, on increased stability in food prices and generalized exchange rate appreciation. An exception is Indonesia, where strong domestic growth is exerting demand-pull pressures on headline inflation.

Table INF.1 Headline inflation and domestic food prices by world region

	2009	2010	2011	Q1-2011	Q3-2011	Latest 2012
Headline Consumer Prices	Annual percentage change			Annualized percentage change saar		
World	**1.3**	**2.8**	**4.0**	**5.1**	**3.4**	**3.2**
High income countries	**0.2**	**1.6**	**2.7**	**4.0**	**1.9**	**2.5**
Developing countries	**4.3**	**5.8**	**7.2**	**7.8**	**7.1**	**5.0**
East Asia and Pacific	-0.2	3.5	5.5	5.4	5.5	1.6
EAP excluding China	2.8	4.4	5.8	7.4	4.4	3.2
Europe and Central Asia	8.9	7.1	8.1	7.4	7.1	3.1
Latin America	5.8	6.1	6.8	7.4	7.1	4.6
LAC excluding Argentina	5.8	5.7	6.6	7.3	6.8	4.2
Middle East and N. Africa	8.9	7.2	14.6	19.2	19.8	25.8
South Asia	10.5	11.7	9.3	12.8	8.4	9.0
SAS excluding India	9.1	10.7	10.9	11.3	8.5	12.3
Sub-Saharan Africa	8.8	7.3	8.9	11.2	7.0	9.6
SSA excluding South Africa	9.9	9.2	11.4	15.0	8.0	14.2
Memo item:						
Developing excluding China	7.4	7.2	8.1	9.3	7.9	7.0
Domestic Food Prices	Annual percentage change			Annualized percentage change saar		
World	**3.1**	**3.2**	**5.0**	**6.0**	**4.6**	**3.7**
High income countries	**1.7**	**0.9**	**3.1**	**3.4**	**3.6**	**2.6**
Developing countries	**6.7**	**8.4**	**8.9**	**10.0**	**8.1**	**4.8**
East Asia and Pacific	2.9	7.0	8.0	4.9	8.4	3.7
Europe and Central Asia	2.6	1.5	6.7	9.5	-6.6	1.9
Latin America	7.6	7.4	9.2	9.2	11.8	10.2
Middle East and N. Africa	10.4	7.2	13.6	22.2	1.7	21.5
South Asia	13.1	12.3	8.5	17.4	4.7	-2.9
Sub-Saharan Africa	-13.1	5.2	9.8	28.2	-0.7	22.5
Memo: Internationally traded commodity prices						
	Annual percentage change			Annual percentage change (yr-on-yr)		
Energy	-37.3	26.3	30.0	34.5	31.7	-3.2
Crude Oil (World Bank Average	-25.2	102.8	31.6	37.0	32.5	-2.2
Food	84.9	11.2	23.9	36.8	18.8	-1.8
Grains	-24.1	1.5	38.9	48.9	31.4	-9.1

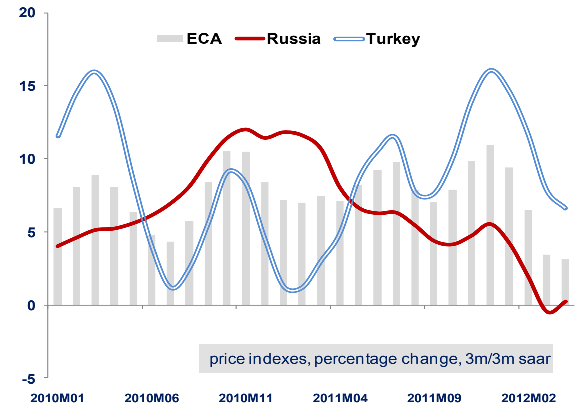
Source: World Bank, International Labor Organization.

Figure INF.3 Dramatic falloff in China's consumer prices drives East Asia



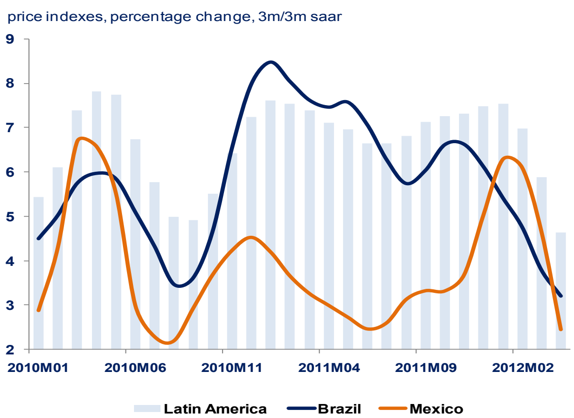
Source: World Bank.

Figure INF.4 Sharp turnaround in Russia and Turkey begin to carry Europe & Central Asia inflation to more moderate rates



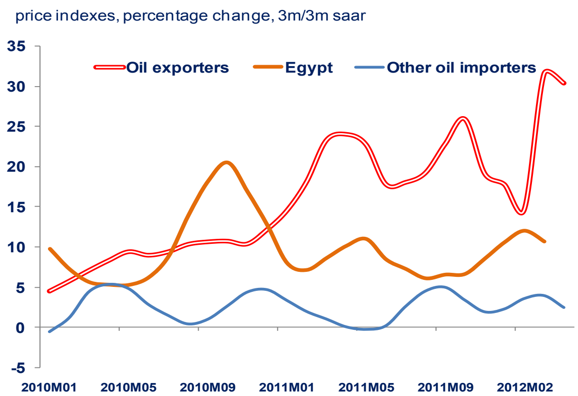
Source: World Bank.

Figure INF.5 Latin America affected by complementary developments in Brazil and Mexico



Source: World Bank.

Figure INF.6 Egypt and other oil importers in Middle East & North Africa see rising price pressures in contrast with oil exporters



Source: World Bank.

- The decline in inflation in Europe and Central Asia to 3.1 percent reflects a significant reversal in food price inflation in Russia, the Ukraine and several countries of Central Asia as following the drought of 2010, crops were much stronger this year. Inflation in the Russian Federation has eased to an annualized rate of 0.2 percent as of the first quarter of 2012. In Turkey inflation also slowed, but strong domestic demand and persistent capacity constraints mean inflation remains just below 7 percent (figure INF.4).

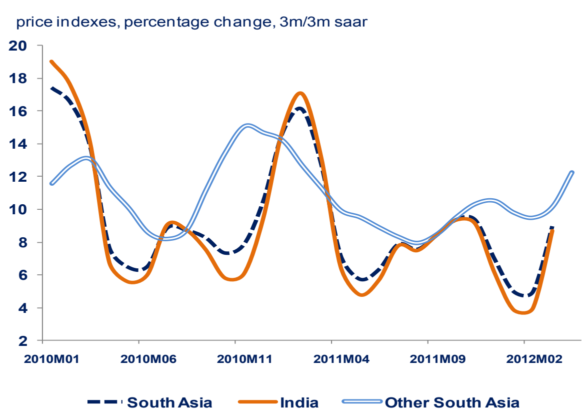
- Latin America's inflation had been elevated, reflecting diverging trends across countries within the region. Inflation in Brazil eased significantly in line with weaker growth and the policy tightening of 2011. And in Mexico it had picked up, reflecting a spate of volatile food prices. Price changes in Mexico have now softened to 2.4 percent as of April, and expectations for inflation appear to be moderate. Recorded inflation in Argentina has decelerated modestly in recent months but with prices rising at a 9.5 percent annualized pace, inflation poses a potentially serious problem – all the more so if suggestions that recorded inflation is underestimating actual price developments by a significant degree are correct (figure INF.5).

- In the Middle East and North Africa the disruptions of the transition in Arab countries continue to drive economic and price developments. Developing oil exporters of the region have seen headline inflation rise on the back of increased budgetary outlays in support of social- and infrastructure programs. And In the case of Iran, a wholesale revision of subsidies and prices was recently implemented affecting outturns there (figure INF.6). Oil exporter's CPI has since dissipated to a degree, but remains elevated at 30 percent (saar) at latest readings. Oil importing countries (here classifying Egypt as a non-oil dominant economy) have seen consumer price changes accelerate on the back of higher oil prices, substantial year-on-year increases in local food prices, plus the effects of subsidies. Uncertainty continues for the region with many political economy decisions facing authorities in coming months, importantly including questions on subsidies.

- South Asian inflation has declined significantly grounded in improvements in India. At the start of 2010, inflation in South Asia was 18 percent (saar); as of March 2012 that rate had halved to 9 percent. The bulk of the improvement is tied to lower food prices, easing economic activity, and price controls that have limited the pass-through of higher energy prices in India (figure INF.7). Outside of India, however, other South Asian inflation (notably in Pakistan) is ranging within a 12 percent band. An upturn in Indian inflation in March and April reflects strong wage growth.

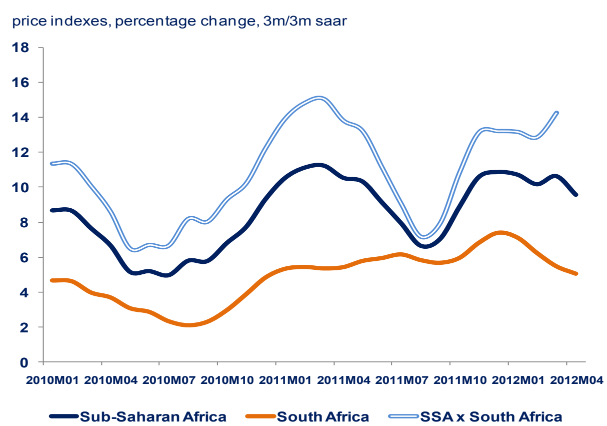
- In Sub-Saharan Africa, South Africa has witnessed a receding of inflation pressures to 5 percent as of April 2012, and for the region excluding South Africa 14.2 percent, in the latter tied to poor weather and high food prices (figure INF.8). But an important differential has emerged between oil exporters and oil importers. The former group is using available hydrocarbon resources to boost investment and government outlays, helping to underpin stronger rates of domestic demand (examples include Ghana and Sierra Leone both new to the oil market, and Nigeria). CPI for Sub-Saharan Africa oil exporters ramped up from 6.8 at mid-year 2011 to 17 percent by early 2012 (saar). At the same time inflation for oil importers has been softening, as oil prices in this period were fairly subdued: inflation moved from 10 to 7.2 percent over the same period. With data timeliness problems for many Sub-Saharan African countries, it is likely that oil importers will show some pick-up in inflation, exporters- some softening as further data becomes available for analysis.

Figure INF.7 A recent rebound in South Asian headline inflation



Source: World Bank.

Figure INF.8 Coming to convergence at higher CPI rates in Sub-Saharan Africa



Source: World Bank.

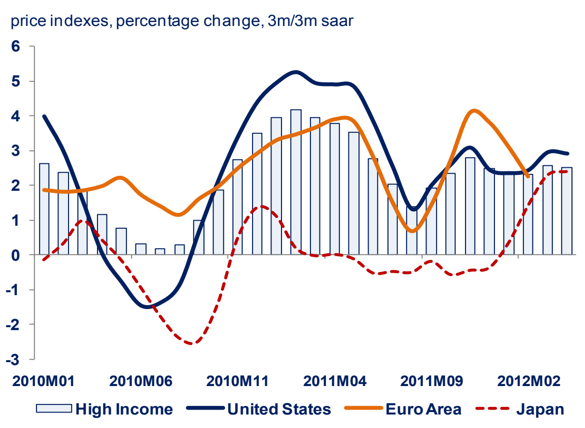
Despite the generalized decline in inflation, several countries continue to face high-or accelerating inflation

- Several countries are continuing to be affected by high or accelerating inflation, and this for a number of reasons. Some economies continue to operate at or above potential GDP – raising concerns of "overheating" due to demand pressures and creating an environment where suppliers find it easier to raise prices, for example in Argentina, Brazil, Ghana (new oil), India and Turkey.

In contrast with developing countries, high income countries in aggregate witnessed a slight increase in headline consumer price inflation

Consumer prices increased from 1.9 percent in September 2011 to 2.5 percent by April (saar), with a notable characteristic that deflation that has characterized the Japanese economy since 2010 has ended (figure INF.9). Several factors have contributed to these overall developments, including the large liquidity injections of high-income central banks in response to the crisis. The depreciation of the euro during the recent spite of financial weakness in the euro zone has either augmented the upward movement of traded commodity prices, or yielded higher landed prices in local currency terms for a given dollar price. In the United States, in addition to the series of liquidity injections to the economy, higher landed crude oil prices have moved quickly to the petrol pump, raising consumer prices, but also underpinning substitution to alternate means of transport, and purchase of more fuel efficient vehicles. Inflation based on fundamental domestic factors is not a particular worry at the current interval with economic activity on the weaker side.

Figure INF.9 High-income inflation converging toward a 2.5% rate (saar)



Source: World Bank.

Core consumer prices (adjusted to remove the prices of food and fuel) have increased moderately over the past 12 months (year-on–year basis) in each of the United States, Japan and the Euro Area. The biggest acceleration in core CPI has been in the United States, moving from 1.3 percent to 2.3 percent over the year to March 2012, as very gradual pass-through of higher imported raw materials costs, a pickup in wage rates in selected overseas suppliers to the United States, and spillovers from increasing prices of domestic services have likely served to underpin this development.

Looking forward, inflation is likely to encounter opposing forces over 2012 to 2014.

The view for inflation moving into the projection period is linked to the progress with which (for the large part developing-) countries first converge toward potential output growth by 2013. And thereafter, given expected more favorable developments in the external environment to grow at or about the pace of potential GDP. This would imply a modest re-acceleration in inflation and inflation expectations for developing countries, and eventually for the United States and Europe, to carry global inflation back to modest gains in a range of 2 to 2.5 percent.

On the downside, domestic demand could be lackluster, mitigating chances of demand pull elements of inflation. The view for commodity prices is for decline or small positive changes in these years, meaning that base effects of high international prices will fall "out of calculation" for headline inflation. In contrast, the potential for faster growth in the United States-; for headwinds from the oil markets-; and for a new flight to quality once the intensity of the global crisis subsides are "real" risks to the upside for inflation.

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Recent developments in financial markets

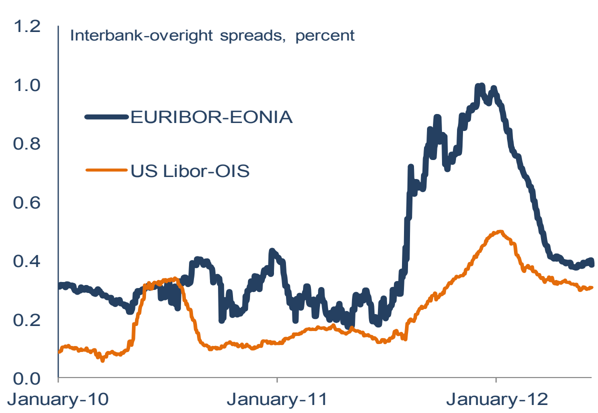
After several months of heightened uncertainty, conditions in financial markets improved significantly during the first four months of 2012. Relatively positive news on the real side outside Europe and ECB intervention contributed to a marked improvement in market sentiment. The spreads and credit default swap rates paid on the sovereign debt of high-income and developing countries declined markedly, with CDS rates in non-European high-income and many developing countries returning to close to their July 2011 levels (see discussion and figure 3 in the main text).

Funding pressures on European banks have been eased thanks in part to the ECB's long-term refinancing operations (LTRO) in late December and end-February. The €1 trillion LTRO operations have boosted confidence in the interbank market and lowered the Euribor-Eonia spread—a gauge of European banks' willingness to lend to each other in the unsecured interbank market (figure FIN.1). US interbank spreads have narrowed supported by the results of US banks' stress test. Despite improvements, spreads for both markets are still well above pre-crisis levels (historical levels for these spreads are around 10 basis points, versus 30 basis points currently), suggesting that banks still face funding gaps.

The decline in global risk aversion during these months also led to equity market rebounds with global equity markets regaining almost all the losses incurred during the second half of 2011 By late March, stock market volatility (proxied by the VIX index) dropped to the lowest level since 2007, plunging 64 percent between October 2011 and March 2012.

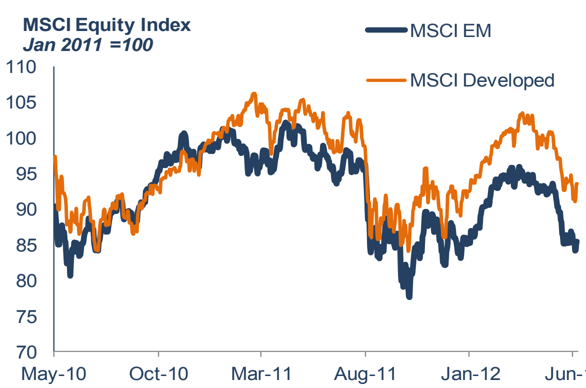
Tension returned to the markets during the first week of May. Market sentiment took a turn for the worse driven by election outcomes, renewed concerns about the health of the European banking sector and discussions about Greece leaving the Euro Area. Since the beginning of May, emerging equity markets (as measured by the MSCI index) dropped 7.4 percent reversing most of the 9.3 percent gain of the first four months of the year (figure FIN.2). All developing regions experienced price declines—although these were much more marked (around 9.1 percent) in Eastern Europe, with the largest drop in Russia. Developed country equity markets also fell by 6.7 percent since May after 8.6 percent gain earlier in the year.

Figure FIN.1 Funding pressures for European banks have eased in wake of LTORs



Source: Bloomberg. Last observation is June 7th.

Figure FIN.2 Global equity markets lost almost all of their earlier gains in May 2012



Source: Bloomberg. Last observation is June 7th

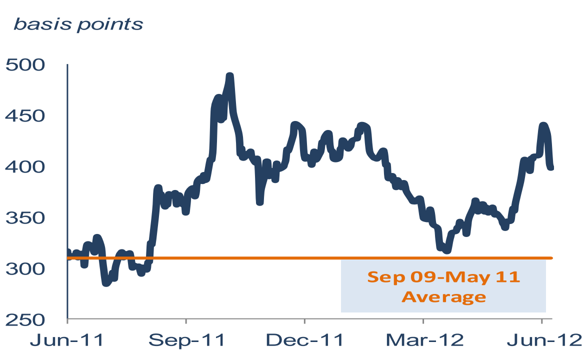
The increased market volatility accelerated outflows from Emerging Market (EM) equity funds that started in mid-April. Outflows totaled $7.2 billion since April. While EM fixed income funds have been more resilient, they posted outflows during the last two weeks of May. Despite the recent withdrawals, investors have put $14.2 billion into the EM bond funds, with most inflows going into hard-currency debt.

Developing country sovereign bond spreads have also started to widen after falling to long-term average rate in March. In tandem with the decline in global risk aversion, developing-country sovereign bond spreads narrowed by 165 bps to 316 bps—close to the long-term average of 310 bps—in mid-March down from 481 bps in October 2011 (figure FIN.3).

After a temporary jump in March, spreads widened again reaching to 422 bps in May—to their January 2012 levels. Spreads narrowed slightly to 398 bps by the first week of June reflecting the easing in risk-aversion following the announced extension of ECB's short-term lending operations as well as positive Spanish bond auction.

Implied developing country bond yields fell to 5.4 percent in April for the first time since November 2010 and remained low despite the recent widening in the emerging market spreads as US treasury rates declined (figure FIN.4).

Figure FIN.3 EMBIG Sovereign Bond Spreads

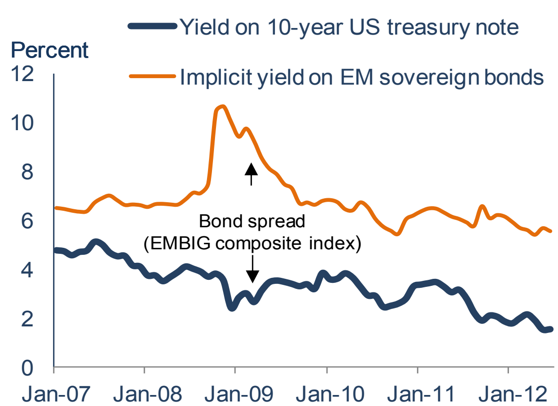


Source: JP Morgan. Last observation is June 7th.

After increasing steadily during the first four months of the year, gross capital flows to developing countries declined in May. Gross capital flows (international bond issuance, cross-border syndicated bank loans and equity placements) to developing countries totaled $184 billion during the first five months of 2012, down 22 percent compared to the like period in 2011 (figure FIN.5). Most of the decline was in bank lending and equity issuance, which fell 38 percent and 36 percent respectively, while bond issuance stood just 2.8 percent below last year's levels.

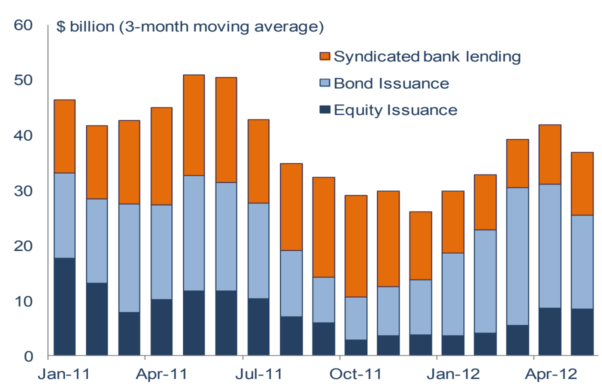
Gross capital flows actually increased steadily during the first four months of the year supported by a record level of bond issuance,

Figure FIN4. Implicit yield on EM sovereign bonds



Source: JP Morgan and Bloomberg.

Figure FIN.5 Gross capital flows to developing countries



Source: Dealogic, World Bank. Last observation is May.

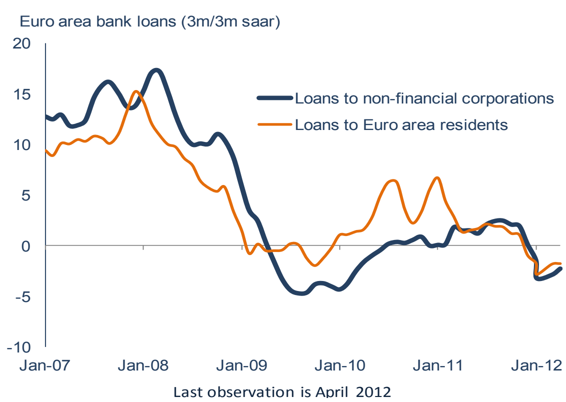
which reached a historic high of $94.4 billion. The boom reflected both a decline in investor risk aversion, but also a desire by borrowers (mainly state-owned resource firms in Latin America) to compensate for reduced bank-lending. Corporate issuers accounted for about 62 percent of total issuance. The biggest corporate issuers were oil & gas and financial companies, with about $28.6 billion of combined bond issuance, including a record (for developing country firms) $7 billion bond offering by Brazilian oil company Petrobras in February. Bond issuance totaled only $7 billion in May partly reflecting increased market volatility and higher cost—making its year to date value $101.7 billion.

Contrary to bond flows, equity issuance by- and syndicated bank-lending to- developing countries declined sharply in 2012. Equity placements (a combination of IPOs and follow-on issuance) by developing countries remained relatively subdued since summer 2011 but slightly picked up in April due to strong activity in China and Brazil. Following the weak May issuance, total equity issuance reached only $33.2 billion during the first five months of 2012, 36 percent lower than the same period in 2011. Syndicated bank lending fell off sharply totaling only $49.5 billion, only two-thirds of the 2011 level for the same period partly reflecting banking-sector deleveraging in high-income Europe.

Deleveraging by the European banks has intensified since the second half of 2011. Pressure on European banks to deleverage intensified in the second half of 2011 following increased funding pressures and regulatory requirements. Rising funding costs, increased counter-party risk assessments, deteriorating bank-asset-quality (notably that of sovereign bond holdings), and growing concerns over the adequacy of capitalization, all contributed toward a deleveraging trend among European banks in the second half of 2011. Those pressures intensified in October 2011 when the European Banking Authority (EBA) required banks to mark-to-market (to the September 2011 market-value) their sovereign bond holdings and raise capital ratios to 9 percent by June 2012. EBA estimates suggest that banks needed an additional €115 billion of capital to fulfill these requirements. While most banks indicated that they would meet these objectives without reduced lending, credit growth in the Euro Area eased noticeably, and actually began to fall at a 2.3 percent annualized pace during the three months ending April 2012 (figure FIN.6).

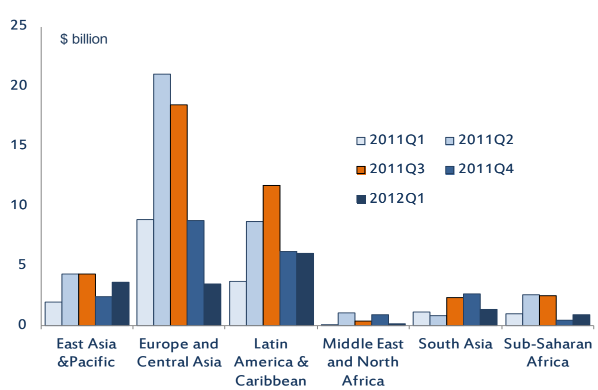
European banking-sector deleveraging has also cut into trade finance flows. European banks play a pivotal role in the provision of global trade finance, and their funding problems, in particular dollar liquidity constraints, negatively affected the availability and pricing of trade finance in 2011Q4. Anecdotal evidence shows that lenders from other regions (mainly Asian

Figure FIN.6 Euro area lending: weak and weakening



Source: Datastream, World Bank

Figure FIN.7 Recovery of trade finance flows to developing countries is mixed

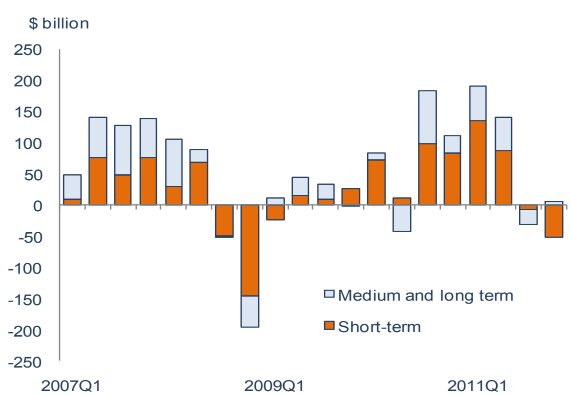


Source: Dealogic, World Bank.

financial institutions) partly filled the funding gap. Funding shortfalls have been sharpest for SME trading companies, especially from lower-volume IDA countries, partly because higher risk ratings under Basel III rules make these investments less attractive than earlier. The WBG has increased its support to trade finance in low income countries, through the IFC's Global Trade Finance Program, and a recently launched program to support commodity traders from low income countries.

The sharp decline in global syndicated bank lending for trade finance purposes in 2012 Q1 indicates that the market was still under stress in early 2012 (figure FIN.7). The year-on-year volumes declined by 20 percent, with the largest falls in Europe (includes both high-income and developing European economies). Europe had been hardest hit with Q1 2012 flows well below the levels observed even in Q4 2011, when European trade activity was falling at a 17 percent annualized pace. In developing regions the story is mixed. In East Asia and Latin America the data show some pick up perhaps reflecting entry of regional banks into the trade finance arena, and in the Middle East the dissipation of some of the turmoil associated with political change in North Africa has supported flows. Trade finance flows to Africa are slightly up, however in South Asia which witnessed a sharper Q4 2012 trade contraction, flows remain down. A recent ICC-IMF survey suggests a net improvement in the outlook for trade finance to developing regions for 2012. In fact, preliminary data for April and May indicate that global syndicated bank lending for trade finance increased significantly in Europe and Central Asia—especially to Turkey—reflecting recovery in trade in the region.

Figure FIN.8 Change in international short- and medium&long-term claims by BIS banks in developing countries



Source: Bank for International Settlements, World Bank.

The impact of deleveraging was also evident as international claims (earlier discussion was on only syndicated loan sector) by BIS banks in developing countries declined sharply in the second half of 2011. International claims—including all the cross-border claims and local claims in foreign currency—by Bank for International Settlements (BIS) reporting banks declined by $78 billion (3.3 percent) from July to December in 2011 (figure FIN.8). The impact was much sharper in developed countries as the claims by BIS banks fell by $1.7 trillion (10 percent) during the same period. Among developing regions, the impact was the highest in the Middle East and North Africa, Eastern Europe and Central Asia and East Asia and Pacific regions, where cross-border claims dropped by $7.9 billion (13 percent), $32.6 billion (6 percent) and $37 billion (5 percent), respectively. Other regions were hit less hard, falling slightly or remaining the same. Among individual countries the sharpest value declines were in China, Malaysia, Turkey and Brazil with $18 billion (3.5 percent), $12 billion (17 percent), $10 billion (7.8 percent) and $8 billion (3.4percent) declines in international claims in 2011H2.

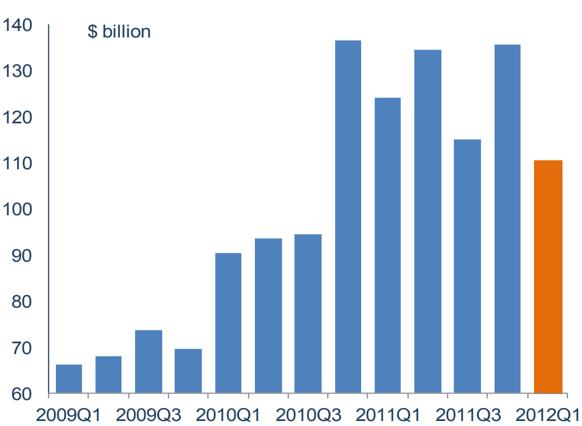
The largest decline in international claims was in short-term debt (debt with an original maturity of one year or less) confirming the tension in trade financing. Short-term debt in developing countries—mostly trade finance—declined significantly by $58 billion (5 percent) in the second half of 2011 totaling $1.1 trillion after the sharp increase in the first part of the year.

While the accelerated phase of deleveraging by European banks may have passed, deleveraging pressures are expected to continue to be felt for years to come. The speed of deleveraging is expected to slow (many banks have announced that they have already reaching new required capital ratios and restored their balance sheets), but regulatory reform is ongoing and will likely require further efforts. Beginning in 2013, banks will start operating under Basel III, with a range of provisions being gradually phased in through 2019—implying continued tightening of conditions. A number of European regulators have proposed to introduce capital requirements that are more stringent than the Basel III minimum and which kick in earlier. Regulations are not the only reason that banks have been selling assets and certain lines of business. Several banks are revising their business models. Several Spanish and French banks have shed specific assets, even though they had no shortfall of regulatory capital. Several market reports estimate overall asset disposal by European banks over the coming years will be in the range of €0.5-3 trillion.

Foreign direct investment (FDI) inflows remained relatively stable throughout 2011, but declined in the first quarter of 2012

FDI inflows rose by an estimated 23 percent in nominal terms reaching $624 billion (2.7 percent of GDP) in 2011 (figure FIN.9). FDI inflows remained strong throughout the year with a slight decrease in the third quarter. The largest increase was in the South Asia region —mainly in India, where FDI inflows almost doubled due to large deals in oil and gas sectors. The Middle East and East Africa was the only region where FDI declined, due to disruptions caused by the Arab Awakening. Increase in FDI inflows in 2011 partly reflects the pick-up in M&A activity as a result of consolidation in many sectors. As in previous years, reinvested earnings accounted for around one-third of FDI inflows in 2011.

Figure FIN.9 FDI inflows in selected developing countries



Source: World Bank staff estimates based on data from central banks. Note: Countries include Brazil, Bulgaria, Chile, China, India, Indonesia, Kazakhstan, Malaysia, Mexico, Pakistan, Romania, Russia, Serbia, Thailand, Turkey, Ukraine and Venezuela.

That said FDI inflows are expected to fall in 2012 as the heightened uncertainty of the second half of 2011 seems to have started to cut into medium to long-term investments. FDI inflows to selected developing countries with high frequency data declined by 14 percent in the first quarter of 2012 (figure FIN.9). Similarly, global cross-border M&A activity in first quarter of 2012 declined by 36 percent compared to the first quarter of 2011.

International capital flows to low-income economies

Low-income countries have weathered the recent financial crises better than middle income countries in terms of private capital inflows. Private capital flows to low-income countries (LICs) have remained relatively stable compared to flows to middle-income economies (MICs) despite increased global financial market volatility over the past three years. After the 2008 crisis, private capital flows to LICs declined by 20 percent compared with 30 percent in MICs. In 2011 they actually increased by an estimated 15 percent versus a 10 percent decline in MICs. The relative resilience of flows to LICs mainly reflects the high share of FDI (a more stable source of flows) in total flows. FDI to LICs was supported by increased South-South FDI and resource-related investments.

FDI compensated for the sharp contraction in short-term debt, mainly trade finance, which reversed from a $1 billion inflow in 2008 to net $1 billion outflow in 2009. Similar contraction was also experienced by middle income countries in 2009, mainly associated with the significant fall in trade. Interestingly, private debt flows from China compensated for the fall in debt flows to LICs from other sources for economies such as Ethiopia. Most LICs have no access to international bond markets and receive very limited portfolio equity flow.

On-going debt problem among high-income countries has started to affect LICs through aid flows that fell in 2011 for the first time in more than a decade. Net overseas development assistance (ODA) has been a stable source of development financing for the poor economies with limited or no-access to international capital markets. ODA flows fell in 2011 for the first time in more than a decade. According to an OECD report, net ODA flows were $133.5bn in 2011, 2.7 per cent less in real terms compared with a year earlier. This reverses the rising aid trend since 1997.[1]

The cut in the overall aid budget reflects a reduction in bilateral aid, particularly steep among some European countries (a 39 percent fall in the case of Greece and 33 percent fall from Spain).

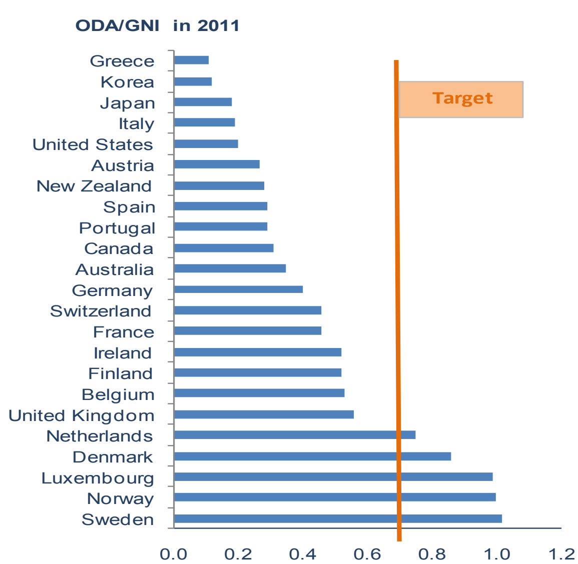
In 2011, aid flows increased to North Africa in response to the Arab uprising, while funds to Sub-Saharan Africa and other poor countries declined. The outlook for aid looks gloomy as many high-income countries continue to struggle with fiscal sustainability and it is unlikely that they will be able to meet their Monterrey targets of providing 0.7 per cent of their national income in ODA—except in a few instances. For 2012, bilateral flows are expected to remain flat at best. Aid channeled through multilateral agencies might increase based on earlier commitments (figure FIN.10).

The heightened uncertainty of 2011 is expected to reduce FDI flows slightly in 2012, which might pose challenges for investment in the face of projected declines in Official Development Assistance flows.

Prospects: Short-term adjustment, medium-term expansion

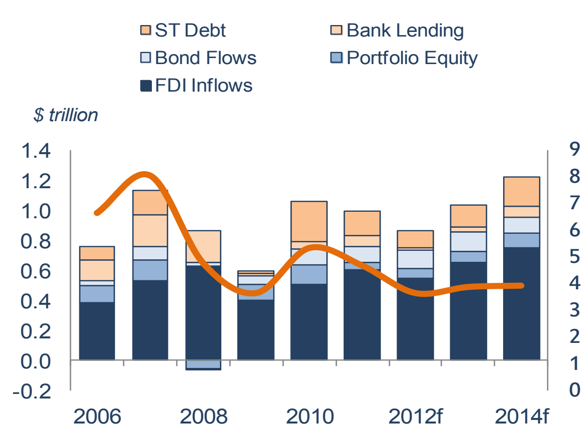
Despite increased volatility in international financial markets, medium-term prospects remain strong for developing countries, as conditions that underpin capital flows to developing countries are strong. The risk profile of emerging markets continues to improve compared with high-income countries—suggesting that they will continue to attract a growing share of international capital flows. Flows are also likely to be attracted by higher growth prospects[2] and risk-adjusted interest rates as the stance of monetary policy in developing

Figure FIN.10 Overseas development assistance



Source: OECD.

Figure FIN.11 Capital flows to developing countries



Source: World Bank.

Table FIN.1 Net capital flows to developing countries ($billions)

	2008	2009	2010	2011e	2012f	2013f	2014f
Current account balance	410.2	243.3	185.9	97.8	109.7	94.9	63.1
Capital Inflows	830.9	674.2	1131.2	1038.5	818.1	994.8	1198.1
Private inflows, net	801.4	593.7	1059.9	989.0	775.4	953.2	1152.1
Equity Inflows, net	570.7	508.7	634.1	649.1	533.6	647.0	774.9
FDI inflows	624.1	400.0	506.1	624.6	517.7	593.6	684.9
Portfolio equity inflows	-53.4	108.8	128.4	24.5	15.9	53.4	90.0
Private creditors, net	230.6	85.0	425.8	339.9	241.8	306.2	377.2
Bonds	26.7	51.1	111.4	109.1	113.8	119.8	108.6
Banks	213.1	20.2	44.3	67.1	15.1	40.3	66.9
Short-term debt flows	-4.4	14.7	268.5	163.2	115.0	145.0	200.0
Other private	-4.8	-1.1	1.6	0.5	-2.1	1.1	1.7
Offical inflows, net	29.5	80.5	71.2	49.5	42.7	41.6	46.0
World Bank	7.2	18.3	22.4	12.0			
IMF	10.8	26.8	13.8	8.0			
Other official	11.5	35.4	35.0	29.5			
Capital Outflows/a	-311.7	-168.8	-291.1	-369.1	-387.0	-372.0	-417.0
FDI outflows	-214.5	-148.2	-217.2	-238.1	-220.0	-250.0	-300.0
Portfolio equity outflows	-19.8	-65.6	-24.3	-40	-45.0	-50.0	-57.0
Private debt outflows	-78.3	50.7	-57.3	-81.0	-110.0	-65.0	-54.0
Other outflows	1.0	-5.7	7.7	-10.0	-12.0	-7.0	-6.0
Net Capital Flows (Inflows+Outflows)	519.2	505.5	840.0	669.4	431.1	622.8	781.1
Net Unidentified Flows/a	-109.0	-262.2	-654.2	-571.6	-321.4	-527.9	-718.0

Source: The World Bank, Note: e = estimate, f = forecast.
/a Combination of errors and omissions, unidentified capital inflows to and outflows from developing countries.

countries is expected to remain significantly tighter than in high-income countries.

Taken together, and assuming that ongoing uncertainty will gradually recede toward the end of the year, private capital flows to developing countries are projected to ease in 2012, before strengthening in 2013 (figure FIN.11, table 1). Net private debt flows (incoming disbursements less principal repayments) and net equity inflows (FDI and portfolio inflows), are projected to remain at $775 billion in 2012, before jumping to $1.2 trillion in 2014 around 3.7 percent of developing country GDP (figure).

All private capital flows except bond flows are expected to contract in 2012. FDI is projected to fall in 2012 after a strong rebound last year as it has been restrained by the heightened uncertainty in the global economy since the summer of 2011. FDI flows tend to respond to these types of uncertainties with a time-lag because of a longer time horizon between the decision and the actualization of the investment. Medium and long-term bank-lending is also expected to remain below its historically low level as on-going deleveraging and tighter regulations will continue to limit lending to developing countries.

By 2013, total flows are projected to increase, may be to a lesser degree in bond issuance, as firms no longer need to compensate to the same degree for strengthening bank lending picks. By 2014, if high-income countries start to shift toward tighter policy, longer-term interest rates may begin to rise—raising the cost of capital for developing countries and likely weakening portfolio investment flows, in particular those attracted by interest-rate differentials. Nevertheless, the strong growth fundamentals and improving risk profile should continue to attract other types of capital flows to the developing world compensating for decline in volatile capital flows.

Despite the slight easing in 2012 and gradual improvement projected in the baseline, significant risks remain in the short-term, which have been accentuated by the recent developments. First and foremost, further deterioration of the European debt crisis or a prolonged period of heightened market nervousness would likely reduce flows (compared with the baseline) in the latter case and could prompt broad-based risk-aversion in global financial markets driving capital flows toward safe-haven assets leading to a sharp reversal in capital flows to developing countries in the former case. The possibility of such an event has increased following the events of May. As discussed in detail in the January 2012 edition of *Global Economic Prospects*, developing countries with relatively high private debt levels and current account deficits would be most vulnerable to such a generalized tightening of financial conditions. In addition, countries that have attracted significant level of hot money flows would likely be hit sharply as these are among the kinds of flows that tend to reverse rapidly in times of acute market unease.

Another risk is the acceleration of deleveraging by European banks. While the on-going deleveraging process has been orderly so far, cross-border implications might be more significant if it starts to accelerate and becomes more abrupt in reaction to possible deterioration of the European debt crisis and/or earlier and rapid implementation of tougher capital requirements. The recent developments in Greece have put enormous pressure on an already stressed Euro-area banking system. Deleveraging by Greek-owned banks is likely to accelerate, with possible spill-over effects to other Euro-area banks.

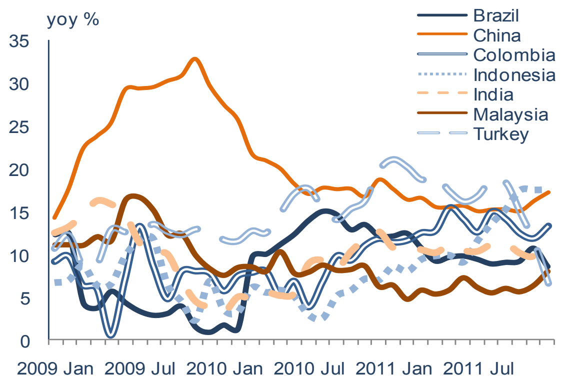
In the case of a more-accelerated deleveraging, policy coordination will be crucial to restore confidence. In this context, the second Vienna Initiative of March 2012, like the earlier one in the wake of the 2008/9 crisis seeks to reduce the likelihood of a disruptive transmission of such a crisis to the financial systems of developing Europe and Central Asia by bolstering cross border supervisory and fiscal cooperation between home-host authorities. However, the second Vienna Initiative might be less effective compared to the initial one as the health of parent banks' balance sheet is now weaker, and many of the sovereigns of the banks have limited ability to recapitalize their banks.

Medium-term considerations

Overall international debt will be less abundant and more expensive in coming years with considerable real-side effects for developing countries. In the medium-term, emerging market yields are expected to increase amid expected policy tightening in high-income countries. Spreads for developing countries might also widen, as the trend decline in risk premiums partly reflects the very low policy rates and quantitative easing in high-income countries. These easy monetary conditions have suppressed the price of risk in both developed and developing countries, and prompted a search for yield similar to that observed in the pre-crisis period. Policy tightening in high-income countries together with on-going banking sector deleveraging limiting the availability of funding, will put upward pressure on cost of cross-border financing in coming years.

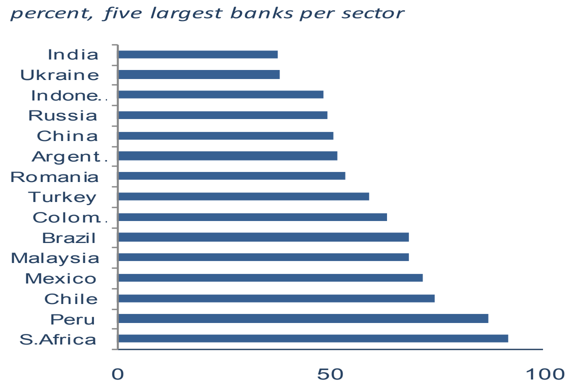
Higher capital costs and less abundant capital are likely to cause firms to invest less, which will reduce the amount of capital employed in the economy. During the transition period from a high capital usage regime to a lower capital usage regime, potential growth rate will slow. Global Economic Prospects 2010 estimated that the substitution away from capital intensive techniques could reduce potential output in developing countries during the medium term by between 3 and 5 percent and potentially by as much as 8 percent—depending on how much long-term interest rates rise. Developing countries can mitigate the costs of a tightening of global financial conditions through strengthening regional and domestic institutions. Improvements in the policies and institutions

Figure FIN.12 Real domestic growth in selected economies



Source: IMF and World Bank.

Figure FIN.13 Emerging markets banking concentration



Source: Fitch Ratings.

governing the financial sector can thus have a significant impact on domestic borrowing and capital costs in developing countries.

After strong credit growth for many years, anticipated slower growth might underscore the idiosyncratic vulnerabilities in banking sectors among other developing countries. Given rapid credit expansion in recent years, commercial banks could see a marked deterioration in loan performance in the face of slowing growth (figure FIN.12). Although non-performing loans (NPLs) remain low in most developing regions-except Eastern Europe and Central Asia so far, they could shoot up in the event of a sharp slowdown in growth. In some cases, the data do not fully reflect the vulnerabilities of banking system in developing countries. For example, while the NPL ratio for China was only 1.1 percent in 2010 despite rapid credit growth since 2009, signs of pressure continue to emerge in the Chinese financial system as the first quarter's bad loan figures have shown a significant rise for the third largest Chinese bank. In addition, Chinese state banks have large exposures to local government debt which in the context of a slowing of global activity could go into default, threatening the solvency of some banks. Similarly, Vietnam's banks have become burdened with rising bad debts after years of credit growth, much of which was channeled to state-owned companies. The NPL ratio rose from 2.1 percent in 2010 to 3.4 percent last year, according to official data, but the real level of bad debt is believed to be 2-3 times higher if measured by global standards.

In recent months, a number of developing country banks were downgraded or have been put under watch by one of three major rating agencies. In some cases, subsidiaries and branches were downgraded because of their weakened parent institutions. In others the underlying factors for the rating actions were stated as economic slowdown, weakening in asset quality and increased pressures on banks' profitability. Bank rating actions occurred in Brazil, Chile, Argentina, Russia, and Bulgaria. These individual bank downgrades may be particularly important for certain countries where banking systems are highly concentrated in few banks (figure FIN.13).

Notes:

1. Aid flows excluding one-off debt.
2. Developing countries growth (between 5 and 6%) is projected to be more than twice as fast as in developed countries (around 2%) over the medium-term.

Trade Annex

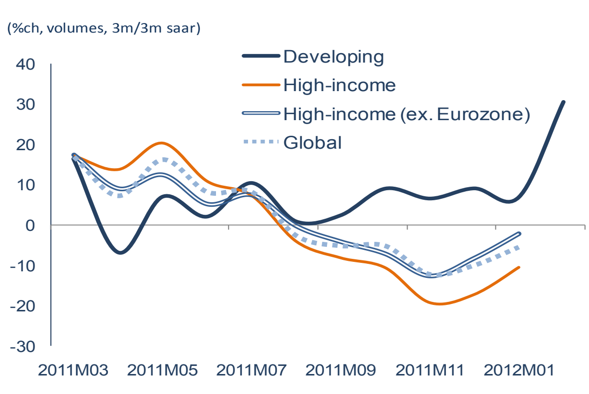
Recent Developments

Recent financial market tensions in the Euro Area threaten to curtail the strong rebound in global trade that occurred in Q1.

Heightened global uncertainty during the second half of last year, disruptions to regional supply chains from the floods in Thailand, lingering effects of the earthquake and tsunami in Japan, and policy tightening in some large developing countries combined to significantly reduce global demand in Q4 2011 – resulting in the sharpest contraction in global merchandise trade seen since June 2009. In contrast with global industrial production, which continued expanding albeit it at a much reduced rate in Q4 2011, global trade fell at a 9.5 percent annualized pace in 2011Q4, reflecting among other things rapidly falling European import demand.

Since then merchandise trade flows have accelerated sharply – boosted by strengthening domestic demand in the United States, a relaxation of monetary policy in large middle-income countries, and easing of financial market tensions in early 2012. Indeed, global trade was expanding at an above historical average of 14.4 percent in the three months ending in March (figure Trade.1).

Figure Trade.1 Global trade begins to pick up after recent deceleration



Source: Thomson datastream and World Bank .

The effects of the recent resurgence of financial market tensions in the Euro Area on global trade flows remain uncertain. Trade data still lags the more recent financial side data. It is however most likely having a dampening effect on Q2 2012 global trade, as some pull back on business investment and drawing down of inventory levels is expected in this environment of heightened uncertainty. However, the slowing down of trade is less likely to be as steep as was observed in Q4 2011, as risk levels remain less elevated than they were late last year (see main text).

Performance across regions however differs

Partly reflecting differences in the relative strength of domestic demand across countries, import performance has diverged across major trading blocs.

An escalation of Euro Area sovereign debt concerns in Q2 2012 is likely to have dampened import demand, not withstanding the rebound in Q1 2012, following the steep contraction in the latter half of 2011. Ongoing fiscal consolidation, rising unemployment and tight credit conditions continue to weigh down demand in Europe. And with intra-European Union (EU) trade being about twice the size of extra-EU trade, the recessionary environment in the Eurozone weighed heavily on trade outturns such that by Q4 2011 trade was contracting at close to levels last seen during the great recession in 2009. With the European Union being the largest trading bloc, this sharp contraction was the principal contributor to the decline in global trade, deducting between 5-10 percentage points each month from global trade growth between September 2011 and January 2012. The relaxation of financial market tensions, thanks to the intervention by the European Central Bank's

Long Term Refinancing Operation, supported the pick up economic activity including Euro Area import demand, which was rising at a 8.2 percent annualized pace during the three months ending March 2012.

However, given a resurgence in financial market tensions in the Euro Area since April and with business and consumer confidence in the Euro Area slumping to a two-and-a-half year low and business surveys showing activity at near three-year lows, import demand in Q2 2012 is likely to be much weaker than Q1 2012.

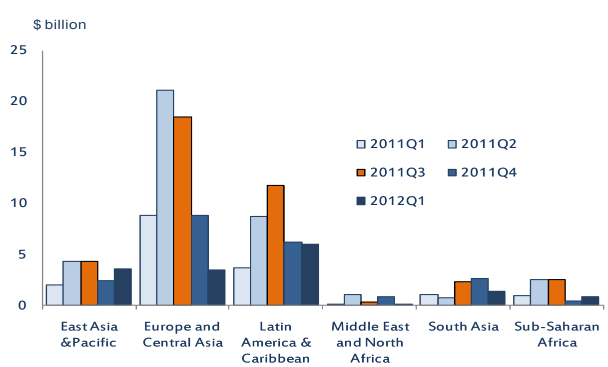
Among other high-income countries, signs of recovery are more robust. In the United States, where the labor market has been recently strengthening with 1.2 million jobs added between September 2011 and April 2012, the pace of decline in import demand was less marked than in the Eurozone during the fall of 2011. U.S. firms reacted to the heightened uncertainty in global financial markets by drawing down inventories – rather than importing through November 2011, but amid signs of strengthening in the US economy toward the end of the year, import demand picked up once again as firms sought to restore inventories to more normal levels. During the three months ending March 2012 U.S. import demand was expanding at an 18-month high 17.6 percent annualized pace. However, unlike the Euro Area where surveys carried out in Q2 2012 show the plummeting of economic confidence and business activity, the US economy has thus far remained resilient. Confidence is hovering around a four-year high and industrial activity and production continues to expand including in the beleaguered housing market where recent signs suggest a nascent private sector led recovery is underway. Consequently, US import demand is likely to continue expanding through Q2 2012.

Japan's import demand has been buffeted by last year's tsunami and earthquake as well as both regional and global uncertainties. Because its export-oriented automotive and electronics sectors are dependent on Thai-made parts Japanese imports and exports were significantly affected by the floods in Thailand, with import demand continuing to fall through January 2012 (-6.8 percent, 3m/3m saar). The normalization of production in Thailand, and strengthening US and Asian economies has supported the rebound in Japanese trade, with imports rising at 7.6 percent annualized pace through March 2012 before stagnating in April 2012 perhaps reflecting the waning influence of the bounce back from the restoration of Thai supply chains.

Box Trade.1 Trade finance for firms in developing countries appears set to firm after recent weakness.

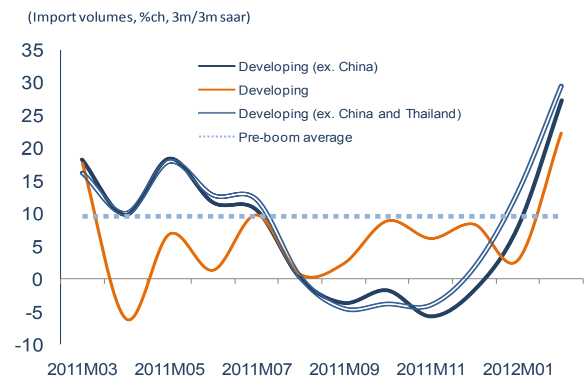
European banking-sector deleveraging cut into trade finance flows as measured by Dealogic in the second half of 2011. Europe and Central Asia faced the sharpest decline, with Q1 2012 flows well below the levels observed even in Q4 2011, when European trade activity was falling at a 17 percent annualized pace. In developing regions the story is more mixed. In East Asia the data shows some pick up perhaps reflecting entry of regional banks into the trade finance arena. In the Middle East and North Africa trade finance flows remain volatile reflecting ongoing political upheaval there. Trade finance flows to Sub-Saharan Africa are also up slightly and have held steady in Latin America. However, in South Asia, which witnessed a sharper Q4 2012 trade contraction, flows remain down. A recent ICC-IMF survey suggests an improvement in the outlook for trade finance to developing regions going forward.

Box figure Trade 1.1 Recovery of trade finance flows to developing countries is mixed



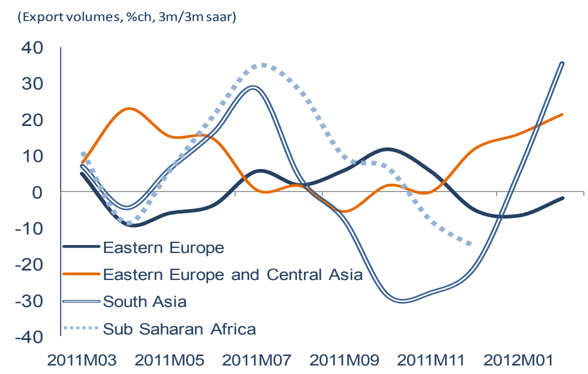
Source: Dealogic and World Bank.

Figure Trade.2 Rapid developing country imports supports recovery in global economy



Source: Thomson Datastream and World Bank

Figure Trade.3 Exports from Eastern Europe, South Asia have commenced recovering falling sharp declines



Source: Thomson Datastream and World Bank

Developing country imports demand partially mitigated the down turn in global trade in the latter half of 2011 and has since accelerated strongly through Q1 2012. Throughout the latter months of 2011 and the initial months of 2012, developing country imports, though also impacted by the events in the latter half of 2011, continued expanding. By March 2012, import demand had accelerated to a 19.7 percent annualized pace, up from 0.1 percent in September 2011 (figure trade.2). This development continued the post-crisis trend where import demand from developing countries has been the most dynamic segment of global trade. Indeed, while imports from high income countries fell by some $52.7 billion (s.a, volumes) between September and February, developing country imports rose by some $9.5 billion, helping to partially mitigate the severity of the decline in global trade.

China, which accounts for about a third of developing country GDP, was the main driver of most of the increase in developing country imports over the past few months contributing some $6.7 billion to the developing country import increase during the September to February period – this notwithstanding the lull in imports during the Lunar New Year holidays. Indeed, for each month in the fourth quarter, China was the sole large economy whose imports were accelerating rapidly at an above 30 percent pace. Excluding China, developing countries imports actually contracted in the fourth quarter (-0.7 percent), but recovered strongly to be expanding by 26.0 percent in March 2012.

Developing country exports were significantly impacted by the slowing of global demand, but exports are now rebounding. The European Union is the most important trading partner for many exporters in developing regions (Eastern Europe, South Asia, North Africa, and Sub Saharan Africa). As a result of the contraction in the Euro Area in the fourth quarter of 2011, as well as banking-sector deleveraging (which reduced access to trade finance, box trade.1) there developing countries with closer trade ties experienced significant decline in their exports. However with the stabilization of economic activity in early 2012, this therefore supported a rebound in those regions that had been earlier affected.

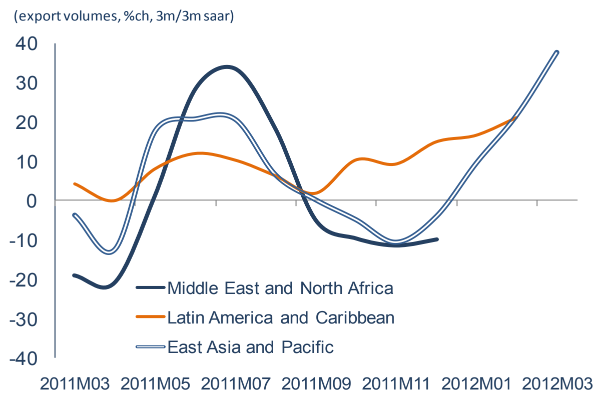
Stabilizing high-income European demand in Q1 2012 has helped the recovery in exports from **Eastern European** developing countries, many of which are part of a Customs Union with the European Union or benefit from various regional trade agreements. Indeed, in the three months ending in March exports expanded at a moderate rate of 4.5% - the highest pace in four months. With Russia and Turkey relatively less dependent on the EU than Eastern European economies, their strong export growth has driven overall exports from the **Europe and Central Asian** region to 20.5 percent pace in March 2012 (figure trade.3).

South Asia, where Europe accounts for some 27 percent of exports, was also hard hit, although policy tightening, Thai floods and a slump in Indian activity also played a role. South Asia exports dropped off precipitously in the fall, declining at a trough of –34.0 percent annualized rate during the three months ending October 2011. Most recently, they have recovered, rising at a blistering 30.9 percent pace in the three months ending March benefitting from the demand pick up elsewhere in Asia and the US and stabilization of Euro Area import demand

Data for **Sub Saharan** lags, but the latest numbers suggest that Sub-Saharan African countries were also hard hit by the slump in global import demand (about 26 percent of regional exports are destined for the EU). Exports were still contracting at a 15.3 percent pace in January 2012 (latest data). Excluding South Africa, the region's largest economy, whose exports actually expanded in Q4 2011 due to the end of labor strikes, exports in the rest of Sub Saharan Africa was contracting at an even faster 20.1 percent rate. Though March data is not yet available for most countries in the region, exports growth is expected to have recovered somewhat given the earlier improving global demand conditions. Secondly for a number of countries the coming on stream of new mineral resources should help boost export output (e.g. Sierra Leone and Mozambique) should boost output. Nonetheless, the recent bout of market tensions which has contributed to a the fall in commodity prices is likely to dampen exports in Q2 2012.

Beyond the weak demand from high-income countries, disruptions from the Arab Spring uprisings and tightening of sanctions on trading with Iran have conspired to curtail exports from the **Middle East and North Africa**. Indeed for five consecutive months through January 2012, exports were contracting. A rebound is however expected in 2012 as the situation there normalizes.

Figure Trade.4 Latin American export expanded through global slump and exports from East Asia and Pacific have recovered from supply chain interuptions



Source: Thomson Datastream and World Bank

While the decline in European demand impacted exports from **East Asia and Pacific** a confluence of other factors were also at play. The restoration of Japanese supply chains by the Q3 2011 and the subsequent expansion in Chinese import demand in Q4 was a positive for exports from other Asian economies. However, floods in Thailand disrupted electronic and some automotive supply chains in the region thus reinforcing the negative developments from weak demand outside the region. In Thailand the contraction was the sharpest among all developing countries reaching -52.7 percent in the three months to December. Excluding Thailand from the East Asia and Pacific aggregate, exports was falling at a more modest 11.2 percent pace in November. However with the normalization of Thai-linked supply chains and strengthening demand elsewhere in the global economy including within Asia (which supports intra-Asian trade) and the US, by April the acceleration in East Asian and Pacific exports had picked up to a robust 15.8 percent, the third successive month of expansion.

The Latin American and Caribbean region is the least dependent of developing regions on European import demand. As a result, its exports were least affected by the fall in European import demand and was the only developing region whose export growth remained positive during the fourth quarter, growing at an impressive 14.1 percent (figure trade.4). This robust growth has continued through 2012, with an acceleration to 16.8 percent in the three months ending in February, before slowing to 12.4% in March. Part of the resilience in exports from this region reflects a strengthening US economy which is the most important trading partner for many Central American countries. And in South America, strong demand from China boosted mineral exports from the sub-region.

Medium term outlook

Going forward global trade is expected to continue expanding, but annual growth rates will remain well below historical standards in 2012. Given the steady improvement in global activity that underpins the baseline scenario (see main text), including a return to modest growth in the European Union in the course of the second half of 2012 (even though annual growth will be negative), strengthening recoveries in the United States and Japan, global trade is projected to slowly pick up pace. However, with developing countries contributing some 50% of the increase in global trade since 2009, global trade outcomes will also be dependent on developments in developing countries. Though developing country cyclical trends are coupled with that of developed countries their trend growth is decoupled. GDP growth in developing countries is projected at more than twice that of developed countries hence developing country trade is expected to continue to serve as the most dynamic engine of global trade growth over the forecast horizon.

Overall, global trade is projected to expand at a subdued 5.2 percent in 2012 rising to 7.0 percent and 7.7 percent in 2013 and 2014 respectively. As discussed in the main text, the weak annual number for 2012 reflects an unusually weak carryover for 2012 due to very weak trade growth in the second half of 2011. Within the year, quarterly growth rates are expected to be much higher – ending year at rates close to 7 percent .

Even with the rebound in the outer years of the forecast above the historical average of 6.8 percent, global trade will remain significantly below trend levels had the 2008/09 recession not occurred.

Risks

Risks to global trade prospects remain weighted on the downside. The projected expansion in global trade is by no means guaranteed. Indeed, the recovery in the global economy remains fragile and vulnerable to significant downside risks (see main text), all of which could dampen future global demand and trade prospects. In the event of a slower growth outturn than envisaged, due to a further unraveling of the Euro Area debt situation than considered under our baseline assumptions, global trade is most likely to be one of the biggest casualties on the real economy .

The risks of weaker outturns in high-income countries remains rather elevated with knock-on effects to developing countries. Simulations conducted on the World Bank's macroeconometric model indicates that for every 1 percentage point decline in income in high-income countries, developing country exports may fall by 2.2 percent, while output in developing countries is likely to decline by about 0.8 percent.

Another risk to global trade expansion that has gained prominence in recent years is a disruption to a global or regional supply chain network. Given the vertically integrated nature of many supply chains involving firms from multiple countries and the just-in-time inventory management systems employed, risks of disruptions to trade are no longer limited to the shores of a single country. Disruptions to production in even a "small country" that is the dominant producer of a critical component in a supply chain implies production in the rest of the chain will also decline, thus amplifying the effects of initial production disruption to other countries. Countries in East Asia, Europe and North America remain the most susceptible as regional supply chains there are more advanced.

In 2011, this was demonstrated in both the Tohoku disaster in Japan as well as the floods in Thailand. The rising importance of production networks could also help account for the rising sensitivity of trade flows to changes in global GDP. For instance, Freund (2009) finds a monotonic increase in the sensitivity of world trade to global GDP changes over successive decades: it has risen from 1.94 in 1960 to 3.69 in the 2000's. As a result, while a 1 percent drop in global income would have led to a 1.9 percent drop in world trade, today this same identical percentage drop in GDP will lead to almost a two percentage point higher drop in global trade than would have been the case in 1960.

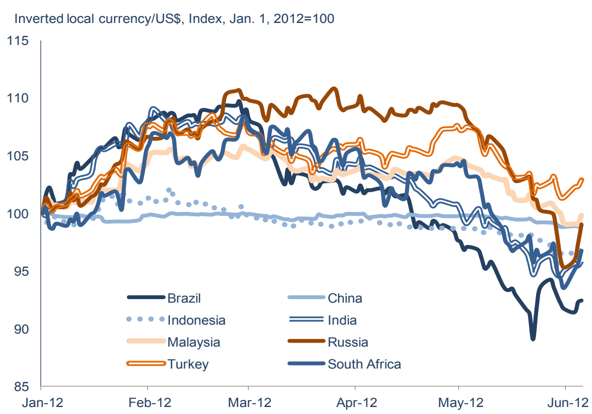
Exchange Rates

Recent developments

In the year to the first week of June, the US dollar strengthened from 1.44 to 1.25 per euro, with the bulk of the appreciation occurring post July 2011 as the nominal (and real) trade weighted US dollar appreciated by 6 percent, largely reflecting the US dollar's safe-haven status at the onset of the Euro Area crisis and the flight to quality that ensued. To a large extent, these developments have also been mirrored in emerging market currencies as developments in the US dollar continues to be a major determinant of both the value and volatility of emerging market currencies. But it is important to realize that in spite of the US dollar's safe haven status, the average real trade weighted emerging market currency has been less volatile than the real US dollar trade weighted exchange rate almost 70 percent of the time over the last 10 years (figure ExR.1).[1]

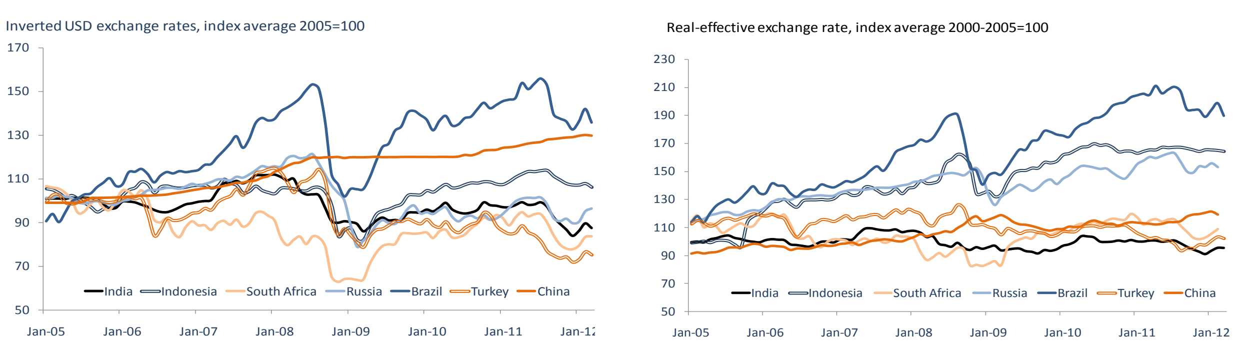
Even so, and despite the improvement in developing countries' relative macroeconomic fundamentals vis-à-vis the U.S., some of the larger emerging currencies still came under significant pressure at the onset of the Euro Area crisis. Likewise, partly because of the liquidity generated by very loose monetary policy in high-income countries several large financially-open emerging market countries experienced a a surge in foreign capital in early 2012 when the (partial) relaxation of tensions in high-income Europe and the stabilization of global financial markets resulted in falling investors' risk aversion. As a result, during the first two months of 2012, the trade-weighted real effective exchange rates of Brazil, Turkey, India and South Africa appreciated by 5 percent or more, while higher international commodity prices boosted the currencies of commodity exporters including Chile, Colombia and Mexico. With resumption of Euro Area uncertainties since early May and flight of private capital to safer US financial assets — and weakening of commodity prices for commodity exporting developing countries

Figure ExR.2 Generalized appreciation of US dollar relative to emerging market currencies



Source: IMF International Financial Statistics, Datastream and World Bank.

Figure ExR.1 In real-effective terms developing currencies have been much less volatile than viz-à-viz the US dollar



Source: IMF International Financial Statistics, J.P. Morgan, and World Bank.

— the US dollar again experienced a generalized appreciation with respect to emerging market currencies (figure ExR.2). Although central bank intervention in foreign exchange markets briefly halted the slide in the Brazilian real in late May, other emerging market currencies showed signs of appreciation in early June, encouraged by expectations of coordinated official actions to deal with the ailing Spanish banking sector, reduction in borrowing costs in China, and possibility of further stimulus measures. Moreover, partly in consequence of the broader appreciation of the US dollar, developing countries' currencies measured against a wider range of currencies have depreciated less in recent months than against the US dollar.

While cyclical factors have played a role, to a large extent the appreciation of the currencies of many of the larger middle-income countries during the last decade has reflected long-term fundamental factors including large changes in commodity prices, productivity differentials and in some cases domestic policy.

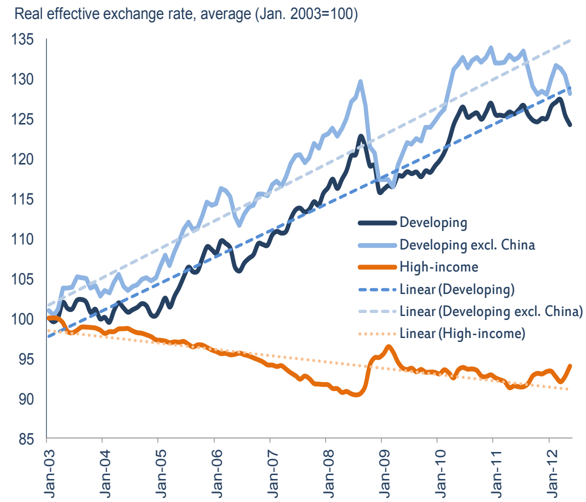
Exchange rates over the medium-term

Developing countries' real exchange rates have appreciated since 2003, with return to trend following crisis

In general, developing countries' average trade-weighted real effective exchange rates have been appreciating more or less steadily since 2003, even as high income countries' real exchange rates have depreciated (figure ExR.3). The average GDP weighted real exchange rate of developing countries (excluding China) appreciated by a cumulative 25.7 percent (26.7 percent) between 2003 and the first quarter of 2012, or by about 2.6 percent (2.7 percent) annually, in spite of significant real depreciations during the Lehman crisis in 2008 and during the Euro Area sovereign debt crisis in late 2011.

In general, the positive trend in developing countries' currencies since 2003 reflects a faster pace of growth and higher rate of productivity increases compared with high income countries.

Figure ExR.3 Developing countries' real exchange rates appreciated between 2003 and 2011



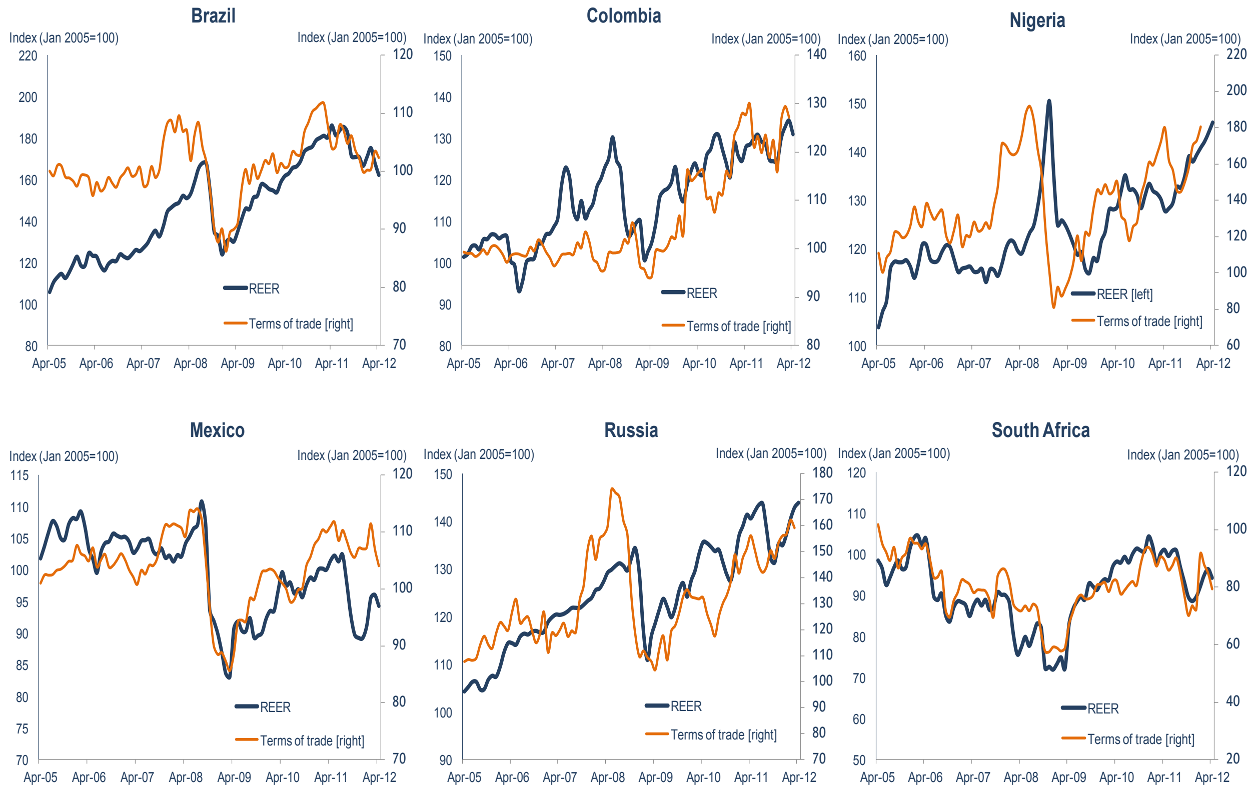
Source: IMF International Financial Statistics, J. P. Morgan, and World Bank.

Developing countries' average annual real GDP growth accelerated from 3.8 percent during 1994 -2002 to 6.4 percent over 2003-11. In the same two periods, high income countries' average growth declined from 2.8 percent to 1.6 percent. Furthermore, developing countries' total factor productivity (TFP) rose 2.2 percent annually, on average, during this period, more than double the rate of increase for high income countries. Other factors at play include improved macroeconomic management in many developing countries, higher commodity prices (in commodity exporting countries), and sustained inflows of private capital and remittances in several middle- and low-income countries. Importantly, the strong appreciation of developing country currencies after the Lehman crisis in 2008 mainly reflects a return to pre-crisis levels and trend appreciation in line with underlying fundamentals – rather than a significant deviation from earlier trends.

Rising commodity prices until April supported commodity exporting currencies

Most commodity exporting countries have experienced (often significant) gains in terms of trade as commodity prices rose sharply over the past decade. These improvements have been

Figure ExR.4 Real exchange rates of commodity exporters appreciated as their terms of trade improved with increase in international commodity prices up until April



Source: IMF International Financial Statistics, J. P. Morgan, and World Bank.

reflected to varying degrees in real exchange rates – depending on the extent to which the authorities have allowed the nominal exchange rate to appreciate (or depreciate) in response to international commodity price shocks. For instance, South Africa's flexible exchange rate regime has allowed the real exchange rate to move closely with its terms of trade, with the nominal exchange rate acting as the economy's main shock absorber and automatic stabilizer. This phenomenon was also observed to a more or lesser extent in other oil and commodity exporting countries such as Brazil, Colombia, Nigeria, Mexico and Russia (figure ExR.4).

Notwithstanding their access to commodity resources, exchange rates in these countries are not only exposed to volatile commodity markets, but this currency volatility is often exaggerated by commodity related capital flows—particularly for the larger, more open middle income commodity exporters. For instance, after experiencing a steep depreciation in the second half of 2011, Brazil's trade weighted real exchange rate appreciated 5.2 percent between December 2011 and February 2012 due to the combined effect of high commodity prices and a surge in capital inflows. But measures to stem the currency appreciation, including extension of taxes on cross-border borrowing by local firms to shorter-maturity loans, resulted in a substantial nominal and real depreciation. Real exchange rates of commodity exporters with a significant manufacturing export sector have also been influenced by developments in trade partner countries. Mexico's trade-weighted real effective exchange rate depreciated steeply during the Euro Area debt crisis in late 2011 similar to that of other financially integrated emerging markets; but it then appreciated 7.6 percent in the first quarter of 2012 as strengthening demand and better employment outturns in the U.S. (its largest trade partner) translated into improved domestic prospects.

There is a widely held perception that the exchange rates of many commodity exporting countries are extremely volatile. However, these currencies are merely reflecting the underlying volatility of commodity prices. Although adverse exchange rate movements (and volatility) are often painful to domestic industry in these countries, the (volatile) exchange rates often act as an automatic shock absorber and stabilizer.

Capital flows are an important driver of short-term movements in emerging market currencies

Capital flows continue to be a driver of short-term movements in nominal and real exchange rates. The rapid withdrawal of foreign capital during the Euro Area sovereign debt crisis from several emerging markets (including from some commodity exporters) appears to have contributed to a steep depreciation of their currencies, but the resumption of capital inflows contributed to appreciation of emerging market currencies, including those of Brazil, Turkey, and India in the first quarter of 2012.

Permanent increases in the underlying capital inflows (such as capital inflows responding to faster potential growth) to a developing country are likely to result in currency appreciation and vice versa. Apart from a once-off adjustment to the new equilibrium capital inflows, this should not raise currency volatility. When capital flows are relatively permanent in nature and are likely to contribute to increasing productivity and longer-term growth, there is little rationale for policymakers to intervene or restrict these flows.

However, when these inflows are more related to speculative "hot money" flows, the flows can be disruptive. Such hot money inflows can potentially erode competitiveness, albeit temporarily, and could give rise to credit and asset price booms. Rapid withdrawals of such flows and the resulting nominal depreciation can increase the burden of foreign currency debt on sovereign and corporate balance sheets (Ostry and others 2011).

To the extent that shorter-term currency movements are driven by (identifiable) speculative capital flows that are temporary in nature, there could be a rationale for "leaning against the wind". Some forms of controls on foreign currency capital inflows or outflows and other prudential regulations may be justified in the shorter-term to reduce excessive exchange rate volatility and to provide space for domestic manufacturers to adjust to a changing economic environment.

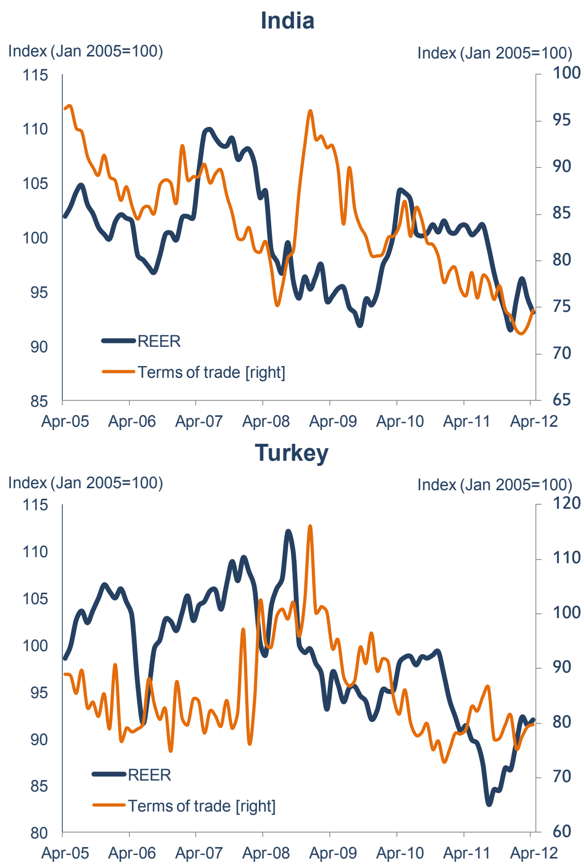
There is a risk, however, that such short-term measures may become "sticky", and over time introduce distortions in production and capital allocation decisions, thereby hurting longer-term growth prospects. Capital flow management measures should therefore be reviewed regularly, and capital controls should be adapted or reversed as destabilizing pressures abate (G20 2011). In particular, capital flow management measures should not be used to avoid or unduly delay necessary adjustments in the economy.

Commodity importing countries' real exchange rates depreciated as commodity prices rose up until April

Several net oil- and commodity-importing countries experienced terms of trade losses and real exchange rate depreciations as the increase in imported commodities prices outpaced manufacturing export prices. Real currency depreciation appears to have been more pronounced in countries with relatively weaker current account positions – which were more exposed to foreign capital, such as India and Turkey (figure ExR.5). Currencies of several net oil-importing African and South Asian countries have faced depreciation pressures due to a combination of rising burden of energy imports amid strong economic growth. For instance, Bangladesh and Pakistan have faced current account pressures and nominal depreciation due to a rising import bill from high international prices of crude oil imports and relatively weak export growth.

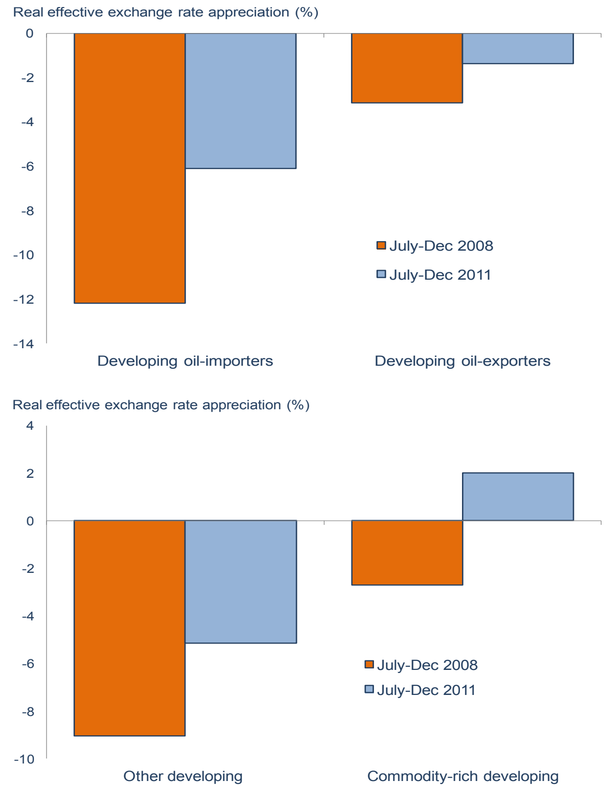
Net oil and commodity importing developing countries as a group experienced significantly

Figure ExR.5 Terms of trade losses and real exchange rate depreciation in India and Turkey



Sources: IMF International Financial Statistics, J. P. Morgan, and World Bank.

Figure ExR.6 Oil- and commodity-importing developing countries experienced larger real depreciation during recent crises



Note: Charts exclude China
Sources: IMF International Financial Statistics, J. P. Morgan, and World Bank.

larger depreciations during recent crises compared to oil exporters. The GDP weighted average real exchange rate of oil importing countries (excluding China) depreciated 12.2 percent during the second half of 2008 during the Lehman crisis in 2008 and 6.1 percent in the second half of 2011 during the Euro Area debt crisis, compared to 3.2 percent and 1.4 percent declines, respectively, for oil-exporting developing countries (figure ExR.6). Even as commodity exporters gained from high prices up until April 2012, oil importing developing countries, in particular those that are relatively open to foreign capital and have weaker current account positions, have faced renewed depreciation pressures with resumption of Euro Area tensions.

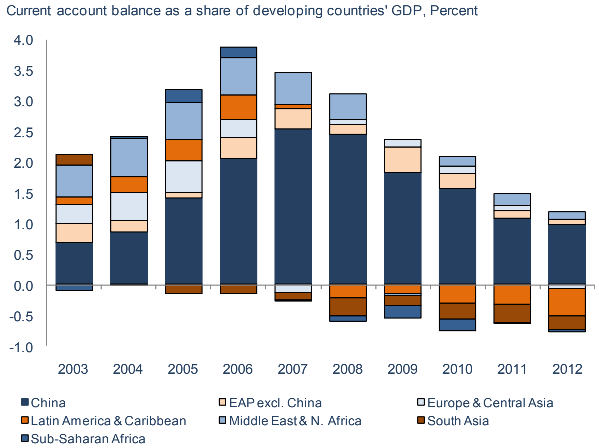
Prospects for developing countries' exchange rates

Developing countries' currencies are likely to appreciate in the longer term, but remain under pressure in the near term

Exchange rates are extremely difficult to forecast over the short run. However, in the longer term, as discussed earlier—with a relatively weak growth outlook in high income countries, continuation of improvement in developing countries' fundamentals, superior growth and total factor productivity differentials—developing countries real appreciation is expected to continue, albeit at a slower rate.

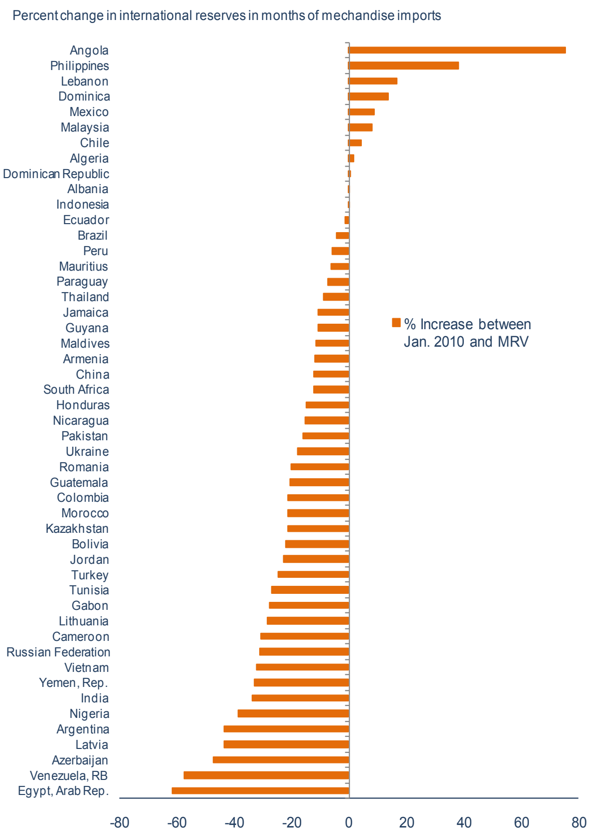
The discussion above suggests that the future path of developing countries' currencies will

Figure ExR.7 Current account surpluses have fallen and deficits widened in developing regions



Source: World Bank.

Figure ExR.8 Reserve cover has fallen in more than 80 percent of middle-income developing countries since January 2010



Note: MRV = Most recent value
Source: IMF International Financial Statistics and World Bank.

depend on capital flows, commodity prices, and most importantly, relative productivity increases. Some developing countries currencies benefited from falling risk aversion and a surge in capital inflows in early 2012, partly reversing earlier depreciation, as loose monetary policies and lower relative yields in high income countries generated renewed interest in emerging market assets.

Going forward, however, developing countries' currencies are likely to come under even greater pressure if private capital flows become more volatile in response to escalation of current Euro Area tensions, regulatory requirements influencing the pace of European banking sector deleveraging (see Finance Annex), and a continued appreciation of the US dollar with respect to emerging market currencies given its safe haven status. Commodity exporting countries' currencies gained from high international prices in early 2012, but weakening global demand and the resulting lower commodity prices are leading to depreciation pressures. On the other hand, commodity importers among developing countries could also face worsening trade and current account positions if weak global demand keeps manufacturing exports below the longer term trend. Moreover, renewed geopolitical tensions in the Strait of Hormuz could result in a spike in crude oil prices, further exacerbating strains on oil-importing countries.

Current account and trade balances of developing regions have deteriorated in recent years (figure ExR.7), in large measure due to the decline in East Asia and Pacific region's current account surplus. China's surplus fell from over 10 percent of GDP in 2007 to 2.8 percent in 2011, reflecting weakening export demand and a shift towards domestic sources of growth, which has resulted in imports growing faster than exports. In other developing regions, however, widening trade deficits and deteriorating current account balances, especially in commodity- and oil-importing countries, suggest that developing countries' exchange rates are likely to remain under strain. International reserves expressed as share of merchandise imports ("import cover") fell in 80 percent of middle-income developing countries between January 2010 and the most recent available date in 2012, by 20 percent on average (figure ExR.8). Reduced international reserves available for meeting short term obligations can increase vulnerability of developing countries to external shocks, in particular if external financing conditions were to deteriorate further and capital flows retreat.

In the longer term, real exchange rates of developing countries are likely to revert to the upward trend. Developing countries will need to learn to live with real currency appreciation and instead focus on maintaining favorable productivity trends and competitiveness. Developing countries with relatively good growth prospects will need to adapt to gradual real appreciation over the foreseeable future.

Notes

1. Using 12-month rolling standard deviations, the average real trade weighted developing country exchange rate had a lower volatility than the same measure for the US dollar 68.8 percent of the time.

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Prospects for commodity markets

After strengthening during the first quarter of 2012, most commodity prices have since retreated below their end-2011 levels (figure Comm.1). The fall of prices was particularly sharp during May as the debt crisis in Europe intensified and China's growth slowed. The World Bank's average crude oil price dropped to $92/bbl in early June, 18 percent lower than May 1st. Most metals and raw materials also fell sharply on concerns about global demand, especially in China. Food prices declined less due to tightness in edible oils and weather concerns. Part of the recent decline in commodity prices reflects the US$ appreciation which gained 6.1 percent against the euro between May 1 and June 5, and 4.5 percent against a broader index of currencies.

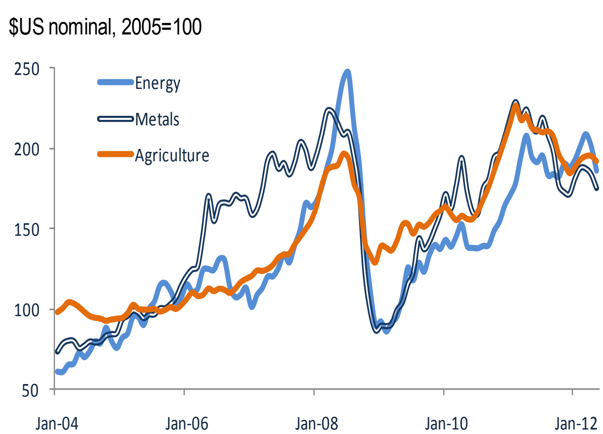
Under the baseline scenario which assumes a gradual easing of financial tensions in Europe, oil prices are expected to average 106.6/bbl in 2012, up from $104.0/bbl in 2011, assuming no further disruptions in the Middle East as OPEC continues to keep the market well supplied (table Comm.1). Metals prices are expected to decline by 11 percent in 2012 on slower demand growth and new capacity coming online. Food prices in 2012 are expected to average 3 percent lower than in 2011, assuming a normal crop year and energy prices staying at current levels. Declines are also expected in raw materials prices due to weaker demand.

There are both up- and down-side risks to the forecast. On the up-side, a deepening of political unrest in the Middle East and North Africa, or a flare up of tensions surrounding Iran, could result in further supply losses and hence higher oil prices--with potentially serious consequences for global activity (see main text). Stronger than expected demand by China could raise metals prices, while a continuation of supply constraints that has plagued the industry could further tighten markets. In view of low stock levels in some agricultural markets, food prices are likely to remain sensitive to adverse weather conditions and energy prices. On the down-side, a sharp deterioration in the global macroeconomic environment could provoke a steep decline in energy and metal prices. Food prices, however, are not likely to be affected as much since most food commodities are less sensitive to income changes than energy and metals.

Crude Oil

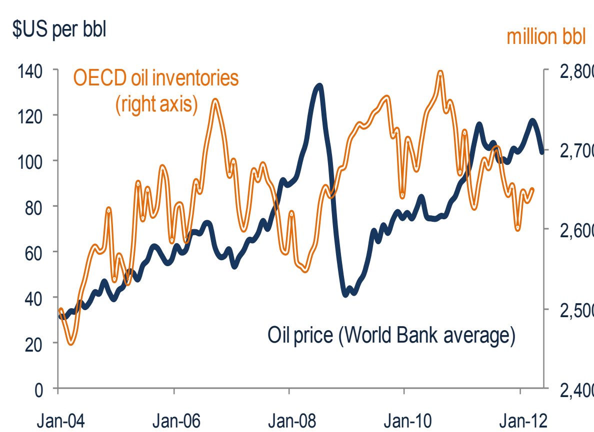
Oil prices (World Bank average) jumped from $104/bbl in 2011 to nearly $118/bbl in March before receding back to $104/bbl in May (figure Comm.2). The price increases earlier in the year occurred despite the fact that global oil demand was growing relatively slowly. World oil

Figure Comm.1 Commodity price indices



Source: World Bank

Figure Comm.2 Oil prices and OECD oil stocks



Source: IEA, World Bank.

Table Comm.1 Nominal price indices—actual and forecasts (2005 = 100)

	ACTUAL						FORECAST		CHANGE (%)	
	2006	2007	2008	2009	2010	2011	2012	2013	2011/12	2012/13
Energy	118	130	183	115	145	188	191	185	1.3	-3.0
Non-Energy	125	151	182	142	174	210	192	188	-8.5	-2.2
Agriculture	112	135	171	149	170	209	193	184	-7.8	-4.4
Food	111	139	186	156	170	210	204	193	-2.7	-5.7
Beverages	107	124	152	157	182	208	168	163	-19.3	-2.7
Raw Materials	118	129	143	129	166	207	177	174	-14.3	-1.9
Fertilizers	104	149	399	204	187	267	268	245	0.4	-8.5
Metals	154	186	180	120	180	205	182	189	-11.2	3.7
Memorandum items										
Crude oil ($/bbl)	64	71	97	62	79	104	107	103	2.5	-3.4
Gold ($/toz)	604	697	872	973	1,225	1,568	1,675	1,600	6.8	-4.5

Source: World Bank.

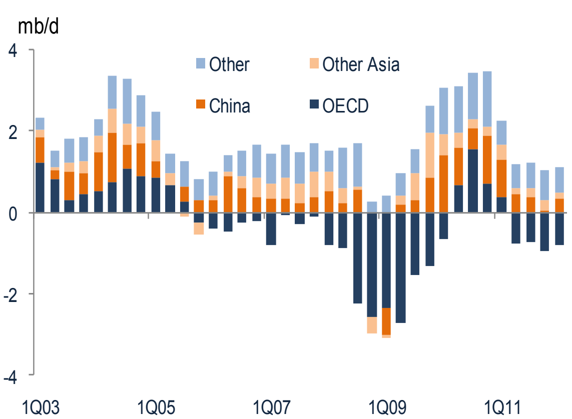
demand increased only 0.7 percent in 2011, and demand growth remained weak during the first quarter of 2012 partly due to a mild winter in the northern hemisphere. OECD oil demand is down more than 4 mb/d or 9% from its 2005 peak. Japan is the only OECD country which increased crude oil demand, with most of the additional demand going to power generation to compensate for lost nuclear capacity. Non-OECD oil demand also slowed, but still remains positive and robust (figure Comm.3).

Rising prices mainly reflect developments on the supply side, notably the loss of more than 1 mb/d in non-OPEC production due to geopolitical and technical problems, including tensions between the U.S./EU and Iran over its nuclear program. The EU banned Iranian imports, while the U.S. prohibits financial institutions that deal with the U.S. from doing business with Iran. Both decisions come into full effect in July.

According to the IEA, up to 1 mb/d of Iranian exports may be halted by this summer. Although Saudi Arabia has stepped up production to compensate for various supply losses, including 1.3 mb/d of Libya's light sweet crude last year (but recovering quickly), OECD inventories have fallen—particularly in Europe and Japan. Higher Saudi production has also lowered OPEC spare capacity—contributing to a generalized sense of tight markets (figure Comm.2).

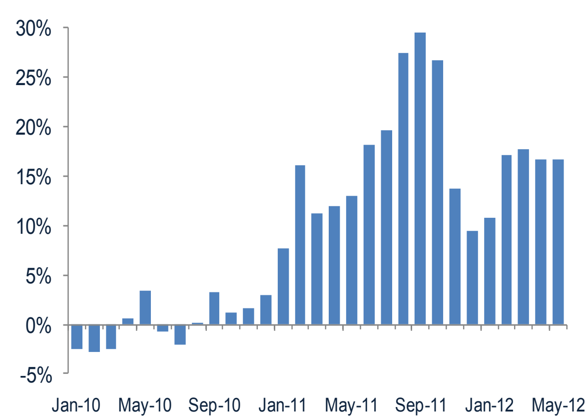
Although Brent prices topped $126/bbl, West Texas Intermediate has remained some $15/bbl below due to the build-up of stocks in the U.S. mid-continent (figure Comm.4). Greater crude flows from Canada through the Keystone pipeline that commenced in 2011 and rapidly

Figure Comm.3 World oil demand growth



Source: World Bank

Figure Comm.4 Brent/WTI price differential



Source: World Bank

rising shale-liquids production in North Dakota have contributed to the build-up of U.S. stocks—at a time when oil consumption is dropping. Currently, there is limited capacity to transport surplus oil to the U.S. Gulf coast, apart from some utilization of rail, barge and truck where possible. While new pipelines and reversal of exiting lines to the U.S. Gulf are planned, the WTI discount is likely to persist for some time.

Oil market conditions are expected to ease in 2012

Looking forward, world oil demand is projected to grow nearly 1% this year, with all of the growth in developing countries. On the supply side, the decline in non-OPEC production growth in 2011 appears to have reversed (figure Comm.5). Overall, a net 0.7 mb/d will be added to global supplies from non-OPEC sources, including Canada, Brazil, Russia and Colombia, but the largest increment will come from the U.S. reflecting large-scale investments to exploit shale rock deposits via use of horizontal drilling and hydraulic fracturing. This technology was first used to extract natural gas, which has risen by 28% since 2005, and caused the U.S. price of natural gas relative to crude oil to fall by 75 percent (box Comm.1).

As a result, U.S. producers are shifting from drilling in dry-gas shale deposits to more liquids-rich (wet gas) and oil-bearing shale deposits. Shale-liquids (or tight oil) production is just commencing and has great potential going forward—although there are concerns about the environmental aspects of fracturing and water use.

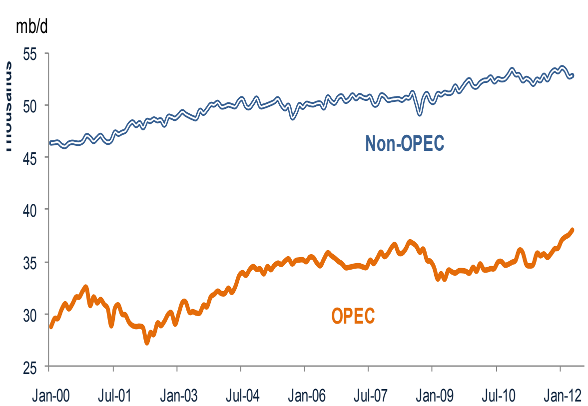
Production among OPEC countries has risen 1.8 mb/d since end-2010 (prior to disruptions in Libya), with Saudi Arabia accounting for 1.5 mb/d of the net gain (figure Comm.6). In the meantime, Libya's oil production has recovered to 1.4 mb/d, compared with 1.6 mb/d pre-crisis, although further gains may be difficult due to internal disputes. Iraq's production hit an 11-year high in April of 3.0 mb/d, and exports are increasing from a new mooring system in the Gulf. Iran's exports have declined by 0.3 mb/d from pre-sanctions levels, and are set to tumble further unless alternative buyers (or buying arrangements) can be found. Iran's traditional crude buyers are struggling to arrange payment mechanisms, secure ships to lift oil, and to engage insurance companies to underwrite the trade.

The net growth in OPEC production has reduced spare capacity to 3.1 mb/d (figure Comm.7), of which nearly two-thirds is in Saudi Arabia. The Saudi Oil Minister has promised to keep the market well supplied, and also deems that $100/bbl is a fair price.

Outlook

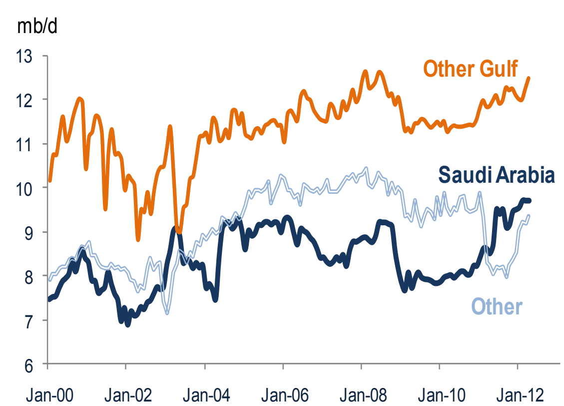
In the near term, oil prices are unlikely to exceed their recent highs of $120/bbl, in part because of the indicated willingness of U.S., UK and France to use strategic reserves to assure adequate

Figure Comm.5 World oil production



Source: IEA

Figure Comm.6 OPEC crude oil production

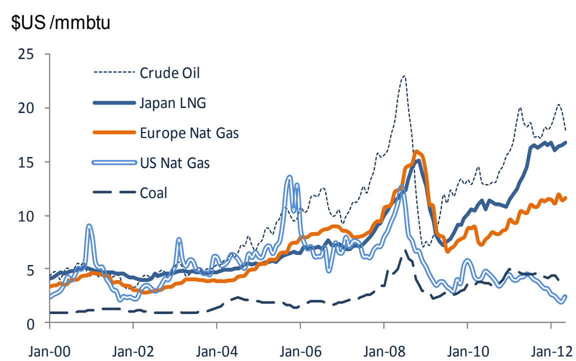


Source: IEA

Box Comm.1 Induced Innovation, Price Divergence, and Substitution

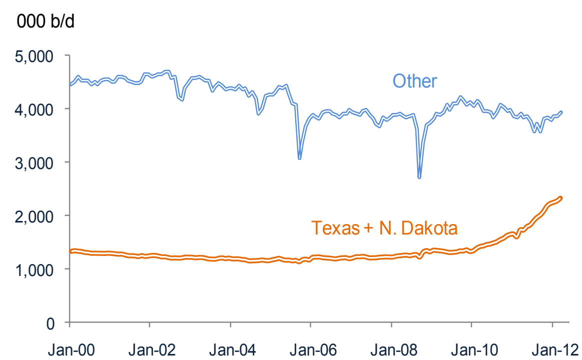
Because large and sustained changes in commodity prices often alter the relative prices of inputs, they induce innovations that support more efficient production or consumption of substitute (or the same) products. The induced innovation hypothesis was originally proposed by Hicks (1932), who noted that "… a change in the relative prices of the factors of production is itself a spur to invention and to inventions of a particular kind–directed at economizing the use of a factor which has become relatively expensive." The hypothesis has been studied extensively (see, for example, Ahmad (1966) and Kamien and Schwartz (1968) for the theoretical considerations; Binswanger (1974) for an application to agriculture, and Newell, Jaffee, and Stavins (2000) and Popp (2002) for applications to energy). In the context of the post-2005 commodity price boom, high energy prices induced significant increase in shale gas exploration and production in the U.S., in turn, causing natural gas prices to fall to just 12% of crude oil prices from near 75% in the decade of the 2000s (box figure Comm 1.1). High energy prices also induced exploration in oil-bearing shale plays, especially in North Dakota and Texas, thus increasing oil production in (box figure Comm 1.2). On the consumption side, high oil prices have triggered new vehicle efficiency standards and alternative/hybrid vehicles that are set to further reduce gasoline demand.

Box figure Comm 1.1 Energy prices



Source: World Bank

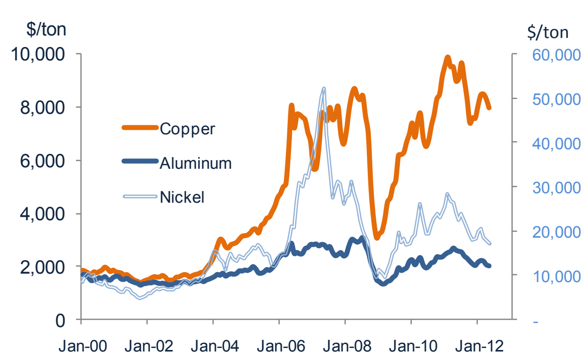
Box figure Comm 1.2 U.S. Crude oil production



Source: IEA

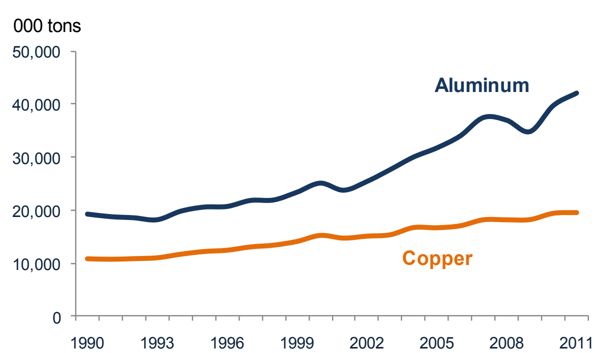
Similar trends have taken place in metals. Copper and aluminum traded at similar price levels 10 years ago, but high copper prices (box figure Comm 1.3) induced substitution to other materials, e.g., aluminum coated wiring and plastic tubing. Aluminum—a light-weight strong metal—continues to displace steel in autos and other applications. Consequently aluminum's volume growth over the past ten years has been nearly four times that of copper (box figure Comm 1.4). And, the nickel price boom caused China to import low grade ores from the Philippines and Indonesia to produce nickel pig iron and reduce refined nickel imports.

Box figure Comm 1.3 Refined metal prices



Source: World Bank.

Box figure Comm 1.4 Refined metal consumption



Source: World Bureau of Metal Statistics supply. Upside risks entail supply disruptions due to further technical and geopolitical problems, particularly in countries dealing with conflict and security, including Libya and Iraq.

In the medium term, world oil demand is expected to grow moderately, at 1.5% p.a., with all of the growth in demand coming from developing countries. Global growth will remain well below GDP growth, reflecting efficiency improvements in vehicle transport—partly induced by environmental pressures to reduce emissions, especially in OECD countries. Consumption growth in developing countries is expected to moderate in the longer term as their economies mature, as subsidies are phased out, and as other fuels penetrate their fuel mix, notably with natural gas.

On the supply side, non-OPEC oil supply is expected to continue its upward climb, in part due to high prices and continued advances in upstream technology. There are no physical resource constraints into the distant future, and new frontiers continue to be exploited, e.g., deep water offshore and shale liquids, with new technologies that lower unit costs. The main impediments to investments are above ground, such as access to resources, security of operations and investments, and suitable fiscal terms and conditions. Production increases are expected from a number of areas, such as Brazil, Canada, the Caspian, West Africa, and the United States. These will be partially offset by declines in mature areas such as the North Sea.

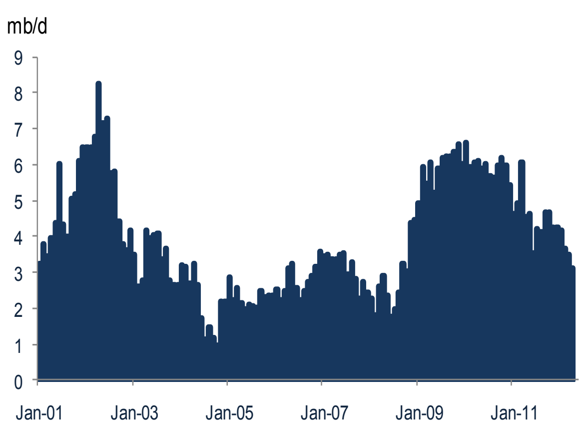
Oil prices are expected to average \$107/bbl in 2012 and decline slightly to \$103/bbl in 2014 as ample supply is likely to accommodate moderate growth in demand. Over the longer term oil prices are projected to fall (a little less than \$100/bbl in 2025 in nominal terms), due to slowing global demand growth, increased supply of conventional and (especially) unconventional oil, efficiency gains, and substitution away from oil. The long-term assumptions that underpin such projections are based on the upper-end cost of developing additional oil capacity, notably from oil sands in Canada, currently assessed at \$80/bbl in 2012 dollars. It is expected that OPEC will continue to limit production in an effort to keep prices relatively high, given the large expenditure needs in most countries.

Metals

Metals prices rose 7 percent during Q1:2012 from the earlier quarter on recovering demand in the U.S. and strong import demand in China, most of which went to restocking. However, prices began to ease from their February highs on renewed concerns about global growth, slowdown in China, still high stocks for most metals, and emerging supply growth. China metals import demand slowed in 2012, portending a few weak months owing to destocking, but the country consumes 43% of world's metal output (figure Comm.8).

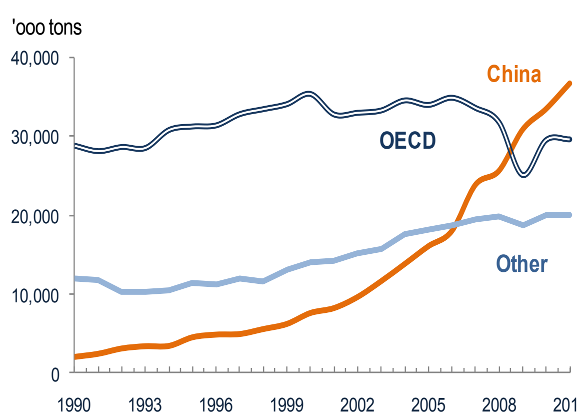
While most metals prices are well below their former peaks due to ample supplies, copper

Figure Comm.7 OPEC spare capacity



Source: IEA

Figure Comm.8 Metals consumption



Source: World Bureau of Metal Statistics prices in May 2012 averaged just 20% below their February 2011 highs and well above production costs due to chronic supply problems, including project delays, labor disputes, and declining ore grades. A prolonged period of high prices has generated substantial investment in new capacity, and supply is emerging for nickel in significant volumes, and is soon to emerge for copper after a long period of supply tightness.

Recent developments in metal markets

Aluminum prices fell to $2000/ton in the second quarter, near where they were in 2005, in response to a persistent global surplus and high stocks. Prices nevertheless are at or below marginal production costs for many producers, with more limited downside risk to prices. In addition, a significant amount of inventories are tied up in warehouse financing deals, and unavailable to the market. Consumption continues to benefit from substitution, mainly from coppers' wiring and cable sectors, as copper prices are some four times that of aluminum. Substitution is expected to continue as long as the copper/aluminum price ratio is at least 2:1, as expected over the forecast period. Global production capacity continues to outstrip consumption, the bulk of which comes from China, and less so from new capacity in Middle East, and restart of idle capacity in North America and Europe. Market surpluses are expected to endure in the near term, but prices are expected to rise in the medium term due to rising costs, especially for energy (which accounts for about 40% of production costs) but also carbon and alumina.

Copper prices rose sharply in early 2012 on falling inventories and strong Chinese import demand which, in recent years has led to significant thrifting and substitution of copper use, and has accelerated recycling rates of scrap reprocessing. These trends are expected to continue in the near term. Copper demand is projected to increase only moderately over the forecast period at about 2.5% p.a., and moderate over the longer term as copper intensity in China—which has risen sharply—plateaus and declines. Copper mine supply (flat in 2011) has struggled to keep pace with demand the last several years due to a host of difficulties, e.g., technical problems, labor strikes, declining ore grades, delayed start-up of projects, rising costs, and shortages of skilled manpower, equipment and materials. The tightness in the copper market in 2011 reflected disruptions and lower grade ore output, and was most pronounced at the world's two largest mines—Escondida in Chile (-24% y/y) and Grasberg in Indonesia (-31% y/y). However, high copper prices have induced a wave of new mine supplies that is expected to come on-stream, especially from Africa's copper belt, Peru, the U.S. and China, and is expected to tip the market into surplus.

Nickel prices rose in early 2012 on improved macro sentiment, but then receded on a sluggish market for stainless steel (the end use of more than two-thirds of nickel production) and rapid restart of nickel pig iron (NPI) production in China. The country accounts for 40% of global stainless steel production—up from 4% a decade ago—and stainless steel undergoes significant stocking/destocking cycles, hence contributing to the volatility of nickel prices. Stainless steel demand is expected to remain robust, growing by more than 6% p.a., driven by its high grade consumer applications and growing wealth and size of middle classes in emerging markets. A wave of new nickel mine capacity is expected to keep nickel prices close to the marginal cost of production. Several ferro-nickel and high pressure acid leach (HPAL) projects will soon ramp up production, including in Australia, Brazil, Madagascar, New Caledonia and Papua New Guinea. HPAL projects have had considerable technical problems and delays in recent years, thus there is a risk that these projects will come on-line more slowly than expected. The other major source of supply is nickel pig iron (NPI) in China, which sources low-grade nickel ore from Indonesia and the Philippines. However, Indonesia has proposed developing its own NPI industry and is considering banning nickel ore exports from 2014. Nickel prices are expected to decline over the forecast period due to the substantial supply additions in the coming years, and are expected

Box Comm.2 The role of emerging markets in commodity consumption

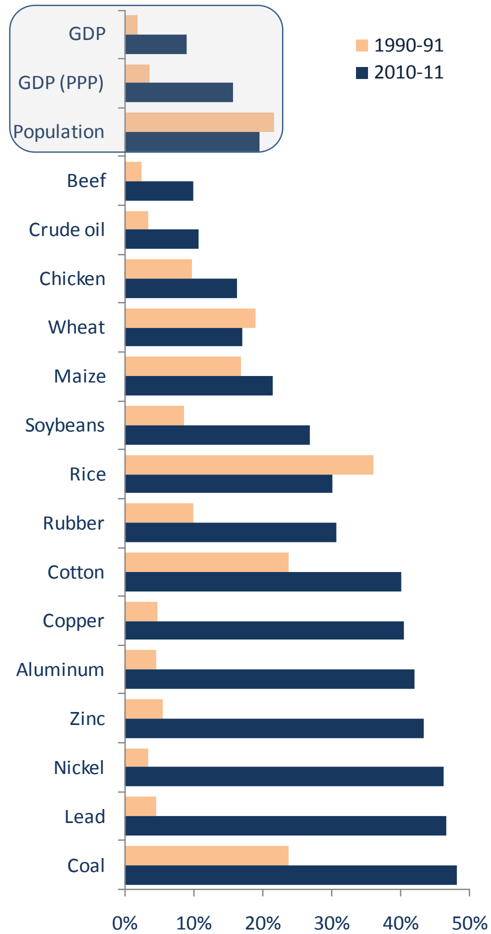
Emerging market demand, especially by China, has been a major force in pulling up the prices of refined metals. In energy commodities, while China plays an important role (especially in coal), its share of crude oil consumption is more limited, but is a major contributor to growth. In fact, it is the entire group of emerging economies that has been the key driver of oil prices. In food commodities, the role of emerging economies is less important than sometimes thought (Baffes 2012).

Since 1990, China's refined metal consumption (aluminum, copper, lead, nickel, tin, and zinc) has jumped seventeen-fold; China now accounts, for 43 percent of the world's refined metal consumption, up from just 5 percent two decades ago (Figure Comm 2.1). This enormous share of the world's metal market reflects substantial investment in construction, infrastructure, and manufacturing that has led China's rapid economic growth. In 1990, China's metal intensity (metal use per $1,000 of real GDP) was three times higher than the rest of the world. By 2008, it was almost nine times higher (Figure Comm 2.2). High demand by China has been instrumental to the super-cycle in metal prices (Jerrett and Cuddington 2008).

Emerging market demand has played a critical role in increasing demand for, and price of, crude oil (Killian 2009). In 1965, OECD countries accounted for three-quarters of global crude oil consumption, but by 2010 their share had fallen to a little over half. Over the same period, China's and India's shares grew from less than one percent each to roughly 10 and 4 percent, respectively. Over the past 15 years non-OECD countries' share of oil consumption has increased from 35 percent to 47 percent. More important, developing countries accounted for all the net growth in global crude oil consumption in the last decade.

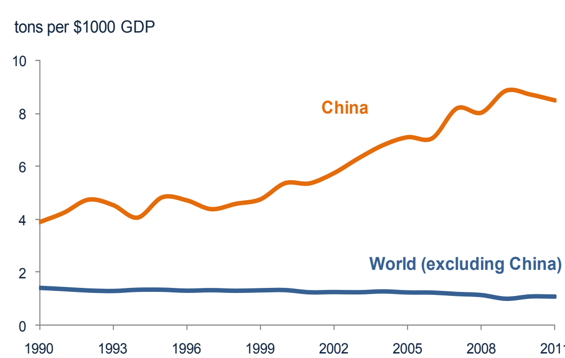
The role of emerging market demand has been much more muted in food commodities, despite the conventional wisdom that rising incomes have translated into much greater demand for food, and hence, higher food prices (see Krugman (2008) and Wolf (2008) as well as Alexandratos 2008 and Baffes and Haniotis (2010) for different views). For example, while in some food commodities China's share in global consumption increased (e.g., meats, soybeans, and to a lesser extent maize) in others did not. In fact, for China's share in rice and wheat declined--from 36.1 to 30.1 percent in rice and from 18.9 to 17 percent in wheat. India's per capita grain consumption has declined as well; and, its per capita calorie intake declined also, despite sharply rising incomes and increased consumption of fruits and vegetables (Deaton and Dreze 2008). Thus, a slowdown in China's growth is likely to have a large impact on metal prices, a moderate impact on crude oil prices, and very little effect on food prices. More generally, a slow-down in emerging economy growth is likely to affect energy prices the most.

Box figure Comm 2.1 China's share of world's commodity consumption



Source: World Bank, USDA, UN, Metal Statistics, IEA

Box figure Comm 2.2 China's metal intensity



Source: World Metal Statistics

to remain within a band of $18,000-$23,500 per ton.

Outlook

Overall, metals prices are expected to decline 11 percent in 2012 on moderating demand growth and reduced metals intensity in China, and increases in new mine capacity (see box Comm.2 for the role of China in commodity consumption). However, aluminum prices are expected to increase over the forecast period due to rising power costs, and the fact that current prices have some producers at or below production costs. Although there are little physical constraints over the forecast period, there are a number factors could result in upward pressure on prices in the longer term such as declining ore grades, environmental and land rehabilitation, as well as rising costs for water, energy and labor.

There are also geopolitical risks from rising resource nationalism, and increased government intervention. The Indonesian government has signed an order to ban exports of all raw ores from 2014, which would affect producers of nickel ore, copper and bauxite. Governments have also been increasing taxes to raise revenues. Depending on the design of those taxes and how widespread tax increases become, such increases could impact future supply and prices.

Agriculture

Despite rising in the first half of 2011, the US dollar price of internationally traded agricultural commodities subsequently eased substantially, ending the year 10 percent lower than a year ago. Prices, especially of food commodities, firmed again, rising 6 percent from December 2011 to April 2012, but declined 2 percent in May (figure Comm.9).

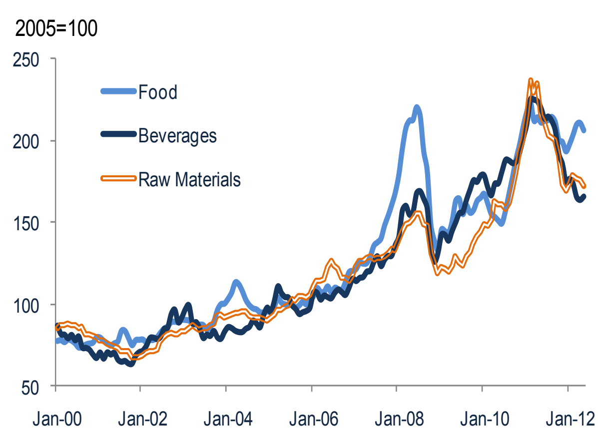
Food prices followed a similar pattern, ending 2011 7.3 percent lower than in December 2010, and firming 6.6 percent since then. Currently (May 2012) they are 2.2 percent lower than a year ago. In real terms, agricultural prices in 2012 are expected to be on average 8.6 percent lower than 2011, but still more than 75 percent above their 2000 levels.

The easing of international food prices has been partly reflected in a moderation of food price inflation in several regions (see Main Text). For example, food price inflation decelerated in Middle East and North Africa and South Asia, while in Europe and Central Asia consumer food prices have actually declined—in contrast, food price inflation has accelerated in Sub-Saharan Africa and Latin America and the Caribbean. Yet, domestic food prices in developing countries remain 25 percent higher relative to non-food consumer prices than they were at the beginning of 2005—a large increase considering that food often represents than 50 percent of their total expenditures of urban families in developing countries (and in very poor countries it reaches 80-90 percent).

Most of the drivers of the post-2005 price increases are still in place (table Comm.2). Energy and fertilizer prices (key inputs to the production of most agricultural commodities) are still high. The US dollar remains weak by historical standards (despite its recent appreciation), while most agricultural commodity markets (especially grains) are experiencing low stock levels.

Nevertheless, three "new" drivers of commodity prices, notably, financial investment activity, biofuels, and export restrictions, have given the

Figure Comm.9 Agriculture price indices



Source: World Bank

Table Comm.2 Most of the post-2005 boom condition are still in place

	2000-05	2006-11	Change
Agricultural prices (nominal index, 2005 = 100)	**87**	**158**	**81%**
Grain price volatility (stdev of log differences, monthly)	**4.5**	**8.0**	**78%**
Crude oil price (US$/barrel, nominal)	33	80	142%
Fertilizer prices (nominal index, 2005 = 100)	75	218	191%
Exchange rate (US$ against a broad index of currencies, 1997 = 100)	119	103	-14%
Interest rates (10-year US Treasury bill, nominal)	4.7%	3.7%	-21%
Funds invested in commodities (US$ billion)	80	230	188%
GDP growth (low and middle income countries, % p.a.)	6.7	7.2	7%
Industrial production growth (low and middle income countries, % p.a.)	5.6	6.5	16%
Biofuel production (millions of barrels per day equivalent)	0.5	1.5	220%
Stocks (total of maize, wheat, and rice, months of consumption)	3.0	2.5	-15%
Yields (average of wheat, maize, and rice, tons/hectare)	3.7	4.1	9%
Growth in yields (average of wheat, maize, and rice, % p.a.)	0.9	1.4	56%
Natural disasters (droughts, floods, and extreme temperatures)	220	207	-6%
OECD policies (Producer NPC, %)	1.3	1.1	-11%

Note: The NPC (OECD policies) for the second period is based on the 2006-2010 average.
Source: World Bank, US Treasury, US Department of Agriculture, Federal Reserve Bank of St. Louis, Barclays Capital, Center for Research for the Epidemiology of Disasters, and OECD.

first signs of moderation. Investment fund activity is currently at 330 US$ billion (as of 2012:Q1), a level similar with the end of 2011, but 9 times higher than a decade ago, when this activity started becoming a popular investment vehicle within the financial community. Production of biofuels did not increase in 2011 and is expected to increase only marginally in 2012. Lastly, with the exception of the Indian cotton ban earlier in March—which did not impact cotton prices because the market was well-supplied—policy restrictions have not been a problem in agricultural markets.

Recent developments in agricultural markets

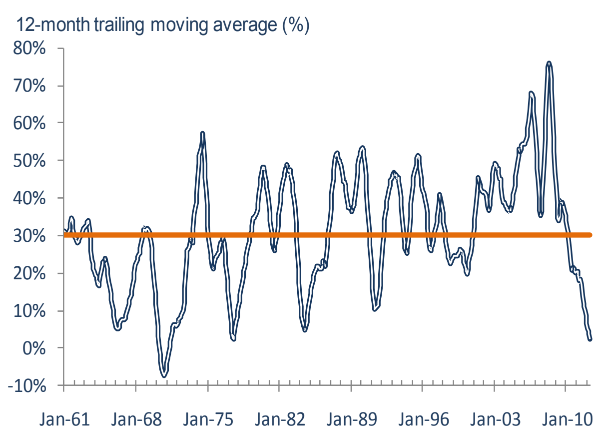
Grain prices declined by 7 percent between August and December of 2011. This was in response to the improved 2011/12 outlook. Indeed, between May and December 2011, the global grain end-of-season stock outlook for the 2011/12 crop season, improved by 7 percent with most of the gains realized in the maize (15 percent) and wheat (3.5 percent) stocks. Prices reversed course at the beginning of 2012, gaining some 9 percent within 4 months after it became apparent that supply conditions were tighter than originally though. Specifically, between December 2011 and March 2012, maize and wheat prices gained 8.5 and 5.5 percent, respectively. Tight maize supplies caused maize to be traded at roughly the same price level with wheat, a very rare occurrence—historically, wheat has been traded 30 percent higher than maize (figure Comm.10). In May, however, both maize and wheat prices retreated somewhat as the global financial conditions deteriorated and the US$ appreciated. Contrary to maize and wheat the ***rice*** market is well-supplied. During the past 3 years rice prices have averaged almost $530/ton. They temporarily exceeded $600/ton in November 2011, following the implementation of the Thai Paddy Rice Program—Thailand is the world's largest rice exporter, accounting for 25-30 percent of global exports, hence the large influence of its policy actions on world markets. Indeed, the 10 percent increase in rice prices in May has been attributed entirely to the Thai rice program.

Following 10 months of declines, ***edible oil*** prices began increasing, with the World Bank edible oil price index gaining 19 percent between December 2011 and April 2012. Tight supplies have been the key driver behind higher prices, in part due to persistent drought in South America (soybeans) and in part due to production cyclicality in East Asia (palm oil). As in the case of grains, the edible oil price index declined 2.5 percent in May.

The strength in ***beverage*** prices during 2010-11 was supported primarily by ***arabica*** prices (it averaged close to \$6.00/kg during 2011, the highest nominal level). However, news that Brazil's crop for the current season will be much higher than anticipated caused arabica price to plummet 37 percent between May 2011 and May 2012—Brazil is the world's largest arabica supplier. On the contrary, ***robusta*** prices declined only 12 percent over the same period despite a large Vietnamese crop as growers and traders have kept their coffee in anticipation of higher price. ***Cocoa*** prices have weakened considerably during the past five months (25 percent lower than the same period of last year), primarily a response to better crop outlook in Côte d'Ivoire. ***Tea*** prices declined a cumulative 22 percent between the all time high of \$3.10/kg in July 2011 and March 2012 as the drought cycles in East Africa eased. However, tea prices gained more than 20 percent between March and May 2012 due to the Indian and Sri Lankan rupee appreciation as well as the new tea crop of higher quality coming in the market.

Tight supplies during the 2010/11 season caused ***cotton*** prices to almost quadruple, from \$1.41/kg in September to \$5.06/kg in March 2011. Since then, prices reversed direction to decline just as sharply and reach \$2.52/kg in August 2011 and \$2.10/kg in December 2011. In addition to tight supplies, the rally was aided by India's decision to impose a ban on cotton exports in 2010. A similar ban by India announced in March 2012, did not have any discernable impact on prices. The cotton market is well-supplied by historical standards. ***Natural rubber*** prices reached historic highs, exceeding \$6.00/kg in February 2011, more than a 4-fold increase within just 2 years. Tight supplies due to adverse weather in South-East Asia and strong demand by China (mainly destined for tire manufacturing) underpinned the rally. Crude oil prices play a key role as well, because synthetic rubber, a close substitute to natural rubber, is a crude oil by-product. ***Timber*** prices strengthened considerably during 2011, aided by the Tohoku disaster in March 2011. However, prices declined 18 percent between August 2011 and May 2012 as the expected surge in demand did not materialize.

Figure Comm.10 Wheat/maize price ratio



Source: World Bank

Outlook

As supply conditions improve, agricultural prices are projected to decline 7.8 percent in 2012. Specifically, for 2012, wheat and maize prices are expected to average 11.5 and 4.0 percent lower than their 2011 levels while rice prices are anticipated to average at roughly the same level as in 2011, about \$550 per ton. Soybean and palm oil prices are expected to be 3.8 and 4 percent lower, respectively. Beverage prices will experience larger declines (cocoa, coffee, and tea, 19.5, 16.5 and, 8.6 percent lower, respectively). On raw materials, timber prices are expected to decline slightly (3.7 percent) but cotton and rubber prices will be 35.4 and 20.2 percent lower.

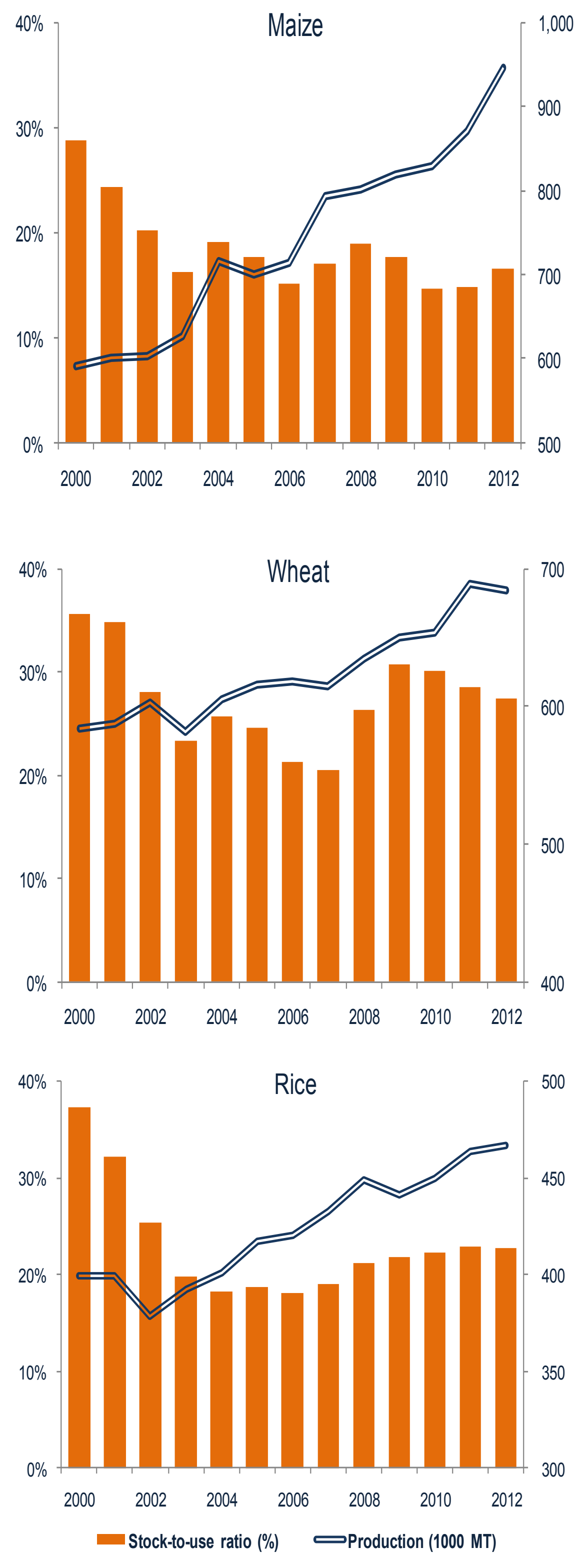
A number of assumptions underpin this outlook. First, the next crop year will be better supplied than 2011/12. The US Department of Agriculture's May 10th outlook—the first projection for the 2012/13 crop, estimated next season's global grain availability (production plus beginning stocks) to reach 2.52 billion tons, up 2.8% from the current season, and 21% higher than the lows reached in 2006/07. Global maize production and end-of-season stocks are set to increase by 8.7-and 19.4% respectively in 2012/13, while moderate increases are expected in the global rice market. The wheat market is expected to be tight next season, however, with production and end-of-season stocks down 2.5- and 4.5% respectively. (figure Comm.11).

Second, there are no foreseeable policy responses that would upset food markets. Such risk however, depends crucially on the degree to which markets are well-supplied. If the assumed outlook materializes, policy actions are unlikely and, if take place, their impact will be limited. For example, when the market conditions for rice and cotton were tight in 2008 and 2010, the respective export bans had a major impact on market prices. However, last year's Thai rice program and the Indian export ban of March 2012 had very limited impact on prices because the markets are well-supplied.

Third, it is assumed that that energy and fertilizer prices will stay at current levels, the former already expected to average 1.3 percent above 2011 and the latter projected to remain at the roughly the same levels . Because agriculture is energy intensive—4 to 5 times more energy intensive than manufacturing—an energy price spike (or decline for that mater) would be followed by food price increases (or declines). The price transmission elasticity from energy to agriculture is about 0.20, implying that for any 10 percent change in energy prices, agricultural prices are expected to change by 2 percent.

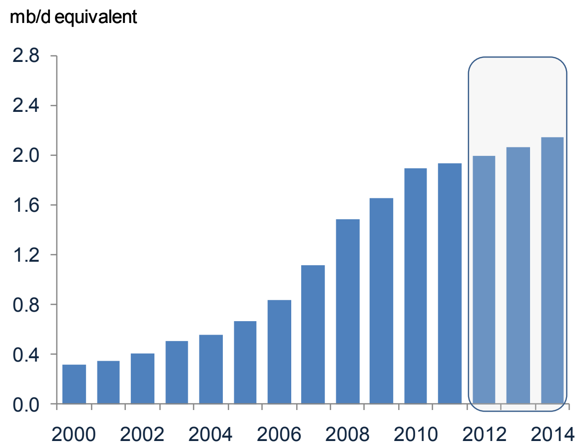
Lastly, biofuels are expected to play a key role in food markets, especially in the long run. Production of biofuels increased only marginally in 2011; it currently accounts for 2/bbl of crude oil equivalent (figure Comm.12). OECD expects it to increase by an annual average of about 3 percent for the next few years, corresponding roughly to 2 percent of global land allocated to grains and oilseeds. Yet, the impact of biofuels on food prices is more complex as it goes far beyond the land diversion. It will depend crucially on (i) whether current energy prices make biofuels profitable and (ii) whether technological developments on existing biofuel crops (maize, edible oils, and sugar cane) or new crops increase the energy content of these crops, thus making them more attractive sources of energy. Thus high energy prices in combination with technological improvements may pose enormous upside risks for food prices in the longer term.

Figure Comm.11 Global Grain Supplies



Source: US Department of Agriculture (May 10, 2012 update).

Figure Comm.12 Biofuel production



Source: BP Statistical Review (history) and OECD (projections).

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East Asia and the Pacific Region

Overview

Growth in the **East Asia and Pacific** region is slowing, partly reflecting an easing of stimulus in China and a shift toward domestic sources of demand. Growth for the region eased to 8.3 percent in 2011 from 9.7 percent in 2010. Slower activity in China, natural disasters (earthquake and tsunami in Japan and flooding in Thailand), and the intensification of the crisis in Europe have each served to temper the pace of growth in the region.

Capital flows, which were resilient during the first half of 2011, slowed markedly in the second half of the year in response to increased risk aversion and new global banking regulations that accelerated deleveraging by Euro Area banks. Foreign direct investment (FDI) inflows increased by $45 billion (largely to China), partly offset by declines in portfolio equity flows (IPOs and fund investments in regional exchanges). Regional equity markets underperformed global markets to a measureable degree, while bond issuance improved by $27 billion in 2011.

Outlook: In the baseline, the financial turmoil currently gripping the Euro Area is assumed to ease, allowing prospects for advanced economies to improve in 2013 to 2014. Nevertheless, uncertainty regarding oil prices, and still relatively weak demand from the high-income world, coupled with slow growth in China are projected to ease GDP gains in **East Asia and Pacific** to 7.6 percent in 2012, before rebounding to 8.1 percent in 2013, and to 7.9 in 2014.

In China, GDP is expected to accelerate on balance from 8.2 percent growth in 2012 to 8.4 percent by 2014. Though production, trade and domestic demand have slowed over 2011 to 2012, this is a response, in part, to earlier policy targeted at slowing certain segments of the economy, especially housing. “Softlanding” is the most likely scenario, but an overshooting to the downside cannot be ruled out. For the **ASEAN-4** countries (Indonesia, Malaysia, Philippines and Thailand), growth is projected to be buoyant, stepping up to 5 percent in 2012 with solid activity in Indonesia and recovery in Thailand. These countries will clearly benefit from the revival of world trade. Vietnam, as an oil exporter, should enjoy a near-term fillip due to high oil prices, but as these prices settle, growth is projected to register 6.5 percent by 2014 grounded in stronger fundamentals.

Risks and vulnerabilities: Financial conditions in high-income Europe, higher oil prices, and a slowdown in China would pose the largest risks to the outlook.

Euro Area. Though financial developments in the Euro Area calmed in the first four months of 2012—tensions have revived in May. While a gradual improvement of conditions remains the most likely outcome, a serious deterioration of conditions in Europe is a possibility. In such a scenario, growth in East Asia and the Pacific could slow by as much as 2 to 4 percentage points due to reduced import demand, tighter international capital conditions and increased precautionary savings abroad and within the region. Countries heavily reliant on remittances (Fiji, the Philippines and Vietnam), tourism (Cambodia, Fiji, Malaysia, Thailand and Vietnam) and commodities (Indonesia, Malaysia and Thailand) as well as those with high-levels of short-term debt or medium term financing requirements (Malaysia) could be hardest hit.

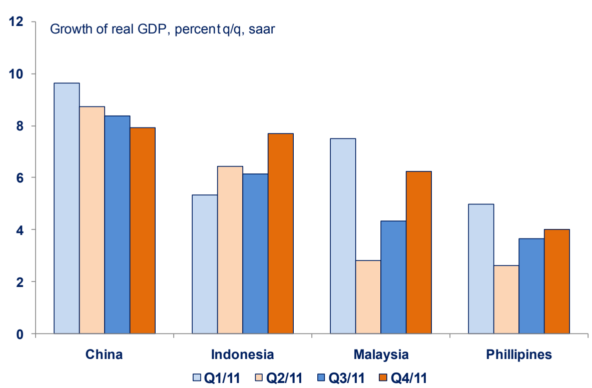
China Growth. A more rapid than expected slowdown in China poses an external risk for the rest of the region. A slowdown in China would spill-over into the rest of the region in the form of reduced demand for exports, and commodity dependent countries would be especially at risk of a slowdown in China's investment.

Recent developments

Overview. Growth for the East Asia and Pacific region is on a moderately easing trend, expected to continue for the next years. Weaker external trade dynamics for China has served to shift the locus of near term growth toward domestic demand and momentum of this demand has been on a softening trend. GDP gains for the region dropped to 8.3 percent in 2011 on the heels of stronger 9.7 percent recovery from the global recession in 2010. Slower activity in China (due to both domestic and external factors); a series of natural disasters in East Asia (a serious earthquake and tsunami in Japan and flooding in Thailand) and intensification of the crisis in Europe, each served to temper the pace of direct trade flows for the major ASEAN economies and trade among countries of the region, playing an important role in the growth slowdown.

More difficult financing conditions during the second half of 2011, as banking flows started to dry up—tied in part to deleveraging by European commercial banks—and a flight to safety across international portfolio flows, also served to restrain the tenor of growth (table EAP.1). GDP for East Asia outside of China was affected sharply by the downturn in global- and local goods trade, and, in some cases the adverse terms of trade attendant upon higher oil prices. Growth for this group registered 4.5 percent in 2011, following a stronger 7 percent performance in 2010.[1]

Figure EAP.1 Quarterly patterns of recovery across 2011 varied



Source: World Bank.

Quarterly GDP figures for 2011 were mixed across countries, reflecting the extent to which some governments supported domestic demand through stimulus measures, and those economies where this did not occur (figure EAP.1). China's growth eased over the course of the year both because of weak external demand and policies geared to stem overheating in specific sectors. Outturns elsewhere began to pickup in the second half of the year, as additional fiscal and other stimulus measures began to offset the building headwinds from international trade and finance (box EAP.1).

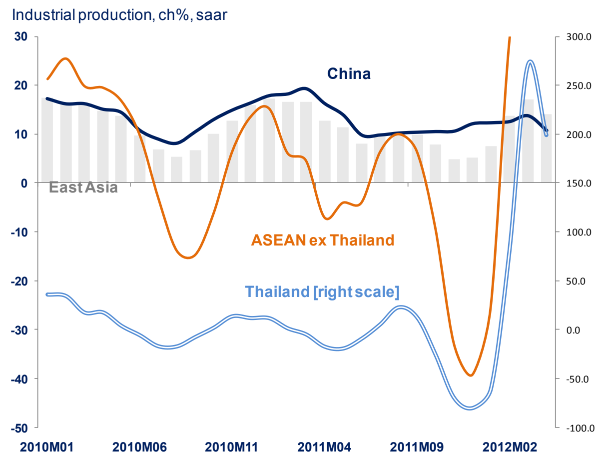
Despite the easing in quarterly patterns of growth, China registered a firm 9.2 percent advance for 2011. Growth in Indonesia (6.5 percent) and Malaysia (5.1 percent) were also robust partly reflecting government spending in the latter country that acted as stimulus. And in contrast with many developing countries, carryover of growth into 2012 will be strong for the ASEAN countries (see Main Text for a fuller discussion of carryover).

Industrial production and trade were exceptionally hard hit in 2011 by the combined effects of the Tohoku earthquake and tsunami (second and third quarters), which affected Japanese output and operation of multi-country production value chains; and by the noted flooding in Thailand (third and fourth quarters) which played a similar role in disrupting production networks among ASEAN members and their tightening links with China. These events had ripple effects throughout the global economy, slowing demand for the region's products, and were exacerbated by the intensification of the financial turmoil and emerging recession in the Euro Area – East Asia's largest export market. Production outturns for the region excluding China and Thailand turned negative, but would have been much weaker if it had not been for the region's domestic demand. More recently, growth has accelerated sharply, particularly in Thailand as the economy recovers from the disruption caused by last year's floods (figure EAP.2)

A similar pattern is observed for both regional exports and imports, with a steep decline in the second half of 2011 having turned into significant recovery in the early months of 2012 (figures EAP.3 and EAP.4). If continued, this development should complement expansion in domestic demand and provide a firm footing for recovery in the second half of 2012. Import volumes for China returned to growth at a robust 27 percent pace (saar) as of April 2012. ASEAN countries have seen momentum build as well, suggestive of revival of the region's production networks, served by countries such as Malaysia, Indonesia and the Philippines. And evidence supports a step-up in reconstruction activity in Thailand, as imports there have turned the corner to growth following a slump in late-2011, to register gains of 55 percent as of March

Early signs of recovery in regional markets finds China showing modest (for China) export gains of 11 percent "saar"[2] as of April 2012. In like fashion, the ASEAN-4 group excluding Thailand had breached zero to jump to 30 percent in the three months to March; while with capacity coming back on-stream, Thailand's' exports boomed to a 57 percent pace. Though these developments could in part be an example of "South-South" recovery, there is now evidence to suggest that import demand from the United States, Japan and Germany is coming to the fore (despite Euro Area turmoil) to support East Asian exports.

Figure EAP.2 Thai rebound from floods, China IP momentum rebuilding



Source: World Bank.

Table EAP.1 East Asia and Pacific forecast summary

(annual percent change unless indicated otherwise)	98-07[a]	2009	2010	2011	Est. 2012	Forecast 2013	2014
GDP at market prices (2005 US$) [b]	8.1	7.5	9.7	8.3	7.6	8.1	7.9
GDP per capita (units in US$)	7.1	6.7	8.9	7.4	6.7	7.2	7.0
PPP GDP [c]	8.0	7.4	9.6	8.2	7.5	8.0	7.9
Private consumption	6.0	6.9	5.6	7.5	7.6	7.7	8.0
Public consumption	8.5	9.1	11.2	7.7	7.8	6.5	6.5
Fixed investment	8.8	18.9	11.3	11.3	9.0	7.9	7.9
Exports, GNFS [d]	14.2	-9.9	23.9	9.9	8.7	10.6	11.4
Imports, GNFS [d]	11.4	-2.0	19.3	12.5	9.4	10.8	12.9
Net exports, contribution to growth	1.4	-3.9	2.9	-0.2	0.3	0.7	0.2
Current account bal/GDP (%)	4.1	5.1	3.7	2.4	2.4	3.0	2.9
GDP deflator (median, LCU)	5.5	0.2	6.6	5.1	4.1	3.5	4.4
Fiscal balance/GDP (%)	-2.1	-3.2	-1.8	-1.4	-2.1	-1.7	-1.4
Memo items: GDP							
East Asia excluding China	3.6	1.5	7.0	4.5	5.1	5.8	5.8
China	9.9	9.2	10.4	9.2	8.2	8.6	8.4
Indonesia	2.6	4.6	6.2	6.5	6.0	6.5	6.3
Thailand	3.3	-2.3	7.8	0.1	4.3	5.2	5.6

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).

Source: World Bank

Tourism and remittances play important ancillary roles in the non-merchandise portions of East Asia's current account position. Among developing regions, East Asia is the largest destination for global tourism arrivals, having accommodated some 116 million visitors in calendar year 2010, according to the United Nations World Tourism Organization (UNWTO). And worker remittances provide a foundation for consumer spending, and in some cases investment, for countries such as the Philippines, Vietnam and smaller island economies. Table EAP.2 highlights some of the main currents in revenue flows for the region. In the case of each revenue source, flows diminished at the peak of the crisis in 2009, but have since recovered sharply to exceed pre-crisis levels by a wide margin.

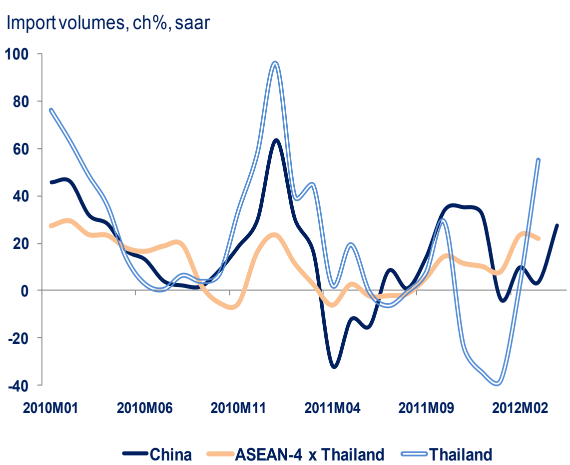
- *Tourism*. According to the UNWTO, 85 percent of countries reported positive figures for 2011, with 33 percent recording double digit gains. Cambodia, Thailand and Vietnam saw arrivals increase by 20 percent during the year. Overall, East Asian tourism receipts reached an estimated $115.5 billion, or 1.5 percent of GDP during 2011, a small share at regional level, but of substantial importance for countries like Fiji, Cambodia, Malaysia, Thailand and Vietnam. Overall tourism receipts have recovered strongly from the 2009 crisis and have helped maintain current account positions at moderate levels while representing an important and relatively stable source of foreign currency for some of the smaller island economies.

- *Remittances*. The Philippines is the largest recipient of worker remittances in East Asia, accounting for 10.7 percent of the country's GDP. Philippine remittances have bounced back 24 percent since 2009. Remittances are also an important source of foreign currency and incomes in Fiji (5.8 percent of GDP), Vietnam (5.1 percent) and Cambodia (3 percent).

The region's current account surplus position has diminished by $225 billion from 2008 to 2011, with a large portion of the decline accounted for by China, where surplus declined from $410 billion (10.4 percent GDP) in 2008 to $200 billion (2.8 percent of GDP) in 2011, reflecting both negative terms of trade developments and a reorientation of growth toward the domestic market. Changes in current account balances of other countries in the region have been much more modest. The strengthening recovery in high-income countries is expected to see the regional surplus increase somewhat despite recent increases in oil prices (figure EAP.5).

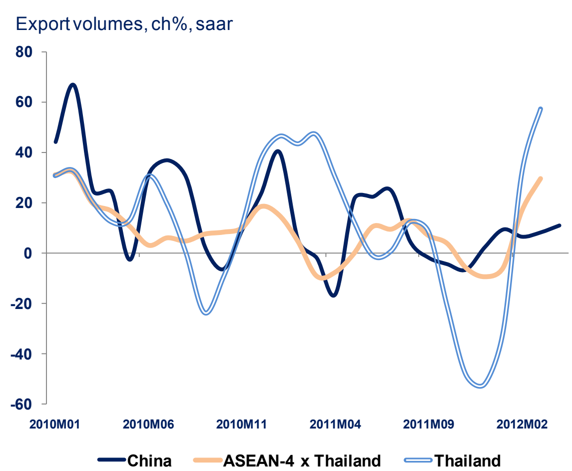
Domestic policies. Most countries in the region

Figure EAP.3 Imports revive following downturns in China and Thailand



Source: World Bank.

Figure EAP.4 Recent revival of exports is of encouragement



Source: World Bank.

Table EAP.2 Tourism and worker remittance flows to East Asia , USD billions

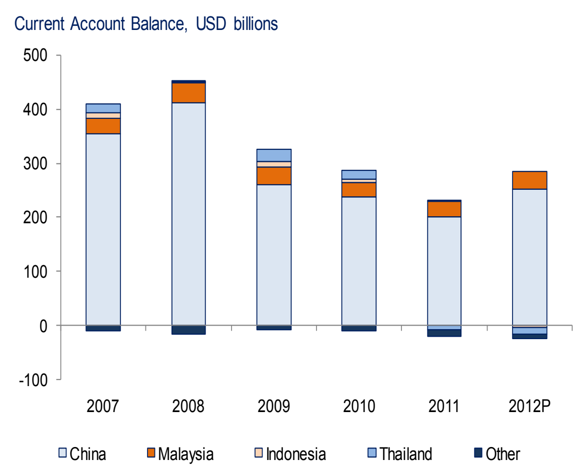
Country	2009	2010	2011E	%GDP 2010	Ch% 11/09
Tourism Revenues $mn					
East Asia and Pacific	**94.2**	**112.1**	**115.5**	**1.5**	**22.6**
China	42.6	50.1	56.3	0.8	32.2
Thailand	19.4	23.4	25.1	7.4	30.0
Malaysia	17.2	19.8	22.2	8.4	29.0
Indonesia	6.0	7.6	8.4	1.1	40.0
Vietnam	4.0	4.5	5.0	4.1	25.0
Philippines	2.8	3.2	3.5	1.6	9.8
Cambodia	2.0	2.4	2.5	21.2	25.0
Fiji	0.6	0.7	0.7	22.9	17.0
Papua New Guinea	0.1	0.1	0.1	0.1	0.0
Worker Remittances $mn					
East Asia and Pacific	**84.4**	**94.9**	**106.8**	**1.4**	**26.5**
China	48.9	53.1	62.5	0.8	27.8
Thailand	2.8	3.6	4.0	0.5	11.1
Malaysia	1.1	1.4	1.2	0.5	9.1
Indonesia	6.8	6.9	6.9	1.0	1.5
Vietnam	6.0	8.3	8.6	5.1	26.4
Philippines	19.8	21.4	23.0	10.7	23.5
Cambodia	0.3	0.4	0.4	3.0	25.2
Fiji	0.1	0.2	0.2	5.8	66.4
Papua New Guinea	0.1	0.1	0.1	0.1	1.2
Memo: Tourism and Remittances	**178.6**	**207.0**	**223.3**	**2.8**	**25.0**

Sources: United Nations World Tourism Organization (e); World Bank.

introduced some form of fiscal and-or monetary stimulus during the course of 2011 in order to compensate for the slowing in high-income economies. Most countries in the region have significant fiscal space with which to work, Vietnam being a notable exception (figure EAP.6). Policy cushions are considerable also with regional central banks holding substantial amounts of international reserves. In response to recent slowing in demand growth, Chinese authorities have announced a return to stimulus mode, with interest rate reductions, changes in subsidies and other demand-boosting measures.

Inflation. A stabilization of domestic food price inflation contributed to a strong deceleration in East Asian headline CPI from 7.5 percent in the second half of 2011 to 4.8 percent in the first months of 2012 (saar). And despite a 15 percent increase in global oil prices in the year through April 2012, developing country inflation continued to ease. However, most of the decline in East Asia reflected disinflation in China. Inflation in the other countries in the region has eased less sharply (figure EAP.7 and Inflation Annex). In several ASEAN countries, price inflation is building due to strong domestic demand growth.

Figure EAP.5 Compression of current accounts during crisis



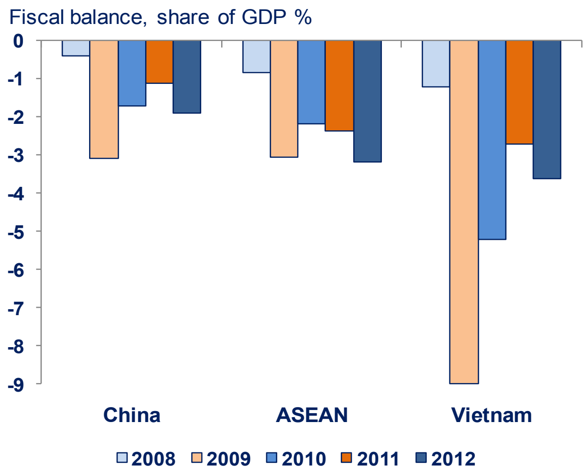
Source: World Bank.

Financial markets and capital flows

Capital flows into the developing East Asia region were resilient during the first half of 2011, but as in other developing regions, flows slowed markedly in the second half of the year, in response to increased risk aversion but also new banking regulation that accelerated deleveraging in several Euro Area banks (see Finance Annex).

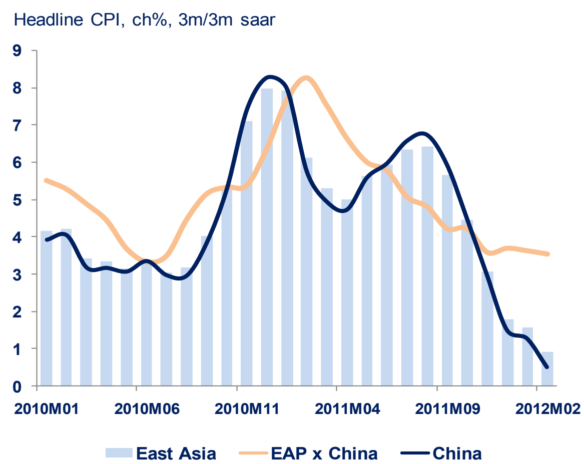
For the region and year as a whole, FDI inflows increased by $45 billion (largely to China), offset by a $20 billion decline in portfolio equity flows (IPOs and fund investments in regional exchanges) (table EAP.3 and figure EAP.8a). Partly reflecting the withdrawal of foreign investors and worries about Chinese growth prospects, regional equity markets underperformed global markets to a measureable degree (figure EAP.8b). Bond issuance, however, stepped up to $27 billion in 2011, an improvement over the robust rate of issuance in the prior year, while short-term debt flows eased by some $30 billion—a possible indication of tightened trade finance conditions in the region.

Figure EAP.6 Fiscal room sufficient for most countries if required



Source: World Bank.

Figure EAP.7 Inflation on a sharp downward course, led by China



Source: World Bank.

Box EAP.1: Recent developments for major countries and groups.

China's economy slowed into the first quarter of 2012, with GDP gains reduced to 8.1 percent (y/y) from 8.9 percent in the final quarter of 2011, the slowest advance in three years. Softer trade conditions, but also an easing in domestic activity led by real estate investment was responsible for the easing, as government maintained tighter policy toward residential investment.[3] The softening of China's growth should be moderate in the near-term, supported at quarterly rates near 8 percent in 2012—during a crucial year for political change in the country.

Several ASEAN countries have been making good progress on the domestic policy and growth fronts. Indonesia's GDP advanced by 6.5 percent in 2011, and the country was re-awarded investment grade status by Moody's; the Philippines, where the government is determined to boost growth from the less-than-expected 3.7 percent results of 2011, anticipates use of fiscal space to enhance investment and consumer spending. Portfolio investment has returned to these countries, supporting private capital outlays. And Thailand is anticipated to recover from the travesty of flooding (a 9 percent GDP falloff in the final quarter of 2011); and growth should rebound to more-than 4 percent in 2012, now that administrative barriers have been removed to clear more post-flood stimulus spending.

Vietnam's growth dropped by a full percentage point in 2011 to 5.9 percent, as oil prices eased to a degree in the second half of the year, and the revival of hydrocarbon prices during 2012 is a key factor in carrying growth back into the country's more traditional trend range of 6.5 percent. In October 2011, the Communist Party Plenum underscored the need for economic restructuring and identified public investment, SOEs and the financial sector as priorities for the coming 5 years.

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

$ billions

	2008	2009	2010	2011e	2012f	2013f	2014f
Current account balance	**439.1**	**318.9**	**277.2**	**210.3**	**253.7**	**341.8**	**392.0**
Capital Inflows	**209.4**	**235.3**	**448.2**	**440.0**	**343.2**	**397.4**	**473.0**
Private inflows, net	210.4	231.7	444.8	437.1	340.9	394.3	470.2
Equity Inflows, net	206.8	166.3	268.2	290.7	245.3	286.1	321.9
FDI inflows	214.1	137.5	227.7	272.2	229.7	265.1	286.9
Portfolio equity inflows	-7.3	28.9	40.5	18.5	15.6	21.0	35.0
Private creditors, net	3.6	65.3	176.6	146.4	95.6	108.2	148.3
Bonds	1.2	8.4	20.8	27.0	23.5	24.0	21.0
Banks	16.1	-6.6	13.1	15.0	9.0	12.0	19.0
Short-term debt flows	-11.4	63.5	141.5	104.3	63.0	72.0	108.0
Other private	-2.3	0.0	1.1	0.1	0.1	0.2	0.3
Offical inflows, net	-1.0	3.7	3.4	2.9	2.3	3.1	2.8
World Bank	1.2	2.2	2.7	1.1			
IMF	0.0	0.1	0.0	0.0			
Other official	-2.1	1.3	0.8	1.8			

Note:
e = estimate, f = forecast

Source: World Bank.

The projected decline in flows for 2012 mainly reflects the drop already observed in the second half of 2011. Indeed, even if flows grow during the course of 2012 at a 10 percent quarterly pace, the low-base at the end of 2011 means that yearly growth rates for 2012 would be low, with all categories of finance affected. Indeed, during the early months of 2012, capital flows improved. Overall, capital flows to the region are expected to rise from about $440 billion (5 percent of regional GDP) in 2011 to $470 billion (4 percent of regional GDP) by 2014.

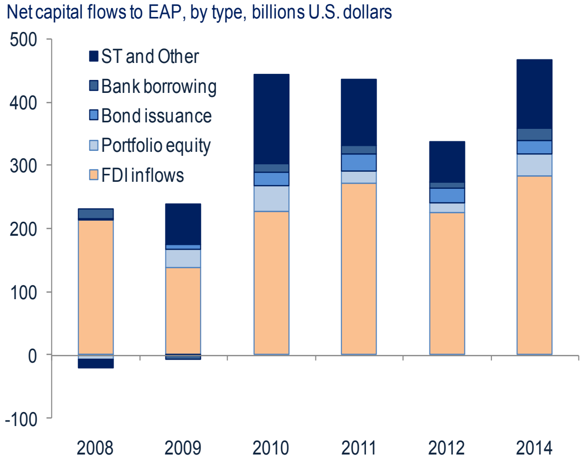
Medium-term outlook

Improved global financial conditions and a gradual step-up in growth prospects in the high-income world are expected to help re-invigorate growth for most of the countries in the region over the forecast period. However, the outlook will not be as robust as it might otherwise have been because of significant external and regional headwinds. Global headwinds include the recent high level of oil prices as well as relatively weak demand growth from high-income countries where recovery will continue to be held back by fiscal consolidation.

Foremost among regional headwinds is likely the gradual slowing of growth in China, as the authorities seek to moderate activity in order that production capacity can catch back up to demand levels. As a result, the easing of growth that began in 2011 will likely give way to further slowing during 2012 to 8.2 percent , due in part to worsening conditions in Europe. Thereafter a pickup with stronger world recovery is expected to yield trend growth of some 8.4 percent by 2014. The evident slowing of growth as read through recent GDP releases, production, trade, PMI surveys, investment and household spending data has placed the Chinese authorities back in "stimulus mode", (subsidy measures, acceleration of infrastructure investment and lowered required reserves ratios for the banking system). With more fiscal than monetary space available, the burden is expected to fall on the fiscal side, helping to sustain growth until external demand factors come to play over 2013-14 (table EAP.4).

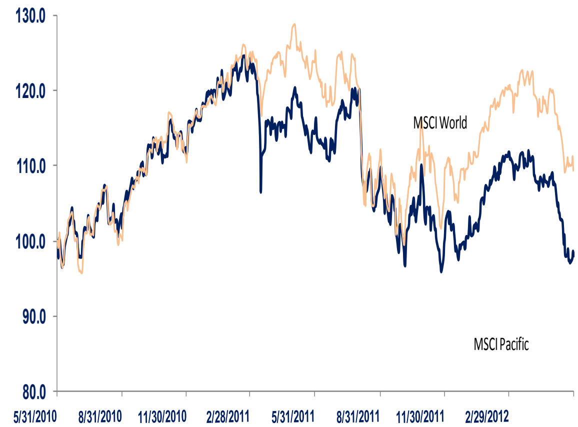
Growth in other major economies of the region is projected to accelerate moderately before easing into the latter years of the projection period. Despite the expected near-term anemic

Figure EAP.8a Capital flows diminish by 2.3% of GDP between 2010 and 2012



Source: World Bank.

Figure EAP.8b East Asia's bourses have been outperformed at the world level



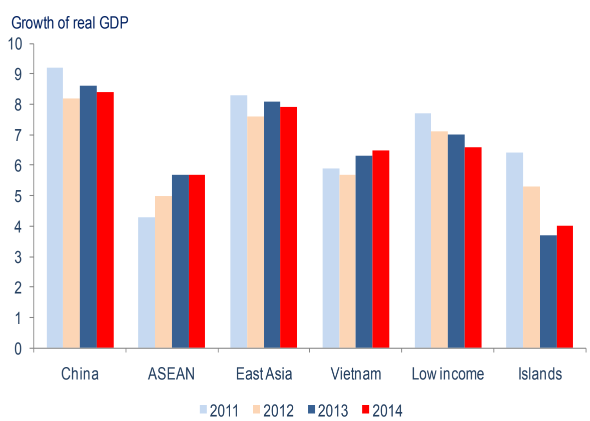
Source: Thomson-Reuters Datastream.

recovery in the high-income world, demand for the exports of East Asia and Pacific will strengthen (partly because Euro Area imports will stop falling and partly because of faster growth elsewhere in the high-income and developing worlds), prompting an acceleration of regional exports from a more sluggish 9.9 percent pace in 2011 to 11.4 percent by 2014.[4] But the vigor of growth in the region will be sapped by the expected reversal of some of the regional stimulus measures that were introduced in 2011 (figure EAP.9).

For the major ASEAN countries, growth is viewed to be buoyant for 2012, as broadly favorable "carry over" should sustain domestic demand until impetus from a revival in global trade comes to the fore in the second half of the year. For the group in aggregate, growth is expected to step-up to 5 percent in 2012 on activity remaining strong in Indonesia and recovering in Thailand. The pace of growth is expected to increase to 5.7 percent through 2014, as Indonesia continues to grow rapidly at around 6.5 percent, followed by Malaysia, Thailand and the Philippines nearer 5-5.5 percent. These countries will clearly benefit from the revival of world trade. Vietnam, as an oil exporter, will enjoy a near-term fillip to growth due to high oil price levels, but as these prices settle, growth is projected to establish a 6.5 percent pace by 2014 grounded in improved fundamentals.

Among low- income countries of the region, Cambodia and Lao PDR, GDP gains in aggregate eased to 7.1 percent in 2012 from 7.7 in the preceding year. Lao PDR should be sustained at growth rates between 7 to 8 percent by continued strong investment in hydropower; while Cambodia (5 to 6 percent) is deriving growth dividends from focus on higher rice production, inflows of FDI into the growing garment industry and building of tourism arrivals.

Figure EAP.9 A moderating growth profile in line with medium-term potential output



Source: World Bank.

The smaller Pacific Islands of East Asia, among which, Fiji, Papua New Guinea (PNG) and Vanuatu were hard hit in recession (3.2 percent growth in 2009), but have recovered fairly well in the two years succeeding, with activity for the group advancing by 5.3 and 6.4 percent respectively. The driver for the aggregate of the Islands may be found in PNG, where LNG investment has been a critical factor. Despite shocks to its export prices, the economy slowed only marginally, and had jumped to a 9 percent advance in growth for 2011. Expectations for GDP gains of this group of countries are for a moderate easing of activity toward a 4 percent range by 2014, as LNG investment falls off in PNG, and remittances may require some time to recoup.

The Island economies, and indeed the major ASEAN countries, are expected to benefit from a pickup in tourism arrivals, which are projected to increase by about 6 percent per year (globally) over the projection period, as incomes and confidence are gradually restored in high-income countries that have been most affected by the crisis.

Overall, growth for the developing region is anticipated to ease from 8.3 percent in 2011 to 7.6 percent in 2012 before recouping to an 8.1 percent pace in 2013, then easing to 7.9 percent, a figure closer to potential output gains for the aggregate of the region.

Risks and vulnerabilities

- Though financial developments in the Euro Area calmed in the wake of the Greek settlement, this unraveled with Greek elections, generating a spurt in CDS rates across the Area, increasing the fragility of the situation. While the likelihood of a serious deterioration of the situation in Europe has declined, it remains a distinct possibility – which would have significant effects on regional growth in East Asia. Down-side simulations presented in *Global Economic Prospects, January 2012,* suggest that growth in East Asia & the Pacific could slow by as much as 1.5 to 2.3 percentage points due to reduced import demand in high-income countries, much tighter international capital conditions and increased pre-cautionary saving within the region. Countries heavily reliant on external remittances (Fiji, the Philippines and Vietnam), tourism (Cambodia, Fiji, Malaysia, Thailand and Vietnam), and commodities (Indonesia, Malaysia and Thailand) as well as those with high-levels of short-term debt or medium term financing requirements (Malaysia) would be hardest hit.
- Over the last several months geo-political tensions in the Gulf region have increased (although they now show signs of prospective waning). Should the situation escalate, or if developments in the Arab Awakening were to spread to a major oil-exporting country, global oil prices could increase substantially. As discussed in the main text, should oil prices rise by $50 dollars per barrel for a sustained period, that would cut as much as 1.7 percent points from oil importers growth, raise inflationary pressures and generate a significant deterioration in regional trade balances.
- A slowdown in China would spill-over into the rest of the region in the form of reduced demand for exports, and commodity dependent countries would be especially at risk of a slowdown in China’s investment. Though a “soft landing” is the most likely growth outturn, a more rapid-than-expected slowing is possible.

Table EAP.4 East Asia & the Pacific country forecasts

(annual percent change unless indicated otherwise)	98-07 [a]	2009	2010	2011	Est. 2012	Forecast 2013	2014
Cambodia							
GDP at market prices (2005 US$) [b]	9.3	0.1	6.0	6.9	6.5	6.8	6.3
Current account bal/GDP (%)	-4.2	-8.9	-7.7	-8.7	-9.9	-9.5	-8.1
China							
GDP at market prices (2005 US$) [b]	9.9	9.2	10.4	9.2	8.2	8.6	8.4
Current account bal/GDP (%)	4.1	5.2	4.0	2.8	3.0	3.5	3.6
Fiji							
GDP at market prices (2005 US$) [b]	2.1	-1.3	-0.2	2.0	1.5	1.7	1.9
Current account bal/GDP (%)	-6.3	-7.6	-11.3	-11.9	-9.8	-18.6	-8.7
Indonesia							
GDP at market prices (2005 US$) [b]	2.6	4.6	6.2	6.5	6.0	6.5	6.3
Current account bal/GDP (%)	3.1	2.0	0.8	0.2	-0.9	-0.4	-0.6
Lao PDR							
GDP at market prices (2005 US$) [b]	6.4	7.6	9.4	9.4	8.2	7.6	7.4
Current account bal/GDP (%)	-10.6	-14.0	-8.7	-2.1	-12.9	-15.9	-9.0
Malaysia							
GDP at market prices (2005 US$) [b]	4.3	-1.6	7.2	5.1	4.4	5.2	5.2
Current account bal/GDP (%)	12.5	16.5	11.6	10.5	11.1	10.6	9.0
Mongolia							
GDP at market prices (2005 US$) [b]	6.4	-1.3	6.4	14.9	17.2	11.8	
Current account bal/GDP (%)	-2.9	-9.0	-5.8	-15.1	-13.6	-1.8	
Papua New Guinea							
GDP at market prices (2005 US$) [b]	1.3	5.5	8.0	9.0	7.3	4.2	4.6
Current account bal/GDP (%)	3.3	-10.8	-8.7	-14.6	-26.3	-18.0	-21.5
Philippines							
GDP at market prices (2005 US$) [b]	4.2	1.1	7.6	3.7	4.0	5.0	5.0
Current account bal/GDP (%)	0.6	5.6	4.2	2.3	1.7	2.5	3.0
Thailand							
GDP at market prices (2005 US$) [b]	3.3	-2.3	7.8	0.1	4.3	5.2	5.6
Current account bal/GDP (%)	4.7	8.3	4.9	-2.3	-3.5	1.8	3.3
Vanuatu							
GDP at market prices (2005 US$) [b]	2.9	3.5	3.0	3.9	4.0	4.2	4.2
Current account bal/GDP (%)	-9.6	-8.9	-7.9	-7.0	-7.2	-7.7	-8.2
Vietnam							
GDP at market prices (2005 US$) [b]	7.1	5.3	6.8	5.9	5.7	6.3	6.5
Current account bal/GDP (%)	-8.6	-13.8	-13.6	-12.5	-3.5	-4.9	-6.6

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.

Source: World Bank.

Notes:

1 For the region excluding both China and Thailand, where GDP in the latter was constrained to 0.1 percent in 2011 due to catastrophic flooding, East Asian growth dropped to 5.7 percent in 2011 from 6.7 percent in the previous year.

2 Saar--or seasonally adjusted annualized rate.

3 The first quarter GDP release shows that residential property prices fell 15 percent in the year to Q1-2012.

4 That is, country (i)s partner import volumes weighted by the share of country (i)s exports in partner imports.

Europe and Central Asia Region

Overview

Europe and Central Asia posted another year of strong growth of 5.6 percent in 2011, driven mainly by oil-exporters Russia and Kazakhstan, Turkey and a rebound in Bulgaria, Romania, Ukraine, and some others. Growth picked up despite strong headwinds from the Euro Area in the latter part of 2011. The increased financial turmoil in high-income Europe was reflected in weakening external demand that caused both industrial production and export growth to slow sharply in the second half of the year. The region also experienced a reversal in capital flows and a collapse in stock prices. Deleveraging by European banks, which intensified during the second half of 2011, has cut into syndicated bank lending to the region.

The effects of the Euro Area crisis were offset to a significant degree by favorable domestic developments in large middle income countries of the region. Favorable terms-of-trade effects, declining unemployment and accommodative fiscal and monetary policies all supported domestic demand. For the year as a whole, net private capital flows increased to $159 billion in 2011, from $150 billion in 2010. Most of the increase came in the form of foreign direct investment (FDI). Remittances grew by 12.6 percent in 2011 despite the problems in Western Europe.

Outlook: Growth in the developing **Europe and Central Asia** region (box ECA.1) should slow in 2012 to 3.3 percent, rebounding to 4.1 percent in 2013 and 4.4 percent in 2014, assuming a resolution of the Euro Area crisis by end-2012. Growth in Russia and Kazakhstan will moderate, as countries close output gaps. Russian growth is projected at 3.8 percent in 2012, 4.2 and 4.0 percent in 2013 and 2014. After two years of unsustainably strong growth, GDP in Turkey is projected to slow to 2.9 percent in 2012 (from 8.5 percent in 2010), before firming to 4 and 5 percent in 2013 and 2014.

Box ECA 1. Country coverage

For the purpose of this note, the Europe and Central Asia region includes 21 low– and middle-income countries with income of less than $12,276 GNI per capita in 2010. These countries are listed in the table ECA.4 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.

Net capital flows are expected to fall in 2012, before rebounding in 2013, while remittances are projected to grow in line with activity over the medium-term.

Risks and vulnerabilities: As tensions in the Euro Area have returned, economic prospects are fragile and risks of a contagion to developing countries in the region remain real, especially for those with strong economic linkages (trade, remittances, commodity prices, international finance). These linkages were discussed in detail in the January 2012 edition of *Global Economic Prospects*. A major deterioration of conditions in the Euro Area could reduce GDP in the region by 5 or more percent compared with the baseline.

Even if the worst downside risk does not materialize, some of the region's vulnerabilities could be magnified by slow growth, and weak and volatile international capital conditions.

Deleveraging and banking systems. The region's banking system is particularly susceptible to deleveraging by high-income European banks. Some deleveraging has already been undertaken in a more or less orderly fashion. However, recent events are likely to accelerate deleveraging by Greek-owned banks, which have a large presence in Albania, Bulgaria, Macedonia, Romania and Serbia. Possible spill-over effects to other Euro-area banks, should they occur, would have a more widespread effect in the region. Deleveraging has been adding to vulnerabilities of the domestic banking system in many countries, some of which already have high rates of non-performing loans (NPL).

Oil prices. The baseline growth forecast assumes that the recent decline in oil prices will not be reversed, but there are both up- and down-side risks to that assumption. While a sharp decline in commodity prices—due to faltering of global growth—would have potentially serious consequences for commodity exporting countries in the region, persistently high oil prices might cause a deterioration of external and domestic imbalances in some commodity-importers.

Recent developments

Growth in the region was strong in 2011 despite global financial turmoil

2011 turned out to be another year of strong growth for Europe and Central Asia with the region registering 5.6 percent growth, slightly higher than the 5.4 percent recorded in 2010 (box ECA.1). While almost all countries grew at a faster rate in 2011 compared with 2010, growth in the region was mainly driven by the oil-exporting countries (Russia and Kazakhstan), Turkey and the rebound in Armenia, Bulgaria, Latvia, Lithuania, Romania, Serbia, and Ukraine from the very low growth rates of 2009 and 2010 (table ECA.1).

The strong headwinds in the second half of 2011 generated by the intensification of the fiscal crisis in Europe (discussed in detail in the January 2012 edition of Global Economic Prospects) hit several economies in the Western Balkans particularly hard because of strong trade, financial and banking linkages with the Euro area. In fact, industrial production growth in the region declined to a 3 percent annualized pace in the second half of the year compared with 15 percent in the first half. Similarly, export growth slowed to a 6.1 percent annualized pace in the second half of the year, after 21 percent growth in the first half of the year. The region was also affected by the sharp decline in risk appetite among investors, which led to abrupt reversal in capital flows (particularly in portfolio investment flows), a jump in risk-premia, and a collapse in regional stock prices.

The negative influence of the intensification of the Euro Area crisis in the region was offset to a significant degree by the favorable domestic developments in large middle income countries. Favorable terms-of-trade developments (especially for commodity exporters), declining unemployment and accommodative fiscal and monetary policies supported domestic demand in most of the middle income countries. Beginning in August, several countries shifted their policy focus from inflation towards growth as the global economic outlook started to deteriorate and inflationary pressures started to ease. Turkey, Serbia, and Romania cut their policy rates. In addition to policy rates, many developing countries have been pro-actively relaxing the conditions governing credit growth, such as reserve requirements. Fixed investment spending was also supported by higher capital flows, particularly FDI inflows to the region, which increased 21 percent in 2011.

High commodity prices contributed to the economic growth in oil exporters in the region, such as in Russia (50 percent of the regional GDP) and Kazakhstan. In Russia, fixed investment and inventories were the largest contributors to growth in 2011, as stocks are still being rebuilt following the sharp depletion in 2009. Similarly, in Kazakhstan high oil prices boosted income (and private consumption) and spurred investment spending. Following the 2010 drought the bumper harvest in the region in 2011 contributed significantly to regional growth, particularly in economies with large agricultural sectors, such as Romania and Ukraine.

Unlike other developing regions which are beginning to rub up against capacity constraints, the supply side was able to keep up with the strengthening of demand in the region, because many countries have yet to recover the output lost following the 2008/09 crisis (figure ECA.1). Industrial output remains much lower than its long term trend in several countries (Ukraine, 28 percent lower; Bulgaria 28 percent lower, Armenia 27 percent lower, Lithuania 25 percent, and Latvia 16 percent). Economy-wide output gaps exceed 3 percent of potential output in all these economies.

In Turkey, the second largest economy in the region, growth was exceptionally strong amidst indications of growing imbalances. The growth was mainly driven by the rapidly rising domestic demand, pro-cyclical policy (increased government expenditure prior to the elections in June 2011) and increased investment. Domestic demand has also benefited from accommodative monetary policy by the Central Bank of Turkey, which has resulted in rapid credit growth. The

Table ECA.1 Europe and Central Asia forecast summary

(annual percent change unless indicated otherwise)	98-07[a]	2009	2010	2011	Est. 2012	Forecast 2013	2014
GDP at market prices (2005 US$) b	5.3	-6.5	5.4	5.6	3.3	4.1	4.4
GDP per capita (units in US$)	5.2	-6.9	5.0	5.5	3.3	4.0	4.4
PPP GDP c	5.4	-6.6	5.1	5.3	3.4	4.1	4.4
Private consumption	6.2	-5.1	3.9	7.5	5.4	4.6	5.3
Public consumption	2.7	1.4	1.7	1.3	2.1	2.3	2.6
Fixed investment	8.2	-17.3	9.9	7.4	4.3	6.6	5.8
Exports, GNFS d	7.6	-7.0	6.9	5.7	3.9	5.9	7.2
Imports, GNFS d	9.9	-24.0	16.6	9.6	6.5	7.1	8.0
Net exports, contribution to growth	-0.3	6.5	-2.7	-1.3	-0.9	-0.5	-0.4
Current account bal/GDP (%)	2.4	0.8	0.8	0.8	0.3	-0.7	-1.1
GDP deflator (median, LCU)	10.0	2.5	8.7	7.0	6.0	5.2	5.1
Fiscal balance/GDP (%)	-2.1	-5.4	-2.9	0.6	0.0	0.7	0.1
Memo items: GDP							
Transition countries e	5.9	-7.1	3.9	4.4	3.5	4.1	4.2
Central and Eastern Europe f	4.8	-7.9	-0.5	3.1	1.4	2.8	3.5
Commonwealth of Independent States g	6.1	-7.0	4.7	4.6	3.9	4.3	4.3
Russia	5.8	-7.8	4.3	4.3	3.8	4.2	4.0
Turkey	4.0	-4.8	9.2	8.5	2.9	4.0	5.0
Romania	3.8	-6.6	-1.6	2.5	1.2	2.8	3.4

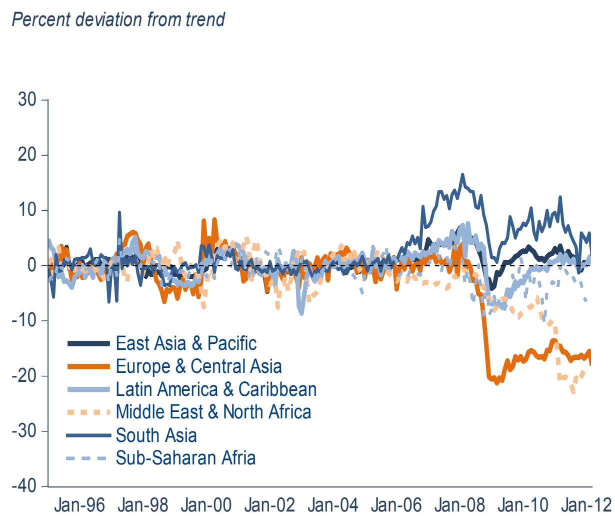
a. Growth rates over intervals are compound average; growth contributions, ratios and the GDP deflator are averages.
b. GDP measured in constant 2005 U.S. dollars.
c. GDP measured at PPP exchange rates.
d. Exports and imports of goods and non-factor services (GNFS).
e. Transition countries: f + g below.
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, Moldova, Russian Federation, Tajikistan, Turkmenistan, Ukraine, Uzbekistan.

central bank increased reserve requirements rates in December 2010 and later in March 2011, but later reversed the policy and reduced the rates in August 2011 due to increased concerns about global economic prospects. Strong domestic demand amid weakening external demand has led to a sharp increase in the current account deficit and inflation.

Indications are that the industrial production and trade slowdown have already bottomed out

Global economic news during the first four months of 2012 were generally positive. Tensions in financial markets eased significantly and real-side global economic activity strengthened following the significant structural, fiscal and monetary policy steps in high-income Europe. Global industrial production has recovered from November lows and trade has improved led by developing country imports.

Figure ECA.1 Industrial output remains significantly below its long-term trend in ECA region



Source: World Bank.
Note: For this analysis, the Europe and Central Asia region includes Armenia, Bulgaria, Kazakhstan, Latvia, Lithuania, Romania, Russia, Serbia, Turkey and Ukraine.

Similar trends were seen in the Europe and Central Asia region.

Industrial production data indicate that the recovery of activity in the second half of 2011 continued into early 2012 largely due to improving demand in high-income countries outside the Euro area, including among large developing economies. Reflecting these developments, production growth accelerated to a 5.3 percent annualized rate (3m/3m saar) in Europe and Central Asia in the first quarter of 2012 (figure ECA.2). Despite the strong growth of recent months, activity within the region remains well below pre-crisis trends and unlike other developing regions there is much spare capacity.

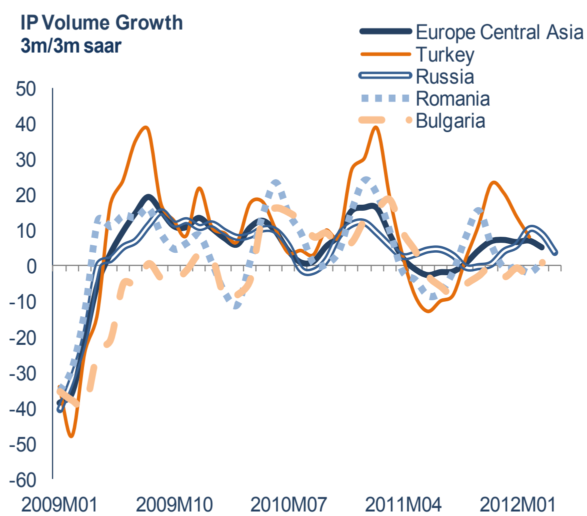
Industrial output performance varied markedly by country as country specific factors continue to shape the individual trends. For example, while initially the rebound was driven by the strong performance of Romania and Turkey, more recently industrial production has picked up noticeably in commodity exporters Russia and Kazakhstan as well as Latvia. In contrast, industrial production continues to slow in Turkey and Romania. Indeed, industrial production in Romania began shrinking toward the end of the year, reflecting fiscal tightening and weak import demand from high-income European countries. Similar contractions were experienced in other economies like Serbia and Bulgaria, all of which have relatively close ties to high-income Europe. While industrial production growth has remained positive in Turkey in 2012, it has lost momentum since November.

The activity in the region has started to slow down in April, however. Among the countries that have data for April, industrial production growth slowed down in Russia, Ukraine, and Kazakhstan and increased only in Lithuania.

Exports in the region had a strong rebound towards the end of 2011, and grew at a 16.9 percent annualized pace in the last three-months ending March (figure ECA.3). The rebound came despite the recession and weak import demand in high-income Europe—the region's main export destination (high-income European demand contracted through November, before firming marginally to grow at a 8.9 percent annualized pace during the three months ending March 2012).

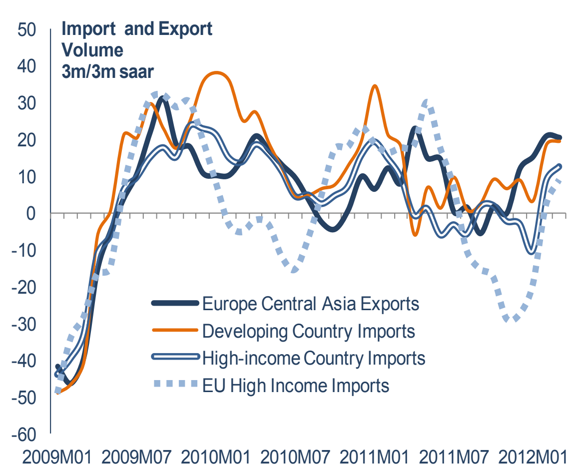
Thus while exports in Romania and Albania, which are heavily oriented toward high-income Europe declined in 2012, exports rebounded strongly in countries like Turkey (38.5 percent saar during the three months through March 2012), Lithuania (13.6 percent) and Russia (4 percent). In part, this reflected the trade

Figure ECA.2 IP growth had a rebound in October



Source: World Bank.

Figure ECA.3 Export growth rebound mostly driven by developing country demand



Source: World Bank.

orientation of these economies whose exports are relatively more oriented to fast-growing developing economies (developing-country import demand continued to expand even in the second half of 2011), or the recovering United States economy. Exports to other developing countries are particularly important for some countries in the region with Turkey being a major destination for exports from the South Caucus region and China for countries in Central Asia.

...but capital flows were mostly subdued in the region despite the improved financial conditions

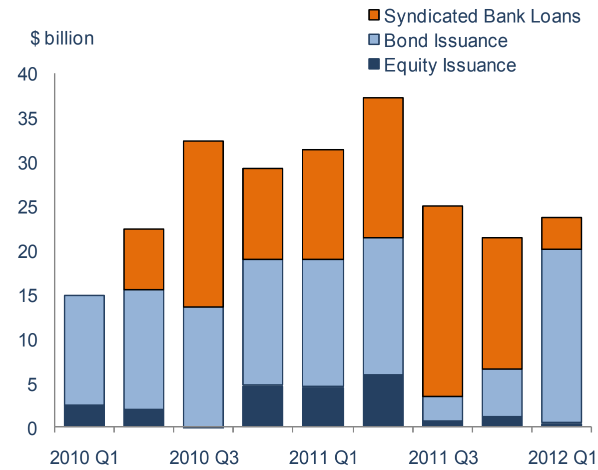
As discussed in the main text, after several months of heightened uncertainty and much weaker capital flows, conditions in financial markets improved significantly during the first four months of 2012. Spreads paid on sovereign debt of both high-spread European and developing economies also came off their late 2011 highs and global equity markets rebounded. More recently, however, there was a considerable increase in spreads and retrenchment in the equity markets as debt sustainability concerns for high-spread economies returned.

Gross capital flows (international bond issuance, cross-border syndicated bank loans and equity placement) were subdued in the Eastern Europe and Central Asia (figure ECA.4). Similar to the other regions and despite the slowdown in May, bond flows surged in the first five months of 2012, but only partially compensated for the sharp reduction in syndicated bank lending and equity issuance. Bond flows reached $26 billion in the first five months with issuances by large middle income countries in the region Russia, Turkey, Romania, Lithuania, Latvia and Kazakhstan.

...with Euro-zone bank deleveraging on-going

Syndicated bank flows weakened sharply during the second half of 2011 in part due to an intensified deleveraging process by the European banks (see main text and the Finance annex). International bank lending totaled only $15.6 billion in the first five months. While the sharp decline partly reflects weaker economic activity in the region, deleveraging by the European banks has also curtailed the availability of cross-border bank credit, including trade finance.

Figure ECA.4 Gross capital flows were subdued in 2012



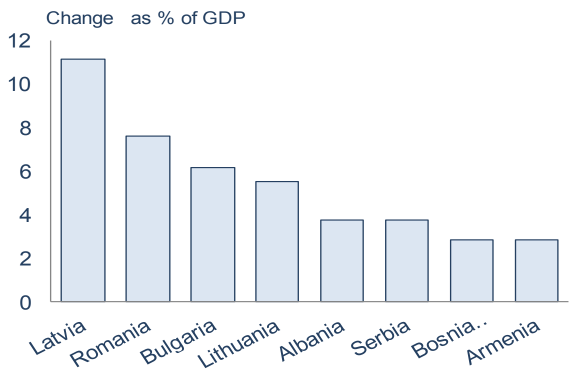
Source: World Bank

The impact of deleveraging was also evident as foreign claims data—including all cross-border and local lending by subsidiaries—by BIS reporting Euro-area banks declined by $44 billion between June and December 2011 in the Europe and Central Asia region (figure ECA.5). While the bulk of the reduction were in large economies such as Romania ($14 billion), Turkey ($13 billion) and Russia ($9 billion), the impact was much more widespread when the size of economies were taken into account (figure ECA.5)

Net capital flows are expected to decline in 2012…

Net private capital flows in the Europe and Central Asia region increased to $159 billion (4.4 percent of the region's GDP) in 2011 from $150 billion (4.9 percent) in 2010. Most of the increase came in form of foreign direct investment (FDI). While FDI inflows increased in most economies including Bulgaria, Latvia, Russia, Kazakhstan and Turkey, it contracted in Romania.

Figure ECA.5 Foreign claims by European banks declined between June and December 2011



Source: Bank for International Settlement and World Bank.
Note: Local lending portion of foreign claims is unadjusted for foreign exchange rate changes.

Going forward, net private capital flows are expected to fall in 2012, reflecting weaker FDI flows as the investment decisions that were postponed in the second half of 2011 will reduce flows in the first half of the year, and bank-lending that has continued to decline since the second half of 2011. Under the assumption that the ongoing turbulence in Europe will be resolved to market's satisfaction by the end of 2012 and early 2013, net private capital flows to the region are expected to rebound in 2013 with the growth in global economy and are projected to reach $188 billion in 2014—around 4 percent of region's GDP (table ECA.2). By 2014, all flows are expected to increase, with bond issuance expected to level off slightly as bank lending picks up the pace, with the latter supported by increased South-South flows.

Worker remittance flows are expected to increase further in 2012 as oil prices remain high

Remittances are an importance source of both foreign currency and domestic incomes for several countries in the developing Europe and Central Asia region. They represent more than 20 percent of GDP in Kyrgyz Republic, Moldova and Tajikistan. Remittances flows increased by 12.6 percent in 2011 despite the on-going economic problems in Western European countries, which contribute 40 percent of the remittances flows to the region (table ECA.3). Much of the increase came from the other developing countries, notably Russia. Russia and other developing countries account more than 30 percent of the remittances in the region. Oil prices have been an important determinant for the remittance flows in the region as buoyant oil

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

$ billions

	2008	2009	2010	2011e	2012f	2013f	2014f
Capital Inflows	**313.0**	**104.0**	**172.8**	**171.6**	**111.4**	**170.1**	**201.6**
Private inflows, net	301.0	68.4	150.2	158.6	99.2	157.2	188.0
Equity Inflows, net	146.9	92.3	85.4	95.6	70.8	96.4	119.6
FDI inflows	162.2	85.9	86.3	104.7	80.8	94.4	113.6
Portfolio equity inflows	-15.3	6.4	-0.8	-9.1	-10.0	2.0	6.0
Private creditors, net	154.1	-23.9	64.7	63.0	28.4	60.8	68.4
Bonds	16.4	-1.8	27.1	23.1	24.0	29.2	25.6
Banks	145.1	16.8	-7.7	24.0	-7.2	7.0	14.0
Short-term debt flows	-6.9	-38.5	45.5	15.8	13.0	24.0	28.0
Other private	-0.6	-0.4	-0.2	0.1	-1.4	0.6	0.8
Offical inflows, net	12.0	35.7	22.6	13.0	12.2	12.9	13.6
World Bank	0.7	3.0	3.5	1.7			
IMF	7.0	20.5	9.4	4.2			
Other official	4.3	12.2	9.8	7.1			

Note:
e = estimate, f = forecast

Source: World Bank.

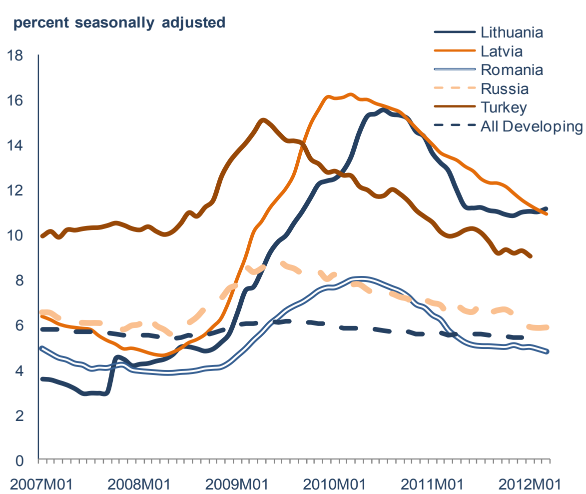
revenues and increased spending on infrastructure development tend to create opportunities for immigrants in Russia and other oil producing countries.

Remittance flows to the region are expected to grow at a slower pace of 8.8 percent in 2012 and to reach $45 billion, before accelerating to 10.1 percent ($49 billion) by 2013 (see Migration and Development Brief 18).

Unemployment rates have also declined but remain quite high

Unemployment surged following 2008 crisis in the region reflecting the sharp contractions in the Eastern Europe and Central Asian economies (figure ECA.6). While the increased output since then has helped to reduce the unemployment rate in countries such as Turkey, Latvia, Lithuania and Russia, it was not accompanied with

Figure ECA.6 Unemployment declined but still quite high in many economies in the region



Source: World Bank.

improved labor market conditions in many other such as Armenia, Albania and Bulgaria and Serbia. Despite the improvement in large economies, the region's unemployment rate remains higher than developing country average and might not get better in the medium-term as economic growth is expected to slow further in 2012.

Outlook

Growth is expected to slow in 2012 as the region faces several headwinds…

Despite the improved industrial production and trade, GDP growth in Europe and Central Asia is projected to slow to 3.3 percent in 2012 from 5.6 percent in 2011 (table ECA.4). There are several factors contributing to the slowdown:

- Despite the high(er) annual growth rates in 2011, economic growth declined in the second half of 2011 in most of these economies (figure ECA.7). The weakness in activity particularly in the last quarter of the year has reduced the carry-over growth in 2012 (see footnote 5 in the main text for an explanation). While carry-over from 2011 is generally low in many economies in the region, it is the weakest for Bulgaria and Serbia.

- The strong contribution to growth made by a rebounding agricultural sector in 2011 following the 2010 drought will be absent in 2012. The extreme weather conditions in the first quarter of 2012 may imply a weaker crop, especially in countries Ukraine, Romania, and Albania where harvests may disappoint.

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

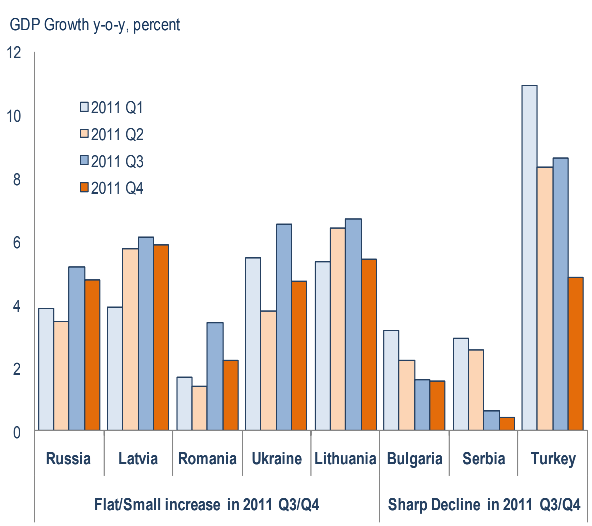
	2008	2009	2010	2011e	2012f	2013f	2014f
$ billions							
All developing countries	**324**	**308**	**332**	**372**	**399**	**430**	**467**
Europe and Central Asia	45	36	37	41	45	49	55
Growth rate (%)							
All developing countries	**16.4%**	**-5.2%**	**6.0%**	**8.0%**	**7.3%**	**7.9%**	**8.4%**
Europe and Central Asia	16.3%	-19.8%	-0.1%	12.6%	8.8%	10.1%	11.4%

Source: World Bank Migration and Development Brief #18.

- While high oil-prices forecasted for 2012 should help the economic activity in oil-exporting countries, growth in Russia and Kazakhstan is expected to slow slightly as they have been closing their output gaps and might be facing with capacity constraints. In Russia, output has already returned to its pre-crisis levels in 2011. In Kazakhstan, the output gap remained small and industrial production already surpassed its long-term trend in 2011. In addition, both economies benefited from bumper harvest in 2011, which is expected not to be a major contributor to growth in 2012.

- After two years of unsustainably strong growth, GDP growth in Turkey is also projected to slow to 2.9 percent in 2012 from 8.5 percent in 2011—assuming that global conditions do not deteriorate further. Much of the forecast slowing in the annual growth relates to a weak carry-over, as quarterly growth during the year is forecast to be higher. However, growth can be lower as the country is highly dependent on global financial conditions and with various macroeconomic indicators (high inflation, large and growing current account) pointing towards growing imbalances, the country is vulnerable to adverse developments in investor sentiment.

Figure ECA.7 Growth has been slowing down….



Source: World Bank.

- Apart from Turkey (discussed above), other economies in the region with strong economic and banking linkages with high-income Europe, will continue to be held back by weak growth in Europe (dragged by on-going fiscal consolidation in these countries) in 2012 and deleveraging by European banks, which is expected to limited credit growth (and therefore domestic demand). In addition, FDI is expected to moderate in 2012, which might limit investment growth in countries where FDI accounts for an important share of gross fixed investment such as Montenegro, Albania, and Kosovo.

…with modest recovery in the medium term

GDP growth in the region is projected to rebound to 4.1 percent in 2013 and rise further to 4.4 in 2014, under the assumption that European debt crisis will be resolved by the end of 2012 and global economic conditions will improve. Medium-term prospects for the region will critically depend on progress in addressing external (large current account deficits) and domestic (large fiscal deficit, unemployment, inflation) imbalances; lack of competitiveness; and structural constraints in their economies. For example, for the commodity exporters, the key challenge continues to be high dependence of extractive industries—most of them are facing capacity constraints and diversifying their economies from the extractive sector and reducing their dependence on commodity-related earnings (and international commodity prices). Diversification has been challenging, largely due to the lack of competitiveness in the non-oil sectors, high cost of doing business and weak investment climate. Russia's accession to the World Trade Organization which is expected to be finalized this summer might be an important milestone for Russia's medium-term prospects.

The economies that have yet to fully recover from the 2008/09 crisis face significant structural policy challenges in terms of balancing the need to reach/maintain fiscal prudence and addressing reforms of labor markets, healthcare and education. Several upcoming elections in 2012 and 2013 may delay the progress in necessary fiscal adjustments. In fact, IMF lending has been suspended in the lead-up to elections in Serbia (May) and Ukraine (October) on the disagreement about fiscal measures. Postponements have generated uncertainty regarding medium-term growth for these countries due to their high external financing needs and limited access to international financial markets.

Current account balance is forecasted to deteriorate while fiscal balance improves in the region

The region's current account balance is projected to shift to one percent of GDP deficit in 2014, from a surplus of 0.8 percent of GDP in 2011. High growth rates driven by strong domestic demand amid weakening external demand have led to large current account deficits in many commodity importing countries in the region. The increase in commodity prices and moderate recovery in exports combined with slowing domestic demand during the first quarter of 2012, is forecast to result in a rather slow narrowing of current account deficits. In fact current account deficits among oil importers are estimated to have reached over 7.8 percent of GDP in 2011 and is forecast to only gradually improve to 6.3 in 2013 and 5.8 percent in 2014. Moreover, despite high commodity prices the current account surplus of commodity-rich exporters is expected to fall from 6.3 percent of GDP in 2011 to 1.9 percent in 2014, as additional revenues are projected to leak into spending and imports relatively quickly.

Nonetheless, high commodity prices should boost government revenues in resource-rich countries, turning government deficits of 2.3 percent of GDP in 2011 to a slight surplus of 1.3 percent by 2014. At the same time, slowly improving activity levels and ongoing fiscal consolidation measures are projected to reduce government deficits in oil importing countries from 2.5 percent of GDP in 2011 to about 1.8 percent of GDP in 2014.

Risks and vulnerabilities

Tensions in the Euro Area are coming to the fore again forcefully after a relatively calm during the first quarter. Market sentiment had taken a turn for the worse during the first week of May, driven by election outcomes, renewed concerns about the health of the European banking sector and discussions about Greece leaving the Euro Area. As a result, the revival in the global economy that was observed in the first four months of the year and more favorable prospects remain fragile, and risks of contagion to developing countries in the region, especially those with strong economic linkages, remain real. These links (through trade, remittances, commodity prices, international finance) and the vulnerabilities of developing countries were discussed in detail in the January 2012 edition of *Global Economic Prospects*. Based on simulations highlighted in the main text, the real-side impact of serious deterioration in high income Europe could reduce growth in Europe and Central Asia by 2.9 percent in 2012, 5.2 percent in 2013 and 3.9 percent in 2014 (see main text box 5 for details).

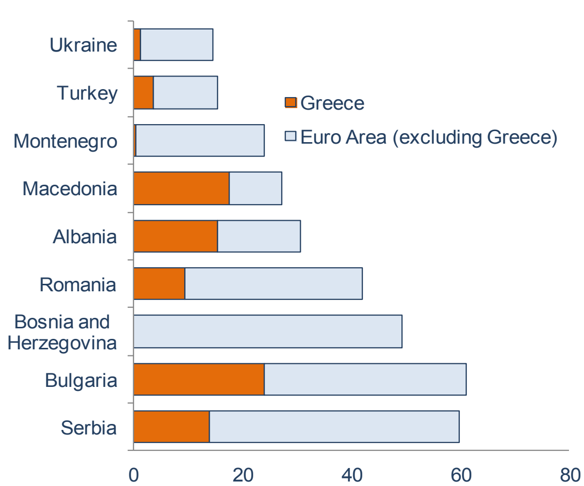
Even if policymakers will eventually act to avoid the materialization of the worst downside risks, a volatile international environment characterized by slow growth in major markets, weak and volatile international capital conditions and high commodity prices can exacerbate some of the region's vulnerabilities.

There are significant exposures and vulnerabilities for the region's banking system. As discussed in the January edition, the banking system is particularly susceptible to deleveraging by high-income European banks with its unusually strong linkages both in terms of ownership and day-to-day financing. So far, a fair bit of European banking-sector deleveraging has already been undertaken, in a more or less orderly fashion. Nevertheless the recent developments in Greece have put enormous pressure on an already stressed Euro-area banking system. Deleveraging by Greek-owned banks is likely to accelerate, with possible spill-over effects to other Euro-area banks.

Greek banks have a large presence in Albania, Bulgaria, Macedonia, Romania and Serbia and account for large shares of domestic bank assets in these economies—the highest in Bulgaria with 23.7 percent. Despite shedding $8.5 billion of their claims between June and December 2011, Greek-owned banks still had $69 billion in foreign claims (direct cross-border lending, and foreign and domestic currency lending through its subsidiaries) in the region by the end of 2011 (figure ECA.8). In countries such as Bulgaria and Serbia, subsidiaries of some of these banks have relied upon cross-border lending from their parents to support their loan portfolios, with loan –to–deposit ratios well over 100 percent. Nevertheless, most of the Greek-bank presence in the region is through subsidiaries (as opposed to branches) allowing host country authorities to monitor and address the developments, although their effectiveness will depend on various factors including the health of the domestic and other foreign banks operating in their country. Possible acceleration of deleveraging by other Euro-area banks will have a more widespread effect with $0.35 trillion foreign claims in the region (figure ECA.8).

In case of a more accelerated deleveraging, policy coordination will be crucial to restore confidence. In this context, the second Vienna Initiative of March 2012, like the earlier one in the wake of the 2008/9 crisis seeks to reduce the likelihood of a disruptive transmission of such a crisis to the financial systems of developing Europe and Central Asia by bolstering cross border supervisory and fiscal cooperation between home-host authorities. However, the second Vienna Initiative might be less effective compared to the initial one as the health of parent banks' balance sheet is now weaker and many of the sovereigns of the banks have limited ability to recapitalize them. In fact, several subsidiaries and branches in the region were downgraded or have been put under watch by one of three major rating agencies because of their weakened parent institutions in recent months.

Figure ECA.8 Foreign Claims as percentage of GDP (December 2011)



Source: Bank for International Settlements; World Bank.

Funding pressures from deleveraging has been adding to vulnerabilities of the domestic banking system in many countries. Overall, the condition of the region's banking system has deteriorated sharply following the 2008/09 crisis as non-performing loans (NPLs) jumped to 11 percent in 2011 from 3.8 percent in 2007. Many countries in the region could see a further marked deterioration in loan performance in the face of slowing growth. While many banks in the region seem well-capitalized, rating agencies have already downgraded or put several regional banks under watch because of increasing signs of weakness in the bank's asset quality, or in response to the downgrade of the sovereign. These downgrades will in return increase the cost of international funding and might generate constraints to investment in the medium-term.

Several economies in the region have high external financing needs (current account deficits and amortization of external debt) in 2012, which places them in vulnerable positions to a sudden reversal of global conditions. Some of these vulnerabilities have decreased, as all countries in the region—with the exception of Macedonia, FYR, Moldova and Armenia—have reduced short-term debt throughout 2011 lowering their external financing needs for 2012.[1]

Commodity prices—in particular oil prices—exhibited a significant level of volatility over the course of last twelve months (see the main text).

Table ECA.4 Europe and Central Asia country forecasts

(annual percent change unless indicated otherwise)	98-07[a]	2009	2010	2011	Est. 2012	Forecast 2013	2014
Albania							
GDP at market prices (2005 US$) [b]	6.8	3.3	3.5	3.0	1.6	2.5	3.0
Current account bal/GDP (%)	-6.3	-15.3	-11.9	-12.2	-10.8	-10.1	-9.7
Armenia							
GDP at market prices (2005 US$) [b]	10.4	-14.1	2.1	4.6	4.1	4.2	4.5
Current account bal/GDP (%)	-8.6	-15.8	-14.7	-12.2	-11.6	-9.6	-8.2
Azerbaijan							
GDP at market prices (2005 US$) [b]	15.3	9.3	5.0	0.1	3.1	3.5	4.5
Current account bal/GDP (%)	-7.2	23.7	28.3	27.8	24.9	21.6	18.0
Belarus							
GDP at market prices (2005 US$) [b]	7.4	0.2	7.7	5.3	2.9	3.5	4.4
Current account bal/GDP (%)	-3.9	-13.0	-15.5	-10.8	-6.2	-6.4	-6.1
Bulgaria							
GDP at market prices (2005 US$) [b]	5.3	-5.5	0.2	1.7	0.6	2.5	3.3
Current account bal/GDP (%)	-8.7	-8.9	-1.1	0.9	0.1	-1.2	-1.8
Georgia							
GDP at market prices (2005 US$) [b]	6.6	-3.8	6.4	7.0	6.0	5.5	5.2
Current account bal/GDP (%)	-10.5	-10.6	-10.3	-11.7	-9.4	-8.9	-8.4
Kazakhstan							
GDP at market prices (2005 US$) [b]	8.1	1.2	7.3	7.5	6.0	5.8	7.5
Current account bal/GDP (%)	-2.7	-3.8	2.9	7.1	5.3	4.4	3.3
Kosovo							
GDP at market prices (2005 US$) [b]		2.9	3.9	5.0	4.0	4.1	4.4
Current account bal/GDP (%)		-25.7	-25.6	-26.2	-23.7	-22.1	-19.5
Kyrgyz Republic							
GDP at market prices (2005 US$) [b]	4.2	2.9	-0.5	5.7	4.7	5.4	5.5
Current account bal/GDP (%)	-8.4	0.7	-6.9	-3.1	-5.1	-4.5	-3.6
Latvia							
GDP at market prices (2005 US$) [b]	7.9	-18.0	-0.3	5.5	2.3	2.9	3.5
Current account bal/GDP (%)	-11.6	6.3	3.0	-1.2	-1.9	-3.1	-4.7
Lithuania							
GDP at market prices (2005 US$) [b]	6.6	-14.7	1.4	5.9	2.3	3.5	4.2
Current account bal/GDP (%)	-8.5	4.5	1.8	-1.7	-3.2	-3.7	-3.7
Macedonia, FYR							
GDP at market prices (2005 US$) [b]	3.1	-0.9	1.8	3.0	2.2	2.9	3.1
Current account bal/GDP (%)	-5.2	-6.5	-2.2	-2.8	-5.4	-6.0	-5.1
Moldova							
GDP at market prices (2005 US$) [b]	3.4	-6.0	7.1	6.4	3.0	3.8	3.7
Current account bal/GDP (%)	-8.4	-9.8	-10.2	-12.6	-12.9	-11.5	-8.5
Montenegro							
GDP at market prices (2005 US$) [b]		-5.7	2.5	2.5	0.5	1.5	3.0
Current account bal/GDP (%)		-29.6	-24.6	-19.4	-16.9	-15.7	-13.7
Romania							
GDP at market prices (2005 US$) [b]	3.8	-6.6	-1.6	2.5	1.2	2.8	3.4
Current account bal/GDP (%)	-7.0	-4.2	-4.4	-4.4	-4.6	-4.5	-4.8
Russian Federation							
GDP at market prices (2005 US$) [b]	5.8	-7.8	4.3	4.3	3.8	4.2	4.0
Current account bal/GDP (%)	9.5	4.0	4.7	5.5	3.4	1.7	1.2
Serbia							
GDP at market prices (2005 US$) [b]	3.1	-3.5	1.0	1.6	0.5	3.0	3.5
Current account bal/GDP (%)	-7.4	-7.1	-7.2	-9.1	-8.6	-7.9	-6.0
Tajikistan							
GDP at market prices (2005 US$) [b]	7.9	3.9	6.5	7.4	5.8	5.9	6.0
Current account bal/GDP (%)	-4.2	-5.9	-2.1	-2.3	-3.6	-5.0	-4.9
Turkey							
GDP at market prices (2005 US$) [b]	4.0	-4.8	9.2	8.5	2.9	4.0	5.0
Current account bal/GDP (%)	-2.4	-2.2	-6.4	-10.0	-7.8	-7.5	-6.9
Ukraine							
GDP at market prices (2005 US$) [b]	5.7	-14.8	4.2	5.2	2.5	3.8	4.0
Current account bal/GDP (%)	3.2	-1.6	-2.1	-5.5	-4.7	-4.2	-3.9
Uzbekistan							
GDP at market prices (2005 US$) [b]	5.6	8.1	8.5	8.3	8.0	6.5	6.7
Current account bal/GDP (%)	6.2	2.2	6.2	5.8	4.5	4.4	4.5

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. 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.

Source: World Bank.

While prices increased earlier in the year reflecting supply-side issues, they later fell considerably with increased uncertainty related to global economic prospects. The baseline scenario assumes that the recent declines in oil prices do not reverse themselves and that oil prices gradually move toward a long-term level of about $80 dollars at today's prices. There are both up- and down-side risks to the forecast.

If international tensions (or internal tensions within an important oil exporter) intensify and a serious disruption to global supply ensues, prices could rise much higher. Higher oil prices might accentuate some of the vulnerabilities in oil-importing economies in the region. According to simulations highlighted in the main text (see the main text Box 6), headwinds associated with persistent higher oil prices are estimated to reduce baseline growth by 1.0 percent in 2012, 1.3 percent in 2013 and 0.4 percent in 2014 for the region's oil importers, while they increase baseline growth by 0.6 percent, 1.0 percent and 0.5 percent for the region's oil-exporters, respectively.

In addition to the adverse regional growth impacts, higher oil prices will likely cause further deterioration of external and domestic imbalances in some countries. For example, as discussed earlier, Turkey's economy is already showing signs of growing imbalances with its high inflation and large and growing current account deficit. Given that energy imports account for almost half of its current account deficit, high oil prices will add to these vulnerabilities and may increase the probability of a hard-lending. According to the Central Bank of Turkey, a permanent $10/barrel increase in the price for Brent crude would add 0.4 percent to headline inflation and 0.7 percent of GDP to the current account deficit over a 12-month period while cutting real GDP growth by 0.5 percentage points.

The recent decline in commodity prices attests to the possibility that commodity prices could indeed come down sharply in the projection period. Weaker global demand and a more rapid than anticipated delivery of new supply could result in lower than expected commodity prices. According to the simulations, lower oil and non-oil prices will have significant affects on economic prospects of the resource-rich economies in the region (see Main text Table 5).

On-going economic problems among high-income countries might also constrain remittances flows, which several small economies in the region are highly dependent on. The medium-term growth in remittances might be hindered if high unemployment rates persist in high-income Europe (which accounts for 40 percent of remittance inflows) as it will not only limit the job opportunities for migrants, but might also generate political pressures to reduce immigration.

Notes:

1 Much of the increase in short-term debt in Macedonia, FYR was the result of new measures initiated by the central bank and increase in trade-related credit.

Latin America & the Caribbean Region

Overview

Having made a strong recovery from the global financial crisis of 2009, economic activity in **Latin America and the Caribbean** is once again facing external and domestic headwinds. Overall growth in the region eased to 4.3 percent in 2011, from a remarkable 6.1 percent post-crisis rebound in 2010. Growth in Brazil, the region's largest economy, slowed markedly to 2.7 percent in 2011, from 7.5 percent in 2010, on sharply slower investment growth and slowing private consumption growth. Growth in the Caribbean was supported by a continued, albeit subdued, recovery in tourism, and a notable increase in activity in the mining and extractive sectors. Growth in the Central American region, which excludes Mexico, accelerated marginally, in part due to a marked acceleration in growth in Panama, due to the expansion of the Panama Canal, the construction of Metro system, and strong private consumption.

Increased concerns about the worsening of the situation in the Euro area during May has caused market sentiment to deteriorate globally. Increased financial tensions have driven up the price of risk, caused most currencies to depreciate against the U.S. dollar, and caused commodity prices and stock market indexes to decline markedly. This is in contrast to developments in early 2012, when improved sentiment in high-income Europe and the associated improvements in market expectations had prompted a robust rebound in capital flows, equity markets and regional currencies.

Outlook: The short-term outlook for **Latin America and the Caribbean** is clouded by a fragile and uncertain external environment, still high oil prices and capacity constraints in select economies. Due to resurgence in tensions in the high-income world the region is once again facing headwinds from marked declines in commodity prices and weaker capital flows. Consequently growth is expected to decelerate to 3.5 percent in 2012, before firming marginally to 4.1 percent and 4 percent in 2013 and 2014, respectively. Growth in Brazil is projected at 2.9 percent in 2012, accelerating to 4.2 percent in 2013, and 3.9 percent in 2014, supported by more expansionary policies and increased investment ahead of the World Cup. Argentina is expected to record one of the sharpest slowdowns in the region, with GDP projected at 2.2 percent in 2012 (8.9 percent in 2011), and to grow below 4 percent on average in the 2013-2014 period. Growth in the Caribbean is expected to consolidate at 4 percent by 2014, due, in part, to improvements in labor markets in the United States. The expected gradual recovery in the United States bodes well for Mexico, Costa Rica, El Salvador, and Haiti; countries that have strong industrial links to the world's largest economy. It will also support remittances and tourism to Central America and the Caribbean.

Risks and vulnerabilities: Risks to growth in the region have shifted to the downside. Large fiscal deficits and public debts in high-income countries and very loose monetary policies suggests that capital flows will remain volatile in the next years, making the fine-tuning of macroeconomic policies challenging.

Euro Area. A sharp deterioration of conditions in the Euro area is one of the main risk to the Latin American and Caribbean economies. In such a scenario global demand could drop significantly, and commodity prices, remittances, tourism, finance, and consumer and business sentiment would be negatively affected, potentially causing regional output to decline relative to baseline by close to 4 percent.

Countries that have fewer macroeconomic buffers could be particularly vulnerable in the face of a significant weakening in global demand.

Looking East. As the region, notably South America, is becoming increasingly reliant on exports to East Asia, particularly China, a hard-landing there could have important implications for export growth in the region.

Recent economic developments

LAC economies have recovered from the 2009 slump…

Economic activity in most Latin American and Caribbean economies has recovered from the global economic crisis, with output gaps positive or close to zero (greater than -0.5 percent of potential GDP) in two thirds of the economies in the region. Regional industrial output[1] in the first quarter of 2012 was in line with its long term trend level (figure LAC.1), with output in Colombia, Mexico, Peru, and Uruguay having recovered long-term trend levels, while industrial production in Argentina, Brazil, Chile, and Ecuador remains below long-term trend levels. Unemployment has fallen well below pre-crisis levels, in part a continuation of the downward trend established in the pre-crisis period. Several economies in the region have started to run against capacity constraints whether in terms of production capacity or labor force (figure LAC.2), which has been reflected in rising inflation or a slowdown in the pace of expansion.

…with annual growth decelerating in 2011 after robust performance the previous year

Overall growth in the region eased to 4.3 percent in 2011 from a remarkable 6.1 percent post-crisis rebound in 2010 (table LAC.1). Growth decelerated the most in the fastest growing economies that had started to push against production capacity constraints and where fiscal, monetary and prudential tightening was most aggressive. Growth in South America eased 2 percentage points to 4.6 percent, while growth in Central America (excluding Mexico) and the Caribbean (outside of Dominican Republic), which lagged behind the global cycle, accelerated marginally in 2011. Nevertheless growth in many countries in this part of the

Table LAC.1 Latin America & the Caribbean summary forecast

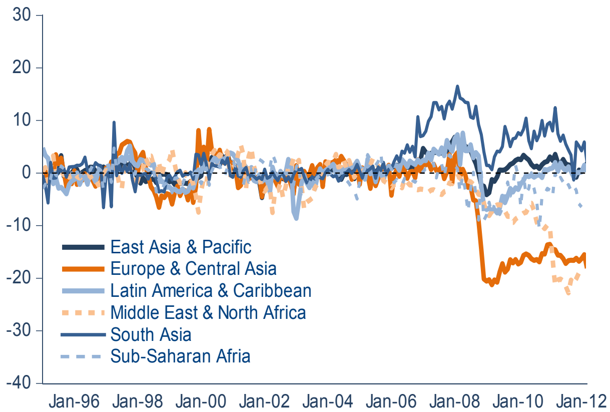
(annual percent change unless indicated otherwise)					Est.	Forecast	
	98-07[a]	2009	2010	2011	2012	2013	2014
GDP at market prices (2005 US$) [b]	3.1	-1.9	6.1	4.3	3.5	4.1	4.0
GDP per capita (units in US$)	1.7	-3.0	4.9	3.0	2.2	2.8	2.7
PPP GDP [c]	3.1	-1.6	6.1	4.5	3.4	4.1	4.0
Private consumption	3.9	-0.8	6.0	5.1	3.6	4.0	3.8
Public consumption	2.6	4.0	4.1	2.9	3.1	3.2	3.4
Fixed investment	3.9	-10.2	12.8	8.6	6.6	8.3	8.0
Exports, GNFS [d]	6.0	-9.7	11.4	6.2	5.6	6.4	6.6
Imports, GNFS [d]	6.4	-14.8	22.3	9.7	7.6	8.1	8.0
Net exports, contribution to growth	-0.1	1.6	-2.7	-1.2	-0.8	-0.8	-0.8
Current account bal/GDP (%)	-0.9	-0.6	-1.3	-1.4	-1.9	-2.1	-2.4
GDP deflator (median, LCU)	6.2	3.0	5.2	5.3	6.6	6.1	5.9
Fiscal balance/GDP (%)	-2.9	-3.9	-3.0	-2.6	-2.8	-2.5	-2.4
Memo items: GDP							
LAC excluding Argentina	3.2	-2.1	5.8	3.9	3.6	4.1	4.0
Central America [e]	3.4	-5.3	5.4	4.0	3.6	4.0	3.9
Caribbean [f]	4.7	0.4	3.5	2.7	3.5	3.8	4.0
Brazil	2.8	-0.3	7.5	2.7	2.9	4.2	3.9
Mexico	3.3	-6.0	5.5	3.9	3.5	4.0	3.9
Argentina	2.6	0.9	9.2	8.9	2.2	3.7	4.1

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: Antigua and Barbuda, Belize, Dominica, Dominican Republic, Haiti, Jamaica, St. Lucia, St. Vincent and the Grenadines, and Suriname.

Source: World Bank

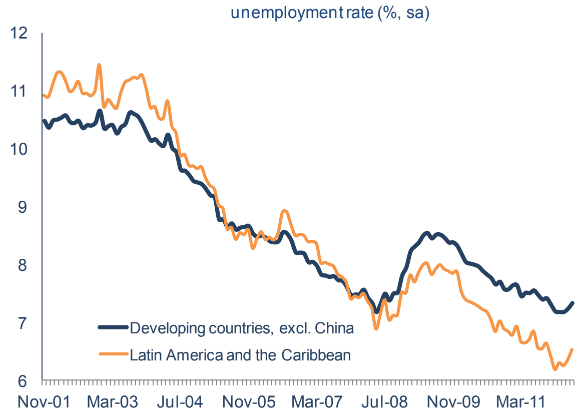
Figure LAC.1 Industrial output above its trend level

Percent deviation from trend



Sources: World Bank, Thomson Datastream.

Figure LAC.2 Unemployment at decades low in Latin America



Sources: Thomson Datastream, World Bank.

region remained relatively subdued. Panama was a notable exception, with growth accelerating markedly in 2011 to 10.6 percent, boosted by public works related to the expansion of the Panama Canal and the construction of the Metro, and by strong private consumption. Robust private consumption also supported growth in Guatemala, alongside stronger external demand.

The Caribbean region has finally recovered from a two-year recession, but efforts to consolidate fiscal accounts in combination with negative terms of trade (notably higher oil prices), have kept growth in check. The economy of the Dominican Republic expanded at a robust 4.5 percent pace in 2011, following a 7.8 expansion in 2010, supported by rapid growth in mineral output and a strong acceleration in free-zone manufacturing output. Elsewhere in the Caribbean, growth was supported by continued albeit subdued recovery of tourism, as high unemployment in high-income countries has held back tourist arrivals (up 3.6 percent in 2011 and now 3.4 percent higher than pre-crisis levels) and tourist spending. In addition, there was a notable increase in activities in the mining/ extractive sector. Haiti's economy expanded at a 5.6 pace in 2011, after the output collapsed in 2010 following the devastating earthquake that struck in January 2010. The recovery was weaker than anticipated due to the slow pace of reconstruction and political instability. The weakness of governing institutions has made the reconstruction more difficult, while agricultural output was affected by poor harvest conditions, further limiting growth.

The deceleration in growth in South America was largely on account of the sharp deceleration in Brazil, the largest economy in the region and the spillover of weaker demand to its main trading partners in the region. Brazil's growth slowed markedly to 2.7 percent in 2011, down from 7.5 percent in 2010, when the economy began to show signs of overheating (rising inflation, falling unemployment, rising current account deficit, and declining competitiveness in part due to rising wage costs). The slowdown in 2011 has helped relieve these pressures, bringing output back into line with potential output (Brazil's 2011 output gap is estimated at 0.8 percent of GDP). This was partly the result of policy tightening in the first half of 2011, and softer external demand in the second half of the year. Performance in the manufacturing sector was particularly weak, held down also by the appreciation of the real in the context of strong capital inflows. The marked slowdown in Brazil has had negative consequences for its main trading partner in the region. Growth has also decelerated markedly to 4 percent in Paraguay, down from a remarkable 15 percent growth in 2010, as agricultural output was negatively affected by a drought following a bumper harvest in 2010, and as the foot and mouth disease took a toll on the cattle sector. The contraction in the construction sector, induced by the slowdown in private sector credit and capacity constraints has also contributed to the deceleration in growth. Similarly growth in Uruguay eased from robust 8.9 percent rebound in 2010, to a still strong 5.7 percent growth in 2011, partly due to the marked deceleration in growth in its main trading partner Brazil.

Most other countries in the region recorded only mild deceleration in growth or they actually saw an improvement in their economic performance. Output in Colombia bucked the slowing trend, with its economy expanding 5.9 percent, almost 2 percentage points faster than in 2010, with growth driven by robust domestic demand. Colombia's economy was particularly resilient in the second half of 2011 notwithstanding the challenging external environment, and is starting to run against capacity constraints prompting the central bank to continue raising interest rates through early 2012. Although Mexico's economy decelerated 1.6 percentage points to 3.9 percent, it proved more resilient than other economies in the second half of 2011. Although private consumption growth slowed somewhat, it continued to be supported by rising employment, recovery in credit growth, and strong households' balance sheets. Growth in both exports and imports decelerated markedly in 2011, on account of weaker external demand (exports have a large import content). Investment growth accelerated as Mexico competitiveness and its proximity to the U.S. continues to attract investment.

…largely on account of a marked deceleration in the second half of 2011

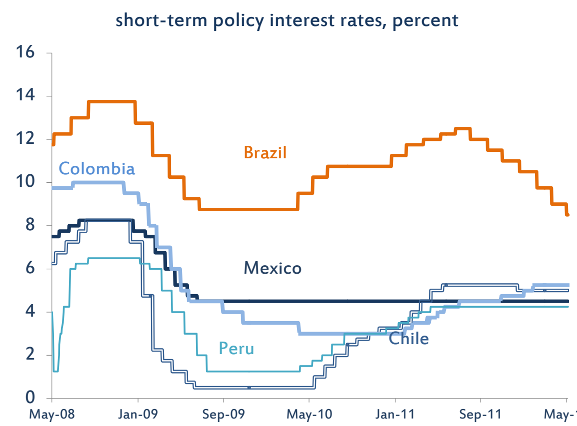
Industrial production in the Latin America and the Caribbean region declined for much of 2011, falling at a 1.7 percent annualized rate in the fourth quarter. The slowdown was triggered by domestic policy tightening introduced beginning in late 2010 in several large Latin American economies, but was exacerbated by the rise in global uncertainty mid-year as concerns about Euro Area fiscal sustainability heated up once again.

Market nervousness affected the Latin American and Caribbean region both directly and indirectly. Credit Default Swap rates for virtually every country in the region rose sharply. By the end of 2011, CDS rates had increased by 90 basis points on average for the financially integrated economies (Brazil, Chile, Colombia, Peru, Mexico) of the region. The spreads for Argentina and Venezuela increased much more sharply rising close to 300 basis points and 490 basis points respectively, as rising global risk aversion was compounded by concerns regarding domestic conditions. Market tensions prompted a flight to safe haven assets and a sharp decline in foreign capital flows to the region (40 percent year-on-year decline in equity issuance and a 9.5 percent year-on-year decline in syndicated bank lending in the fourth quarter), sharp equity selloffs and currency depreciations.

The combination of monetary policy tightening and fiscal consolidation (figure LAC.3) and the sharp deterioration of global sentiment and capital flows caused growth in the region to falter, with regional industrial production falling for some 5 months straight. Overall, regional GDP growth slowed to an estimated 4.3 percent in 2011, down from 6.1 percent the previous year.

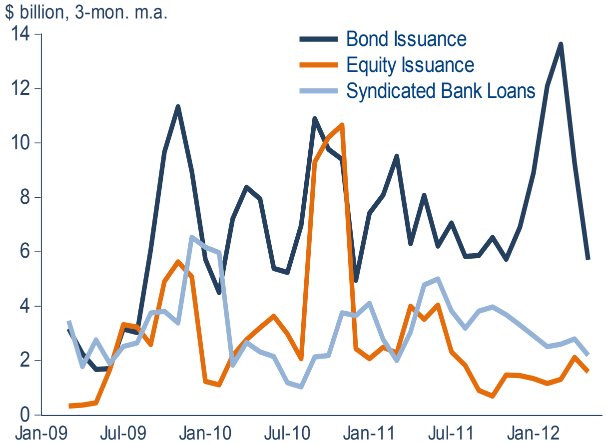
At the same time, the slowing of growth in the second half of 2011 and a stabilization of global food prices served to ease regional inflation pressures. Seasonally adjusted quarterly inflation

Figure LAC.3 Monetary policy in inflation-targeting countries



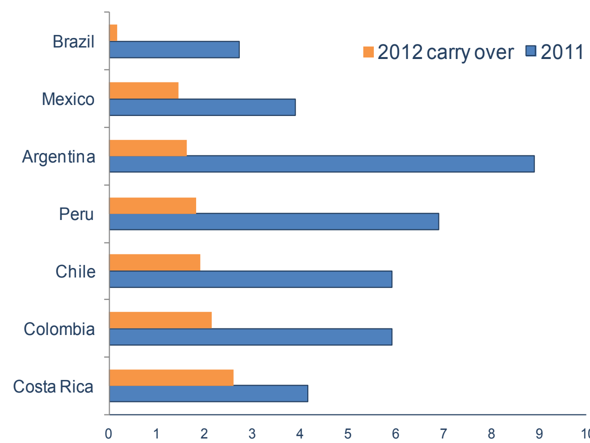
Sources: National agencies through Datastream.

Figure LAC.4 Weak bank flows and equity placements



Sources: Dealogic and World Bank staff calculations.

Figure LAC.5 Growth and growth carry over in Latin America & the Caribbean



Source: World Bank staff calculations.

rates in the first quarter of 2012 were lower than in the first quarter of 2011 in two out of three of the regional economies that report data. The disinflation was particularly pronounced in Chile, Dominican Republic, Guatemala, Haiti, Mexico, Uruguay, and R. B. de Venezuela. However, annual inflation rates remain in the double-digit range in R. B. de Venezuela. Inflation has decelerated also in Brazil, to 5.2 percent year-on-year by March, or 4 percent quarter-on-quarter, seasonally adjusted annualized basis in the first quarter of 2012. Inflation remains elevated in Argentina.

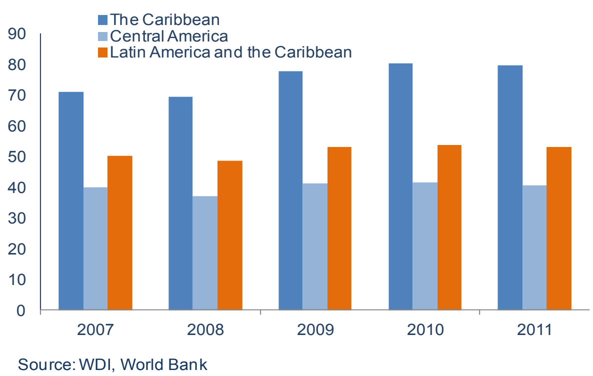
Current account balances continued to deteriorate in South America despite very favorable terms of trade, in part due to very robust domestic demand in some cases boosted by very expansionary policies which have fueled import growth.

More buoyant domestic demand in Central America led to a 0.9 percentage point deterioration in current account balances to 6.7 percent of GDP, as stronger import growth offset the relatively strong growth in export revenues and remittances. Remittances grew on average by 7.6 percent in 2011, up from 4.4 percent growth in 2010.

Similarly in the Caribbean countries that rely on tourism services, current account deficits have also deteriorated, by nearly 0.5 percentage points, in part due to high oil prices. On aggregate, remittances to Caribbean countries, which amount on average to about 6.4 percent of GDP, expanded at a slower pace of 3.7 percent in 2011. In Jamaica, where remittances accounted for 14 percent of GDP, remittances were growing at a 3.8 percent pace in the year to April, down from 8 percent pace of the previous year. Remittances to most Central America and Caribbean countries are now above their pre-crisis levels, with the notable exceptions of Mexico, El Salvador and Jamaica. The decline in migration from Mexico to the United States over the period 2005-2010 and an increase of migration back to Mexico by Mexican nationals in the wake of the crisis has brought net migration to the United States from Mexico down to zero or even negative. Remittances have mirrored this patterned reaching an all-time high of $26.9 billion in 2007, and have since decline to $23.6 billion, in part due to increased unemployment among migrants in the U.S. in the wake of the crisis.

Public debt as a share of GDP has increased moderately in the wake of the 2008/2009 crisis as governments in the region used counter-cyclical fiscal policies to support domestic demand while at the same time economic growth decelerated. Nevertheless vulnerabilities to external shocks have been reduced. Improved macroeconomic performance and stability, and more prudent fiscal policies have helped reduce the public debt burden, whose levels are now well below the levels of the 1990s (figure LAC.6). In addition, a restructuring of debt toward local currency and longer-maturity instruments have reduced the scope for balance sheet effects, which along with higher reserves have reduced vulnerabilities further. In contrast , in the Caribbean debt burdens have increased significantly immediately following the crisis and continued to rise in subsequent years, with debt servicing taking a heavy toll on growth (IMF 2011).

Figure LAC.6 Public debt in Latin America & the Caribbean as share of GDP



Sources: World Bank.

Capital flows returned to the region in early 2012

Financial market tensions eased in the first 4 months of 2012 after heightened uncertainties in the second half of 2011. In part as response to major policy initiatives in Europe sentiment lifted and market expectations improved, and capital flows, equity markets and regional currencies rebounded in early 2012.

Latin America benefited the most from the partial recovery of capital flows to developing countries in the first quarter of 2012, receiving almost half of the $117.7 billion gross capital flows (international bond issuance, cross-border syndicated bank loans and equity placements) received by developing countries. Almost all the increase came in the form of increased bond issuance, which surged, to $41 billion up 43 percent year-on-year to reach historic highs in the first quarter of 2012. Meanwhile syndicated bank lending was up close to 30 percent. In contrast equity issuance remains very weak. The strong inflows reflected very robust bond issuance by mainly state-owned resource firms in Latin America on the one hand and very weak bank-lending on the other hand. The biggest corporate bond issuers were oil & gas, including a record (for developing-country firms) $7 billion bond offering by Brazilian oil company Petrobras in February.

There was also evidence of a weak recovery in trade finance flows to the region. These had been fallen by 47.4 percent in the fourth quarter despite a 1.4 percent increase in trade. Trade finance is up $4.2 billion in absolute terms in the first quarter of 2012 with its share in regional merchandise exports rising 4.7 percentage points, to 11.5 percent of merchandise exports, with at least some of the rebound reflecting entry of regional banks into the trade finance arena (see the Finance Annex).

Most recently however there are indications of a deterioration in financial conditions for developing countries. The stock market indexes in the region declined during May and early June, with the MSCI LAC index down 17 percent in U.S. dollar terms since early May. The marked weakening in many of the currencies in the region against the U.S. dollar is likely due in part to capital outflows and increased risk aversion. The Mexican peso lost 9 percent of its value against the U.S. dollar while the Brazilian real and the Chilean peso depreciated more than 7 percent. Credit Default Swap spreads rose by nearly 50 basis points for LAC countries.

Economic outlook

Short-term outlook is clouded by a weak external environment

Growth for the Latin America and the Caribbean region is expected to decelerate to 3.5 percent in 2012, from 4.3 percent in 2011, due to a weaker

Table LAC.2 Net capital flows to Latin America and Caribbean

$ billions

	2008	2009	2010	2011e	2012f	2013f	2014f
Current account balance	**-35.5**	**-22.2**	**-60.6**	**-77.5**	**-109.7**	**-144.6**	**-184.3**
Capital Inflows	**181.5**	**173.2**	**319.8**	**278.5**	**230.7**	**258.3**	**298.5**
Private inflows, net	174.9	155.3	298.4	267.4	223.5	250.4	289.9
Equity Inflows, net	120.4	119.9	153.9	161.5	124.4	145.7	178.7
FDI inflows	130.0	78.3	112.6	155.0	118.8	131.3	158.7
Portfolio equity inflows	-9.7	41.6	41.3	6.5	5.6	14.4	20
Private creditors, net	54.6	35.4	144.5	105.9	99.1	104.7	111.2
Bonds	9.0	40.7	48.8	49	61	57.6	50
Banks	40.4	-0.3	27.4	14	11	12	15.9
Short-term debt flows	5.7	-4.5	67.2	42.7	27.0	35.0	45.0
Other private	-0.5	-0.5	1.1	0.2	0.1	0.1	0.3
Offical inflows, net	6.5	17.9	21.4	11.1	7.2	7.9	8.6
World Bank	2.4	6.6	8.3	1.9			
IMF	0.0	0.4	1.3	2.4			
Other official	4.1	10.9	11.8	6.8			

Note:
e = estimate, f = forecast

Sources: World Bank.

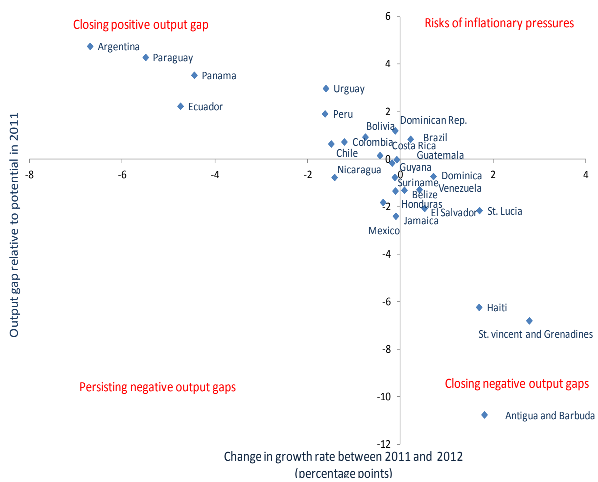
global external environment, high oil prices, capacity constraints in selected economies, and weak carry-over effects (box LAC.1 and figure LAC.5) following the pronounced slowdown experienced by some of the largest economies in the region during the second half of 2011. In contrast growth in the Caribbean is expected to accelerate slightly to 3.5 percent in 2012, benefitting in part from improvements in the U.S. labor markets. All other sub-regions are expected to see deceleration in growth, with growth in South America expected to ease 1.2 percentage points to 3.4 percent.

Countries that are more financially integrated with the global economy are projected to benefit from improved conditions on capital markets (as compared with 2011H2), but in selected countries stronger speculative capital flows may complicate macroeconomic policy. In particular, unless currencies are allowed to appreciate large capital inflows could fuel credit growth domestically and lead to build up in inflationary pressures in countries operating close to potential.

The recent improvement in economic sentiment in the U.S. economy and the expected gradual recovery bodes well for countries like Mexico, Costa Rica, El Salvador, Haiti that have strong industrial economic links to the world's largest economy, while improvements in the U.S. labor market will similarly support remittances and demand for tourism services benefitting countries in Central America and the Caribbean.

In Mexico growth is projected to decelerate gradually in the first half of 2012, but re-accelerate again towards the end of the year as demand from its major trading partner strengthens and the inventory reduction that weakened growth in 2011 come to an end. Moreover, the 8 percent increase in investment last year is projected to improve external competitiveness, while increasing future production capacity. In addition government spending in preparation for the presidential elections scheduled to take place in July will further support growth in 2012. Growth will continue to accelerate marginally over the 2013-2014 to close to 4 percent from 3.5 percent in 2012, as the manufacturing sector will benefit from stronger external demand as well as relocation of manufacturing activities and

Figure LAC.7 Growth deceleration in 2012 and output gaps



Source: World Bank.

increased investment in manufacturing as Mexico's competitiveness rises, including with respect to that of China, as wages there rise while transport costs are expected to remain high over the forecasting horizon. Continued sound and skilful macroeconomic policy and fundamentals are likely to be conducive to higher growth, but much needed structural reforms on the labor markets, energy, tax and education will be slow-coming at will continue to limit potential growth.

With global demand for commodities expected to moderate this year, partly reflecting slower Chinese growth, commodity exporters will see a decline in export performance. Most commodity prices are expected to decline this year, due to weaker demand, and in some cases improved efficiency, lower intensity of use and substitution. On annual basis oil prices are expected to rise 2.5 percent this year (before declining in 2013-2014 by 2 percent on average), mostly reflecting price increases observed in early 2012. Prices during the second half are projected to decline gradually as supply disruptions dissipate. Metal prices are expected to decline 11.2 percent in 2012, as demand growth is moderating in China and its metals intensity declines, before recovering 3.4 percent in 2013. Additional increases in new mine capacity are also expected to contribute to dampening prices. Agricultural prices are expected to decline 7.8 percent in 2012 on improved supply, and an additional 4.4 percent in 2013 (See the Commodity Annex).

Brazil's economy will continue to grow below potential in 2012 (2.9 percent), despite more supportive government policies, in part due to a weak external environment. Starting in August 2011 in response to perceived disinflationary effects of the worsening global economic outlook, the authorities have reversed their monetary policy stance, which had been tightening since April 2010. A 14.2 percent increase in the minimum wage, additional fiscal stimulus, and a 400 basis point decline in monetary policy interest rates are among the measures already announced or planned. Reflecting these efforts, gross domestic expenditure is projected to accelerate to 4 percent in 2012. Reflecting somewhat stronger domestic demand, increased labor costs and sectoral bottlenecks, net exports are expected to subtract from growth, and the current account balance as a share of GDP is expected to deteriorate by 1 percentage points (despite the recent imposition of "voluntary" trade restriction on Mexican autos), while inflation pressures will build up further. Growth is projected to accelerate to 4.2 percent in 2013, supported by

Box LAC.1 Slow growth in 2011, will reduce annual growth in 2012 because of unusually weak carry-over

The weakness seen in many of the larger economies in the second half of 2011 has reduced the carry-over growth in 2012 to below the ten-year average. Over the last decade, the contribution of the previous year to the following year's growth rate (the carry-over – see Box xx in the main text for a fuller discussion of carryover) averaged 1.8 percentage points. In 2012, however, it is expected to come in at only 1.3 percentage points, the weakest carry-over among developing regions. By comparison for high-income countries, lower than normal carry-over (0.7 percentage points) can be expected to cut about 0.3 percentage points from the 2012 growth rate. Among the major Latin American economies Brazil's carry-over is the weakest, at 0.2 percentage points, more than 3 percentage points below its ten-year average – 1/2 standard deviation, due to the pronounced slowdown observed in the second half of 2011 on account of policy tightening at home and weaker external demand. Argentina, Chile, Colombia, and Mexico have carry-overs slightly above their 10-year averages, while Bolivia, Costa Rica, and Paraguay have relatively strong carry-overs compared to historical averages.

increased government spending in connection with the 2014 presidential elections and stronger investment growth ahead of the World Cup, before capacity constraints and building tensions cause a slowing to 3.9 percent in 2014.

Colombia's economic expansion is expected to decelerate to 4.7 percent in 2012 from a robust 5.9 percent in 2011, mainly reflecting capacity constraints that are increasingly binding. Last year's 225 basis points increase in interest rates should help slow consumer and investment spending growth – thereby limiting inflationary pressure and current account deterioration. Growth is projected to decelerate further to 3.9 percent by 2014, reflecting continued policy tightening and a weaker external environment and tighter financial conditions at home. Below trend demand growth in 2013 and 2014 should allow the supply side of the economy to catch up with demand by the end of the projection period setting the stage for stronger growth in the years to follow.

Quarterly growth in Chile is also projected to decelerate in 2012, after a robust performance in the first quarter, with the economy showing signs of pushing against potential (tight labor markets, rising wages) and as softer external demand will affect growth in the tradable sector. Technical difficulties in the mining sector earlier in 2012 have affected mining output and subtracted from annual growth. Nevertheless, GDP growth expected to ease to a still robust 4.4 percent in 2012, supported partly by strong real income gains, rising employment, strong credit growth, as well as by strong carry-over from last year. Growth is expected to accelerate marginally over the 2013-2014 period to near 5 percent.

In commodity exporters that are not integrated financially with the global economy growth will be shaped predominantly by weak external demand, and in particular weak demand from high-income countries, growth in China that is slower than in the recent past, and by domestic policies and their impact on consumer and business sentiment.

Argentina is expected to record one of the sharpest decelerations in growth in the region, with GDP projected to decelerate sharply to 2.2 percent, from a very strong 8.9 percent expansion in 2011, with the pace of quarterly growth decelerating sharply by the end of 2012. The expected deceleration is due to softer domestic demand and subdued external demand in main trading partners, such as Brazil. Consumer and business sentiment will continue to deteriorate. The government's decision to nationalize the shares of a major oil producer could negatively affect investor confidence and weaken investment growth. The macro imbalances are likely to persist with private consumption deflator growth remaining in double digits, and the current account balances deteriorating despite tightening controls (e.g. the elimination of any automatic access to exchange rate market, the introduction of tariffs on capital goods imports etc.). The elimination of energy subsidies will yield fiscal savings of about 1 percent of GDP but revenues will be adversely affected by the deceleration in economic activity. Growth is expected to pick up in the 2013-2014 period, but remain below potential.

Growth in R.B de Venezuela is expected decelerate marginally but should remain above potential over the 2012-2014 horizon, assuming a relatively stable political environment. The 32.3 percent increase in minimum wage announced for 2012 will boost private consumption, but the gain in real incomes will be eroded by continued high inflation, expected to remain in the mid-20s over the forecasting horizon. Uncertainties regarding the results of the upcoming elections and the health of the incumbent and the weakening of the policy framework are likely to weigh down business sentiment.

Growth in the Plurinational State of Bolivia will continue to be supported by strong domestic demand and higher natural gas production over the forecasting horizon, although growth is expected to inch down slightly, on account of weaker external demand. The increase in public employment and the increases in real incomes will support private consumption growth in excess of 4 percent. Government plans to boost investment in infrastructure projects will also be supportive of growth going forward. The prudent macroeconomic policies that have been implemented in recent years have also put the economy on a more sustainable growth path, prompting credit rating agencies to increase Bolivia's long-term foreign currency rating by a notch. This paves the way for Bolivia's return to the international capital markets for the first time in more than 70 years this year. The recent nationalization of an electricity company could have a negative impact on foreign investor sentiment.

Growth in Central America, excluding Mexico, is expected to ease in 2012 to 3.9 percent partly due to a 4.5 percentage point deceleration in economic expansion in Panama, from a very strong pace in 2011, due in part to a weaker growth performance in the financial sector. Growth in Panama will remain however above 6 percent, supported by the expansion of the Panama Canal and the construction of the metro for which financing has already been secured. Central American economies that are still operating below potential could see growth accelerate as external demand improves. In addition, better financing (higher remittances and capital flows) could allow a step up in investment. Low tax-to-GDP ratios keep the structural deficits at relatively elevated levels, and will continue to limit the fiscal space. A weaker fiscal impulse relative to 2011 or fiscal consolidation will negatively affect domestic demand in some of the economies in the region. In addition growth will continue to be constrained by structural issues in selected economies, including inadequate infrastructure, deteriorating security situation, and a weak rule of law that will hold back investment growth and will continue to depress total factor productivity.

The Caribbean economies that are reliant on tourism will continue to face subdued growth in tourism arrivals and spending due to continue high-unemployment in high-income countries, although recent improvements in the labor market in the United States may bring some respite. Growth in the Caribbean excluding Dominican Republic is expected to accelerate marginally to 2.4 percent in 2012. Growth in the Dominican Republic is expected to continue to expand at a relatively robust pace of 4.4 percent in 2012, boosted by continued expansion in the mineral output and increased government spending ahead of presidential elections. Jamaica's growth will remain weak, notwithstanding a gradual recovery in the United States, its main trading partner, and a marginal increase in remittances. The public debt burden remains very heavy and together with the high-crime rate are constraining growth. Investment ratio to GDP has declined markedly in the wake of the crisis and remains close to 8 percentage points below the pre-crisis ten-year average, with negative consequences for potential growth. In Haiti growth is expected to accelerate in 2012 to above 7.3 percent on account of an acceleration in the path of reconstruction, following improved political stability after the government has finally took office in October 2011, although the security situation remains fluid. Growth will be buoyed by increased agricultural output, as well as acceleration in construction sector growth and a rebound in manufacturing output. The garment industry will benefit from HOPE II agreement that grants duty-free access to the US for the textile products. Post-disaster reconstruction efforts will also support growth in Dominica over the next couple of year, with the costs of reconstruction estimated at close to 6.5 percent of GDP.

Fiscal consolidation especially in the high-debt Caribbean countries will negatively affect domestic demand's contribution to growth. Higher oil prices will fuel inflation and will undermine private consumption (which accounts for more than 70 percent of GDP) in the oil-importing countries in the region. In addition, countries that rely on Official Development Assistance for meeting their external financing needs will likely see a decline in ODA over the coming years as many high-income countries continue to struggle with fiscal sustainability and as they will probably not meet their Monterrey targets of providing 0.7 per cent of their national income in ODA. For 2012, bilateral flows are expected to remain flat at best although multilateral aid might increase based on earlier commitments.

Risks and vulnerabilities

Risks to growth have shifted to the downside. A main risk to the global economy is posed by the possibility of a marked deterioration in conditions in Euro area. A sharp deterioration of conditions in the Euro area could have repercussions for global growth. The January edition of Global Economic Prospects outlines some of the major developing country vulnerabilities to such a scenario – emphasizing that no region would be spared (in the worst case scenario Latin American & Caribbean GDP could be hit by as much as 3.8 percent of GDP).

Even in a less dramatic scenario – one where the European recession deepens and recovery is even slower than in the baseline would have important implications for developing countries in Latin American and Caribbean. In such a scenario, global demand and demand for commodity would be significantly weaker than in the baseline, negatively affecting commodity prices, incomes, fiscal balances and GDP in commodity exporting countries.

An additional down-side risk is that of a major oil supply disruption in the Middle East that would have negative repercussions for global growth, including for the region, and in particular for oil-importing countries. Domestic imbalances and/or policy errors could also be detrimental to growth in selected economies in the region. In the Caribbean countries with weak financial systems a sharp slowdown in growth would result in a marked deterioration in credit quality that could further impair growth. In addition, a significant downside risk for some the Caribbean economies, notably Grenada, Guyana, and Jamaica is that of a change to the concessional financing terms offered by Venezuela for oil imports. This could result in substantially higher oil import prices adding further pressure on current account balances. Increased competition for FDI and tourists from Cuba represent additional downside risks for the tourism dependent economies in the region.

As the region, particularly South America, has become increasingly reliant on exports to East Asia, prospects in that region and China in particular are increasingly important. Either a stronger or weaker than anticipated outturn in East Asia could have significant impacts on activity and incomes among metals exporting economies (more than 50 percent of all metals are consumed by China alone). Commodity exporting countries that have not rebuilt fiscal buffers could be particularly vulnerable in the face if a significant weakening in demand for commodities and prices – especially if they occur in a context where global financial conditions are tightening. With regional economies already fully recovered a much stronger than anticipated increase in global demand (or prices) for its exports could exacerbate overheating and exchange rate pressures to the detriment of already struggling manufacturing sectors in countries like Brazil.

In this context, domestic policy making is especially complicated. Last year demonstrated the difficulties inherent in fine-tuning externally oriented economies in a volatile international environment. Just as necessary policy tightening at that time was exacerbated by the slowdown in Europe, so too there is a risk that the subsequent loosening of policies since then and perhaps in the future could combine with improved external conditions to provoke an overshooting in economic activity and inflation. Such challenges appear particularly elevated in countries like Brazil, Chile, and Colombia, where capacity constraints pressures and commodity-based exchange rate appreciations have fueled growing current account deficits and eroded the competiveness of local industry.

Notes:

1 Regional industrial output is proxied by industrial output in 10 Latin American and Caribbean countries which represent 95 percent of the regional GDP and more than 90 percent of the value added by the industrial sector.

Table LAC.3 Latin America and the Caribbean country forecasts

(annual percent change unless indicated otherwise)	98-07[a]	2009	2010	2011	Est. 2012	Forecast 2013	2014
Argentina							
GDP at market prices (2005 US$) [b]	2.6	0.9	9.2	8.9	2.2	3.7	4.1
Current account bal/GDP (%)	1.3	2.7	0.8	-0.3	-0.5	-1.2	-2.0
Antigua and Barbuda							
GDP at market prices (2005 US$) [b]	5.4	-10.3	-8.9	-0.2	1.7	2.4	3.1
Current account bal/GDP (%)	-12.6	-19.3	-12.8	-10.8	-13.6	-14.0	-14.0
Belize							
GDP at market prices (2005 US$) [b]	5.8	0.1	2.9	2.6	2.7	2.8	2.6
Current account bal/GDP (%)	-13.1	-6.1	-3.3	-3.3	-4.2	-5.5	-5.9
Bolivia							
GDP at market prices (2005 US$) [b]	3.3	3.4	4.1	5.1	4.3	4.2	4.1
Current account bal/GDP (%)	0.7	4.3	4.9	2.2	2.5	1.4	0.2
Brazil							
GDP at market prices (2005 US$) [b]	2.8	-0.3	7.5	2.7	2.9	4.2	3.9
Current account bal/GDP (%)	-1.2	-1.5	-2.2	-2.1	-3.1	-3.2	-3.4
Chile							
GDP at market prices (2005 US$) [b]	3.7	-0.9	6.1	5.9	4.4	4.7	4.9
Current account bal/GDP (%)	0.3	2.0	1.5	-1.3	-3.2	-2.9	-2.9
Colombia							
GDP at market prices (2005 US$) [b]	3.2	1.7	4.0	5.9	4.7	4.2	3.9
Current account bal/GDP (%)	-1.4	-2.1	-3.1	-3.0	-2.8	-3.1	-3.2
Costa Rica							
GDP at market prices (2005 US$) [b]	5.5	-1.0	4.7	4.2	3.7	3.8	4.1
Current account bal/GDP (%)	-4.6	-2.0	-3.5	-5.2	-5.3	-5.6	-5.7
Dominica							
GDP at market prices (2005 US$) [b]	2.2	-0.4	0.1	0.9	1.6	2.2	2.2
Current account bal/GDP (%)	-15.5	-21.9	-20.8	-21.2	-18.0	-16.9	-15.8
Dominican Republic							
GDP at market prices (2005 US$) [b]	5.6	3.5	7.8	4.5	4.4	4.6	4.8
Current account bal/GDP (%)	-1.4	-5.0	-8.6	-8.1	-7.5	-7.8	-8.0
Ecuador							
GDP at market prices (2005 US$) [b]	3.3	0.4	3.6	7.8	3.0	3.2	3.6
Current account bal/GDP (%)	-0.1	-0.2	-3.1	-2.1	-0.6	-1.8	-3.4
El Salvador							
GDP at market prices (2005 US$) [b]	2.9	-3.1	1.4	1.5	2.0	3.1	2.9
Current account bal/GDP (%)	-3.2	-1.5	-2.3	-3.8	-4.3	-4.0	-3.7
Guatemala							
GDP at market prices (2005 US$) [b]	3.9	0.5	2.8	3.8	3.6	3.7	3.4
Current account bal/GDP (%)	-5.4	-0.1	-1.5	-3.1	-3.5	-4.1	-4.5
Guyana							
GDP at market prices (2005 US$) [b]	1.5	3.3	3.6	4.8	4.7	5.0	4.6
Current account bal/GDP (%)	-8.7	-8.2	-7.2	-8.9	-15.0	-18.3	-21.7
Honduras							
GDP at market prices (2005 US$) [b]	4.3	-2.1	2.8	3.4	3.3	4.1	3.9
Current account bal/GDP (%)	-6.7	-3.7	-6.2	-8.6	-7.8	-6.5	-5.7

(annual percent change unless indicated otherwise)				Est.	Forecast		
	98-07a	2009	2010	2011	2012	2013	2014
Haiti							
GDP at market prices (2005 US$) [b]	0.9	2.9	-5.4	5.6	7.3	7.1	6.9
Current account bal/GDP (%)	-1.0	-3.7	-3.0	-5.3	-5.8	-6.2	-6.9
Jamaica							
GDP at market prices (2005 US$) [b]	1.3	-3.1	-1.4	1.5	1.4	1.7	1.5
Current account bal/GDP (%)	-7.8	-10.9	-8.1	-9.9	-11.4	-9.6	-8.2
Mexico							
GDP at market prices (2005 US$) [b]	3.3	-6.0	5.5	3.9	3.5	4.0	3.9
Current account bal/GDP (%)	-1.9	-0.7	-0.5	-0.8	-1.4	-1.6	-1.9
Nicaragua							
GDP at market prices (2005 US$) [b]	4.1	-1.5	4.5	4.7	3.3	4.0	4.5
Current account bal/GDP (%)	-18.4	-12.2	-14.4	-17.4	-18.2	-18.6	-17.2
Panama							
GDP at market prices (2005 US$) [b]	5.6	3.9	7.5	10.6	6.1	6.3	5.9
Current account bal/GDP (%)	-5.5	-0.7	-10.8	-12.7	-12.1	-10.8	-9.5
Peru							
GDP at market prices (2005 US$) [b]	4.0	0.9	8.8	6.9	5.3	5.5	5.7
Current account bal/GDP (%)	-1.1	0.2	-1.5	-2.6	-1.7	-2.2	-3.2
Paraguay							
GDP at market prices (2005 US$) [b]	1.9	-3.8	15.0	4.0	-1.5	6.0	4.6
Current account bal/GDP (%)	-0.1	0.5	-3.6	-1.9	-4.3	-3.4	-2.9
St. Lucia							
GDP at market prices (2005 US$) [b]	2.5	-1.3	3.4	0.3	2.0	3.3	3.0
Current account bal/GDP (%)	-17.8	-12.1	-13.7	-18.1	-16.8	-15.7	-14.4
St. Vincent and the Grenadines							
GDP at market prices (2005 US$) [b]	4.2	-2.3	-1.8	-0.2	2.6	3.1	3.3
Current account bal/GDP (%)	-17.6	-29.1	-31.6	-29.0	-25.6	-24.3	-23.1
Suriname							
GDP at market prices (2005 US$) [b]	3.6	2.5	4.0	5.0	4.9	5.4	5.6
Current account bal/GDP (%)	8.9	3.9	2.0	1.1	-10.7	-10.9	-8.4
Uruguay							
GDP at market prices (2005 US$) [b]	1.2	2.4	8.9	5.7	4.0	4.6	4.4
Current account bal/GDP (%)	-1.0	-0.3	-1.1	-1.9	-1.5	-2.5	-4.2
Venezuela, RB							
GDP at market prices (2005 US$) [b]	2.9	-3.2	-1.5	4.2	4.6	2.7	3.4
Current account bal/GDP (%)	8.4	1.8	3.1	8.6	6.3	4.4	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.

Cuba, Grenada, St. Kitts and Nevis, 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.

Source: World Bank.

Middle East and North Africa Region[1]

Overview

Uncertainty, volatility, and significant social unrest continue to characterize conditions in the developing **Middle East and North Africa r**egion. Aggregate GDP grew by only 1 percent in 2011, in contrast with 3.8 percent in 2010. In Egypt, GDP fell by 0.8 percent in calendar 2011, while growth in oil exporting Algeria registered 2.5 percent due to increased infrastructure outlays. In Iran, growth eased to 2 percent as new domestic policies were implemented and economic sanctions by Europe and the United States began to take a toll. High-income oil-exporting countries of the Gulf Cooperation Council (GCC) posted a strong 6.1 percent gain in 2011, on the back of stronger oil prices.

Despite the volatility in the region, there are signs that economic developments during the first half of 2012 are moving in a more favorable direction. Industrial production for the first quarter is showing advances across the diversified oil importing economies, while trade flows appear set to break into positive territory. However, tourism is likely to remain a problem area until the political situation stabilizes, with aggregate tourist arrivals to the region having fallen by 8.8 percent in 2011 versus a global increase of 4.4 percent. Tourist arrivals declined about 30 percent during 2011 in both Egypt and Tunisia, 40 percent in Syria and 24 percent in Lebanon.

Foreign direct investment (FDI) inflows to the region (including the oil exporters) more than halved in 2011, dropping to an estimated $9.5 billion versus $22.7 billion in 2010, with major declines throughout the Maghreb, Egypt, Jordan and Syria. Net capital inflows fell by almost 90 percent in the year, reflecting large outflows on debt instruments as both foreign and domestic investors sought safer havens. Regional stock markets lost 15 percent over the last 2 years, in contrast with modest gains of 2.5 percent for all emerging markets, while bond issuance dropped from $3.2 billion in 2010 to $1 billion in 2011 and as regional credit default swap (CDS) rates skyrocketed.

Outlook: Assuming a degree of stabilization in the political situation in the **Middle East and North Africa** during 2012, regional growth is projected at 0.6 percent for the year, largely as sanctions take hold on growth in Iran, and GDP continues to decline in Syria and Yemen. As these elements fade in importance, growth for the region is expected to firm to a still moderate 2.2 percent in 2013, picking up to 3.4 percent by 2014. Egypt's economy is projected to move out of negative territory to 1.4 percent growth in 2012, rising by 4.6 percent in 2014. Growth is expected to pick up sharply in Jordan and Lebanon, from 2.1 percent and 3.6 percent respectively in 2012, to near 4.5 percent each by 2014. Despite recent declines, oil prices are projected to average $107/bbl in 2012, up 3.6 percent on 2011. As a result, developing oil exporters are expected to maintain strong spending on domestic infrastructure and social projects. Growth in Algeria is projected to firm to 2.6 percent this year, rising to 3.6 percent in 2014, while in Iran it is anticipated to compress by 0.8 percent in 2012 and 2013 before rising to 1.5 percent by 2014.

Risks and vulnerabilities: Economic progress in the region will continue to be highly dependent on the overall political climate.

Regional spillovers. Economic spillovers from Syria to Jordan and Lebanon are beginning to look serious as Lebanon's service-based economy is beginning to feel the effects of the conflict next door.

Economic tensions. Egypt is coming under increasing pressure to finance its burgeoning fiscal and current account deficits. Should these difficulties become acute, the country could be forced to cut radically into government spending and/or imports and potentially seek assistance from the international community.

Recent developments

For the Middle East and North Africa, 2011 marked the start of a potentially historic year of transition, many elements of which have carried over into 2012. Political transitions in Egypt, Tunisia and Libya continue with elections now planned or ongoing; "evolving monarchies" are undertaking political reforms (Morocco, Jordan (high-income Kuwait)); but conditions remain turbulent in Syria, Libya, Iraq and Yemen. Short term uncertainty has increased with new election formulas, broad disagreement between old and new constituents regarding choice of prospective candidates; evolving institutions and weak capacity. As a result, foreign investors and tourists have taken a more cautious view to the region. And the economic fallout of that caution was worsened by financial uncertainty and volatility in high-income Europe, culminating in the current Greek stalemate – with Europe the Middle East and North Africa's largest partner for trade in goods, services and income.

Economic progress within the developing region has varied across countries in the interval since the onset of transition for several Arab nations in December 2010. Aggregate GDP grew by a diminished 1 percent in calendar year 2011 contrasted with 3.8 percent in the year preceding (table MNA.1). GDP fell by 0.8 percent in Egypt, due to dislocations associated with popular unrest and political uncertainty, sharp declines in investment (domestic and foreign) and in tourism. And Tunisia's extensive links to developments in the Euro Area contributed to a GDP downdraft of 1.8 percent in the year, with major declines in tourism and investment.[2]

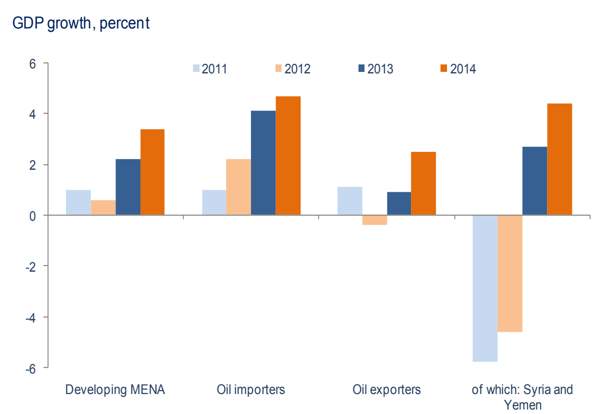
GDP in Yemen and Syria declined by a substantial 10.5 and 3.1 percent respectively, reflecting significant domestic tumult, and in both cases declining oil production. For oil developing exporters as a group GDP advanced by a sluggish 1.1 percent in the year.

A slow recovery among the diversified economies (oil-importers) on the path of reforms is envisioned for 2012 before conditions are sufficiently conducive to support investment to provide the underpinning for growth to reach 4.7 percent by 2014 (figure MNA.1). Egypt may experience more domestic headwinds to this process than Tunisia and other regional countries. Developing oil exporters are anticipated to benefit from the current and anticipated high price of crude oil (above $100/bbl on a World Bank average basis), allowing continued spending on domestic infrastructure and social projects. A notable exception is Iran, where product boycotts and financial sanctions are expected to exact a toll on growth over 2012 and 2013, compressing GDP to decline of more-than 0.8 percent per year.

For those developing economies under continuing political or civil stress—notably Syria—substantial losses are likely to characterize the near term, until closure can be achieved for the military-, social and political fallout generated by developments in the country. For these reasons, growth for oil exporting economies will likely decline in 2012 (0.4 percent) and register less-than 1 percent growth in 2013, before a gain of 2.5 percent sets in by 2014 on a coming to an end of present violence and other conflicts among the group.

Activity improves for several oil-importing economies. Uncertainty and significant political economy issues continue to characterize conditions in the region. Nevertheless, there are signs emerging that economic developments during the early months of 2012 are moving in a

Figure MNA.1 A gradual recovery toward growth centered on 3.5 percent

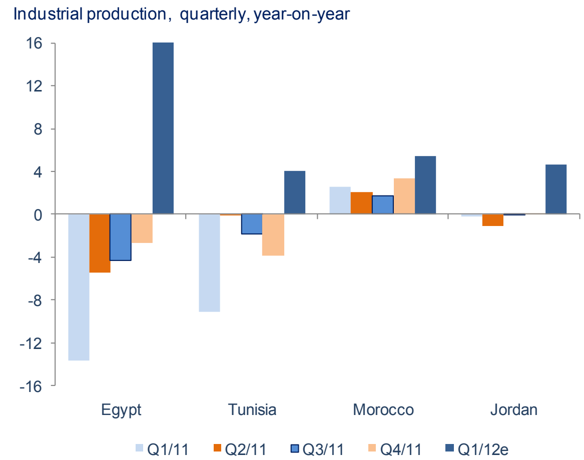


Sources: World Bank.

more favorable direction. Industrial production for the first quarter is showing advances across the oil importers, while trade flows (though volatile) appear set to break into positive territory. Worker remittance flows were fairly strong during 2011 and anecdotal evidence suggests continued solid flows in 2012 as overseas workers increase efforts to provide support for incomes in home countries. Tourism however, is likely to remain a problem area until conditions stabilize across the main destination countries. Tourist arrivals declined by about 30 percent during 2011 in both Egypt and Tunisia.

Industrial production for the diversified economies firmed in the first quarter of 2012. In Egypt, following a 3 percent decline in crude oil production in the last quarter of 2011, oil output has been growing during the first 5 months of 2012, gaining 2.6 percent in the first quarter (year-over-year); electricity production (a good proxy for commercial and industrial activity) is up 12.5 percent over the same period, yielding total production gains of 16.8 percent for the quarter (3mma, year-on-year, figure MNA.2). In Tunisia, a revival of activity in mining, chemicals, and to a lesser degree manufacturing, has boosted production by 4.1 percent on the same measure over the year through March. While in Morocco and Jordan, less adversely affected over the course of 2011, production is

Figure MNA.2 Industrial production moving higher into 2012



Sources: National Sources through Haver Analytics.

Table MNA.1 Middle East and North Africa forecast summary

(annual percent change unless indicated otherwise)	98-07[a]	2009	2010	2011	Est. 2012	Forecast 2013	2014
GDP at market prices (2005 US$) [b]	4.6	3.3	3.8	1.0	0.6	2.2	3.4
GDP per capita (units in US$)	2.9	1.7	2.1	-0.6	-1.0	0.6	1.8
PPP GDP [c]	4.7	3.2	3.8	0.8	0.4	1.9	3.3
Private consumption	4.8	2.5	3.6	1.8	3.2	3.6	4.3
Public consumption	3.8	19.7	4.2	8.2	5.7	5.0	5.2
Fixed investment	6.8	5.6	1.5	-0.1	0.9	3.5	4.2
Exports, GNFS [d]	5.6	-7.5	3.2	-1.9	0.2	1.8	3.4
Imports, GNFS [d]	7.4	-2.5	2.5	3.6	5.5	5.3	5.4
Net exports, contribution to growth	-0.2	-1.9	0.2	-1.8	-1.9	-1.4	-1.0
Current account bal/GDP (%)	7.4	-0.7	2.4	3.4	1.8	0.2	-0.9
GDP deflator (median, LCU)	4.9	1.5	6.5	8.2	8.9	4.6	4.3
Fiscal balance/GDP (%)	-1.0	-4.2	0.4	-1.8	-4.7	-3.4	-2.2
Memo items: GDP							
MENA Geographic Region [e]	4.2	1.6	4.0	3.2	2.4	3.2	3.6
Resource poor- Labor abundant	4.6	4.7	4.5	1.0	2.2	4.1	4.7
Resource rich- Labor abundant	4.7	2.3	3.3	1.1	-0.4	0.9	2.5
Selected GCC Countries [f]	3.7	-0.5	4.4	6.1	4.8	4.5	3.7
Egypt	4.7	4.7	5.1	-0.8	1.4	3.6	4.6
Iran	5.1	1.8	2.9	2.0	-1.0	-0.7	1.5
Algeria	4.0	2.1	3.3	2.5	2.6	3.2	3.6

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.

Source: World Bank

up 5.5 and 4.7 percent respectively, reflecting earlier strong exports of phosphates which have supported output in the mining and processing sectors.

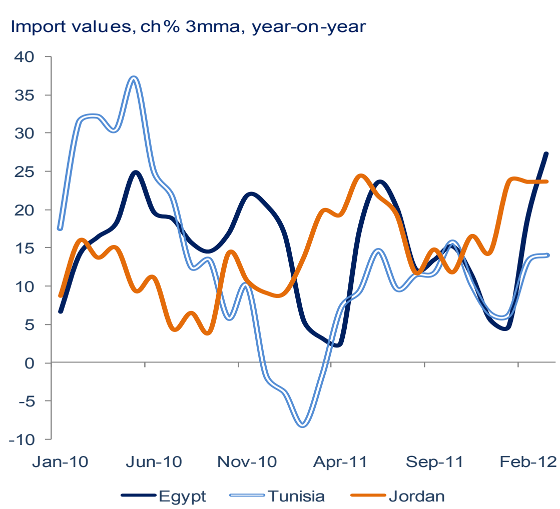
The track record for goods imports and exports for the diversified economies over the past 18 months has been buffeted by both domestic turmoil and the collapse of European import demand in the second half of 2011. Imports by Egypt, Tunisia and Jordan accelerated in mid-2011, following the reform uprisings in those countries, as governments likely replenished stocks depleted during the turmoil (figure MNA.3a). After easing in the second half of 2011, the dollar value of imports accelerated once more into the early months of 2012, rising to a 24 percent annualized pace in Jordan (3mma, year-on-year), 27 percent in Egypt and 14 percent in Tunisia. While high oil prices explain part of the upturn, it also likely reflects stronger domestic demand and emerging strength in economic activity.

On the export side of the ledger, the effects of the 2011 European downturn in demand are clear, compounded by disruptions to industrial output, logistics and associated factors in the region (figure MNA.3b). Export declines have been substantial for Morocco and Jordan, which as noted had enjoyed a boom in phosphate shipments; Egypt's hydrocarbons exports have helped to buoy shipments to better performance. In two of four diversified economies highlighted in the figure, exports appear to be turning the corner to growth, possibly reflecting renewed import demand in countries such as Germany and to a degree the United States. Prospects for the second half of 2012 should improve, if as expected in the baseline forecast, following a near-term increase in uncertainty related to Greece and the EMU, the Euro Area emerges from recession, implying increased demand for regional exports.

But trade prospects will remain fragile, with key partners for the Maghreb such as Italy, France and Spain all facing substantial challenges at home, which are likely to be reflected in weaker-than-normal import demand. Moreover, many of the diversified economies in the region are running large trade deficits, ranging from $28 billion for Egypt (13 percent of GDP) to $6 billion for Tunisia (16 percent of GDP). If external financing conditions become more difficult still—or if capital flows dry up such that countries in the region do not have the foreign currency to finance imports, they could find themselves in difficult straits.

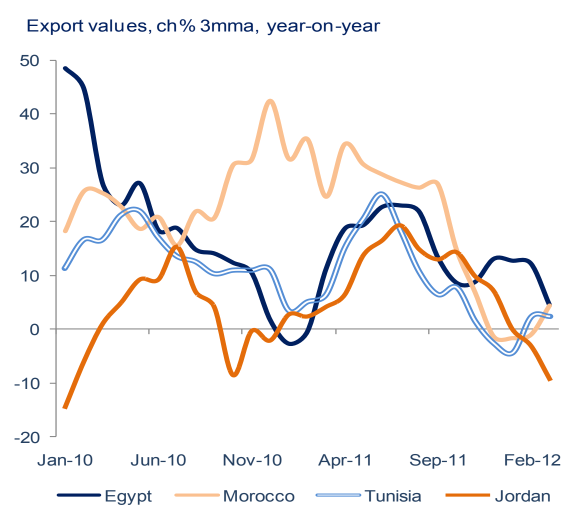
Oil exporters enjoy renewed windfall. For oil exporting economies in the broader geographic region, including the high-income GCC countries, higher oil prices will translate into

Figure MNA.3a Notable acceleration in MENA imports



Source: National sources through Haver Analytics

Figure MNA.3b Exports turning the corner to growth?



Source: National sources through Haver Analytics moderate increases in government revenues in 2012. Oil prices are projected to average $107/bbl in 2012, up 3.6 percent from 2011. These revenues should permit exporters to continue supporting social spending, subsidies and other measures supportive of domestic living standards. If oil prices remain high, oil-importing countries in the region may see increased remittances, FDI, and aid flows from the high-income oil-exporters of the region. But if prices moderate substantially, GCC government accounts could come under strain – prompting cuts and a decline in these positive externalities (box MNA.1).

Countries under heightened political pressure

The open civil conflict *in Syria* contributed to an estimated 3.1 percent fall in GDP in 2011 and is expected to provoke a further large 6.4 percent contraction in 2012. With FDI and tourism absent, reserves are being depleted rapidly. The regime appears to be holding and unlikely to collapse in 2012, but conditions would change rapidly if divisions within the administration's supporting groups came to believe that they would be better served by a negotiated

Box MNA.1: Oil markets and hydrocarbon revenues for regional exporters.

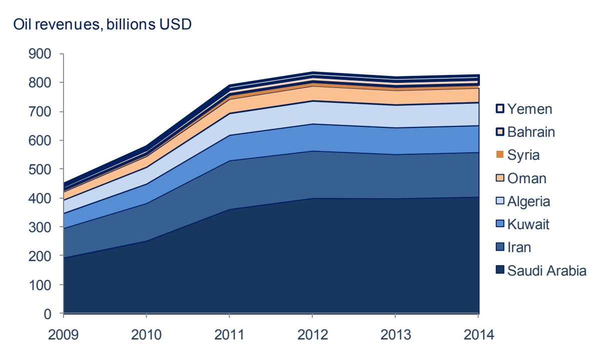
Crude oil (World Bank average) prices are expected to register $107.8/bbl in 2012, up from $104/bbl in 2011, assuming that political unrest and disruption in the Middle East are contained and OPEC continues to keep the market well supplied. Price increases are occurring despite the fact that global oil demand has been growing relatively slowly. Demand increased only 0.7 percent in 2011, and demand growth remained weak in the first quarter of 2012 partly due to a mild winter in the northern hemisphere. OECD oil demand is down more than 4mb/d or 9 percent from its 2005 peak. And non-OECD oil demand also slowed, but remains positive.

Rising prices mainly reflect developments on the supply side, notably the loss of more than 1mb/d in non-OPEC production due to geopolitical and technical problems, as well as geopolitical tensions between the U.S./EU and Iran. The EU has banned Iranian imports (an order to take full effect at the end of July 2012), while the United States is prohibiting financial institutions that deal with the U.S. from doing business with Iran.[3] According to the IEA, up to 1mb/d of Iranian exports may be halted by this summer. Although Saudi Arabia has stepped up production to compensate for boycotted Iranian crude, the global supply losses—including 1.3mb/d of Libya's light sweet crude last year (but now recovering quickly)—have lowered OECD inventories—while the uptick in Saudi production has lowered OPEC spare capacity – contributing to a generalized sense of tight markets.

In the medium term, world oil demand is expected to grow moderately, at 1.5 percent per annum, with *all of the growth in demand coming from developing countries*. Global demand growth will remain well below GDP growth, reflecting efficiency improvements in vehicle transport – partly induced by environmental pressures to reduce emissions, especially in OECD countries. Consumption growth in developing countries is expected to moderate in the longer term as their economies mature, as subsidies are phased out, and as other fuels penetrate their fuel mix, notably natural gas.

With oil prices remaining above $100/bbl for the period through 2014, hydrocarbon exporters in the Middle East and North Africa region will continue to enjoy export revenue windfalls that will maintain current account positions at high levels of GDP and allow continued fiscal spending to shore up economic conditions during the current period of sluggish global growth, through to the expected stronger recovery of the world economy in 2013-14. Although GCC economies will benefit most from the maintenance of high prices—given their scale of production and exports—Algeria and Iran (in the absence of sanctions) would be expected to benefit from market conditions. Box figure MNA 1.1 highlights the profile of anticipated oil and gas revenue flows for exporters of the region, reaching a peak $825 billion by 2014.

Box figure MNA 1.1 Oil revenues continue to mount through 2014



Source: World Bank.

resolution. *In Libya*, the U.S. Security Council extended the U.N. mission supporting Libya's democratic transition for a further 12 months. And parliamentary elections are due to be held in June 2012, the first multiparty elections in 50 years. Government challenges have been eased to a degree by the economy which has recovered more rapidly than expected; but deep divisions still stand in society. Following a 60 percent contraction in GDP during 2011, quickly reestablishing oil output will help the government to revive the wider economy. *And in Yemen,* President Aleh stepped down in February 2012 under a transition agreement that brought Yemen back from the brink of civil war. High turnout for the election of his successor has given some cause for optimism—however the fragile political situation and continuing security crisis in several parts of the country mean that following an estimated 10.5 percent decline in GDP during 2011, output will contract once more in 2012, by a moderate 1.1 percent.

Tourism, remittances and foreign direct investment

Sharp falls in tourism have been among the most serious impacts of the political turmoil in the region. Both Egypt and Tunisia suffered 30 percent declines in international arrivals during 2011, with arrivals in the first quarter of the year as much as 70 percent lower than in the like period of 2010. Countries perceived by international visitors to be more politically stable, such as Morocco, have picked up some of the suffered by Egypt in particular.

The United Nation's World Tourism Organization (UNWTO) estimates that international arrivals to the developing region fell by 8.8 percent in 2011, versus a global increase of 4.4 percent (table MNA.2). Arrivals for other Middle East and North African countries are as stark as those found in table MNA.2, with Syria down 40 percent in the year due to civil strife and ongoing violence, and Lebanon reporting declines of 24 percent. The revenue losses associated with these declines are substantial for many countries, ranging from a shortfall of $4 billion for Egypt or 1.8 percent of GDP to $0.7 billion for Tunisia (1.8 percent of GDP). With widening trade deficits, these important revenue losses will have to be offset from alternate sources in the near term, increasing pressures on finance, exchange rates and international reserves.

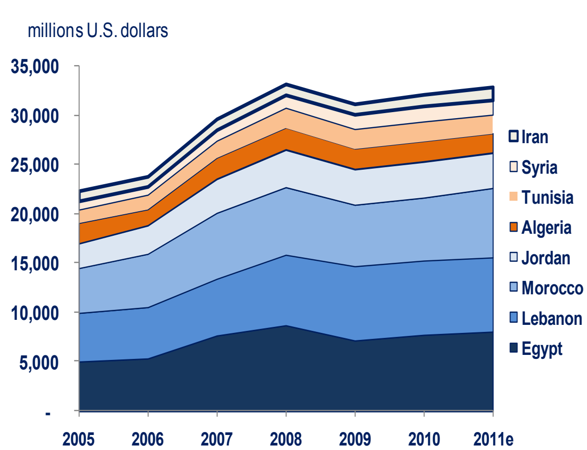
Worker remittance inflows to the region held up fairly well during 2011, after experiencing a 6 percent contraction in 2009 during the global recession, and a modest rebound in 2010 (3 percent) during recovery from the global economic downturn (figure MNA.4). According to World Bank estimates, two Middle East and

Table MNA.2: International tourism arrivals and revenues, 2008-2011e

	2008	2009	2010	2011E
Arrivals % change				
Total Region	**12.0**	**4.1**	**17.0**	**-8.8**
Egypt	16.0	-3.0	18.0	-32.0
Morocco	6.5	6.0	11.5	7.5
Tunisia	4.5	-2.0	0.0	-31.0
Jordan	9.0	2.0	20.0	-8.5
Revenues, % change				
Total region	**13.5**	**0.1**	**14.5**	**-6.5**
Egypt	17.2	-3.0	16.0	-30.0
Morocco	7.0	-10.0	2.5	5.5
Tunisia	16.0	-10.0	-1.5	-28.5
Jordan	28.5	-2.0	16.0	-10.0

Sources: United Nations, World Tourism Organization, country sources, World Bank.

Figure MNA.4 Worker remittances retained a positive flow in 2010 and 2011

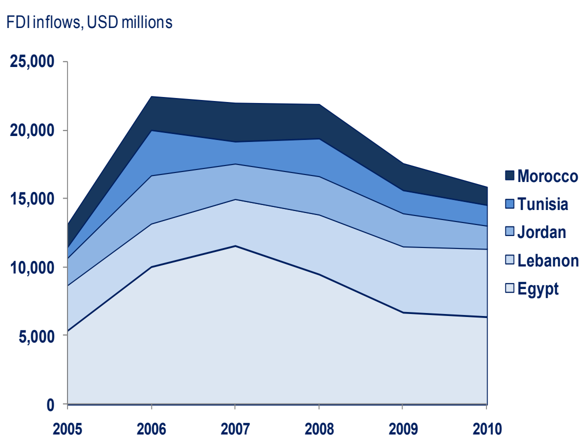


Sources: World Bank.

North African countries were able to sustain strong inflows during 2011: Morocco with a 10.3 percent gain worth some $700 million, mitigating goods trade deficits on current account while supporting income and consumption outlays; and Egypt (4 percent, or $300 million). Remaining countries of the region registered a moderate 1.2 percent falloff in receipts, with larger shortfalls in Tunisia, Algeria and Syria. With gradual recovery in Europe, and with fresh hydrocarbon windfalls among the GCC, it is hoped that this important income flow can be reestablished in the next quarters and years to help finance current account "debit" items while contributing to offset a portion of fiscal deterioration.

Foreign direct investment inflows to the diversified economies of the region have declined sharply from their pre-crisis peaks of $22 billion per annum (figure MNA.5). Egypt was the recipient for the largest of these flows, destined for tourism infrastructure and related business but also into manufacturing, where niche industries attracted foreign interest. Lebanon and Morocco also garnered increased share in the period. But the onset of global recession in 2009 took a strong toll on FDI flows, dropping some 20 percent in the year (a decline of $4 billion), highlighted by a 33 percent falloff in flows to Tunisia. The decline continued in 2010, with a further edging down of $2 billion (a fall of 10 percent in the year), with the decline spread fairly evenly across the diversified economies. According to the Secretariat of the U.N. Conference on Trade and Development (UNCTAD), which compiles data on international investment flows, FDI advanced by 5 percent at the global level in 2010, or by $58 billion, with the Middle East and North Africa one of the few regions witnessing decline.

Figure MNA.5 FDI falls a cumulative 30% over 2009 to 2010



Source: United Nations, UNCTAD, International Investment Report.

On a brighter note, there have been several recent announcements of interest on the part of GCC members to recommence investing in the diversified economies of the region. For example a report that the UAE would invest up to $3 billion in four Egyptian agricultural projects; and interest on the part of Qatar in collaborating with Tunisia to build the first private oil refinery in the country have been regional news items.

Financial developments and capital flows

In contrast to the firming of real-side activity, financial developments for the diversified economies have deteriorated sharply, notably in Egypt. A number of countries are encountering difficulty sustaining access to external finance due to downgrades to sovereign credit ratings, widening CDS rates, and a broader downturn in syndicated bank lending due in part to deleveraging among Euro-Area commercial banks. Falling reserve levels– a symptom of widespread support for exchange rates are of concern across several countries. And as financing requirements mount, effective lack of access to capital—including foreign direct investment—is an important risk moving forward.

In Egypt, the financing of the fiscal deficit, a sharp fall in international reserves and volatile domestic activity remain points of fragility. The fiscal shortfall is anticipated to reach 9.5 percent of GDP in FY11/12, and financing the deficit from domestic sources is getting increasingly more expensive (15 percent or more from domestic commercial banks). Subsidies running at 27.8 percent of the budget need to be addressed to lessen these pressures.

For Tunisia, the fiscal deficit is estimated at a fairly high 3.7 percent of GDP in 2011, and could move still higher (6.6 percent) in 2012, especially if the government fails to rein-in spending, especially on public sector wages. As in Egypt, financing has become more difficult due to ratings downgrades and uneven conditions in banking. Tunisia has resources that have gone unspent that could serve to fortify growth in the near term.

Options for these and other countries could include an International Monetary Fund (IMF) loan, but political opinion remains divided over whether assuming further debt and adopting IMF adjustment policies represents a politically expedient course of action. Other sources of finance, including bilateral (looking to the GCC and others for support) are actively being sought. The fiscal situation is also a key point of stress in Jordan, with the deficit having registered 12.7 percent of GDP in 2011.

Overall FDI inflows to the developing Middle East and North Africa (including the region's developing oil exporters) more than halved in 2011, dropping to an estimated $8.6 billion versus $22.7 billion in 2010, with major declines throughout the Maghreb, Egypt, Jordan and Syria (table MNA.3). On balance, with economic recovery and favorable outturns for countries undergoing political and regulatory reforms, FDI could return to a range of $23 billion by 2014—about the magnitude of the halcyon days of the mid-2000s.

Net capital inflows to the region fell by almost 90 percent in 2011, reflecting large outflows on debt instruments as both foreign and domestic investors sought safer havens for their assets, given political and regulatory uncertainty. Gross flows also fell sharply with no new equity issuance in 2010, and a negative net figure for 2011 of some $200 million. Regional stock markets have lost 15 percent over the last 2 years contrasted with modest gains of 2.5 percent for all emerging markets. And bond issuance dropped from $3.2 billion in 2010 to $1 billion in 2011, as regional CDS spreads (developing region issuers of sovereign bonds include Lebanon, Morocco and Tunisia) jumped much more than those for other developing countries–as investors feared that new governments might not fully respect the debts incurred by their predecessors. Prospects for bank lending and short-term debt flows, larger items in the

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

$ billions

	2008	2009	2010	2011e	2012f	2013f	2014f
Current account balance	**69.8**	**-6.2**	**25.1**	**38.2**	**22.8**	**2.8**	**-13.4**
Capital Inflows	**19.7**	**28.3**	**25.4**	**1.2**	**12.9**	**24.2**	**33.8**
Private inflows, net	21.5	25.9	24.2	-0.3	11.7	22.8	31.7
Equity Inflows, net	29.6	27.3	22.7	8.4	11.7	19.5	24.6
FDI inflows	29.2	26.1	22.7	8.6	12.2	18.5	22.6
Portfolio equity inflows	0.4	1.2	0.0	-0.2	-0.5	1	2
Private creditors, net	-8.2	-1.4	1.5	-8.7	0.0	3.3	7.1
Bonds	-0.8	0.1	3.2	1	1	1	2
Banks	-1.8	-2.1	-1.9	-0.5	-2.1	0.3	2
Short-term debt flows	-4.2	1.6	1.1	-9.2	2.0	2.0	3.0
Other private	-1.3	-0.9	-0.8	0	-0.9	0	0.1
Offical inflows, net	-1.8	2.4	1.2	1.5	1.2	1.4	2.1
World Bank	-0.3	0.9	0.8	1			
IMF	-0.1	-0.1	0.0	0.1			
Other official	-1.4	1.6	0.4	0.4			

Note:
e = estimate, f = forecast

Source: World Bank.

region's capital portfolio, are not favorable, due directly to conditions in the region but also tied to anticipated further deleveraging by European commercial banks (see Finance Annex).

Medium-term outlook

The gradual improvement in the international environment anticipated over 2012-14 will be helpful in stabilizing the region's external receipts and to a degree, domestic finances. Prospects for the region however will depend importantly on the resolution of regional conflicts, tensions and transitions. In the baseline, it is assumed that the political situation will stabilize over the course of 2012, setting the scene for a return to growth more in keeping with underlying potential by 2014.

For the oil importing countries, recovery in the European market (following additional near-term volatility related to Greece) during the second half of 2012 should prompt a revival of goods exports and to a degree, worker remittances and tourism. Should domestic reform programs proceed as planned, growth in Egypt could extend from 1.4 percent in 2012 to 4.6 percent by 2014; and Tunisia could shift from 2.2 percent gains in 2012 to 4.6 percent by 2014 more in line with underlying potential of these economies (table MNA.4).

Growth in Morocco, Jordan and likely in Lebanon (the latter two economies adversely affected by developments in neighboring Syria), may be expected to soften during 2012, before recovery gains traction and the group witnesses GDP gains closer to 5 percent over 2013-14, as remittances, and to a degree tourism and FDI help to underpin the growth outlook. Countries with closer ties to the GCC, including Jordan and Lebanon, may see financial assistance appear more rapidly and readily, as oil windfalls propel financial flows from the high-income countries of the region. The GCC group is anticipated to grow by 4.8 percent during 2012, grounded in higher oil prices and increased oil production and export, following a strong 6.1 percent gain in 2011. An easing of growth toward 3.7 percent by 2014 appears likely, as production is scaled back, oil prices soften moderately and large-ticket projects come to fruition.

For developing oil exporters, high oil prices should underpin current account balances at lofty levels and provide the funding required for maintaining infrastructure-, social- and job-creation programs. Growth for the aggregate of developing exporters is anticipate to rise from 0.9 percent in 2011 to 4.7 percent by 2014. This aggregate includes Syria and Yemen, and should ongoing conflicts in these countries be quelled in the near- to intermediate term, growth in these economies could rise toward 4.5-5 percent by 2014.

Risks

Economic progress in the region will continue to be highly dependent on the overall political climate. The baseline assumes a normalization of conditions from 2012 to 2014. Should such easing of tensions be delayed, growth could be significantly slower in several countries. In this regard:

- The economic spillovers from Syria to Jordan and Lebanon are beginning to look serious, with increasingly adverse effects on neighboring economies. Jordan may require financial support from International Financial Institutions to cover funding shortfalls; while Lebanon's service-based economy is feeling the effects of the nearby conflict, yet registering firm growth on industrial output gains.

- In Yemen, the government has been changed, though conditions on the ground remain fluid; how quickly conditions can be brought to stability in the near term remains uncertain.

- In Egypt the process of establishing a new regime has yet to fully play out, with political and policy uncertainty ongoing at high levels.

- In addition to the political dimension, economic tensions are growing within the region, with several countries (Egypt and Jordan) coming under increasing pressure to finance burgeoning fiscal and current account deficits. Should these difficulties become acute, countries could be forced to cut radically into government spending and or imports and potentially seek assistance from the international community.

Although a good deal of progress has been made to restore fiscal sustainability in Europe, the situation remains fragile. The close economic and trade ties of the Middle East and North Africa with the Euro Area (e.g. some 70-80 percent of goods exports from Morocco and Tunisia are destined for the Zone), has made the region particularly sensitive to a deepening of the crisis. The likelihood of crisis involving Greece and potential serious spillovers through banking systems, remains a palpable threat (see Main Text). Exceptionally serious deterioration of conditions in the Euro Area (and in turn the global economy) could imply GDP losses (vs. baseline) for the Middle East and North Africa of 3.0 to 4.4 percent over 2012 to 2013 respectively. Key channels of transmission would include trade, tourism, remittances, financial flows, and importantly a falloff in local business and consumer confidence, potentially sustaining the downturn for a more extended period.

And outturns in the region remain closely tied to commodity prices (oil as an export, but food commodities as a critical import). The recent uptick in geopolitical tensions and boycotts of Iranian oil boosted oil prices during the first four months of the year, and though prices have fallen to $93/bbl in early June on a World Bank average basis-- prices could spike still higher – if

Table MNA.4 Middle East and North Africa forecast summary

(annual percent change unless indicated otherwise)					Est.	Forecast	
	98-07[a]	2009	2010	2011	2012	2013	2014
Algeria							
GDP at market prices (2005 US$) [b]	4.0	2.1	3.3	2.5	2.6	3.2	3.6
Current account bal/GDP (%)	28.9	0.1	15.6	19.3	12.7	9.8	7.6
Egypt, Arab Rep.							
GDP at market prices (2005 US$)	4.7	4.9	5.1	-0.8	1.4	3.6	4.6
Current account bal/GDP (%)	0.9	-1.8	-2.0	-2.1	-1.8	-1.8	-1.9
Iran, Islamic Rep.							
GDP at market prices (2005 US$) [b]	5.1	1.8	2.9	2.0	-1.0	-0.7	1.5
Current account bal/GDP (%)	10.3	4.6	5.6	8.1	7.4	2.8	1.1
Iraq							
GDP at market prices (2005 US$) [b]		4.2	0.8	9.9	11.1	13.5	11.0
Current account bal/GDP (%)		-8.0	3.0	16.5	11.2	12.6	11.8
Jordan							
GDP at market prices (2005 US$) [b]	5.9	2.3	2.3	2.6	2.1	3.8	4.3
Current account bal/GDP (%)	-2.3	-4.5	-6.9	-10.3	-7.8	-6.4	-5.7
Lebanon							
GDP at market prices (2005 US$) [b]	3.1	8.5	7.0	3.0	3.6	4.5	4.7
Current account bal/GDP (%)	-17.5	-19.3	-19.1	-23.0	-18.2	-17.8	-16.6
Morocco							
GDP at market prices (2005 US$) [b]	4.5	4.8	3.7	4.3	2.8	5.0	5.0
Current account bal/GDP (%)	1.4	-5.9	-4.4	-9.0	-6.4	-6.1	-5.8
Syrian Arab Republic							
GDP at market prices (2005 US$) [b]	4.1	6.0	3.2	-3.1	-6.4	2.5	4.4
Current account bal/GDP (%)	3.0	-1.9	-0.6	-2.8	-16.5	-6.7	-9.1
Tunisia							
GDP at market prices (2005 US$) [b]	4.9	3.1	3.0	-1.8	2.2	3.8	4.6
Current account bal/GDP (%)	-2.5	-2.8	-4.8	-7.4	-7.7	-6.5	-6.2
Yemen, Rep.							
GDP at market prices (2005 US$) [b]	4.1	3.8	7.7	-10.5	-1.1	3.0	4.5
Current account bal/GDP (%)	2.5	-9.7	-0.7	-0.1	2.8	0.6	-1.0

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.

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.

Source: World Bank.

there were a major disruption to global supply. Simulations in the Main text suggest that an illustrative but potentially realistic scenario of a $50/barrel increase in average crude oil price for the second half of 2012 and 2013 would yield a net positive effect for the region, with oil exporters seeing GDP growth improve by 1.4 and 1.7 percent respectively; oil importing countries find GDP growth dampened by some 0.8 to 1 percent over the period.

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 full inclusion in the model aggregates and projections for Djibouti, Iraq, Libya and the West Bank and Gaza, though references to these economies will be made in context of the report—for example regarding tourism flows, or foreign direct investment, where data is available. 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 with the Gulf Cooperation Council (GCC) economies (Jordan and Lebanon); and those with tight ties to the European Union (Arab Republic of Egypt, Morocco and Tunisia).

2 On a fiscal year basis, GDP growth for Egypt comes in at: 1.8% in FY10/11, 2.1% in FY11/12, 3.1% in FY12/13 and 4.2% in FY13/14.

3 Several EU members, Japan, and other nations have already reduced Iranian imports, and further curtailments are likely. On March 20, the Obama Administration granted 180-day exemptions from its sanction to 10 European countries and Japan because they had significantly reduced purchases from Iran. Another 12 nations that are deemed to be major importers—including India, China and South Korea—have until the end of July to take similar actions or face sanctions.

South Asia Region

Overview

Economic activity in South Asia has slowed considerably, following a promising start to 2012. Regional industrial production, exports and capital flows, which showed signs of recovery in the first two months of the year, faltered by the end of the first quarter. The new slowdown comes on the heels of a sharp deceleration in economic growth in the second half of 2011, which saw regional GDP growth decline to an estimated 7.1 percent for the year, from 8.6 percent in 2010. In India, the region's largest economy, growth measured at factor cost slowed sharply to 6.5 percent in the 2011-12 fiscal year ending in March, from 8.4 percent in the previous two fiscal years.

An expansionary fiscal policy stance, energy and infrastructure constraints, and political and security uncertainties, together with headwinds from resurgent Euro Area tensions, are continuing to act as a drag on private investment and growth. Inflationary pressures continue to remain strong across the region, despite easing briefly in India in early 2012. High fiscal deficits compared to other developing regions are likely crowding out productive investment and eroding future growth potential. Trade deficits have widened and current account positions come under pressure, mainly due to high crude oil prices in 2011 and weaker export demand, resulting in depreciation of currencies.

Agriculture, however, has performed well, and remittance inflows have continued to grow robustly. Private capital flows to South Asia saw a brief revival in the first two months of 2012 but appear to have slowed again by the end of May. Net private capital flows fell 18 percent in 2011 and are projected to decline a further 24 percent this year, mainly due to substantially weaker syndicated bank lending and bond inflows stemming from European bank deleveraging and India's worsening credit profile. Foreign direct investment (FDI) inflows are also likely to weaken in 2012 after increasing robustly in 2011.

Outlook: GDP growth in South Asia is expected to slow further to 6.4 percent in 2012, partly due to a weak carryover from the sharp deceleration in the second half of 2011, and to increase modestly to 6.5 percent and 6.7 percent respectively in 2013 and 2014. Economic activity in the region is expected to remain subdued in the medium-term mainly due to continuing external weakness and domestic concerns, including fiscal deficits, high inflation, and energy and infrastructure constraints. Private capital inflows are likely to reach the level reached in 2010 only by 2014. India is expected to see a modest increase in growth measured at factor cost to 6.9 percent in the current fiscal year ending in March 2013, and gradually pick up pace to 7.2 percent and 7.4 percent in the 2013-14 and 2014-15 fiscal years, respectively. In Pakistan, growth is expected to firm from its recent sluggishness to 3.8 percent and 4.1 percent in the 2012-13 and 2013-14 fiscal years, respectively. Bangladesh, which has seen a modest decline of growth in 2011-12, will see growth firm to 6.4 and 6.5 percent in 2012-13 and 2013-14, respectively.

Risks and vulnerabilities: South Asia's growth remains vulnerable to several external and domestic risks.

Euro Area uncertainty. A worsening of Euro Area turmoil, heightened risk aversion and European banking sector deleveraging could result in lower and potentially more volatile private capital inflows, which together with the region's weakened current account position could cause balance of payments difficulties.

Limited policy options. The already loose fiscal policy and high inflation in South Asia imply there is limited room for demand stimulus in the event of a negative external (or domestic) shock. There is an urgent need for rebuilding policy buffers, including credible fiscal consolidation, while protecting the most vulnerable.

Policy uncertainty and infrastructure constraints. In the absence of substantive action, policy uncertainty, electricity shortages and infrastructure constraints could continue to dampen private investment and regional growth.

Recent developments

South Asia's growth slowed sharply in the second half of 2011.[1] Headwinds from the intensification of the Euro area sovereign debt crisis caused a steep deceleration in South Asia's exports and a withdrawal of portfolio capital. Several rounds of monetary policy tightening in India, energy and infrastructure constraints across the region, together with political and security uncertainties and fiscal and inflation concerns, resulted in a falloff in regional investment and industrial activity. Trade balances and current account positions of South Asian countries came under pressure mainly due to the weaker export demand and adverse terms of trade shock from elevated international crude oil prices, which rose 32 percent in 2011 from the average level in 2010. Regional GDP growth, thus, declined from 8.6 percent in 2010 to an estimated 7.1 percent in 2011.

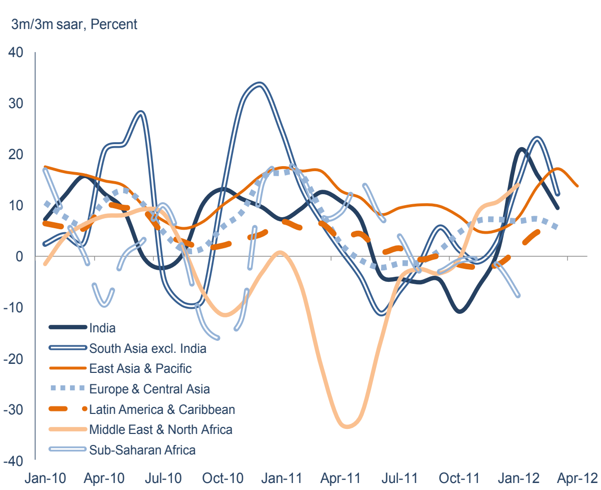
Trade and industrial production activity began to recover in early 2012. Industrial activity, however, faltered by end of the first quarter, with regional industrial production slowing from an annualized pace of 18.8 percent in the three months ending January to 10.3 percent in March (figure SAR.1). While this represents a rebound from the steep quarter-on-quarter declines seen in the second half of 2011, industrial activity remains weak on an annual basis. Regional export (import) volumes surged 22.6 percent (40.3 percent) in the three months ending February, but weakened to 13.1 percent (2.5 percent) by April (figure SAR.2). Imports in US dollar terms outpaced exports during the 12 months ending April, partly due to high crude oil prices compared to previous years.

Private capital flows to South Asia revived briefly in the first two months of 2012, but portfolio flows (mainly focused on India) fell off again between March and May amid concerns about fiscal and current account deficits, slow pace of policy reform, proposed taxes on cross-border investments in India, and resurgent Euro area uncertainties after inconclusive Greek elections in early May. The weaker current account positions and decline in private flows put the balance of payments position of South Asian countries under considerable stress, resulting in a drawdown of reserves and depreciation of currencies. Remittance inflows, however, continued to increase robustly providing support to current account balances, particularly in countries other than India.

Inflationary pressures continue to remain strong in South Asia

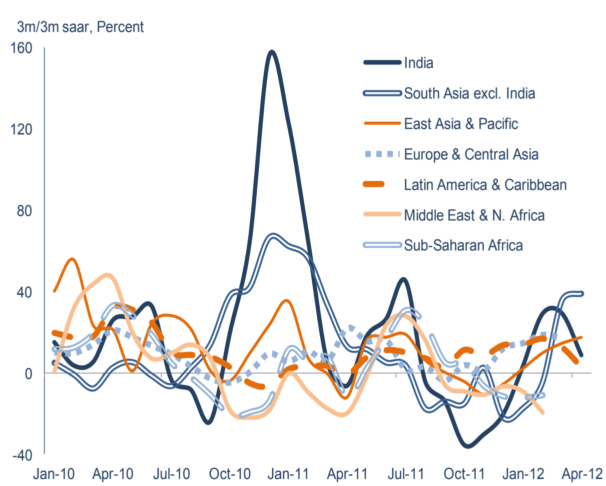
Inflationary pressures continue to remain strong in most South Asian countries. On the domestic side, pressures are arising from capacity

Figure SAR.1 Industrial production is reviving in South Asia



Sources: Datastream and World Bank.

Figure SAR.2 South Asia's exports are showing signs of recovery



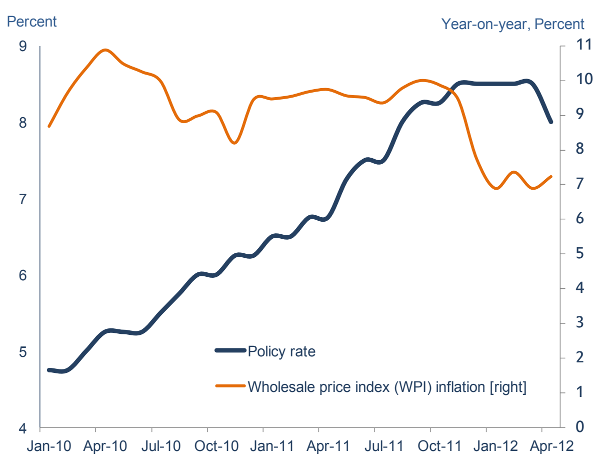
Sources: Datastream and World Bank.

constraints, persistent fiscal deficits, strong wage push pressures, and high food inflation (which is expected to subside after harvests). Increase in crude oil prices from the average levels in previous years and currency devaluation in several countries are further adding to inflationary pressures.

India's inflation rate eased in the early 2012 with the benchmark wholesale price index (WPI) inflation declining from 10 percent on year-on-year basis in September 2011 to 6.9 percent in January 2012, mainly due to interest rate increases and slowing economic growth (figure SAR.3). But WPI inflation inched back again to 7.2 percent by April. Moreover, India's consumer price inflation, based on an index covering rural and urban areas, surged to 10.4 percent year-on-year in April, with food inflation rising sharply to 10.2 percent from 4.1 percent in January. Food prices in India have risen together with international food prices, which increased 8 percent between December 2011 and March. Although India's food grain production has increased robustly, increases in consumption of proteins and other items driven by income gains in the past few years and supply not keeping pace with demand have also contributed to higher domestic food prices.

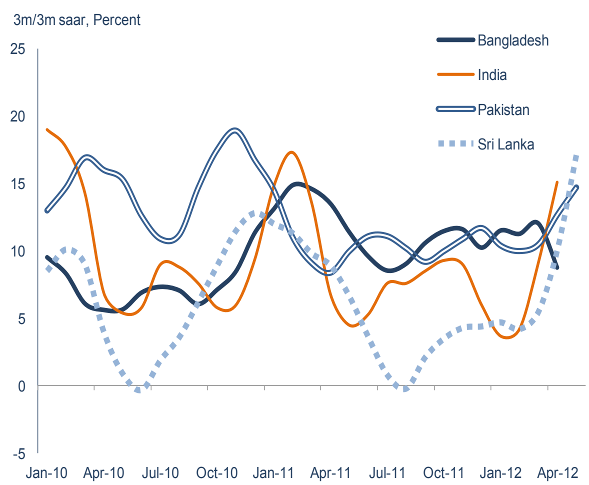
In addition to India, there are signs of an uptick in Pakistan and Sri Lanka, where annualized quarterly inflation is in excess of 14 percent (figure SAR.4). The depreciation of the Sri Lankan rupee and increases in administered prices for fuel have contributed to inflationary pressures. Although inflation in Nepal appears to have moderated in recent months with food inflation easing, its currency has depreciated in step with the Indian rupee, and energy and transport costs have increased. In Bangladesh too, inflation appears to have eased from double-digit rates over most of last year, with lower food inflation contributing to a fall in overall inflation to 9.2 percent on a year-on-year basis in May. Non-food inflation also slowed in May together with easing of international commodity prices, but remains high at 12.7 percent, partly reflecting pressures from higher government spending and strong domestic demand.

Figure SAR.3 Policy rate increases in India helped to drive down wholesale price inflation



Sources: Haver Analytics and World Bank.

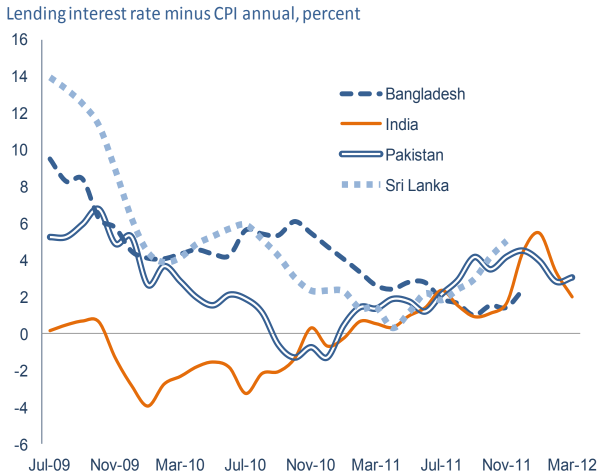
Figure SAR.4 Consumer price inflation remains high across South Asia



Sources: Haver Analytics and World Bank.

South Asian countries tightened monetary policies over the last year to contain inflationary pressures (figure SAR.5). India's key policy rate was increased by a cumulative 375 basis point increase between April 2010 and October 2011, but monetary policy eased in the first four months of 2012 as the central bank reduced cash reserve ratio requirements and cut the policy rate from 8.5 percent to 8 percent in a bid to stimulate investment activity amid slowing growth. Bangladesh's benchmark repurchase rate has been raised 150 basis points since mid-2011

Figure SAR.5 Real interest rates increased with tightening of monetary policies

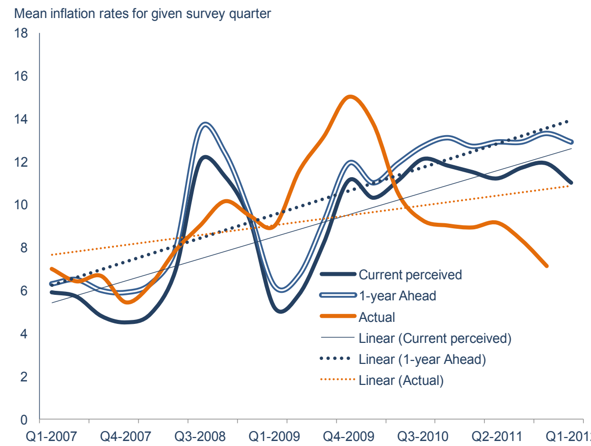


Sources: IMF International Financial Statistics, EIU and World Bank.

to 7.75 percent with a penalty rate for discretionary liquidity support. Pakistan has kept its key policy rate steady at 12 percent since October 2011. Sri Lanka's rapid credit growth of nearly 35 percent in 2011 decelerated sharply in early 2012 after a 50 basis point increase in the policy rate and other policy measures to slow private sector lending.

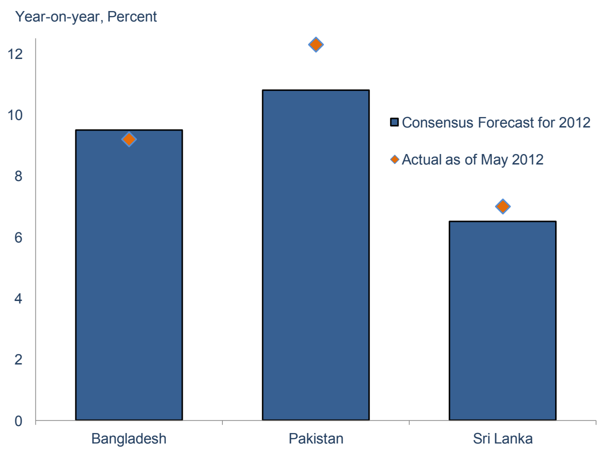
Expectations of future inflation remain high in South Asia. Inflation expectations of households in India for the next quarter, and for next year, lagged the fall in inflation in the first quarter of 2012 (figure SAR.6). This suggests that households expected the fall in inflation in the first quarter to be short-lived. Inflation is also expected to persist at close to current rates in Bangladesh and Sri Lanka through the year, and to fall modestly from the current high rate in Pakistan (figure SAR.7). Inflation expectations in South Asia are partly influenced by the likelihood of higher extent of pass-through of international oil prices to domestic prices, as governments across South Asia reduce fuel subsidies in a bid to rein in fiscal deficits. Administered prices for fuel and electricity have been raised in Bangladesh and Pakistan in order to offset higher input costs and reduce losses of state-owned energy companies. In Sri Lanka, prices of petroleum and electricity were

Figure SAR.6 India's households' inflation expectation have not declined to the extent of fall in actual inflation



Sources: Reserve Bank of India and World Bank.

Figure SAR.7 Inflation is expected stay close to current rates in Bangladesh and Sri Lanka



Sources: Consensus Economics and World Bank.

increased 32 percent and 20 percent, respectively, by mid-March. Similar increases are likely to follow in India, where the administered price of diesel fuel used mainly in the transport sector was last raised in June 2011.

Fiscal deficits remain at worrisome levels

Across the region, fiscal balances have come under pressure from fuel and fertilizer subsidies, social welfare programs, and weak tax collection. Administered domestic fuel prices, which attempt to shield consumers to varying degrees from increases in international prices, have resulted in fiscal subsidies that are eventually unsustainable. These large deficits and government borrowing programs are likely crowding out private investment, and have stoked inflationary pressures and depressed consumption demand. Fiscal slippages have become increasingly common across the region.

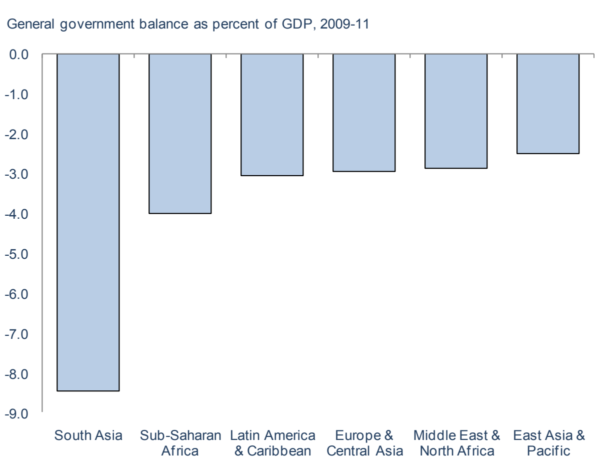
South Asia on average has the highest fiscal deficits among the six developing regions (figure SAR.8). India's central government deficit for the 2011-12 fiscal year ending in March was 5.8 percent of GDP, 1.2 percent higher than targeted, and the general government deficit including state budget deficits exceeds 8 percent of GDP. Sri Lanka's fiscal deficit has fallen from nearly 10 percent of GDP in 2009 due to efforts to control expenditures, but still remains close to 7 percent of GDP, as it does in Pakistan (figure SAR.9).

In Bangladesh, a short-term reliance on oil-powered rental power plants to boost generation capacity and mounting losses of the state-owned Bangladesh Petroleum Corporation due to low administered fuel prices have resulted in a subsidy burden of more than 3 percent of GDP. The off-budget financing of state-owned electricity companies has contributed to fiscal woes and increased non-performing loans of banks. High prices of imported crude oil have similarly resulted in an increasing subsidy burden in Pakistan.

India's subsidy burden reached an estimated 2.4 of GDP in the 2011-12 fiscal year ending in March mainly due to energy subsidies and social welfare programs. The divergence between international prices and domestic prices for diesel, liquefied petroleum gas (LPG) and kerosene in India has resulted in nearly a doubling of "under-recoveries" (losses of public sector oil marketing companies from sale price below import equivalent plus taxes), which are partially covered by the government and have added to the fiscal burden. Petrol prices in India are market-based, but are set by state-owned retailers and have lagged international prices, implying losses for these firms. Transfer payments and employment-generation programs in India have supported demand, particularly in rural areas, but some of the potential welfare gains have been lost due to leakages in public distribution systems and the inflationary impact of the commensurately higher fiscal deficit.

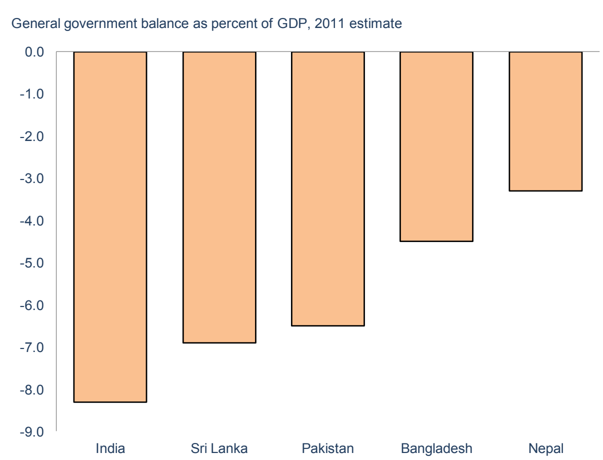
On the revenue side, tax collection as a share of GDP has been weaker in South Asia in recent years compared to other developing regions (figure SAR.10). Reform of indirect taxes in India, which proposes a unified goods and services tax to replace a number of existing

Figure SAR.8 South Asia has the highest fiscal deficit among developing regions



Source: World Bank.

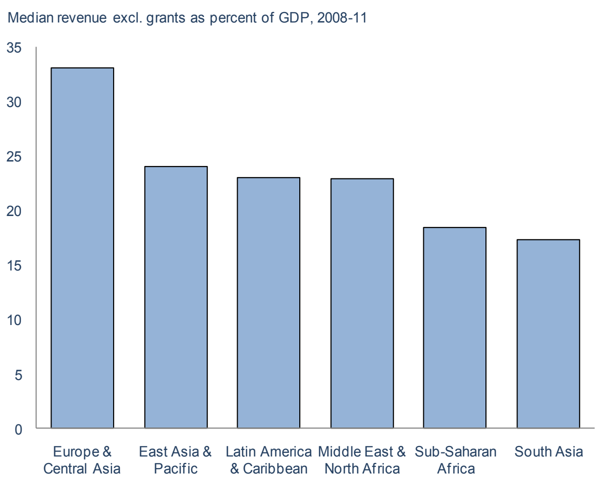
Figure SAR.9 Fiscal deficits are high across South Asian countries



Source: World Bank.

central and state indirect taxes (including excise duty, service tax and value-added tax), has been pending for several years. Pakistan's tax base remains very narrow, with a small fraction of the population paying taxes despite recent efforts by the government to improve tax collection and reduce evasion. Bangladesh's tax revenues amount to a tenth of GDP, constraining development spending and public investment in infrastructure and other areas. One-off factors also contributed to fiscal slippages in specific years. For instance, lower than expected revenues from equity sales of state-owned enterprises in India were part of the reason for a larger than targeted deficit in the 2011-12 fiscal year.

Figure SAR.10 Revenue collection is weaker in South Asia compared to other regions



Source: World Bank.

Trade and current account positions deteriorated mainly due to weaker external demand and negative terms of trade shocks

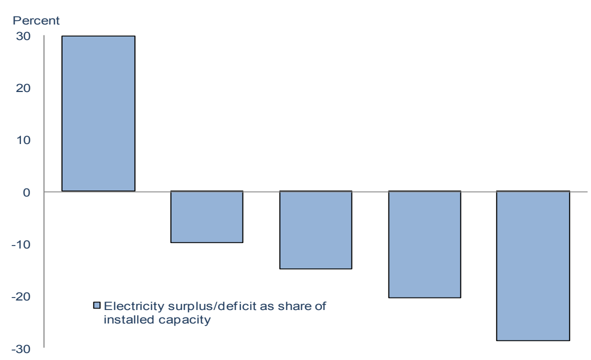
South Asian countries experienced deteriorating current account balances due to the combined effect of weak demand in key export markets and negative terms of trade shocks from the increases in crude oil prices in both 2010 and 2011 (figure SAR.11). Despite an annualized decline of 33 percent in the three months ending November 2011 during the intensification of the Euro area sovereign debt crisis, South Asia's export volumes registered growth of 19 percent for the full calendar year. Exports were cushioned to some extent by increasing diversification towards markets in Asia, Africa and high-income countries that are not part of the OECD, where growth has held up better than the Euro area and the U.S. South Asian firms are also becoming increasingly integrated into global production and supply chains, and are moving into higher value-added and more sophisticated products.

However, imports in nominal dollars terms surged across the region as elevated crude oil prices—which rose 28 percent in 2010 and a further 32 percent in 2011—and relatively strong domestic demand, in particular in India and Sri

Box SAR.1 Energy shortages are weighing down South Asia's investment and growth

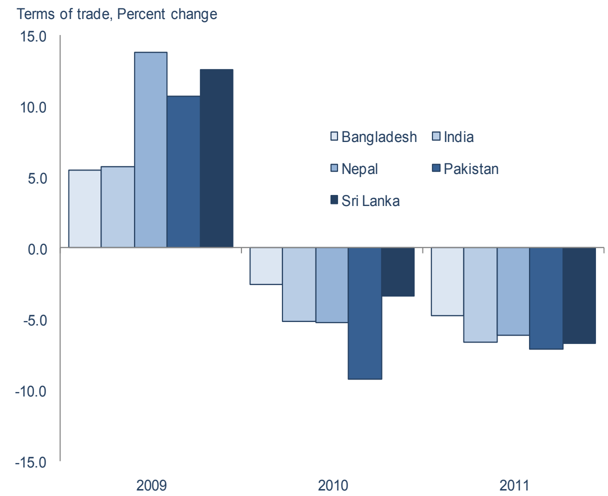
Pervasive electricity shortages and infrastructure constraints across much of the South Asia region have made the operating environment difficult for the private sector and increased the cost of doing business. The gap between the demand for electricity and installed capacity is particularly acute in South Asia, ranging from 10 percent in India to nearly 30 percent in Nepal (SAR box figure 1). Electricity generation companies in Bangladesh, India, and Pakistan often lack reliable access to inputs. In India, the dominance of state-owned enterprises in coal extraction, below-market pricing for certain sectors and underinvestment in capacity expansion, among other factors, has kept production below demand. Supply of imported crude oil used for power generation in Bangladesh has become more expensive and the supply of natural gas in Pakistan remains sporadic. Tight supply of inputs, has, in turn, forced both public and private power generation companies to ration output, which in turn has cut into activity levels and exports. Energy shortages have likely reduced the willingness of South Asian firms to invest, thereby hurting South Asia's longer-term growth potential.

Box figure SAR.1 Electricity demand-supply gaps are acute in South Asia



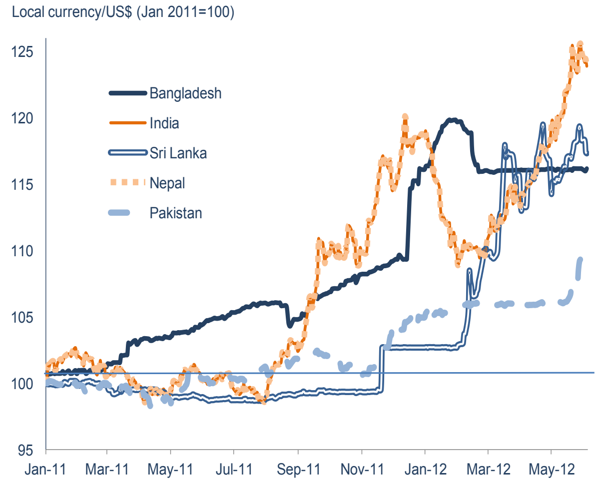
Source: *More and Better Jobs in South Asia*, World Bank.

Figure SAR.11 Terms of trade moved against South Asian countries in 2010 and 2011 as international crude oil prices rose



Note: Terms of trade based on Keyfitz import and export price indices
Source: World Bank.

Figure SAR.12 Nominal exchange rates depreciated in South Asia



Source: World Bank.

Lanka, increased the import bill. In consequence, India's current account deficit widened to nearly 4 percent of GDP in the 2011-12 fiscal year ending in March. Strong demand, in particular for gold (partly due to the perceived safety of the asset in a high inflation environment) also contributed to the deterioration of the current account position and increased pressure on reserves, which declined from 9.6 to 6.4 months of import cover between October 2010 and February 2012. Pakistan's current account went from near balance to a deficit of 1.7 percent of GDP in the first nine months of the 2011-12 fiscal year, despite a 21.5 percent increase in remittances to nearly $10 billion during this period.

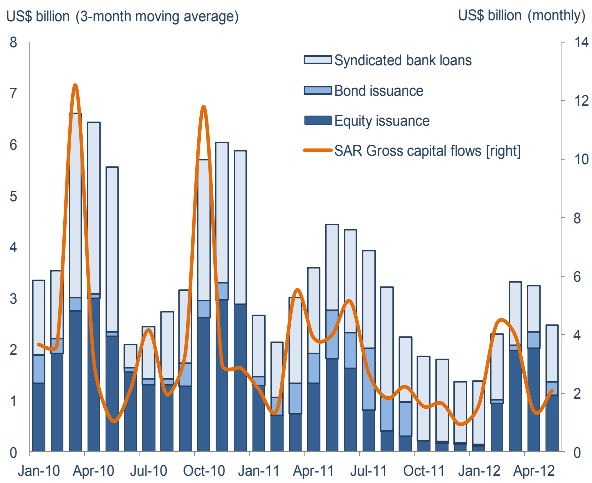
Reflecting the deterioration in India's external balances, the Indian rupee depreciated by over 9 percent against the dollar between February and mid-May, losing all the gains made in January following a steep depreciation during the Euro area debt crisis (figure SAR.12). Nepal's currency depreciated in step with the Indian rupee due to the currency peg. Other South Asian currencies have also faced depreciation pressures requiring international reserves to be drawn down. The Sri Lankan rupee depreciated by over 12 percent between February and April after the central bank removed the trading band and allowed greater exchange rate flexibility. The Pakistani rupee and Bangladeshi taka faced depreciation pressures since mid-2011, with a relatively sharp depreciation of the taka in December during the Euro Area debt crisis. The taka, however, appears to have stabilized since February.

Private capital flows to South Asia slowed sharply, but remittances remained robust

Private capital flows to South Asia fell off sharply during the intensification of the Euro area debt crisis in second half of 2011, with net private inflows to the region declining by an estimated 18 percent in 2011 (figure SAR.13 and table SAR.1). While portfolio equity and debt inflows declined by more than 60 percent, net foreign direct investment inflows to the region—mainly focused on India—rose to $51.6 billion in 2011. However, other countries have seen declines in foreign investment. Net foreign direct investment (FDI) inflows to Pakistan shrunk by nearly 50 percent in the first nine months of the 2011-12 fiscal year ending in June mainly because of deteriorating macroeconomic fundamentals, energy shortages and a difficult political environment.

Portfolio flows to India rebounded in the first two months of 2012 (figure SAR.13). But resurgent Euro area turmoil and concerns about fiscal and current account deficits, delayed reforms, and uncertainty about application of the proposed General Anti-Avoidance Rule (GAAR) to cross-border transactions (subsequently postponed until the start of the 2013-14 fiscal year) again led to a falloff in private flows in the subsequent months. European banking sector deleveraging resulted in a more than two-third decline in syndicated loans organized and led by European banks in the six month period ending March 2012. The lowering of the outlook for India's BBB- investment grade sovereign credit rating from stable to negative by Standard and Poor's in April 2012 has also dampened investor sentiment.

Figure SAR.13 Private capital flows to South revived in early 2012, but fell off since March



Sources: Dealogic and World Bank.

Net private capital flows to South Asia are projected to fall a further 24 percent in 2012 (table SAR.1), with bank lending and bond inflows declining sharply by more than 70 percent. Portfolio equity flows are expected to also weaken by a third in 2012 from a low base in 2011, while net FDI inflows are also likely to weaken by more than 10 percent.

By contrast, remittances sent by international emigrants have remained resilient. South Asia received $97 billion in remittances in 2011, an increase of 18 percent from the previous year (figure SAR.14). India remains the largest recipient of remittances among developing countries, but remittances are more important as a share of domestic product in other South Asian countries, where they range from 5 to 20 percent as a share of GDP. Remittance inflows in nominal dollar terms increased by 27 percent, 25 percent and 17 percent in Pakistan, Sri Lanka and Nepal, respectively, in 2011, while flows to Bangladesh grew at a relatively slower pace of 10 percent.

Slower growth in high income countries and

Table SAR.1 Annual net capital flows to South Asia

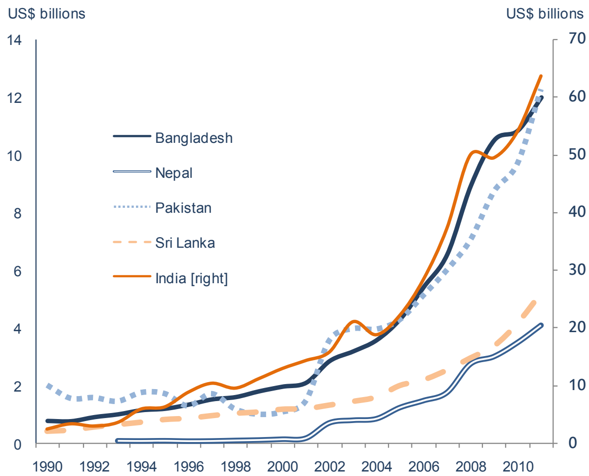
$ billions

	2008	2009	2010	2011e	2012f	2013f	2014f
Capital Inflows	**64.8**	**86.2**	**111.5**	**90.5**	**70.4**	**85.6**	**109.0**
Private inflows, net	55.9	75.2	101.9	83.7	63.3	77.7	100.3
Equity Inflows, net	35.2	59.9	67.4	62.2	52.1	60.5	76.2
FDI inflows	51.1	39.4	28.0	51.6	45.0	48.5	56.2
Portfolio equity inflows	-15.8	20.5	39.4	10.6	7.1	12	20
Private creditors, net	20.7	15.2	34.5	21.5	11.2	17.2	24.1
Bonds	1.7	1.9	10.1	4	0.3	3	3
Banks	11.2	10.8	12.8	6.5	2	3	7
Short-term debt flows	7.9	2.6	11.7	10.9	9.0	11.0	14.0
Other private	0.0	-0.1	-0.1	0.1	-0.1	0.2	0.1
Offical inflows, net	8.8	11.0	9.6	6.8	7.1	7.9	8.7
World Bank	1.4	2.4	3.3	2	..	..	..
IMF	3.2	3.6	2.0	0.5	..	..	..
Other official	4.2	5.0	4.4	4.3	..	..	..

Note :
e = estimate, f = forecast

Source: World Bank.

Figure SAR.14 Exponential increase in remittance flows to South Asia since 2000



Source: World Bank Migration and Development Brief 18

tighter immigration policies in some host countries has dampened remittances from these sources. However, sustained labor demand from oil-exporting Gulf Cooperation Council (GCC) countries that are benefiting from high international crude oil prices (compared to average levels in previous years), and a diversification of migration destinations towards non-OECD high income countries such as South Korea and to other developing countries (e.g., Malaysia) has contributed to relatively robust demand for South Asian migrants, and thereby to the steady growth of remittances.

Medium-term outlook

South Asia's GDP growth is expected to slow further in 2012 due to weak carry-over from 2011

Despite an incipient recovery in industrial activity and exports in early 2012, South Asia's GDP growth is expected to slow further to 6.4 percent in 2012. The weaker than average carry-over (see box 3 in the main text) resulting from the sharp deceleration of growth in India in the second half of 2011, along with domestic policy uncertainties across the South Asia region and a still-fragile external environment are expected to moderate regional growth in 2012. The fiscal balances of South Asian countries are likely to remain under considerable pressure if crude oil prices remain close to the average level in 2011 (see Commodity Annex), and in particular if adjustment of domestic subsidized prices closer to international prices is delayed further. Since inflation expectations have become entrenched in South Asian countries, and because of capacity constraints, particularly in Sri Lanka and Maldives, relatively little progress toward disinflation is expected. Near-stagnant output in the Euro area and spillover of the current turmoil to other high income and developing countries could dampen South Asia's export performance.

Food grain production in South Asia has remained buoyant, with annual production outpacing consumption demand in the 2011-12 crop year (table SAR.2). Although the share of agriculture in South Asia's overall GDP has declined over time, a strong agricultural outturn in the 2012/13 crop year, with production levels similar to that experienced in the previous year, is likely to contribute to rural demand and provide a lift to growth, while reducing inflationary pressures.

However, activity levels in the region are expected to remain subdued in the medium-term due to the fragile external environment amid slower growth in high income countries as well as domestic policy concerns, including fiscal deficits, high inflation, and energy and infrastructure constraints. Private capital inflows are likely to remain below the level reached in 2010 (table SAR.1) and could become more volatile during the course of 2012, particularly if the ongoing Euro area turmoil worsens and if European banking sector deleveraging accelerates. Uncertainty about private capital inflows would make it difficult to finance South Asia's current account deficits. In addition, remittance inflows in dollar terms are likely to increase at a slower pace of 7.4-8.4 percent annually during 2012-14, according to the World Bank's *Migration and Development Brief 18*. South Asia's growth is expected to pick-up modestly during the course of 2013 as global growth resumes (albeit at a relatively weak pace) and to gradually increase to 6.7 percent by 2014

Table SAR.2 South Asia's grain balances are expected to continue to improve

(millions metric tons)

	2000-2001	2001-2002	2002-2003	2003-2004	2004-2005	2005-2006	2006-2007	2007-2008	2008-2009	2009-2010	2010-2011	2011-2012	2012-2013(f)
Production	257	258	233	258	255	268	269	289	292	284	299	315	319
y-o-y growth (%)	*2.2*	*0.3*	*-9.5*	*10.5*	*-1.2*	*5.1*	*0.5*	*7.2*	*1.2*	*-2.7*	*5.1*	*5.4*	*1.5*
Consumption	239	251	247	258	256	261	268	281	279	278	293	300	309
y-o-y growth (%)	*-3.2*	*5.4*	*-1.7*	*4.2*	*-0.6*	*2.2*	*2.5*	*5.0*	*-0.8*	*-0.3*	*5.2*	*2.4*	*3.2*
Net exports	2.1	5.9	8.2	8.3	4.5	6.2	-2.0	4.1	-2.4	1.6	1.4	8.9	7.0
Ending stock	50.1	50.8	28.8	20.9	15.2	15.2	18.4	21.4	36.5	40.7	45.3	51.2	54.1

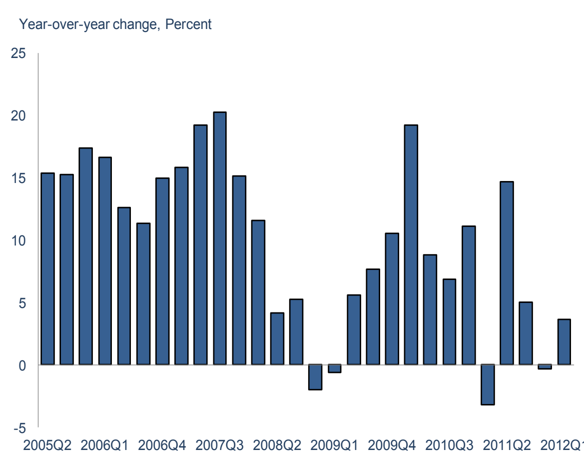
Sources: U.S. Department of Agriculture and World Bank.

(see table SAR.3 for the regional forecast summary and table SAR.4 for country-specific forecasts).

GDP growth in India (the largest economy in the region accounting for about 80 percent of output) slowed to 5.3 percent year-on-year in factor cost terms in the first quarter of 2012—down from the robust 8.4 percent annual growth rates recorded both in the 2009-10 and 2010-11 fiscal years. GDP growth is estimated to have slowed to 6.5 percent during the 2011-12 fiscal year ending in March. A slow pace of policy reform and reversals on a range of issues have dented the confidence of both domestic and international investors. Delays in passing legislation on land acquisition; cancellation of mobile telecom licenses following concerns about allocation; bans on mining activity by the courts in Karnataka state (partially lifted in April) and on cotton exports by the government (lifted in early May); policy reversal on foreign direct investment in the retail sector; and uncertainty about budget plans to expand taxation of cross-border acquisitions involving local assets have contributed towards creating a relatively uncertain policy environment for investors. Together with the effect of loose fiscal policies on credit availability for the private sector, electricity shortages, and the weaker external environment, policy uncertainty appears to have contributed to a slowdown in investment growth in recent quarters, particularly compared to the robust rates of increase experienced in the period prior to the Lehman crisis in 2008 (figure SAR.15).

Agricultural production in India, accounting for nearly a fifth of the economy and close to half of overall employment, has however performed relatively well due to normal rainfall and absence of drought. Good agricultural performance (together with employment generation programs and transfer payments) has provided a boost to the rural economy in recent years. Monsoon rains during the June-September period accounting for more than two-third of India's annual rainfall are expected to be close to the long-term average, according to India's Meteorological Department, although El Nino conditions could cause rainfall scarcity in some parts of India. GDP growth in India measured at factor cost is expected to pick up at a modest pace of 6.9 percent in the 2012-13 fiscal year,

Figure SAR.15 India's fixed investment growth has slowed



Sources: India Central Statistical Office, Datastream and World Bank.

and to rise to 7.4 percent by the 2014-15 fiscal year. The relatively modest recovery projected for FY2012-13 partly reflects the weak carry over from the previous year and is predicated on a limited set of reforms, resumption of mining activity after a partial or full lifting of court-imposed bans, efforts to limit energy and other subsidies, and good agricultural production following normal monsoon rains. A worsening of the current Euro area turmoil, however, could result in a less favorable growth outturn in the 2012-13 fiscal year.

Economic growth in Pakistan, the second largest economy in the region accounting for nearly 10 percent of regional GDP, has remained sluggish. High inflation, power shortages and the political situation have hampered investment activity and industrial output, and led to a sharp decline in foreign direct investment. After experiencing heavy damages during devastating floods in the 2009-10 fiscal year ending in June 2010, agricultural production in Pakistan revived in 2011-12. However, recurrent power shortages and heavy rains that have damaged standing crops in some parts of Pakistan could result in relatively subdued agricultural performance. Pakistan's GDP growth is estimated to have increased to 3.6 percent in the 2011-12 fiscal year after the sharp deceleration experienced in 2010-11. Despite the pickup, growth remains well below the regional average and per capita growth below 1.5 percent. GDP growth is expected to remain in the range of 3.8-4.1 percent in the 2012-13 and 2013-14 fiscal years. Lower foreign investment inflows and IMF debt repayments coming due could exacerbate balance of payments difficulties.

Table SAR.3 South Asia's forecast summary

(annual percent change unless indicated otherwise)					Est.	Forecast	
	98-07[a]	**2009**	**2010**	**2011**	**2012**	**2013**	**2014**
GDP at market prices (2005 US$) [b,f]	6.5	5.3	8.6	7.1	6.4	6.5	6.7
GDP per capita (units in US$)	4.8	3.8	7.1	5.7	5.0	5.2	5.4
PPP GDP [d]	6.5	5.3	8.6	7.1	6.4	6.5	6.8
Private consumption	5.2	6.9	7.4	6.8	5.9	6.2	6.5
Public consumption	5.5	9.3	9.6	5.8	5.5	5.2	4.9
Fixed investment	10.0	8.9	9.4	5.9	5.2	7.6	9.6
Exports, GNFS [e]	14.9	-7.2	13.6	15.0	6.6	7.6	9.2
Imports, GNFS [e]	11.1	-7.4	10.6	16.3	7.7	7.4	8.6
Net exports, contribution to growth	-0.1	0.6	0.0	-1.2	-0.7	-0.4	-0.4
Current account bal/GDP (%)	-0.4	-1.7	-2.5	-3.5	-3.2	-2.4	-2.0
GDP deflator (median, LCU)	6.1	8.5	9.7	8.5	8.0	7.7	7.7
Fiscal balance/GDP (%)	-7.0	-9.2	-8.4	-7.9	-7.5	-7.3	-6.9
Memo items: GDP at market prices [f]							
South Asia excluding India	4.8	3.4	4.9	4.8	5.0	5.2	5.3
India	7.1	9.1	9.6	6.9	6.6	6.9	7.1
at factor cost	-	8.4	8.4	6.5	6.9	7.2	7.4
Pakistan	4.7	3.6	4.1	2.4	3.6	3.8	4.1
Bangladesh	5.6	5.7	6.1	6.7	6.3	6.4	6.5

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 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.

Bangladesh's economy has suffered from political turmoil and periodic strikes, widespread electricity shortages, near-double digit inflation, fiscal deficits, and deteriorating external balances. GDP growth is estimated to have slowed to 6.3 percent in the 2011-12 fiscal year ending in June from 6.7 percent in 2010-11. Exports have been affected by weaker demand from key European trade partners, while infrastructure constraints, especially electricity shortages, have become acute, in part due to high crude oil prices. Agricultural output growth is also estimated to have slowed to less than 2 percent in the 2011-12 fiscal year from the previous fiscal year's 5.1 percent. But good crop harvests are expected for the current agricultural season due to favorable weather. Monetary tightening and easing of food inflation are likely to continue to put downward pressure on overall inflation. Non-food inflation, however, remains persistently high partly due to still high cost of imported inputs and pressures from higher government spending. Migrant remittances have remained resilient increasing 11 percent on a

Table SAR.4 South Asia's country forecasts

(annual percent change unless indicated otherwise)	98-07[a]	2009	2010	2011	Est. 2012	Forecast 2013	2014
Calendar year basis [b]							
Bangladesh							
GDP at market prices (2005 US$) [c]	5.6	6.0	6.4	6.5	6.4	6.4	6.5
Current account bal/GDP (%)	0.1	3.5	2.4	0.6	0.8	1.0	1.2
India							
GDP at market prices (2005 US$) [c]	7.0	5.7	9.5	7.6	6.7	6.8	7.0
Current account bal/GDP (%)	-0.3	-2.0	-2.9	-3.8	-3.6	-2.7	-2.2
Nepal							
GDP at market prices (2005 US$) [c]	3.8	5.3	4.0	3.9	4.2	4.2	4.3
Current account bal/GDP (%)	-1.6	0.9	-1.8	-0.2	0.6	0.8	1.1
Pakistan							
GDP at market prices (2005 US$) [c]	4.7	1.6	3.3	3.0	3.7	4.0	4.1
Current account bal/GDP (%)	-0.8	-2.5	-1.9	-2.2	-2.3	-2.2	-2.0
Sri Lanka							
GDP at market prices (2005 US$) [c]	4.9	3.5	8.0	8.3	6.4	6.7	7.0
Current account bal/GDP (%)	-3.2	-0.7	-2.2	-8.0	-4.4	-3.4	-2.9
Fiscal year basis [b]							
Bangladesh							
Real GDP at market prices	5.6	5.7	6.1	6.7	6.3	6.4	6.5
India							
Real GDP at market prices	7.1	9.1	9.6	6.9	6.6	6.9	7.1
Memo: Real GDP at factor cost	-	8.4	8.4	6.5	6.9	7.2	7.4
Nepal							
Real GDP at market prices	3.7	4.4	4.6	3.5	4.2	4.1	4.3
Pakistan							
Real GDP at market prices	4.7	3.6	4.1	2.4	3.6	3.8	4.1

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.

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.

Source: World Bank.

year-on-year basis in the first eleven months of the 2011-12 fiscal year to $11.8 billion; but reserves have been under pressure due to the high crude oil import bill. GDP growth is expected to pick up to 6.5 percent by the 2013-14 fiscal year.

Sri Lanka's economy has grown robustly since the end of civil war with GDP growth of 8.3 percent in the 2011 calendar year, slightly higher than 8 percent growth registered in 2010. This buoyant growth was mainly due to reconstruction spending, increases in tourism arrivals and strong remittance inflows, which grew at 31 percent and 25 percent, respectively, in 2011. However, Sri Lanka's external position came under tremendous pressure because of a nearly 50 percent increase in import demand fueled by rapid domestic credit growth and robust consumption demand, together with high crude oil prices compared to the average levels in previous years. In consequence, Sri Lanka's current account deficit swelled from 2.2 percent of GDP in 2010 to nearly 8 percent of GDP, and the authorities have had to intervene to support the currency, drawing down international reserves which declined from $8 billion in mid-2011 to $5.5 billion or a little over 2 months of import cover by early 2012. Inflation has inched up to 7 percent in May on a year-on-year basis, suggesting that demand pressures continue to remain strong. The central bank has taken a number of measures to limit domestic credit growth and import demand, allowed the exchange rate to depreciate, and taken recourse to IMF assistance to improve the reserve position. As a result, growth outturns in the medium term are expected to be in the range of 6.4-7.0 percent during 2012-14, a lower but more sustainable pace compared to that in recent years.

Nepal's GDP growth is estimated to have picked up to 4.2 percent in the 2011-12 fiscal year ending in mid-July from 3.5 percent in 2010-11, supported by a good agricultural harvest, robust remittance inflows and tourism revenues. Although the political situation is much improved compared to the period of civil conflict prior to 2007, it remains characterized by instability due to as yet unresolved constitutional issues. This uncertainty continues to hold back investment and industrial activity. Remittances have supported consumption, but resulted in a surge in import demand, rising real estate prices and a current account deficit in 2010. But the ability of the domestic economy to respond to supply remittance-fueled demand appears to be improving. Robust demand for migrants and depreciation of the Nepali rupee (mainly due to the currency peg with the Indian rupee) has also created additional incentives for sending remittances, contributing to an improvement in the current account position. Growth is likely to be subdued in the near term, but increase gradually over the medium-term.

Afghanistan's economy continues to be characterized by a heavy reliance on external aid, weak governance and an uncertain security situation. GDP growth in Afghanistan surged to 21 percent and 8.4 percent respectively in the 2009-10 and 2010-11 fiscal years mainly because of donor assistance. But growth slowed to an estimated 5.7 percent in 2011-12 due to a poor crop and partly since aid has leveled off and is therefore not contributing as much to growth. The monetary policy transmission mechanism and financial sector also remain weak, particularly in the wake of the Kabul Bank crisis. The withdrawal of the majority of foreign NATO forces by 2014 could reduce largely aid-financed growth to 4-5 percent, according to recent World Bank estimates – necessitating an adjustment to domestic sources of growth. Agriculture and services are the mainstay of the economy, but recently awarded contracts for gold and oil extraction could see an increase in the contribution of mining to growth.

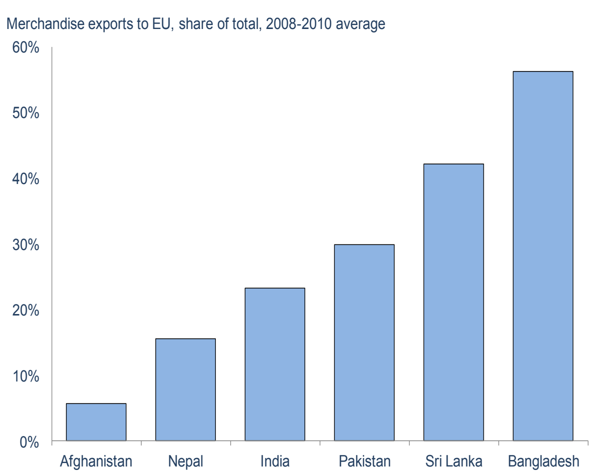
Maldives has been beset by political uncertainties for much of the last year – adversely affecting tourism revenues. Fiscal expansion following the change of government, including increase in public sector wages and the introduction of universal healthcare, has fed into import demand and increased inflationary pressures already running in the double digits.

Fiscal balances in South Asia are likely to continue to remain stressed in absence of substantive action to reduce fuel, electricity and fertilizer subsidies and parallel efforts to improve revenue performance. India has set a target of reducing overall subsidies to 2.0 percent in the 2012-13 fiscal year, which is likely to require significant upward adjustment to administered fuel prices. Even after recent price hikes in Bangladesh and Sri Lanka, energy products are still subsidized to some extent. Moreover, elections scheduled in the coming two years in several South Asian countries and a desire to protect consumers from the inflationary impact of higher fuel prices could make it difficult to reduce subsidies and raise administered fuel price closer to cost recovery levels.

Risks and vulnerabilities

South Asia's growth remains vulnerable to external and domestic downside risks. On the external front, an escalation of Euro area uncertainties during the course of the year—in particular after Greek elections in mid-June—would likely have a negative impact on South Asia's growth prospects. Weaker demand for exports from Europe (figure SAR.16) and lower and potentially more volatile private capital flows would put additional strains on the balance of payments position of South Asian countries, and delay a recovery in investment and output.

Figure SAR.16 South Asian countries have significant trade exposure to European markets



Sources: UN COMTRADE and World Bank.

An increase in geopolitical tensions in the Strait of Hormuz that causes a major disruption to global oil supply would also adversely impact this net oil-importing region. If global oil prices were to rise by $50, South Asia's current account and fiscal deficits could be expected to rise by 1.5 percent and 0.8 percent of regional GDP, respectively, by 2013, and GDP could decline by 1.3 percent relative to the baseline (see scenario in box 6 in the main text).

India's short term debt obligations remain elevated, with short-term claims comprising more than half of overall foreign currency claims of international banks that report data to the Bank for International Settlements (BIS). An increased reliance on short-term funding, which is projected to decline at a much smaller pace than other inflows (table SAR.1), could increase vulnerability to external events.

The already loose stance of fiscal policy and high inflation rates in South Asia imply that there is limited space for demand stimulus in the event of a negative external or domestic shock. Were a crisis to materialize, the burden of adjustment would fall mainly on private consumption and investment, in turn depressing future productivity and growth and potentially eroding the recent gains against poverty. Nonetheless, expansion of demand through further policy easing could prove counterproductive with risk of higher inflation, crowding out of private investment by ever-larger government borrowing, and possibly greater macroeconomic instability.

An upside risk for South Asia's growth is that alleviating the economic policy, energy and infrastructure constraints outlined above could potentially lift South Asia's growth closer to the pre-crisis trend. Recent progress on reducing barriers to intra-regional trade in South Asia, if sustained, could expand markets within the region and bring significant benefits, in particular to South Asian economies other than India. However, tackling South Asia's "behind the border" constraints remains key to improving the region's growth prospects.

Another upside risk for regional growth is that of crude oil and international commodity prices declining over the course of 2012, if global demand weakens further or if additional supply comes on stream, which could reduce the pressure on current account positions of South Asian countries. A 20 percent fall in crude oil prices could reduce South Asia's regional current account deficit by 1.2 percent of GDP and boost regional GDP by 1 percentage point relative the baseline in the presence of government budget financing constraints (see table 5 in main text). Similarly, a faster than expected growth of remittances and larger aid flows would also ease the strain on external positions. But in the absence of substantive policy actions to reduce internal imbalances, both domestic and foreign investment are likely to remain weak, thereby eroding the longer-term growth potential of the region.

Policy measures

There is urgent need for policy action in several areas, including: rebuilding policy buffers, in particular through credible fiscal consolidation over the medium-term while protecting the most vulnerable; creating a stable and predictable policy environment for the private sector; and finding sustainable longer-term solutions to ease electricity shortages and infrastructure gaps.

Allowing domestic energy prices to adjust in line with international prices, reducing leakages in public distribution systems, and better targeting can limit the fiscal burden of fuel and other subsidies. However, given the amplitude of spending in these areas, implementation is likely to be difficult. A policy that explicitly ties reductions in subsidies to an increase in more targeted anti-poverty measures may be easier to implement politically. Moreover, given South Asia's weak revenue performance relative to other developing regions, there needs to be sustained efforts to broaden the tax base, simplify the tax code, and strengthen tax collection.

Recent moves toward greater exchange rate flexibility in some South Asian countries, if sustained, will allow exchange rates to better absorb external shocks, facilitating a faster pace of adjustment of output and prices while reducing pressures on international reserves.

Creating a more predictable policy environment for both domestic and foreign investment and accelerating the pace of reforms will help to increase competitiveness and raise South Asia's growth potential. Longer-term sustainable measures to address South Asia's energy and infrastructure deficit by increasing efficiency of existing players and creating incentives for investment and capacity expansion remains one of the key elements necessary to sustain South Asia's growth performance.

Notes:

1 The years in the text refer to calendar years unless otherwise stated. Several South Asian countries measure output in fiscal years, which extends from July 1 to June 30 in Bangladesh and Pakistan, from April 1 to March 31 in India, and from July 16 through July 15 in Nepal.

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Sub-Saharan Africa Region

Overview

The recent resurgence of financial market tensions in the Euro Area increases the risks of weaker global economic activity going forward, not withstanding a better than expected start to 2012. Though Sub-Saharan African economies are weakly integrated with global financial markets, headwinds from a slowing global economy will impact the region through slower trade, reduced tourism, and weaker capital flows. The recent perturbations in financial markets are still ongoing and the extent to which they will dampen real side activity is uncertain. However, as an indication of potential effects, the similar tensions of the fall of 2011 are estimated to have reduced GDP growth in Sub-Saharan Africa by some 0.4 percentage points.

Nevertheless, GDP in Sub Saharan Africa grew at a still robust 4.7% in 2011 (down from 5% in 2010). Excluding South Africa, growth in the rest of Sub-Saharan Africa was stronger at 5.5 percent. This was a higher rate than the developing country average (excluding China) of 4.9 percent, making Sub-Saharan Africa one of the fastest growing developing regions in 2011. Growth was broadly based, with resource-rich economies, such as Ghana, Mozambique, Nigeria, and Congo, as well as non-resource rich economies, such as Rwanda and Ethiopia, growing by 7 percent or more in 2011.

Growth in 2011 was driven by resilient domestic demand and a supportive external environment during the first half of the year. Rising private consumption underpinned by higher incomes and productivity enhancing infrastructure spending supported growth outturns. Higher commodity prices and improved macroeconomic and political stability in recent years have also supported increased investment flows into the region. Private capital flows increased to $42.4 billion in 2011. Notwithstanding a significant slowdown in the latter half of 2011, export volumes increased by 10.6 percent in 2011 and overall tourist arrivals were up by 6.2 percent.

Outlook

Medium term prospects for the region remain robust, assuming no serious deterioration of the situation in high-income Europe. On this basis, global demand is projected to firm towards the end of 2012 and continue to expand through 2014. Domestic demand in Sub-Saharan Africa is projected to remain robust, and growth is expected to strengthen to 5 percent in 2012, 5.3 percent in 2013 and 5.2 percent in 2014. Excluding South Africa, growth is expected to reach 6.4, 6.2 and 6 percent in 2012, 2013 and 2014 respectively. Rising incomes, lower inflation, higher remittance flows (rising to $27 billion by 2014, from $22 billion in 2011) and lower interest rates in some countries are expected to support growth in private consumption. Infrastructural investment, particularly from China, India and Brazil, should bolster productive capacity. Growth in resource-rich countries (e.g. Angola, Cameroon, Gabon, Ghana, Mozambique, Sierra Leone and Liberia) are expected to be supported by the coming on stream of new exports.

Risks and vulnerabilities

Projected growth outturns for the region are contingent on developments in the Euro Area as well as on the extent of slowdown in China.

If the global growth weakens, commodity prices could decline, hitting exporters of industrial raw materials (e.g. oil, metal, and cotton) and tourism-dependent economies in the region particularly hard. In a crisis scenario, weaker capital flows, remittances and aid inflows could also decline sharply, potentially compromising macroeconomic stability. With policy buffers weaker than they were prior to the crisis in 2008, the ability of government to implement countercyclical fiscal policy may be compromised.

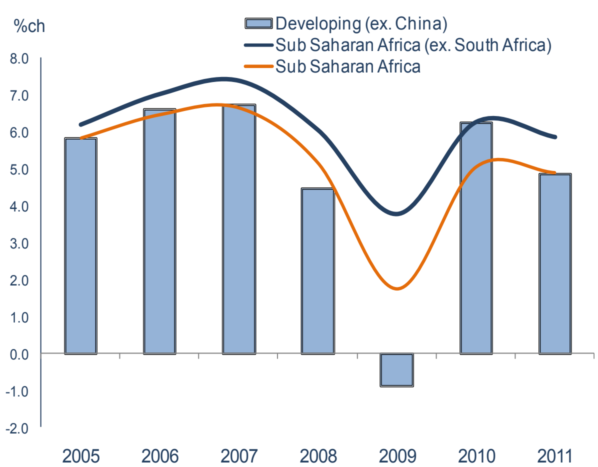
Recent developments

GDP growth remained robust in 2011 despite slow down in latter half of the year. Slower global growth in the latter half of 2011 curtailed economic activity in Sub-Saharan Africa by an estimated 0.4 percent of regional GDP. Nevertheless, economic activity remained robust with GDP growing at 4.7 percent in 2011, below the 5% registered in 2010 and during the pre-crisis period (figure SSA.1). Excluding South Africa, growth in the rest of Sub-Saharan Africa was stronger at 5.5 percent. Growth in the region was broadly based. Over a third of countries grew by 6 percent or more percent, with another forty percent of countries growing between 4-6 percent. Among the fast growing economies were resource-rich countries such as Ghana, Mozambique, Nigeria, and Congo Republic, as well as non-resource rich economies such as Rwanda and Ethiopia, all of whom grew 7 percent or more in 2011 (figure SSA.2).

Besides higher commodity prices that have supported growth in the resource rich economies, improved macroeconomic and political stability in recent years has supported increased private investment flows to both extractive and non-extractive sectors (e.g. telecommunication and financial services).

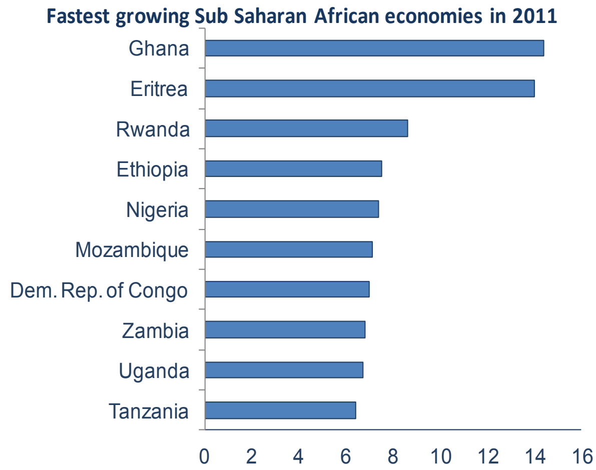
Resilient domestic demand continues to be the main driver of growth. Domestic demand held steady, with its contribution to GDP broadly unchanged at 6.8 percentage points in 2011, versus 6.7 percentage points in 2010 (figure SSA.3). Higher public investment in infrastructure, and rising private consumption supported by higher incomes have underpinned domestic demand growth performance in recent years. In contrast, net exports subtracted 2.1 percentage points from regional growth in 2011 (versus 1.7 percentage points in 2010), as import demand remained strong even as exports slowed in response to the financial and economic turmoil of the second half of 2011. In contrast,

Figure SSA.1 Sub Saharan Africa continues robust growth



Source: World Bank

Figure SSA.2 Fastest growing Sub Saharan African economies in 2011



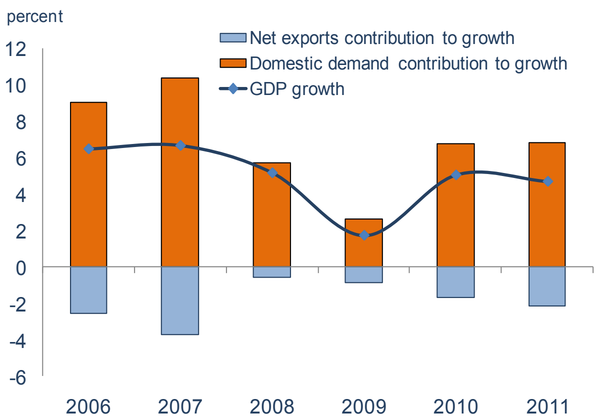
Source: World Bank

Export growth tapered off in Q3 2011, but has since rebounded. Supported by high commodity prices, increased investments in the natural resource sector and strong demand from large emerging markets (China, Brazil and India), export volumes in Sub-Saharan Africa increased by some 10.6 percent in 2011.

However developments in 2011, were marked by two distinct phases.

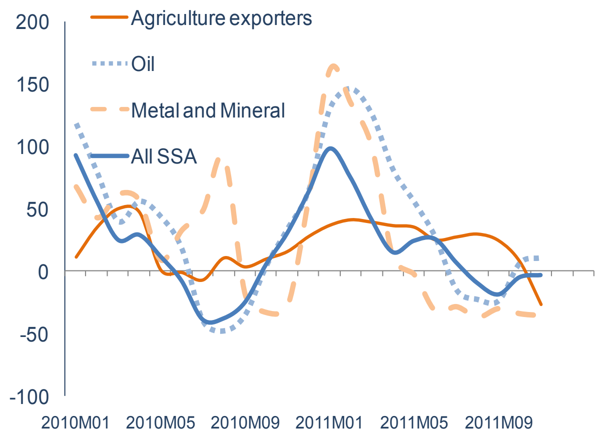
- During the first half of the year export demand was growing at double digit rates. Unlike other regions, Sub-Saharan African exports were not hard hit by the disruptions to supply chains from Japan's Tsunami

Figure SSA.3 Resilient domestic demand supported 2011 GDP growth in Sub Saharan Africa



Source: World Bank.

Figure SSA.4 Exports declined sharply in H2 2011



Source: World Bank

(excluding South Africa's automotive industry), reflecting their weak integration with Japanese supply chains.

- In the second half of the year, in response to the escalation of the Euro Area crisis and policy tightening in some large developing countries, Sub-Saharan exports were also hit, decelerating through November (latest data).

- The deceleration was broadly-based, cutting across all categories of SSA exporters.

Reflecting the sharp deceleration in global industrial production during the latter months of 2011, Sub-Saharan African exporters of metal and minerals (e.g. Democratic Republic of Congo and Mauritania) and cotton exporters (e.g Benin and Burkina Faso) were among the hardest hit, with export values falling at a seasonally adjusted annualized pace of -35.4 percent and -37 percent (3m/3m, saar) respectively in the three months ending in November 2011 (figure SSA.4). Some metal and mineral exporters (e.g. Mozambique and Niger) bucked this trend, as new capacity came onstream and augmented their output.

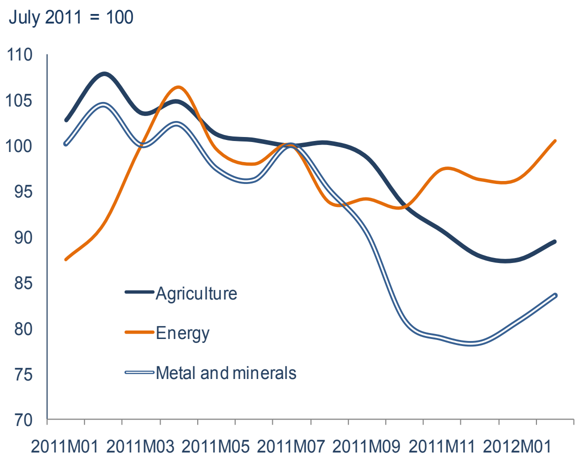
Though agricultural exporters also suffered declines, they were relatively modest compared with those of other exporter groups, reflecting the lower income elasticity of food products.

Most recently, the pace of deceleration of trade appears to have bottomed out. During the three months ending January 2012, the regions export growth was expanding at an annualized pace of 13.6 percent (3m/3m saar) compared with a peak contraction of 17.1 percent in September 2011. This pick up was mainly driven by oil exporters (as oil prices recovered), since for the other exporter groups export values were mostly. However, given the strengthening in commodity prices through March 2012 (figure SSA.5), export values for both agriculture and metal and mineral exporters are likely to have been expanding in February and March 2012 (data not yet available).

Tourist flows to Sub-Saharan Africa slowed in H2 2011, but appear to have stabilized in early 2012. Overall tourism arrivals in Sub-Saharan Africa rose by 6.2 percent in 2011, higher than the global average of 4.4 percent, but lower than the 9.6 percent recorded for the region in 2010, when it benefitted from hosting of the FIFA World Cup. Kenya performed particularly well as arrivals were up by 15 percent and revenues by 32 percent, supported by higher spending of tourists from emerging markets such as China, India and the Gulf countries.

As with merchandise trade, there was a drop in the pace of tourist arrivals to Sub-Saharan Africa in the last quarter of the year, reflecting the

Figure SSA.5 Commodity prices begin to recover from slump late last year



Source: World Bank

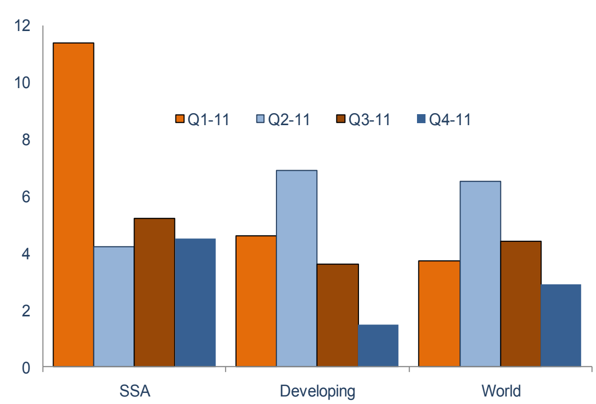
weaker global economy in the latter half of 2011 and Europe's re-entry into recession (figure SSA.6).

In Mauritius, where European tourist make up two-thirds of all tourist arrivals and the tourism sector accounts for some 10 percent of GDP, overall tourist arrivals were up 0.7 percent for 2011 but in December alone, tourist arrivals from Europe fell by -5.3 percent (y/y). With the stabilization of the global economy in 2012, early indications are that tourist arrivals to Sub-Saharan Africa are picking up again, even if at a slow pace.

Capital flows to Sub Saharan Africa increased in 2011, and investor sentiment for region prospects is ticking up. Notwithstanding increased global financial market volatility, increased risk aversion and massive equity market sell-offs that characterized the latter half of 2011, overall private capital flows to Sub-Saharan Africa rose (figure SSA.7 and table SSA.1) by 5% in 2011 to $42.4bn (developing countries as a whole fell by 6.7%). The muted response of capital flows to Sub-Saharan Africa in 2011 reflects the heavy weight that FDI has in overall flows to the region, and their relative stability compared with equity and bond flows. FDI accounts for about 70 percent of private capital flows to Sub-Saharan Africa, versus about 60 percent for developing countries as a whole. According to a recent report, the number of FDI projects to the region increased by 27% in 2011, with services, manufacturing and infrastructure projects accounting for the bulk of new projects. Further, intra-African investment, which accounted for some 17% of all new projects, increased by 32% in 2011, reflecting the growing dynamism of foreign direct investment from countries such as South Africa, Nigeria and Kenya to other countries in the region.

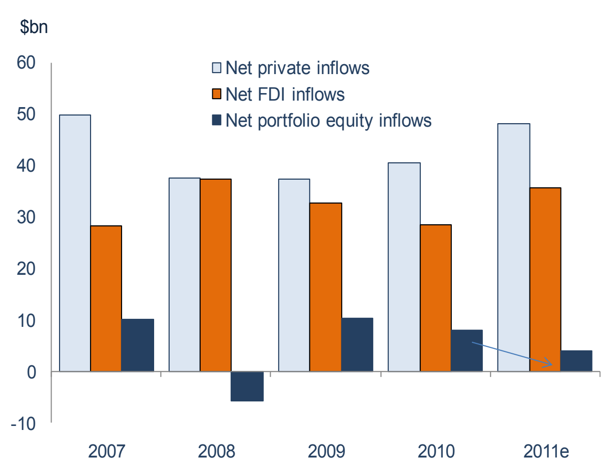
Excluding FDI, net capital flows to Sub Sahara

Figure SSA.6 As with other regions tourist arrivals to Sub Saharan Africa declined in Q4 2011



Source: World Tourism Organization and World Bank

Figure SSA.7 Foreign direct investment increases but shorter-term capital flows decline in 2011



Source: World Bank

Table SSA.1 Net capital flows to Sub-Saharan Africa

$ billions

	2008	2009	2010	2011e	2012f	2013f	2014f
Current account balance	**-14.0**	**-31.8**	**-23.2**	**-15.7**	**0.0**	**-10.7**	**-18.6**
Capital Inflows	**42.6**	**47.2**	**53.5**	**56.6**	**49.5**	**59.3**	**82.1**
Private inflows, net	37.6	37.4	40.5	42.4	36.8	50.9	71.9
Equity Inflows, net	31.8	43.0	36.5	30.7	29.3	38.9	53.8
FDI inflows	37.5	32.8	28.8	32.5	31.2	35.9	46.8
Portfolio equity inflows	-5.7	10.2	8.0	-1.8	-1.9	3	7
Private creditors, net	5.9	-5.6	3.9	11.7	7.5	12.0	18.1
Bonds	-0.7	1.9	1.4	5	4	5	7
Banks	2.2	1.6	0.7	8.1	2.4	6	9
Short-term debt flows	4.5	-9.9	1.5	-1.4	1.0	1.0	2.0
Other private	-0.1	0.8	0.4	0	0.1	0	0.1
Offical inflows, net	4.9	9.8	13.0	14.2	12.7	8.4	10.2
World Bank	1.9	3.1	4.0	4.3			
IMF	0.7	2.2	1.2	0.8			
Other official	2.3	4.5	7.9	9.1			

Note:
e = estimate, f = forecast

Source: World Bank

Africa suffered the same declines that were observed elsewhere among developing countries. Net portfolio equity flows to the region, which are short-term in nature (stocks, bonds and trade finance) and thus more susceptible to market sentiments, fell by about 50 percent (from $8.0bn to $3.9bn). The illiquidity of most SSA stock markets limited the decline in short–term instruments to the deeper financial markets in the region, most importantly South Africa, but also Nigeria, Kenya, and Mauritius. Between July and September 2011 the benchmark indices of these relatively liquid stock exchanges fell by at least 10 percent. And as of April 2012, only the bourses of South Africa and Botswana had recovered their July 2011 levels. Stock markets in Kenya, Ghana, Mauritius and Nigeria still remain on average some 15 percent below their pre-July levels. The ongoing banking sector deleveraging in Europe is also likely impacting trade finance flows to Sub Saharan Africa. A survey carried out in January 2012, shows that some 75% of lenders to the region decreased available credit or liquidity and became more selective with customers as a result of the banking sector deleveraging in Europe. Indeed, trade finance-related data from Dealogic shows a 19% decline in lending activity in the region in H2 2011 compared to H1 2011. However, for the first quarter of 2012, there has been a partial recovery with a 8.1% quarter-on-quarter increase.

Reflecting the strength in domestic demand, consumer spending has remained resilient. With consumer spending accounting for some 60 percent of GDP in Sub-Saharan Africa, the strength of consumer demand is an important driver of growth in the region. However, most Sub-Saharan African countries do not publish high frequency data covering retail sales. Where available, as in South Africa for instance, retail sales increased by 10.1 percent on a seasonally adjusted annualized basis in the three months ending in December, contributing importantly to the solid 3.2 percent (q/q, annualized) Q4 2011 GDP growth in South Africa.

We use quarterly passenger car import data to provide some insight into consumer expenditure in Sub-Saharan Africa (figure SSA.8). On a year -on-year basis, quarterly import demand of durable consumer goods expanded in each quarter of 2011, including during the peak of the global economic turmoil in Q42011, suggesting that in general consumer spending remained robust during this period. For the majority of economies in the region, spending on durable consumer goods appears to have been buoyed by rising incomes (supported by robust growth), easing inflationary pressures, and rising remittance inflows.

Not all countries displayed this pattern, with demand weaknesses having apparently more to do with local rather than international factors. Rising and double digit inflation levels and associated monetary policy tightening in Kenya, Tanzania, Uganda, Eritrea and Malawi cut real incomes in Q4 2011 and reduced spending on durable consumer goods. The fiscal crisis in Swaziland in 2011 likely dampened consumer spending, contributing to the negative growth in consumer's durable goods expenditures.

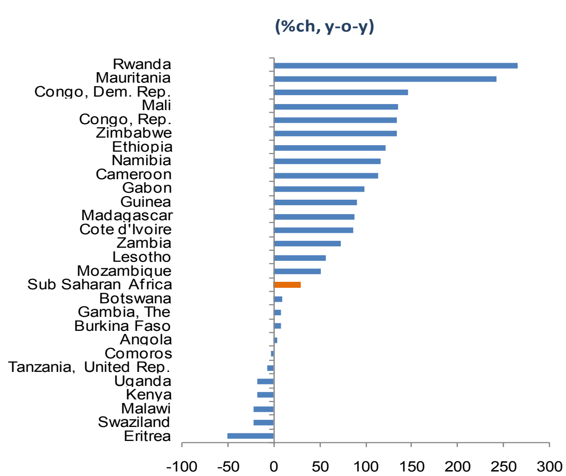
With real side activity in most countries on the upswing compared to the latter half of 2011, decelerating inflation, and stable or rising remittance flows, consumer spending is likely to have continued expanding through Q1 2012.

Macro economic balances diverge across Sub-Saharan Africa economies. Although for the region as a whole fiscal and current account balances improved in 2011, much of this was driven by oil exporters, thanks to higher oil prices as well as production increases from new wells. For oil importers, higher oil prices and increased demand to support robust economic activity led to deterioration in the current account balances (figure SSA.9). However, the extent of the deterioration in individual economies was shaped by different influences.

Current account balances for metal and mineral exporters, many of which also benefitted from positive terms of trade effects in 2011, remained unchanged, even though within this subgroup balances improved among some and worsened among others. Current account balances deteriorated among metals and mineral exporters like Sierra Leone where recent discoveries have spurred big increases in investments, but improved among economies like Mozambique where new mines or additional capacity came on line. In others, like Ghana, strong consumption and/or expansionary fiscal stances have led to a further widening of the deficit despite new capacity coming on line.

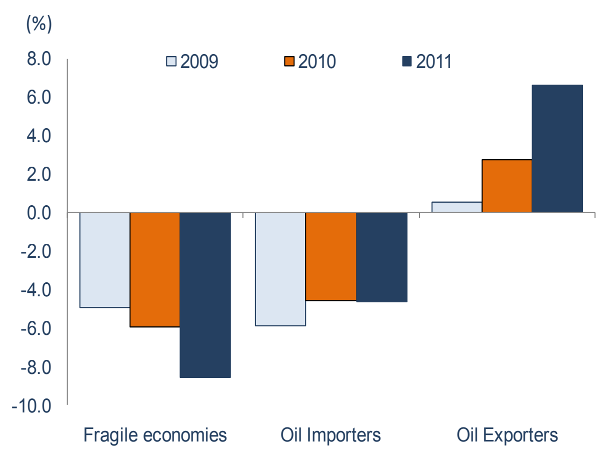
The exports of many resource poor Sub-Saharan African countries suffered from the slowdown in global demand, and have also had to contend with higher fuel costs – resulting in increased current-account deficits (smaller surpluses). Many of these economies are fragile or post conflict economies whose exportables sector remains seriously constrained by weak infrastructure and regulatory barriers thereby rendering them uncompetitive. Fiscal balances in these economies have also suffered as government revenues are mostly tied to

Figure SSA.8 Q4 2011 growth in imports of passenger cars



Sources: Trade Map, ITC

Figure SSA.9 Current account balances diverge across countries in region



Source: World Bank.

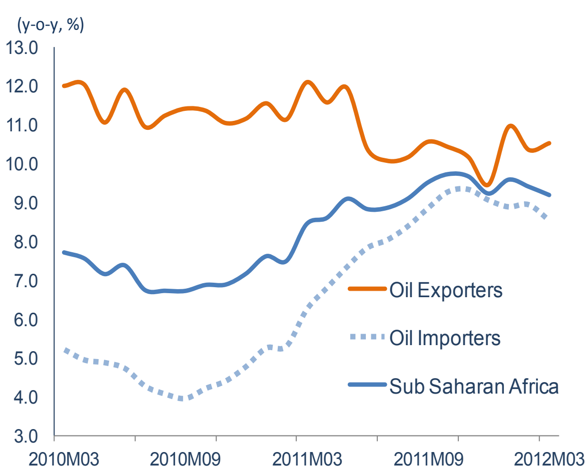
international trade taxes which were impacted by slower global trade. Further, higher oil prices also meant higher government expenditures due to increased fuel subsidy payments.

Inflationary pressures are easing but concerns remain. Higher food and oil prices, coupled with robust demand, adverse weather conditions in some economies, and expansionary fiscal and monetary stances in others combined to raise inflationary pressures in Sub-Saharan Africa in 2011, however headline inflation for the region (on a GDP-weighted basis) has abated somewhat from its peak of 9.7 percent in October 2011 to 9.2 percent in March 2012 (figure SSA.10).

The recent steady decline in inflation which should provide support to consumer spending, reflects policy tightening in some countries, decelerating food price inflation and the waning pass-through effects of earlier oil price hikes. In East African economies, for instance, tighter monetary policy helped bring inflation down from the above-20 percent inflation levels recorded earlier. By April 2012, inflation had fallen to 20.3 percent in Uganda from a peak of 30.4 percent in October 2011, and to 13.1 percent in Kenya from a peak of 19.6 percent in November.

Overall, the decline in headline inflation observed between October and March was stronger among oil importers (falling from 10.0 percent to 7.6 percent), compared to oil exporters (where inflation has been mostly range bound between 10.0 percent and 10.6 percent). While headline inflation (which is measured on a year-on-year basis) has fallen or stabilized for the different exporter groups in the region, inflation momentum (measured on a 3 month-on-3 month moving average annualized basis) which is a better measure of changing trends, is diverging among them. For oil importers inflation momentum is on a declining trajectory (momentum growth dropped to 8.2 percent in March 2012 from 10.3 percent the previous month). suggesting headline inflation could continue declining. However for oil importers inflation momentum accelerated to 16.9 percent in March 2012 from 14.1 percent the previous month.

Figure SSA.10 Headline inflation rates decline in recent months.



Source: World Bank, Datastream.

Medium-term outlook

Medium term growth prospects for Sub-Saharan Africa look promising, despite weak growth in high-income countries. Unlike some of the larger developing countries that are facing capacity constraints, increased investment and productivity growth in recent years has helped expand potential GDP in several Sub-Saharan African economies. Further, due to relatively slower rebound following the crisis in some of the region's largest economies (Angola and South Africa), or earlier political unrest (Cote d'Ivoire) there still exist some spare capacity in a number of economies. As global demand firms through 2012 and 2013 and domestic demand remains robust, growth in Sub Saharan Africa is expected to strengthen to 5.0 percent in 2012 (from 4.7% in 2011) and 5.3 percent in 2013, before slowing to 5.2 percent in 2014 when output gaps in the region would have closed. Excluding South Africa, growth is expected to reach 6.3 percent in 2012 and 2013, before slowing to 6.0 percent in 2014 (table SSA.2).

Notwithstanding the weakening of the Euro in 2011, inflation in CFA zone economies remained low, falling from 4.2 percent in April 2011 to 2.7 percent in December 2011, supported mainly by a fall in food price inflation (from 14.6 percent to 2.4 percent during this time period).

Though weak demand from Europe will impact exports from Sub-Saharan African countries (at least in 2012), the increasing diversification of trading partners should help cushion the effects of weak demand from Europe. Over the past decade, Europe's share in Sub-Saharan African exports has declined from 40 percent in 2002 to around 25 percent in 2010, with the share going to developing Asia having increased substantially.

Prospects among resource-rich countries (e.g. Angola, Cameroon, Gabon, Madagascar, Mozambique, Sierra Leone, Liberia etc) are expected to strengthen further in coming years as new investments in the recent past will support the coming on stream of new exports of oil, gas, metal and minerals.

While trade expansion in the region will provide a positive impulse to growth, domestic demand is expected to remain the main driver of growth. Rising incomes, lower inflation rates, higher remittance flows (rising to $27 billion by 2014 from $22 billion in 2011) and lower interest rates in some countries are expected to support growth in private consumption.

Investment in the region is expected to remain resilient over the forecast horizon. New funding sources for infrastructural investment particularly from some large developing countries (China, India and Brazil) should continue to play an important role in expanding productive capacity. Overall, FDI flows to Sub-Saharan Africa are projected to dip by some 4% in 2012 due to the heightened financial market tensions, however a recovery is projected thereafter with FDI flows forecast to reach a record $46.8 billion by 2014.

Risks

Fragile global recovery. Should conditions in Europe deteriorate markedly, the global economy could return to recession-like conditions. As discussed in the January edition

Table SSA.2 Sub-Saharan Africa forecast summary

(annual percent change unless indicated otherwise)	98-07[a]	2009	2010	2011	Est. 2012	Forecast 2013	2014
GDP at market prices (2005 US$) [b]	4.4	2.0	5.0	4.7	5.0	5.3	5.2
GDP per capita (units in US$)	1.9	-0.5	2.4	2.7	3.0	3.3	3.2
PPP GDP [c]	4.7	1.9	5.2	5.0	5.3	5.5	5.4
Private consumption	2.2	1.5	4.9	4.5	4.6	4.8	4.8
Public consumption	5.6	4.3	9.0	6.0	5.6	5.3	4.9
Fixed investment	8.8	5.0	10.6	10.4	6.2	7.6	6.1
Exports, GNFS [d]	4.6	-5.6	5.0	3.8	6.9	5.9	5.9
Imports, GNFS [d]	7.0	-4.2	7.2	11.2	7.6	7.2	6.2
Net exports, contribution to growth	-0.7	-0.3	-1.0	-2.9	-0.8	-1.0	-0.6
Current account bal/GDP (%)	-0.8	-3.0	-1.6	-0.7	0.6	0.1	-0.1
GDP deflator (median, LCU)	6.3	4.4	7.9	5.3	5.5	5.8	5.8
Fiscal balance/GDP (%)	-0.6	-5.7	-4.0	-1.7	-2.8	-2.1	-1.6
Memo items: GDP							
SSA excluding South Africa	4.9	4.0	6.1	5.6	6.2	6.3	6.0
Oil exporters [e]	5.2	4.3	6.1	5.3	6.5	6.5	6.1
CFA countries [f]	4.0	2.7	4.5	3.1	5.0	5.2	4.7
South Africa	3.7	-1.5	2.9	3.1	2.7	3.4	3.5
Nigeria	5.1	7.0	7.8	7.4	7.0	7.2	6.6
Angola	10.5	2.4	3.4	3.4	8.1	7.4	6.8

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.

Source: World Bank.

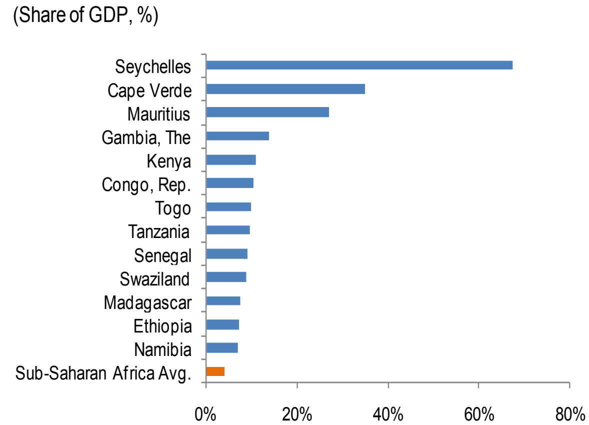
of the Global Economic Prospects 2012, GDP in Sub-Saharan Africa could fall by up to 1.5 percentage points relative to baseline in 2012 and a further 3.5 and 1.8 percentage points in 2013 and 2014 respectively.

Trade impacts are likely to be most severe for regional exporters of oil, metal and mineral, and agro-industrial raw materials (e.g. cotton) because sales (prices and volumes) of these commodities tend to more sensitive to the global business cycle. Food exporters will be less hard hit because food tends to remain stable even as global activity rises or recedes. Countries like the Congo Republic, Angola, Zimbabwe, and to a lesser extent Zambia would also be hard hit because exports represent such a large share of their GDP. Other smaller economies like Swaziland, Seychelles Cape-Verde, and Gambia would be exposed to a sharp decline in global tourism (figure SSA.11). For economies with weak foreign exchange reserves, unfavorable terms of trade changes could trigger significant depreciations and compromise macroeconomic stability, as occurred in a number of regional economies during the crisis in 2009 (e.g. Democratic Republic of Congo, Ghana, and Zambia).

Tighter financial conditions in the wake of a Euro Area crisis (as global risk aversion increases) would likely affect short-term capital flows to the more financially integrated economies like South Africa, and to a lesser extent Nigeria, Mauritius, and Kenya. However, if the crisis endures the FDI inflows, upon which much of the region relies, are also likely to be hit.

Aid and remittances. The baseline assumes flat ODA inflows in 2012 and 2013 before picking up modestly in 2014. In the case of a more serious downturn, even these conservative assumptions may not be met. This remains a credible risk, as in 2011 ODA flows to Sub Saharan Africa declined in real terms by 0.9 percent on account of fiscal consolidation taking place in high-income economies. With many fragile and post-conflict economies in the region heavily dependent on ODA inflows to support

Figure SSA.11 Exports of Services



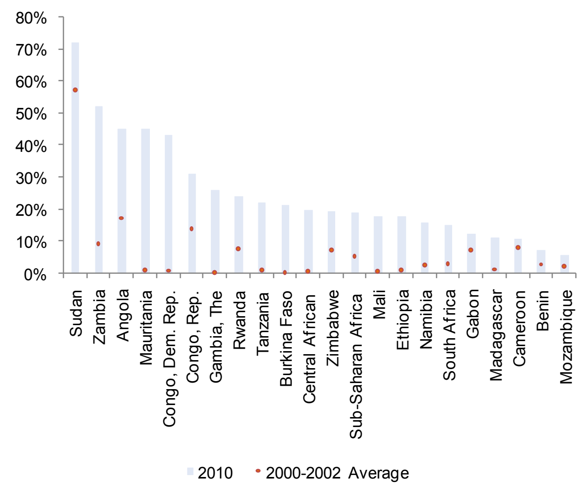
Source: World Bank.

their capital investments, a drop in aid flows are likely to dampen growth prospects among these economies. As regards remittances, a fall in remittances, prompted by a further weakening of the employment situation in advanced economies, could lead to drop of up to 6.2 percent from the current baseline forecasts.

A harder-landing in major commodity importers like China is also a risk. Should China not succeed in engineering the soft-landing scenario of the baseline, demand for and prices of major metals and minerals could decline significantly. Over the past decade Sub-Saharan African exports to China have increased from 5 percent to some 19.3 percent in 2010, with oil (Sudan, Angola, Congo republic) and metal and mineral exporters (Zambia, Mauritania, Democratic Republic of Congo) among the economies whose exports are heavily dependent on Chinese demand (figure SSA.12). As China's share in global metals imports exceeds 50 percent, versus something like 7 percent for oil, slower growth there is likely to hit metals exporters hardest, affecting incomes and therefore domestic demand, government accounts and current account balances.

Domestic risks. While external risks are most prominent – a number of domestic challenges could also cause outturns to sour. Disruptions to productive activity from political unrest are

Figure SSA.12 Share of exports going to China



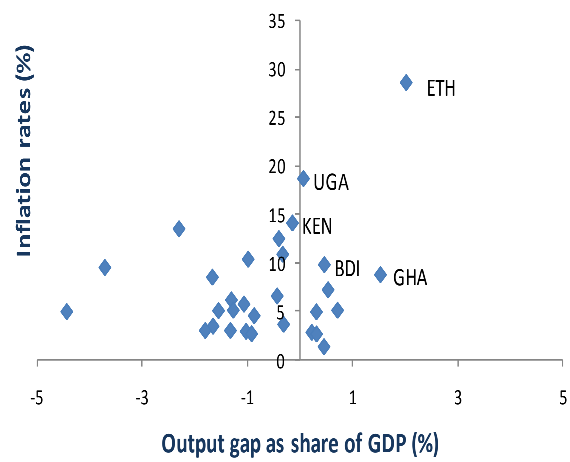
Source: UN COMTRADE, WITS.

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 there and in 2012, there has been political unrest in Mali.

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 an even higher share of employment), and with much of the sector dependent on good rains, the impact of poor rains on GDP growth in the region can be significant. However the effects of poor rains are not limited the agricultural sector but also has implications for the services and industrial sector as they depend on the generation of power from hydroelectric sources. The drought and poor rains in the Horn of Africa is estimated to have curtailed Kenya's GDP growth in 2011 (4.3 percent) by between 0.7 and 1.0 percentage points.[1] Already in 2012, poor rains are forecast for the eastern Horn of Africa as well as the Sahelian zone, affecting parts of Mauritania, Mali and Niger.

Macroeconomic instability is a concern in select economies. Prudent macroeconomic management in recent years has provided a strong foundation for much of the surge in Sub-Saharan Africa's recent growth performance. However, without investments to increase the productive capacities in a number of countries in the region, ongoing expansionary fiscal policy or lax monetary policy, risks overheating these economies, bringing about macroeconomic instability and compromising long term growth prospects. In a few countries (e.g. Ethiopia) persistence of high inflation rates suggest potential overheating, particularly where output gaps have been closed or nearly closed (figure SSA.13).

Figure SSA.13 Overheating remains a concern in a number of economies



Source: World Bank.

Notes:

1 Demombynes, G and J. Kiringai, The drought and food crisis in the Horn of Africa: Impacts and proposed policy responses. World Bank Economic Premise Note, Number 71, November 2011.

Table SSA.3 Sub-Saharan Africa country forecasts

(annual percent change unless indicated otherwise)				Est.	Forecast		
	98-07[a]	2009	2010	2011	2012	2013	2014
Angola							
GDP at market prices (2005 US$) [b]	9.7	2.4	3.4	3.4	8.1	7.4	6.8
Current account bal/GDP (%)	-0.9	-8.9	9.7	12.7	16.2	11.2	8.6
Benin							
GDP at market prices (2005 US$) [b]	3.8	3.8	3.0	3.4	4.3	4.7	4.5
Current account bal/GDP (%)	-7.7	-11.4	-4.7	-3.9	-9.3	-7.2	-7.2
Botswana							
GDP at market prices (2005 US$) [b]	4.7	-4.9	7.0	5.1	5.5	6.5	5.3
Current account bal/GDP (%)	9.5	-2.7	1.0	1.6	2.2	2.2	2.6
Burkina Faso							
GDP at market prices (2005 US$) [b]	4.8	3.5	7.9	4.9	5.2	5.4	5.4
Current account bal/GDP (%)	-13.2	-9.4	-0.9	-0.8	-5.0	-2.2	-1.0
Burundi							
GDP at market prices (2005 US$) [b]	1.8	3.5	3.9	4.2	4.2	4.1	4.0
Current account bal/GDP (%)	-20.5	-19.7	-15.0	-15.6	-16.6	-17.3	-17.9
Cape Verde							
GDP at market prices (2005 US$) [b]	5.9	3.6	5.4	5.8	5.8	6.2	6.4
Current account bal/GDP (%)	-10.8	-15.1	-11.2	-14.6	-16.6	-15.2	-13.0
Cameroon							
GDP at market prices (2005 US$) [b]	3.4	2.0	3.2	3.8	4.1	4.6	4.6
Current account bal/GDP (%)	-2.4	-5.0	-3.8	-2.9	-3.3	-3.2	-3.3
Central African Republic							
GDP at market prices (2005 US$) [b]	0.8	1.7	3.3	4.0	3.5	3.9	3.2
Current account bal/GDP (%)	-4.6	-8.0	-8.8	-8.3	-8.6	-7.7	-6.9
Chad							
GDP at market prices (2005 US$) [b]	8.0	-1.6	13.0	6.0	6.5	4.0	3.0
Current account bal/GDP (%)	-36.5	-28.9	-22.4	-20.0	-20.7	-21.9	-22.5
Comoros							
GDP at market prices (2005 US$) [b]	1.9	1.8	2.1	2.3	2.5	3.1	4.0
Current account bal/GDP (%)	-4.0	-5.9	-8.2	-8.7	-10.1	-10.3	-10.5
Congo, Dem. Rep.							
GDP at market prices (2005 US$) [b]	1.9	2.8	7.2	7.0	7.2	7.0	6.5
Current account bal/GDP (%)	-3.6	-13.0	-17.7	-16.3	-11.0	-4.4	0.5
Congo, Rep.							
GDP at market prices (2005 US$) [b]	2.9	7.5	8.8	5.1	6.0	6.1	5.8
Current account bal/GDP (%)	1.2	-10.6	3.9	10.1	7.0	6.4	5.9
Cote d Ivoire							
GDP at market prices (2005 US$) [b]	0.0	3.8	3.0	-5.1	6.0	5.5	5.5
Current account bal/GDP (%)	0.7	7.2	6.9	2.3	1.5	0.0	-1.3
Equatorial Guinea							
GDP at market prices (2000 USD) [b]	20.7	5.3	-0.8	7.1	4.0	6.8	2.5
Current account bal/GDP (%)	6.7	-18.0	-6.0	-9.2	-7.4	-5.7	-4.6
Eritrea							
GDP at market prices (2005 US$) [b]	-0.1	3.9	2.2	14.0	1.0	7.0	3.5
Current account bal/GDP (%)	-18.9	-6.5	-2.7	-2.9	-3.4	-3.5	-3.6

(annual percent change unless indicated otherwise)	98-07[a]	2009	2010	Est. 2011	Forecast 2012	2013	2014
Ethiopia							
GDP at market prices (2005 US$) [b]	6.5	8.8	10.1	7.5	7.2	7.5	7.2
Current account bal/GDP (%)	-5.3	-6.9	-5.4	-7.1	-7.8	-6.3	-6.2
Gabon							
GDP at market prices (2005 US$) [b]	0.4	-1.4	5.7	5.7	4.3	4.0	4.1
Current account bal/GDP (%)	10.9	13.5	11.3	14.9	19.6	18.6	12.6
Gambia, The							
GDP at market prices (2005 US$) [b]	3.4	6.2	5.0	3.0	3.2	5.5	5.8
Current account bal/GDP (%)	-9.4	4.0	-11.7	-12.2	-12.9	-12.4	-12.0
Ghana							
GDP at market prices (2005 US$) [b]	4.6	4.7	6.6	14.4	7.2	7.0	6.5
Current account bal/GDP (%)	-6.3	-3.6	-6.1	-7.9	-8.6	-10.7	-12.0
Guinea							
GDP at market prices (2005 US$) [b]	2.8	-0.3	1.9	4.3	5.0	6.0	6.5
Current account bal/GDP (%)	-6.1	-10.2	-7.3	-7.4	-7.0	-7.0	-6.0
Guinea-Bissau							
GDP at market prices (2005 US$) [b]	1.8	3.0	3.5	4.8	4.7	4.2	4.6
Current account bal/GDP (%)	-7.3	-13.6	-10.6	-9.0	-8.5	-8.4	-8.2
Kenya							
GDP at market prices (2005 US$) [b]	3.4	2.6	5.8	4.4	5.0	5.1	4.7
Current account bal/GDP (%)	-4.9	-5.5	-7.8	-11.8	-8.2	-7.4	-6.6
Lesotho							
GDP at market prices (2005 US$) [b]	10.2	3.1	3.6	3.1	5.1	4.9	4.8
Current account bal/GDP (%)	-3.5	-0.1	-19.1	-23.8	-17.3	-12.6	-12.2
Madagascar							
GDP at market prices (2005 US$) [b]	3.2	-4.6	1.6	2.6	3.0	4.8	5.0
Current account bal/GDP (%)	-9.5	-15.4	-8.3	-8.7	-8.5	-8.5	-8.5
Malawi							
GDP at market prices (2005 US$) [b]	2.8	7.6	7.1	5.0	4.5	5.0	5.6
Current account bal/GDP (%)	-11.1	-11.9	-7.0	-7.4	-7.7	-7.8	-7.9
Mali							
GDP at market prices (2005 US$) [b]	5.1	4.5	4.5	5.4	4.0	5.2	5.9
Current account bal/GDP (%)	-7.9	-7.3	-7.6	-8.0	-8.5	-8.5	-8.3
Mauritania							
GDP at market prices (2005 US$) [b]	4.1	-1.2	5.0	5.1	4.8	5.2	4.9
Current account bal/GDP (%)	-5.8	-13.2	-10.2	-11.2	-11.9	-11.5	-10.6
Mauritius							
GDP at market prices (2005 US$) [b]	3.6	3.0	4.2	4.1	3.6	4.3	4.5
Current account bal/GDP (%)	-1.2	-7.4	-8.2	-11.1	-11.2	-10.1	-9.0
Mozambique							
GDP at market prices (2005 US$) [b]	6.8	6.3	6.8	7.1	6.7	7.2	7.8
Current account bal/GDP (%)	-14.6	-12.5	-11.9	-12.2	-12.1	-10.5	-8.4
Namibia							
GDP at market prices (2005 US$) [b]	4.4	-0.4	6.6	3.6	4.2	4.4	4.4
Current account bal/GDP (%)	4.0	1.9	-1.8	-6.4	-2.6	-3.9	-3.9

(annual percent change unless indicated otherwise)				Est.	Forecast		
	98-07[a]	2009	2010	2011	2012	2013	2014
Niger							
GDP at market prices (2005 US$) [b]	2.7	-1.2	8.8	6.0	9.5	6.8	6.1
Current account bal/GDP (%)	-7.4	-25.1	-24.5	-24.7	-22.7	-20.3	-17.6
Nigeria							
GDP at market prices (2005 US$) [b]	5.0	7.0	7.8	7.4	7.0	7.2	6.6
Current account bal/GDP (%)	11.0	7.8	1.3	7.6	10.4	7.2	4.5
Rwanda							
GDP at market prices (2005 US$) [b]	6.8	4.1	7.2	8.6	7.4	7.7	7.2
Current account bal/GDP (%)	-6.0	-7.3	-5.9	-7.3	-10.0	-9.7	-10.4
Senegal							
GDP at market prices (2005 US$) [b]	4.0	2.1	4.1	2.0	4.4	4.9	5.2
Current account bal/GDP (%)	-7.0	-6.8	-6.6	-7.5	-9.2	-9.6	-10.0
Seychelles							
GDP at market prices (2005 US$) [b]	2.1	0.7	6.2	5.0	4.0	4.2	3.9
Current account bal/GDP (%)	-15.3	-11.5	-34.3	-25.1	-20.4	-18.7	-14.8
Sierra Leone							
GDP at market prices (2005 US$) [b]	7.5	3.2	4.9	5.6	44.5	11.1	7.6
Current account bal/GDP (%)	-12.2	-15.7	-27.2	-49.7	-11.1	-9.1	-7.6
South Africa							
GDP at market prices (2005 US$) [b]	3.7	-1.5	2.9	3.1	2.7	3.4	3.5
Current account bal/GDP (%)	-2.1	-4.0	-2.8	-3.3	-4.6	-5.0	-4.7
Sudan							
GDP at market prices (2005 US$) [b]	5.9	4.0	4.5	5.0	4.9	5.0	5.5
Current account bal/GDP (%)	-6.9	-6.2	-0.5	-2.9	-3.0	-2.9	-2.4
Swaziland							
GDP at market prices (2005 US$) [b]	2.2	1.2	2.0	0.3	-2.0	1.0	1.9
Current account bal/GDP (%)	-1.3	-13.7	-16.7	-10.8	1.4	-5.5	-6.2
Tanzania							
GDP at market prices (2005 US$) [b]	5.9	6.0	7.0	6.4	8.0	6.4	7.0
Current account bal/GDP (%)	-5.8	-9.0	-4.2	-4.7	-3.0	-3.6	-3.4
Togo							
GDP at market prices (2005 US$) [b]	1.9	3.2	3.4	3.7	4.0	4.4	4.6
Current account bal/GDP (%)	-9.5	-5.6	-7.6	-7.0	-7.8	-7.7	-7.6
Uganda							
GDP at market prices (2005 US$) [b]	6.4	7.2	5.2	6.7	4.0	7.0	7.3
Current account bal/GDP (%)	-5.4	-6.7	-10.4	-11.7	-14.8	-10.2	-5.2
Zambia							
GDP at market prices (2005 US$) [b]	4.2	6.4	7.6	6.8	6.9	6.3	6.0
Current account bal/GDP (%)	-13.7	1.9	2.4	3.6	2.5	3.9	3.4

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.

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.

Source: World Bank.

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