Global Economic Prospects

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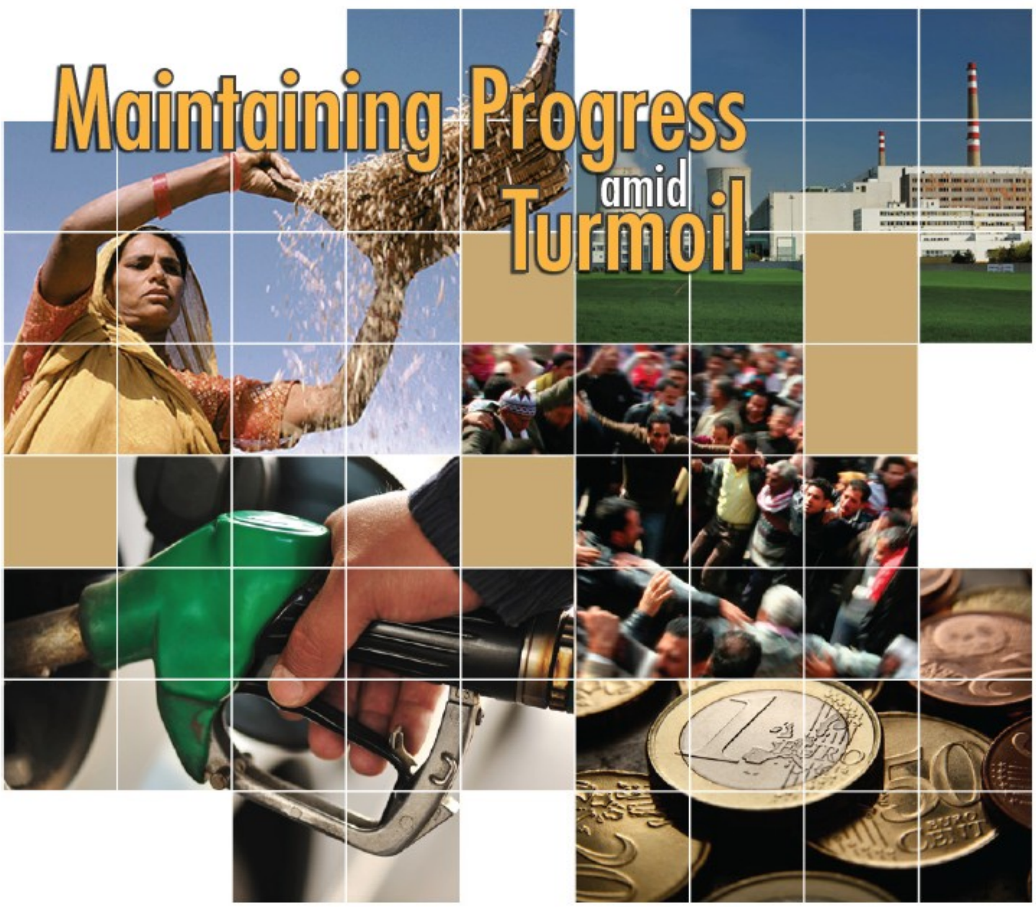

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Global Economic Prospects

Maintaining progress amid turmoil

June 2011

Acknowledgments

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Global Economic Prospects June 2011: *Maintaining progress amid turmoil*

Overview & main messages

The global financial crisis is no longer the major force dictating the pace of economic activity in developing countries. The majority of developing countries have, or are close to having regained full-capacity activity levels. As a result, country-specific productivity and sectoral factors are now the dominant factors underpinning growth.

Macroeconomic policy in developing countries needs to turn toward medium-term productivity enhancements, managing inflationary pressures re-establishing the fiscal and monetary cushions that allowed most developing countries to come through the crisis so well. In contrast, activity in high-income and some developing European countries continues to struggle with crisis-related problems, including banking-sector, fiscal and household restructuring.

The earthquake and tsunami in Japan and the political turmoil in the Middle-East and North Africa have contributed to a modest slowing in global industrial production and trade. Nevertheless, global activity is expanding significantly faster than its long-term trend rate. Indicators point to some further slowing in the second quarter of 2011, as the expansion slows toward a more sustainable pace.

Global growth is projected to remain strong from 2011 through 2013. After expanding 3.8 percent in 2010, global GDP is projected to slow to 3.2 percent in 2011 before firming to a 3.6 percent pace in each of 2012 and 2013, (4.8, 4.3, 4.4 and 4.5 over 2010 to 2013) percent when aggregated using purchasing power parities) (table 1).

- **Policy tightening and the earthquake in Japan, among other factors, are projected to reduce growth in high-income countries to 2.2 percent in 2011.** Subsequently, the expansion is expected to firm to near 2.6 percent in 2012 and 2013, as the negative effects of household, banking and government budget consolidation begin to fade and rebuilding in Japan intensifies. Excluding Japan, high-income growth will be more stable, slowing only marginally in 2011 and strengthening to 2.7 percent in 2012 and 2013.
- **As output gaps close , aggregate growth in developing economies is projected to ease to a still strong 6.3 percent pace** in 2011 through 2013—broadly in-line with these countries' underlying potential growth rate. The good performance is broadly-based with non-BRIC countries projected to grow by around 4.5 percent (3 or more percent in per capita terms).

Robust domestic demand growth in developing countries has supported output in high income countries, but has accentuated capacity constraints in some domestic markets and in global energy and metals markets. Low–and middle-income countries were responsible for 46 percent of global growth in 2010. Importantly, they were responsible for more than all the increase in global oil and metals demand over the past 5 years, and their growth was, therefore, responsible for much of the rise in global inflation. In addition, still loose policies and ample global credit flows have contributed to domestic inflation pressures and asset price bubbles in some middle-income countries.

Both monetary and fiscal policy in developing countries may have to tighten more quickly to curb these pressures. While macro-policy is tightening, a more rapid tightening of fiscal and monetary policy and more exchange rate flexibility may be required to avoid overheating and keep inflation in check. More discretionary tightening would also help re-establish the macro -policy cushions that enabled countries to

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

	2009	2010e	2011f	2012f	2013f
Global Conditions					
World Trade Volume (GNFS)	-11.0	11.5	8.0	7.7	7.7
Consumer Prices					
G-7 Countries [1,2]	-0.2	1.2	1.9	1.7	1.9
United States	-0.3	1.6	2.2	2.1	2.5
Commodity Prices (USD terms)					
Non-oil commodities	-24.1	27.6	20.7	-12.0	-9.4
Oil Price (US$ per barrel) [3]	61.8	79.0	107.2	102.1	98.7
Oil price (percent change)	-36.3	28.0	35.6	-4.8	-3.3
Manufactures unit export value [4]	-5.6	2.5	4.9	-3.2	0.3
Interest Rates					
$, 6-month (percent)	1.2	0.5	0.7	1.2	2.2
€, 6-month (percent)	1.5	1.0	1.6	2.1	2.4
International capital flows to developing countries (% of GDP)					
Developing countries					
Net private and official inflows	3.9	4.8			
Net private inflows (equity + debt)	3.4	4.4	3.9	3.8	3.8
East Asia and Pacific	3.6	5.0	4.2	3.8	3.6
Europe and Central Asia	2.2	3.5	4.0	4.1	3.9
Latin America and Caribbean	3.7	4.8	4.3	4.2	4.1
Middle East and N. Africa	2.7	2.3	0.3	1.7	2.1
South Asia	4.2	3.8	4.8	4.5	4.5
Sub-Saharan Africa	3.9	3.7	3.9	4.2	5.0
Real GDP growth [5]					
World	**-2.2**	**3.8**	**3.2**	**3.6**	**3.6**
Memo item: World (PPP weights) [6]	-0.8	4.8	4.3	4.4	4.5
High income	**-3.4**	**2.7**	**2.2**	**2.7**	**2.6**
OECD Countries	-3.5	2.6	2.1	2.6	2.5
Euro Area	-4.1	1.7	1.7	1.8	1.9
Japan	-6.3	4.0	0.1	2.6	2.0
United States	-2.6	2.8	2.6	2.9	2.7
Non-OECD countries	-1.9	4.2	4.3	4.8	4.9
Developing countries	**1.9**	**7.3**	**6.3**	**6.2**	**6.3**
East Asia and Pacific	7.4	9.6	8.5	8.1	8.2
China	9.1	10.3	9.3	8.7	8.8
Indonesia	4.6	6.1	6.3	6.5	6.5
Thailand	-2.3	7.8	3.7	4.2	4.3
Europe and Central Asia	-6.4	5.2	4.7	4.4	4.6
Russia	-7.8	4.0	4.4	4.0	4.1
Turkey	-4.8	8.9	6.1	5.1	5.3
Romania	-7.1	-1.2	1.6	3.7	4.0
Latin America and Caribbean	-2.1	6.0	4.5	4.1	4.0
Brazil	-0.7	7.5	4.2	4.1	3.8
Mexico	-6.1	5.5	4.4	4.1	4.2
Argentina	0.9	9.2	6.3	4.2	4.3
Middle East and N. Africa	2.8	3.1	1.9	3.5	4.0
Egypt	4.7	5.2	1.0	3.5	5.0
Iran	0.1	1.0	0.0	3.0	3.0
Algeria	2.4	3.3	3.7	3.6	3.5
South Asia	6.2	9.3	7.5	7.7	7.9
India [7, 8]	9.1	8.8	8.0	8.4	8.5
Pakistan [7]	3.6	4.1	2.5	3.9	4.3
Bangladesh [7]	5.7	5.8	6.2	6.4	6.6
Sub-Saharan Africa	2.0	4.8	5.1	5.7	5.7
South Africa	-1.8	2.8	3.5	4.1	4.4
Nigeria	6.7	7.9	7.1	7.5	7.3
Angola	2.4	3.4	6.7	8.1	7.8
Memorandum items					
Developing countries					
excluding transition countries	3.1	7.8	6.5	6.4	6.5
excluding China and India	-1.8	5.5	4.5	4.5	4.6

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 India, Pakistan and Bangladesh are reported on a fiscal year basis in Table 1.1. Aggregates that depend on these countries, however, are calculated using data compiled on a calendar year basis.
8 Real GDP at market prices. GDP growth rates calculated using real GDP at factor cost, which are customarily reported in India, can vary significantly from these growth rates and have historically tended to be higher than market price GDP growth rates. Growth rates stated on this basis, starting with FY2009-10 are 8.0, 8.5, 8.2, 8.5, and 8.6 percent – see Table SAR.2 in the regional annex.

counteract so effectively the cyclical effects of the financial crisis.

Although solid growth led by developing-countries is the most likely outcome going forward, high food prices, possible additional oil-price spikes, and lingering post-crisis difficulties in high-income countries pose downside risks.

- **Further increases in food and fuel prices cannot be ruled out.** Although prices are expected to moderate, supply conditions remain tight.
  - *A worsening of conditions in the Middle-East and North Africa* could derail global growth. If oil prices were to rise sharply and durably — either because of increased uncertainty or due to a significant disruption to oil supply, global growth could be reduced by around 0.5 percentage points.
  - *A poor harvest during the 2011/12 crop year*, or a second substantial increase in oil prices could cause domestic food prices in developing countries to rise much higher, with dire consequences for poverty.
  - *Domestic food prices may come under upward pressure in many countries.* Since June 2010, local food prices in developing countries increased 7.9 percent—much less than the 40 percent surge in international dollar prices. International prices are expected to moderate in the second half of 2011 and into 2012/13. However, if crops disappoint or oil prices (an important cost-side determinant of food prices) rise, lagged pass through of high international prices could see local food prices increase further — with important negative impacts for poverty in many developing countries.
- **Concerns about fiscal sustainability in high-income countries persist.** High fiscal deficits and rising sovereign debt pose medium-term challenges to a wide-range of OECD countries (gross sovereign debt is projected to reach 103 percent of OECD GDP in 2012). Although steps being taken by authorities to resolve short-term problems in the euro-zone should prevent an acute crisis, a loss of confidence such as envisioned in ECB stress-test scenarios could have large (but manageable) negative implications for developing countries.
- **Further financial stresses may emerge, as monetary policy in high-income countries begins to tighten.** As short– and long-term interest rates and re-financing costs rise, both banks and firms may find their balance sheets coming under renewed pressure — requiring additional measures to address shortcomings.

The remainder of this report is organized as follows. The next section discusses recent developments in global production, trade, inflation, and financial markets, and presents updates of the World Bank's forecast for the global economy and developing countries. This is followed by a more detailed discussion of some of the risks and tensions in the current environment, and a short section of concluding remarks. Several annexes address regional and sectoral issues in much greater detail.

Recent economic developments

The global recovery continued robustly during the final months of 2010 and into early 2011. Vibrant domestic demand in developing countries, still loose macro policy, reduced drag on growth from a recovering financial sector, and improved labor market conditions in several high-income economies helped to overpower the influence of a gradual tightening of monetary and fiscal policies, rising commodity prices, the political turmoil in the Middle-East and North Africa, and the natural disaster and nuclear catastrophe in Japan

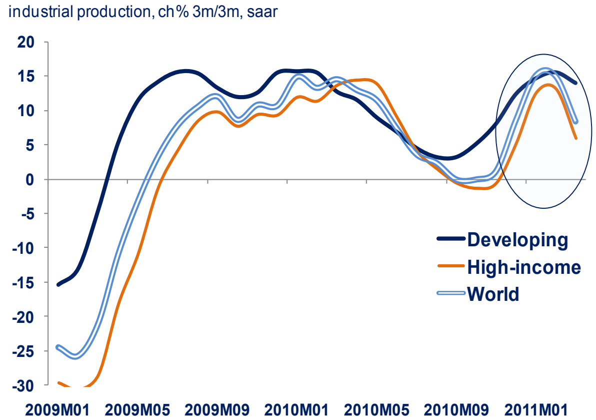
The recovery in industrial activity is progressing at a moderate pace

Recent developments in industrial production is described in more detail in the industrial production annex (http://go.worldbank.org/6J3VPK07S2).

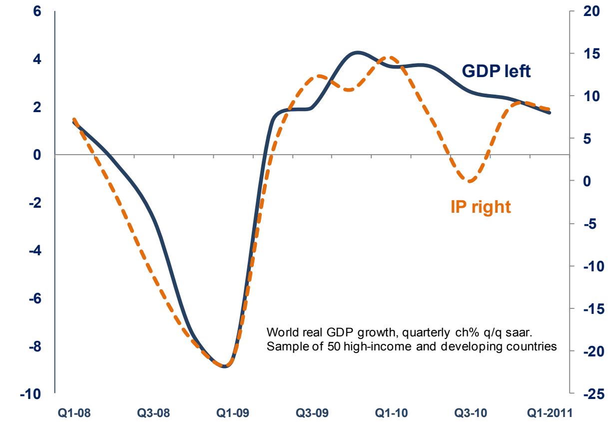
After marking a pause in the third quarter of 2010, industrial production in both high-income- and developing countries expanded at a more-than 15 percent annualized rate (3m/3m, saar) toward the end of 2010. Output once again

Figure 1 Industrial production has been more volatile than global demand

Global industrial production slowing once again



Inventory cycle in manufactured goods makes IP more volatile than underlying demand



Source: World Bank, Thomson/Reuters.

began to slow in the first quarter of 2011 (first panel, figure 1). The recent fading in world industrial production growth from a 15 percent 3m/3m annualized pace in February to 8.5 percent in March reflects the 15 percent decline in Japanese production in March, and similar declines in Egypt and Tunisia. Excluding these countries, momentum growth in the rest of the world was 10.3 percent, well above the longer-term trend growth rate of just under 3 percent.

Among developing countries, the pickup in production has been broadly-based, but also quite differentiated, with output expanding 19 percent in East Asia & the Pacific during the first quarter of 2011 (saar)—this rate subsequently slipped to 15 percent in April; in Latin America & the Caribbean, growth has maintained a 10 percent pace. In contrast, developing Europe & Central Asia has seen momentum dip from 10 percent in March to 3.8 percent by April (saar). Though production in South Asia was weak in the fourth quarter of 2010, it picked up pace into the first quarter — expanding at a 9 percent rate. Data for Sub-Saharan Africa are sparse, but industrial production was increasing at a modest 2.1 percent pace at the end of 2010 in the 4 Sub-Saharan African countries for which industrial production data are available.

Based on the limited recent data available for industrial production in the Middle-East and North Africa, the political turmoil in the region has had a notable impact on activity. In Tunisia production dropped 18.8 percent between December 2012 and February 2011, but has picked up 8 percent in March; still, output stands 9 percent lower in the first quarter of 2011 versus year earlier levels. As of February 2011, industrial activity in Egypt was down 20 percent from December 2010 levels and 14.4 percent from a year earlier.

Post-earthquake data for Japan indicate a sharp contraction of activity in that country. Industrial production declined 15.5 percent in March on a seasonally adjusted basis, while consumer demand has also drawn back as individuals conserve energy and moderate consumption in solidarity with disaster victims. Retail sales in March were 8.5 percent lower than a year before, while machinery and equipment sales were off 17 percent. Overall, preliminary estimates suggest that GDP declined by 3.7 percent in the first quarter of 2011 (saar), although much of that decline appears to reflect a fall in inventories (box 1).

Box 1 Short-term impact of the disaster in Japan

Official estimates place the damage from the March 11 earthquake and tsunami at between 3 and 5 percent of Japanese GDP, directly affecting a region that represents about 4 percent of Japanese GDP and 4.5 percent of its population. Some 450 thousand people have been left homeless, and more than 20,000 may have died. Although in some respects, the disaster is similar in scale to the Kobe earthquake of 1995, notable differences include the nuclear crisis, the additional loss of life and property damage attributable to the tsunami (see box table). In particular, the disaster has damaged an estimated 7.3 percent of Japan's power supply, about 3.8 percent due to disrupted thermal generation and 3.5 percent from nuclear. In addition about 2 percent of the county's distribution substations were damaged (table). The lost thermal capacity is expected to be fully restored by May, while lost nuclear capacity may be permanent. Currently, generating capacity in the Tokyo area, which represents about 40 percent of Japanese GDP, exceeds demand levels by almost 20 percent— partly because of voluntary conservation efforts. At the peak of the crisis capacity was reduced by 40 percent. TEPCO now expects to have 55m KW-hours of capacity in place by the end of July, approximately 87 percent of peak summer demand. For Japan as a whole, the projected shortfall represents 3.8 percent of generating capacity (TEPCO, 2011).

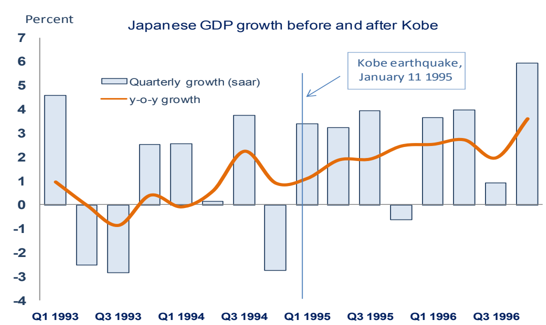
Impacts of the 1995 Kobe and 2011 Tohoku earthquakes

	Kobe 17-Jan-95	Tohoku 11-Mar-11
Dimension of tragedy		
- size of tremor (Richter scale)	7.3	9.1
- Lives lost	6434	15,202
- Missing		8,718
- people left homeless	300,000	450,000
- Estimated Property Damage (% of GDP)	2.5	4-5
- Initial disruption to power system (% of generating capacity)		7.3
- Medium-term disruption to power system (% gen. cap.)		3.8
- Industrial production growth (month of disaster)	-0.1	-15.3
- Quarterly GDP growth (quarter of disaster)	2.9	-3.7

Source: World Bank; Various press reports and official estimates.

Although the Kobe disaster had little impact on Japan's GDP growth, the current crisis is expected to cut into growth more sharply. Following Kobe, industrial production fell marginally. Both imports and exports declined by 2 percent for two months, but bounced back in the third, and GDP growth in the quarter of the earthquake was subdued but positive — in part because of a sustained increase in government spending of between 1 and 2 percent of GDP. As a result, GDP growth came in at 1.9 percent, a full percent point higher than the preceding year, and about 0.4 percent above estimates of the economy's productive potential at that time (figure).

Kobe had no noticeable impact on growth



Source: Japanese statistical bureau.

The impacts from this year's disaster are more serious. Industrial production in March was down 15.5 percent from February, in part because of electricity disruption and the pull-back in consumer spending that has been associated with the first weeks of the post-crisis period. Retail sales during March were down 8.5 percent from a year ago, while machinery and business equipment sales were down 17 percent. For the car industry, disruptions are expected to last until the end of the second quarter of 2011, potentially reducing output by one-half. GDP is estimated to have fallen 3.7 percent in the first quarter and uncertainty is large, many are now expecting second-quarter GDP to decline by a further 3-7 percent (annualized rates), before reconstruction efforts overcome the effects of economic disruption and cause growth to rebound. Regional impacts so far have been limited, with slower growth in the initial quarter of at most 0.5 percentage points for countries with closest trade ties (Malaysia, Vietnam and Thailand).

Should the nuclear situation deteriorate, or if nuclear pollution already having occurred requires an extended clean -up effort, longer-term impacts could be envisaged. Using Chernobyl as a model (a 50 km exclusion zone was put in place, some 400 thousand people would be permanently displaced, and some 3 percent of Japanese agricultural production lost (4 percent of Japanese and 0.1 percent of global rice production).

The expansion of global demand has been more stable

Recent developments in trade is described in more detail in the prospects for trade annex (http://go.worldbank.org/2OPGGNPVD0).

The recovery in aggregate demand has been more stable than that of industrial production (second panel, figure 1). GDP for the 50 high-income and developing countries for which quarterly data are available indicates that aggregate demand continued to expand during the last half of 2010 and into the first quarter of 2011 — albeit at a slower and more sustainable pace than earlier. The relative stability of demand viz-a-viz industrial production, partly reflects the concentration of the real-side effects of the crisis in durables consumption and investment goods, but the mid-2010 pause in industrial activity is also consistent with a sharp inventory cycle. An initial period of de-stocking during the acute phase of the crisis forced a rapid resumption of activity to meet gradually strengthening demand and to rebuild inventories. This re-stocking may have overshot demand, resulting in a pause in industrial activity growth at mid year. But by the final quarter of 2010, demand had caught up and industrial activity growth accelerated once more.

World trade has also bounced back

Reflecting the high content of manufactures in global trade, the recovery in world merchandise export and import volumes also paused during the middle of 2010, but is now expanding at a moderate to strong pace across economies.

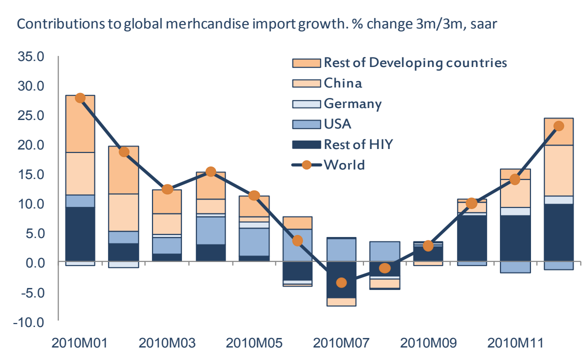
Importantly, demand from developing countries was responsible for more-than 50 percent of the increase in global import volumes (first panel, figure 2). Strong developing-country import expenditures partly reflect robust domestic demand growth in these economies. Global retail sales have posted positive growth rates for the past 20 months of between 7 and 10 percent (3m/3m, saar), outstripping that of high-income countries by a factor of 2 (second panel, figure 2). The main beneficiaries of expanding demand for tradables have been high-income countries, whose exports were expanding at a still strong 15 percent annualized rate in the first quarter of 2011, down from close to 20 percent at the end of 2010.

Developing country exporters also benefitted from the uptick in global demand, with their export volumes expanding at a 12.1 percent annualized rate in the three months ending March 2011. South Asian exports have been particularly strong, with volumes up more than 30 percent from their year-earlier levels, driven by sales to China and the rest of East Asia.

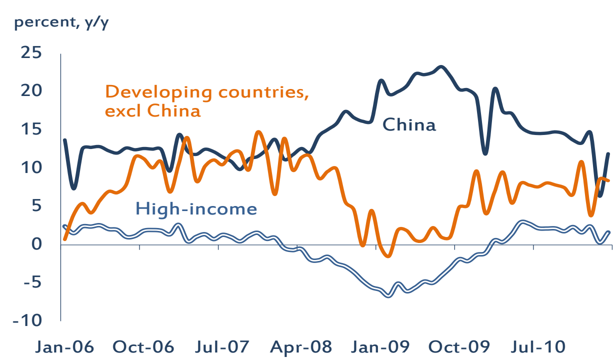
Exports from Europe and Central Asia have grown rapidly, notably in Russia, where they have expanded at more-than a 17 percent annualized pace (supported by energy exports), and in Romania and Turkey (reflecting stronger

Figure 2. Robust domestic demand causes Developing country imports to lead the rebound in trade

Contributions to global merchandise import growth, % change 3m/3m saar

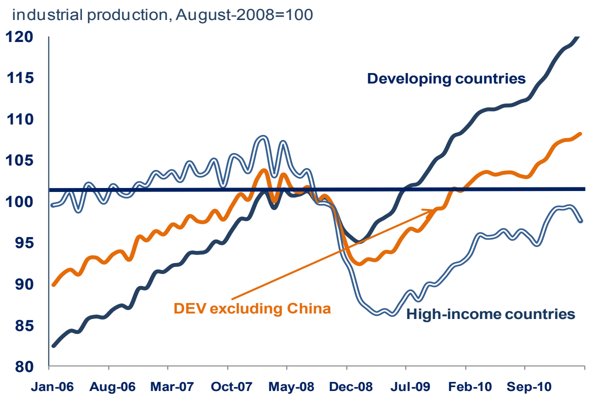


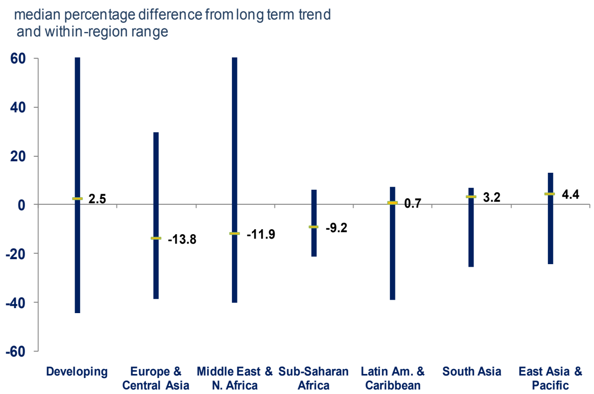
Retail sales growth, GDP-weighted 3m/3m saar



Source: World Bank. Thomson Datastream.

Figure 3. Industrial production has recovered pre-crisis trends in many developing countries





Source: World Bank, Thomson/Datastream.

high-income European investment and consumer demand). In Latin American and the Caribbean, Brazilian exports had been growing briskly in response to continued strong East Asian demand, but growth has eased to 12 percent as of April (saar). And the expansion has been less robust in Argentina and Chile. Overall exports from the region have been expanding at a 9.3 percent annualized pace during thee three months ending March 2011 (saar).

Both trade and industrial production have reached — or are close to recovering — trend levels

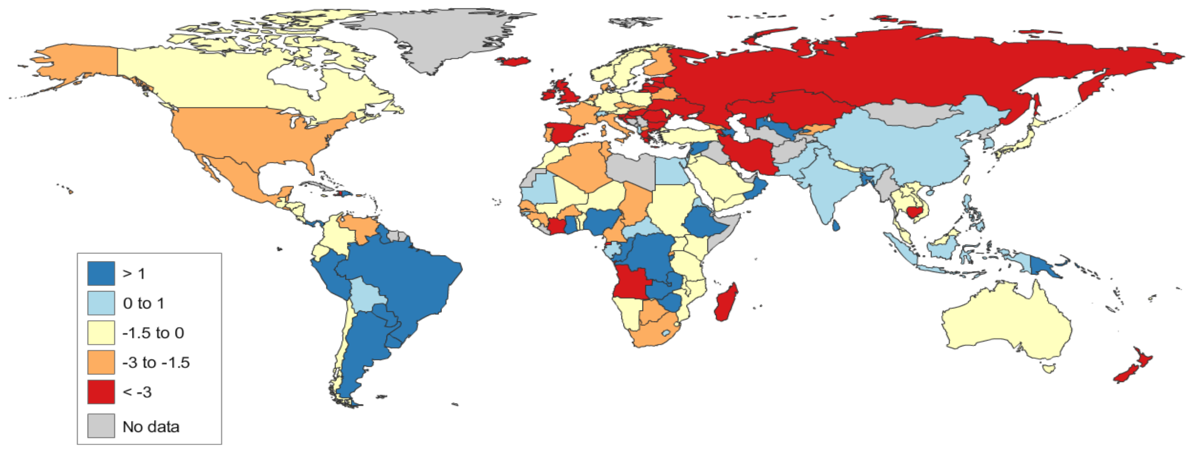
Recovery in industrial production has brought developing country output more-than 20 percent above its pre-crisis August 2008 levels (first panel, figure 3), while production in high-income countries is now about 2.5 percent below that level, and some 9 percent below peaks of February 2008 (trade volumes have also recovered pre-crisis levels)[1].

Industrial output in China is more than 40 percent above its pre-crisis peak, and 36 percent higher for the East Asia region considered as a whole. After booming during the first half of 2010, output growth in South Asia slowed toward the end of 2010. Nevertheless, output stands 24 percent higher than before the crisis. Among other developing regions, Europe and Central Asia had eclipsed pre-crisis levels by 5 percent as of March; while Sub-Saharan African production now stands 2.5 percent below.

Compared with levels of output that might have been expected had there been no crisis[2], significant gaps remain. Gaps are especially large among high-income countries because these economies were most directly affected by the financial crisis (second panel, figure 3). Among developing regions, the gap with pre-crisis trends is largest for Europe & Central Asia (13.8 percent), partly reflecting unsustainably high pre-crisis growth rates and the severity of the post-crisis adjustment underway in those economies. The shortfall in both the Middle East & North Africa and Sub-Saharan Africa is estimated to be close to 10 percent (partly reflecting the recent political turmoil), while the gap has closed in East Asia & the Pacific, South Asia, and Latin America & the Caribbean.

Overall, the recovery is well advanced in many developing countries and industrial capacity constraints have become increasingly binding. Whole economy output gaps for 2011, the difference between actual and potential GDP, are expected to be less than one percent in 72 countries, 64 percent of the developing economies outside of Europe and Central Asia for which data exist (figure 4). Output gaps among high-income countries are larger, with 45 percent of high-income countries facing a negative output gap of more-than 2 percent.

Figure 4 Growing capacity constraints are contributing to rising inflation in some countries
(Estimated % difference between actual and potential GDP in 2011)



Source: World Bank.

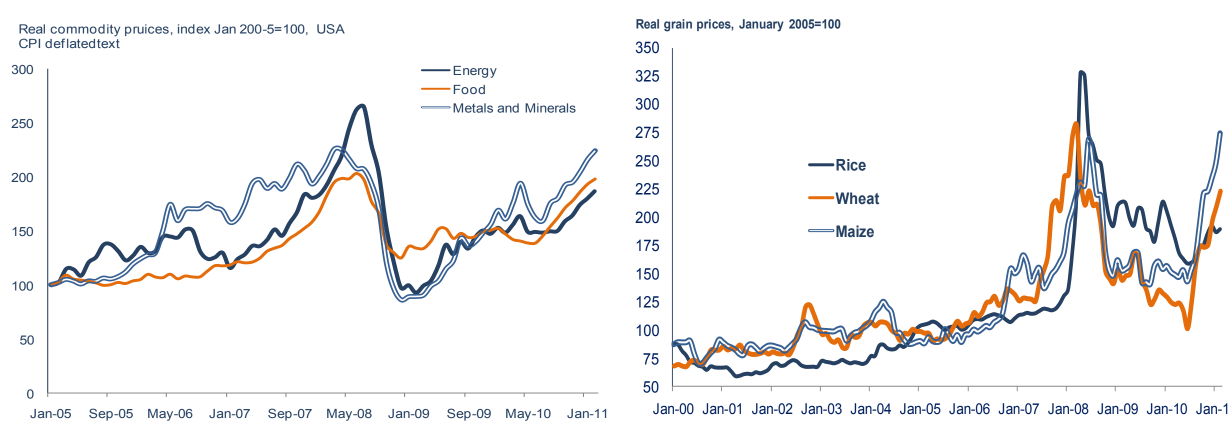
The rise in international fuel, metals and food prices

Recent developments in, and prospects for, these markets are described in more detail in the commodity annex (http://go.worldbank.org/5KM5S6POA0).

Strong GDP growth and the elimination of spare capacity in major developing economies has contributed to a sharp increase in the prices of metals and oil (box 2) during the second half of 2010 (first panel, figure 5) and into the first months of 2011. Higher energy prices have in turn contributed to increased fertilizer and agricultural production costs, which in combination with supply shortfalls in several markets caused food prices to spike in the second half of 2010 in the face of only gradually rising demand (box 3).

As of early 2011, prices of internationally traded food commodities reached levels just below peaks observed during the 2008 food crisis. However, the overall price of grains — the most critical food component from a poverty standpoint[3]— did not increase as much as in 2008, mainly because international rice prices remained broadly stable (second panel, figure 5). Since February, commodity prices have stabilized or declined, reflecting weakening demand and perhaps profit taking by institutional investors. Prices are off earlier peaks by between 3 and 10 percent for the main aggregates.

Figure 5 Commodity prices have recovered much of the losses observed since the financial crisis



Source: World Bank.

Box 2 Strong demand from developing countries driving up prices of extractive commodities

Strong demand by developing countries (notably China) is shaping the markets for extractive commodities, and has contributed to the rise in their prices during the post-crisis period.

Developing countries now account for almost 1/2 of global crude oil demand

More than all of the net increase in global oil demand over the past 5 years has come from developing countries (oil demand in high-income OECD countries peaked in 2005:Q4 and has since declined by 3.7 mb/d), with demand for oil by developing countries growing by more than 4.1 percent per annum over the past 5 years. Non-OECD countries now consume 47 percent of global oil production, up from 25 percent in 1970, with more than two thirds of that amount going to countries other than China and India (their global shares are 10.4 percent and 3.8 percent, respectively).

Crude oil prices began rising during the fourth quarter of 2010 despite ample supplies and spare capacity, boosted by strong demand from developing countries, declining stocks and expectations of future supply tightness. This trend was exacerbated toward the end of the year and into 2011, as political turmoil in the Middle East and North Africa disrupted oil deliveries from the region (notably the shutting out of some 1.3mb/d of sweet, distillate-rich Libyan crude-oil exports[4]) and fears of further possible disruptions in the region.

Although fraught with uncertainty, estimates suggest that the supply loses in North Africa added about $15 to the price of a barrel of oil. Assuming no further supply disruptions and a gradual reduction in uncertainty arising from the political situation in the Middle-East and North Africa, oil prices are expected to ease in the second half of 2011, averaging $107/bbl for the year as a whole, before declining further in 2012 and 2013 toward a real price of 80 2011 U.S. dollars per barrel, consistent with long-term demand and supply conditions.

Chinese demand dominates metals markets

In 2009, China overtook the OECD as the world's largest metal consumer, now consuming more than 40 percent of global metal supplies. Chinese metal demand growth over the past decade has served to single-handedly the metals intensity of global GDP (tons of metals used to produce a unit of GDP). As of 2004, increased metals demand had reversed 30 years of declining metal content of global GDP due to technological change and increased consumption of services (World Bank, 2008).

Although metals and minerals prices declined sharply with the financial crisis, many now exceed their pre-crisis peaks. Prices have risen the most for supply-constrained metals, such as copper and tin (up 460 and 590 percent from their average levels in 2000/03), while despite stronger demand growth, other metal prices have increased less rapidly due to ample supply (aluminum for example, is up 86 percent over the same period despite stronger demand growth).

Prices for a number of metals appear to have peaked in February 2011, reflecting weaker demand growth, rising inventories and strong supply. In those few cases where future prices exceed spot prices, a large portion of stocks are tied up in warehouse financing arrangements and not available to the market — which has given an appearance of market tightness that has helped support prices[5].

Mainly reflecting price increases already observed, metals prices in 2011 are expected to average 17 percent higher than in 2010 before they begin to decline in 2012, as additional supply and demand-side substitution eases market pressures. While metals markets are generally less concentrated than oil markets (and therefore less open to cartel-like pricing) future supply and prices will remain sensitive to labor disputes and energy costs.

While supply shocks played a central role in explaining the sharp rise in grain prices in the second half of 2010 (box 3), the trend rise in food and other agricultural prices since the turn of the century reflects among other things rising fuel, transportation and fertilizer costs as well as increased demand from biofuels (Timilsina and Shresha, 2010).

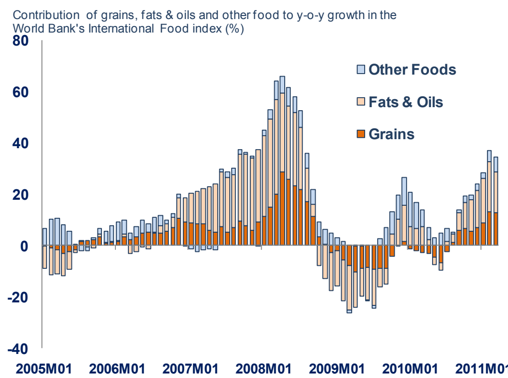
Typically, a sustained 10 percent increase in energy prices yields a 2-3 percent increase in the long-run price of most foods (Baffes, 2010), with this relationship being stronger in high-income countries that use particularly energy–intensive technologies and lower in countries where less fuel and fertilizer is used, e.g. in Sub-Saharan Africa. Bearing these relationships in

Box 3 Understanding the recent rise in global agricultural prices

The rapid rise of global agricultural prices in the latter half of 2010 and into 2011 reflects a combination of factors. Some agricultural commodities are used as raw materials, and demand and capacity constraints for these picked up in the second half of 2010, leading to sharp increases in, for example, cotton (up 147 percent since June 2010) and rubber (up 158 percent).

The rise in food prices was broadly based. Unlike the 2008 food-price spike, when almost half (48 percent) of the increase in the overall food index was due to rising grain prices, this time rising fats and oils prices were responsible for the bulk (40 percent) of the increase in the aggregate index. The main drivers of the run-up in internationally traded food prices in the second half of 2010 were poor grain crops and low inventories. While demand for food continued to rise, thereby contributing to market tightness, there was no major change in this trend, and indeed demand growth for most major food groups is slowing (see box 4).

Fats and oils were responsible for the majority of the increase in global food prices in 2010/11



Source: World Bank.

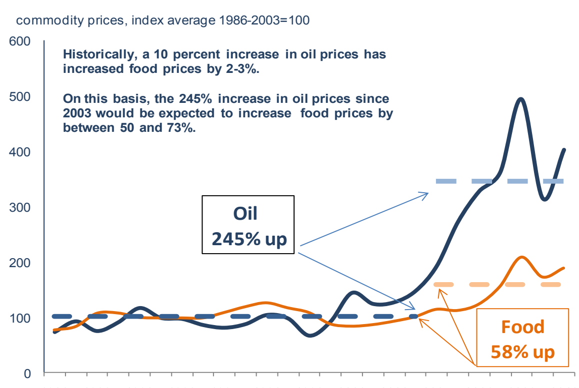
World wheat production in the 2010/11 crop year is estimated to have declined by 5.3 percent, mainly due to a 25 percent shortfall in Russian output; and stock-to-use ratios in major exporting countries have fallen to 25 percent, well below the 30 percent average of the past decade.[6] Maize prices also came under pressure as global production increased just 0.2 percent in 2011 and by only 2.5 percent over the past 3 years combined. Rice prices in contrast, have remained relatively subdued, ranging within a fairly narrow band of $450-$550/ton over the past two years. International food prices have declined somewhat in recent months, partly reflecting expectations of a normal 2011/12 crop-year — although volatility remains a concern, as crops are not expected to be large enough to restore stocks to comfortable levels.

Market tightness has been accentuated by demand for biofuels, notably maize for ethanol use in the United States, and edible oils (mostly rapeseed oil) for biodiesel in Europe. Approximately 30 percent of U.S. maize production now goes to biofuels, reducing availability for food and feed and contributing to a fall in stock-to-use ratios to 15 percent (from the historical average of 20 percent).[7]

mind, most of the 58 percent increase in the average price of food between the periods 1986/03 and 2004/10 can be explained by the 245 percent increase in the price of oil during that period (figure 6).

Once the short-term supply-shortage induced component of current high food prices dissipates; and assuming (i) that energy prices ease as discussed in box 2, and (ii) that 2011/12 is a normal crop year, then long-run equilibrium food prices should also tend to decline over the next few years. Nevertheless, food prices are anticipated to remain substantially higher than during the late 1990s — largely reflecting higher fuel and fertilizer costs. In the baseline projection, wheat, maize and rice prices are expected to decline in 2012 to roughly the same

Figure 6 Higher energy prices explain most of the 58 percent increase in agricultural prices since the 1990s.



Source: World Bank

level as in 2010.

Local food prices in developing countries have not increased as much as international food prices

Notwithstanding the 40 percent increase in the dollar price of internationally traded food commodities since June 2010, and food-price unrest in several countries, overall food price indexes in developing countries have risen by much less (7.9 percent through January 2011) (figure 7). Lower food price increases in developing countries reflect a variety of factors (see commodity annex).

- International prices are quoted in dollars, but the dollar is depreciating against most developing country currencies (down 9 percent in nominal effective terms since June 2010)— so even if all of the price increase were passed through, the price rise in local currency terms would be smaller.

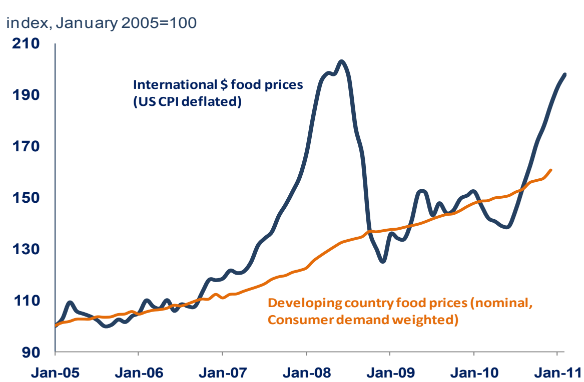
- In addition, local transport costs, price controls and other market imperfections introduce significant gaps and lags between international and local prices.

- The weights used to calculate international food price indexes are those of commodities in international trade, not in consumption. Because the vast majority of food is not traded internationally, the price of domestically produced and consumed foods enters in local price indexes with a bigger weight than in the international food price index. Most important for local food price indices are grains prices, including the price of rice (which has not increased much), cassava and other products whose prices are only loosely connected to international markets.

- Finally, although 2010/11 was a bad crop year for several major exporters of internationally traded foods, it was a good crop year for many developing countries — actually driving down domestic prices for some of these goods (notably maize in much of Africa) even as internationally traded food prices rose rapidly.

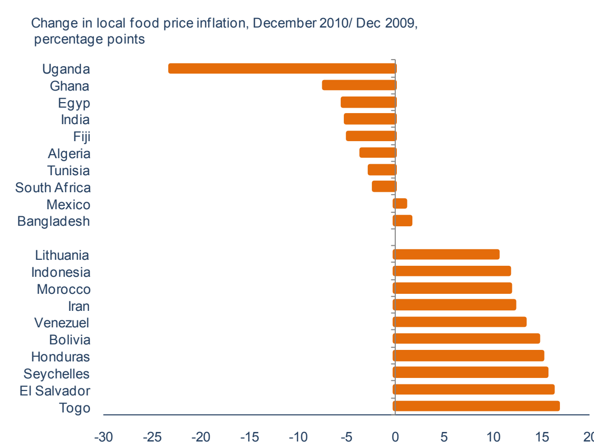
Overall, pass-through of world prices to local prices (even of the same commodity) is weak (see commodity annex for a fuller discussion). On average, only about one quarter of international price increases are passed on to local prices in the space of a year, although over the long-run this ratio tends to rise in those instances where local prices are not controlled. Countries where pass-through is stronger tend to either be major importers or exporters of the commodity in question, and have limited regulations or price controls. Pass-through is weaker or even non-existent among countries that are more self-sufficient and have weak infrastructure. Local grain prices change rapidly

Figure 7. Domestic food prices in developing countries have not increased as much as international food



Source: World Bank.

Figure 8 Biggest changes in food inflation



Source: World Bank, ILO food price database.

Box 4. Trends in the global demand for food

Demand for food tends to be relatively stable, responding to slowly evolving factors (principally, population and income growth), and its rate of growth has not accelerated in the recent past. Indeed, global demand for major food groups has been slowing over the past half century. This trend is expected to continue to do so as global population growth slows, and the increment to per capita demand from rising incomes declines.

Per capita demand for food tends to rises with incomes, although after income reaches a certain threshold per capita food demand tends to level off. For grains (including indirect demand to produce meat), most of the world's population has already reached the point where per capita demand has leveled off. Demand for meat is still rising faster than is population, but the differential is declining as meat consumption of most of the world's population approaches peak levels. Only demand for edible oils continues to rise much more rapidly than population, and is expected to continue to do so over the next twenty years or so, as poorer populations are increasingly able to afford the packaged and prepared foods that are heavy in edible oil content.

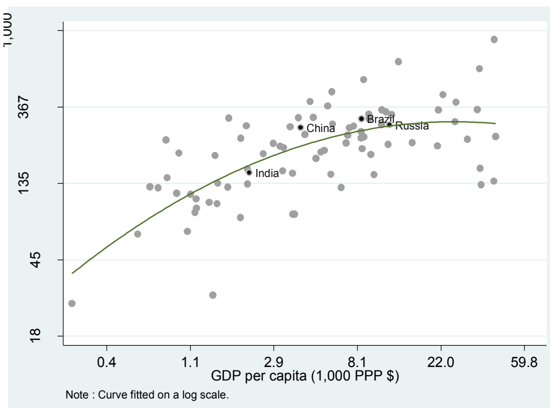
The somewhat higher growth rates for grains and edible oils projected for this decade reflect the diversion of some of these products to biofuels[7] — biofuel-related demand for food products is expected to grow rapidly over 2010-2019.

Global food demand trends, 1960-2030

	Population	Grains	Edible oils	Meats
1961-70	2.0	2.9	4.6	3.8
1971-80	1.8	2.3	4.4	3.2
1981-90	1.7	2.3	3.9	2.7
1991-2000	1.4	1.3	2.4	2.7
2000-08	1.4	1.1	2.7	2.0
2009-19[f]	1.4	1.4	2.9	2.1

f) FAO-OECD forecast (meat = simple average of chicken growth 2.4 percent and other meats 1.7 percent).
Source: World Bank, FAO, OECD.

Per capita grain consumption (direct and indirect) rises as income rises



Source: World Bank, FAO.

in response to international prices in only a very few developing countries, for example South Africa and Argentina (see the Commodity Annex for more on food price pass through).

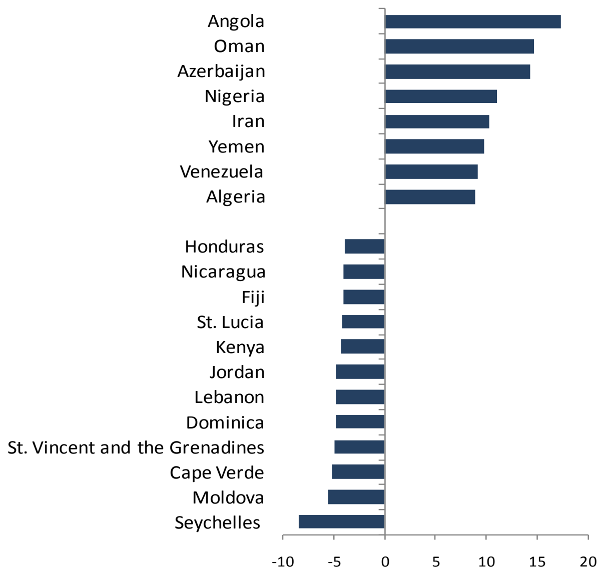
Of course, some countries are much more dependent on imported food, and therefore more sensitive to fluctuations in international food prices. Many island states and countries in the Middle-East and North Africa import large proportions of their food (import ratios for some grains exceed 80 percent in 12 of 14 Middle-East & North African countries for which data are available). Partly reflecting this, the Seychelles and Togo were among the developing countries (for which data are available) that experienced the largest increase in food inflation rates between December 2009 and December 2010 (figure 8). Overall, food inflation in 2010 exceeded 10 percent in 33 of 80 developing countries for which data are available.

In countries with price controls on food, rising prices have put enormous pressure on fiscal budgets (for example Bangladesh, Egypt and India). Moreover, several cases where the authorities sought to raise controlled prices in line with market developments resulted in significant political turmoil and even rioting (for example, Egypt, Tunisia, Mozambique, and Uganda).

High and rising commodity prices imply varied terms-of-trade effects across developing countries

A sharp increase in fuel and food prices during the course of 2010 has imposed large changes in the terms of trade of many developing countries (see below and the commodity annex for more on the implications of higher food and energy prices). Gains have been concentrated among oil exporters, and losses among resource and food-

Figure 9 Largest terms of trade effects
Estimated, *ex ante* terms-of-trade effects (% of GDP) in 2010



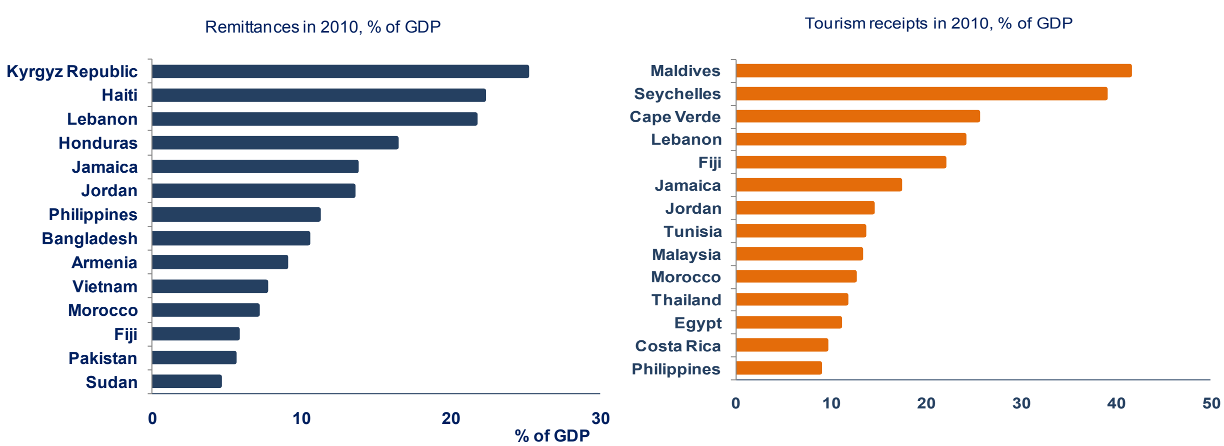
Source: World Bank.

poor oil-importing countries. Despite oil prices expected to average about $107/bbl, terms of trade impacts for many oil importers are not as large as might be expected, because other commodity prices (food, as well as metals and minerals) are also high and rising, which tends to generate offsetting effects. The ten countries experiencing largest positive terms of trade effects saw gains exceeding 8 percent of GDP, and were concentrated among oil exporters. The largest negative effects were smaller in scale, generally less than 6 percent of GDP, and included significant impacts in small island states such as Seychelles, Cape Verde and St. Vincent and Grenadines — all of which are oil importers and dependent on imported food (figure 9).

Remittances and tourism are important sources of foreign currency, representing inflows of 10 or more percent of GDP for several developing countries (figure 10). The dollar value of remittances received by residents of developing countries increased a modest 5.6 percent in 2010. However, because of inflation and dollar depreciation the local market purchasing power of these remittances is estimated to have declined by 3.6 percent in the year. Flows to South Asia and East Asia increased the most (8.2 and 7.4 percent respectively), with inflows to Europe and Central Asia and Latin America and the Caribbean (the two regions having been hit hardest in 2009) rising by just 1.3 and 1.7 percent respectively.

In 2010 world tourism recovered more strongly than expected following the global recession. Tourism arrivals increased by an estimated 7 percent and the dollar value of receipts increased 6.6 percent (World Tourism Organization, 2011), with emerging economies serving as the engine for growth. Among developing regions, the Middle-East, East Asia, and South Asia saw the biggest increases in volumes, up 14-, 13-,

Figure 10 Tourism and remittances are important sources of foreign currency for many developing countries



Source: World Bank, UN International Tourism Organization and 10 percent respectively, with intra-regional tourism in the Middle-East and North Africa playing a big role.

However, the political turmoil in the Middle East and North Africa at the end of 2010 and in the first months of 2011 has cut into the tourism business sharply. As of mid May, 2011 tourist arrivals have declined sharply in Bahrain, Egypt, Jordan, Syria and Tunisia. According to the World Travel and Tourism Council, first quarter tourist arrivals in Egypt and Tunisia were off about 45 percent compared with the like period of 2010. If tourism receipts decline 18 percent in Egypt during 2011, that would imply a direct 1.5 percent of GDP foreign currency shortfall. Jordan, Syria and Tunisia could experience negative impacts of similar magnitude, while the fall-off in other countries in the region is likely to be less pronounced.

Of course some of this tourism spending will show up as an increase in tourism in other countries — although for the moment data do not indicate which developing countries might be the most significant beneficiaries. During the first two months of 2011, tourism arrivals were up in all regions except the Middle East (-10 percent y/y) and North Africa (-9 percent). Latin America & the Caribbean and South Asian destinations saw volumes rise by 15 percent compared with the same period in 2010, while arrivals were up 13 percent in both Sub-Saharan Africa and developing Europe and Central Asia. Arrivals to East Asia & the Pacific were up 6 percent. Overall, the U.N. World Tourism Organization expects tourism arrivals to rise by about 4-5 percent in 2011.

Capital flows to developing countries have recovered

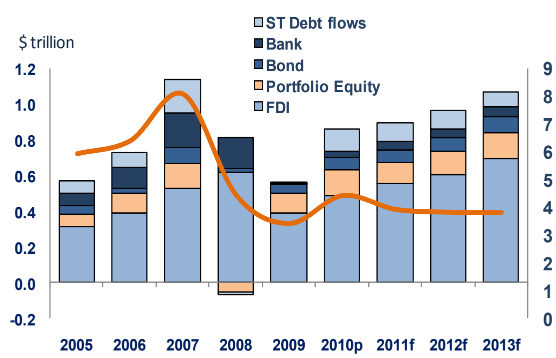
Recent developments in finance is described in more detail in the financial markets annex (http://go.worldbank.org/II5NRC07Z4).

Capital flows to developing countries recovered substantially in 2010, reaching about 4.6 percent of developing country GDP (table 2). Flows remain well below their peak levels of 2006 and 2007, with most of the compression endured by Europe and Central Asia, while flows as a share of GDP for other developing regions have been much more stable.

For 2011 as a whole private capital inflows are expected to increase only 5 percent, as the more volatile flows that led the sharp recovery in 2010 are expected to stabilize or weaken. In particular, portfolio equity flows into developing countries are projected to decline 20 percent, with the sharpest falloffs expected in the Middle-East and North Africa, reflecting political turmoil in the region. In contrast, firms in developing countries continue to rely on international bond markets for debt financing, as they are faced with ongoing tightening in domestic credit markets and limited recovery in international bank-lending.

The dollar value of FDI[8] is expected to rise by a further 14 percent in 2011, but will not regain its pre-crisis level in absolute terms until 2012, when it is projected to reach $604 billion (vs. $615 billion in 2008). Overall, net private capital flows to developing countries are anticipated to reach more than $1 trillion by 2013, but their share in developing country GDP will be falling from an estimated 4.4 percent in 2010 to around 3.8 percent at that time, in part reflecting an expected tightening of short-term debt flows as interest rates begin to rise and regulatory conditions tighten (figure 11).

Figure 11 Net private capital flows to developing countries



Source: World Bank.

Table 2 International capital flows to developing countries rebounds, surpassing 2008 levels
$ billions

	2003	2004	2005	2006	2007	2008	2009	2010e	2011f	2012f	2013f
Current account balance	138.3	195.2	318.8	450.3	469.1	440.6	284.4	264.5	219.6	159.9	163.1
as % of GDP	2.0	2.4	3.3	4.0	3.4	2.6	1.7	1.4	1.0	0.6	0.6
Financial flows:											
Net private and official inflows	264.1	342.2	502.9	656.3	1132.1	771.1	633.8	930.2			
Net private inflows (equity+debt)	276.1	366.3	567.0	725.9	1132.1	743.3	557.4	857.8	892.7	963.5	1065.3
Net equity inflows	180.6	243.6	379.2	497.0	664.9	561.2	498.1	633.2	674.1	733.9	839.8
..Net FDI inflows	154.3	206.7	311.7	389.3	529.8	614.4	390.0	485.4	555.0	603.6	696.2
..Net portfolio equity inflows	26.3	36.9	67.5	107.7	135.1	-53.2	108.2	147.8	119.1	130.3	143.6
Net debt flows	83.6	98.6	123.8	159.3	467.2	209.9	135.6	297.0	218.6	229.6	225.5
..Official creditors	-11.9	-24.1	-64.0	-69.6	0.0	27.8	76.4	72.4			
....World Bank	-2.5	2.4	2.7	-0.2	5.2	7.3	17.7	19.3			
....IMF	2.4	-14.7	-40.2	-26.7	-5.1	10.0	26.5	16.3			
....Other official	-11.8	-11.8	-26.6	-42.6	0.0	10.6	32.2	36.8			
..Private creditors	95.5	122.7	187.8	228.9	467.2	182.1	59.2	224.6	218.6	229.6	225.5
....Net M-L term debt flows	38.3	69.8	113.3	145.0	283.0	196.1	52.8	104.1			
......Bonds	23.1	34.3	48.3	31.7	88.2	24.1	51.1	66.5			
......Banks	19.5	39.7	70.3	117.9	198.5	176.8	3.2	37.6			
......Other private	-4.4	-4.1	-5.3	-4.7	-3.7	-4.8	-1.6	0.0			
....Net short-term debt flows	57.2	52.9	74.5	83.9	184.2	-14.0	6.4	120.5			
Balancing item /a	-116.9	-137.5	-406.9	-458.6	-509.5	-733.5	-271.1	-524.4			
Change in reserves (- = increase)	-285.5	-399.9	-414.8	-647.9	-1091.7	-478.2	-647.0	-670.3			
Memorandum items											
Net FDI outflows	23.6	46.1	61.6	130.5	148.7	207.5	153.9	210.0			
Workers' remittances	137.5	159.3	191.8	226.3	278.2	325.0	307.6	324.7	348.6	374.5	
As a percent of GDP											
	2003	2004	2005	2006	2007	2008	2009	2010p	2011f	2012f	2013f
Net private and official inflows	3.9	4.3	5.3	5.8	8.1	4.6	3.9	4.8			
Net private inflows (equity+debt)	4.1	4.6	5.9	6.4	8.1	4.4	3.4	4.4	3.9	3.8	3.8
Net equity inflows	2.7	3.0	4.0	4.4	4.8	3.3	3.1	3.3	3.0	2.9	3.0
..Net FDI inflows	2.3	2.6	3.3	3.4	3.8	3.7	2.4	2.5	2.4	2.4	2.5
..Net portfolio equity inflows	0.4	0.5	0.7	1.0	1.0	-0.3	0.7	0.8	0.5	0.5	0.5
..Private creditors	1.4	1.5	2.0	2.0	3.3	1.1	0.4	1.2	1.0	0.9	0.8

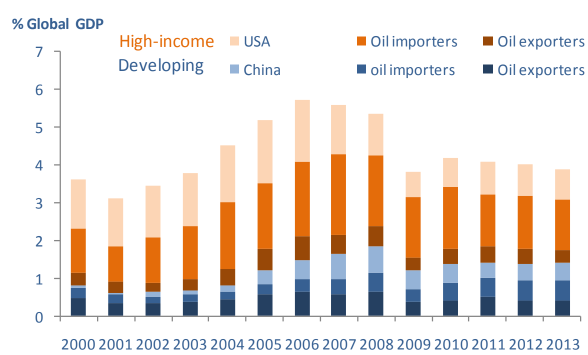
Source: World Bank.
Note: e = estimate, f = forecast
/a Combination of errors and omissions and transfers to and capital outflows from developing countries.

Global imbalances are expected to remain well below 2007 levels

Reflecting offsetting terms-of-trade effects for most developing countries and modest improvements in remittance and tourism flows, few countries are expected to run into extreme current account problems in 2011, and most developing countries are expected to be able to finance additional current account shortfalls that may arise.

Higher oil prices will increase the current account surpluses of oil exporting countries, which *ex ante* serves to increase global imbalances (which

Figure 12. Global imbalances have declined and are expected to remain at much lower than in mid-decade



Source: World Bank.

rebounded from decade lows in 2009 to reach about 5 percent of global GDP in 2010). The combined balances of the United States and China have halved from 2.6 percent of global GDP in 2006 to 1.3 percent in 2010 (figure 12).

Looking forward, a lagged step-up in imports by oil exporting economies; policy tightening in high-income countries and continued reliance on domestic demand for growth among developing countries, are expected to combine and maintain global imbalances at levels well below those of 2007, when persistent increases were a cause for genuine policy concern. The absolute value of current account imbalances among developing oil importers (including China) are expected to moderate slightly as these economies have already returned to close to full capacity levels of demand. In contrast, further recovery is expected in high-income countries, which may be reflected in a decline in private-sector savings and therefore increased deficits. However, this effect is expected to be offset by increased public-sector savings from fiscal tightening — with the result that imbalances for this group of countries are also projected to decline modestly, from about 3 to 2.8 percent of global GDP between 2011 and 2013.[9]

Growth will slow but remain robust

The global recovery has broadened to encompass more firms, more countries and more components of aggregate demand. Improving labor market conditions in high-income countries, and strongly expanding domestic demand in developing countries augurs well for a continued maturation of the recovery that is now almost two years old (global industrial production began picking up in March 2009).

The recovery in the United States has gained strength over the past 6 months and shows signs of becoming more self-sustaining. Significant gains in levels of manufacturing and services activity, business investment have helped to improve conditions in U.S. labor markets (employment has been growing by more than 115 thousand per month since March 2010, and the unemployment rate dropped to 9.1 percent as of May 2011). Following a relatively weak weather-influenced first quarter GDP results, and some flagging in the pace of the recovery in the second quarter, GDP growth is expected to pick up in the second half of the year, with whole year gains of 2.6 percent in 2011 and 2.9 percent in 2012, and with growth easing to 2.7 percent by 2013.

The recovery in Europe continues to face substantial headwinds from uncertainty surrounding sovereign debt in several Euro Area members, and a wide-reaching but necessary process of fiscal consolidation. Nevertheless, outturns in Germany and France have shown increasing strength, with unemployment in Germany now well below pre-crisis levels. But in many other countries, growth is becoming constrained by fairly austere fiscal consolidation programs, ongoing banking-sector restructuring and by a skepticism regarding the financial sector that is serving to raise borrowing costs. As monetary policy has entered a renewed tightening phase additional stresses in the financial sector—may become more apparent, presenting further challenges for these economies. Overall, after expanding 1.7 percent in 2010, Euro Area GDP is expected to repeat that performance in 2011, strengthening to 1.8 percent in 2012 and 1.9 by 2013, as financial-sector headwinds to growth begin to fade.

The horrible natural disaster and ensuing nuclear challenge in Japan will shape economic and human developments in that country for years to come (see box 1). Despite the very real human and wealth losses associated with the crisis, its impact on GDP growth is expected to be temporary. While second quarter GDP could decline at a 3 percent annualized rate, the pace of activity is expected to pick up to a 3 or 4 percent annualized rate in the final two quarters of the year — bringing whole year growth to around 0.1 percent in 2011. GDP is likely to increase to 2.6 percent in 2012, before settling at 2 percent in 2013 — broadly in line with the country's growth potential.

Overall, global growth is projected to ease from 3.8 percent in 2010 to 3.2 percent in 2011, before picking up to 3.6 percent in each of 2012

Box 5. Synopsis of regional outlooks

The regional annexes to this report contain more detailed accounts of regional economic trends, including country-specific forecasts (for more details, http://go.worldbank.org/OBY9F2CJV0)

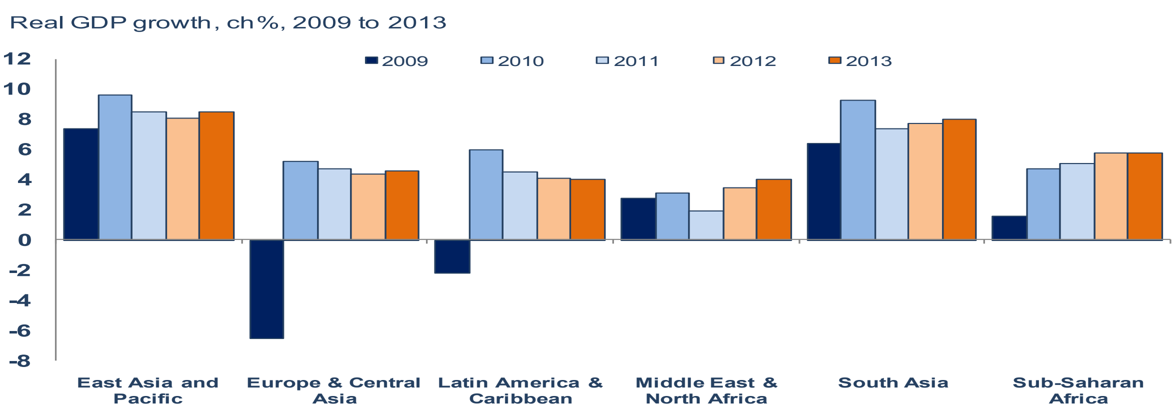
Growth in developing *East Asia and the Pacific* (http://go.worldbank.org/Q2V3HPR0F0) is projected to slow from 9.6 to 8.5 percent between 2010 and 2011, reflecting the shorter term adverse consequences of the Japanese earthquake for regional exports, as well as a tightening of both monetary and fiscal policies within the region (figure). China's expansion is projected to slow from the its 10.3 percent pace of 2010 to 9.3 in 2011 and around 8.7 percent in each of 2012 and 2013, as the effects of government's policy tightening take stronger effect. Output in the remainder of the East Asia region is also projected to slow, from 6.8 percent in 2010 to 5.3 percent in 2011, before strengthening gradually to 6.4 and 6.5 percent in 2012 and 2013.

Economic activity in developing *Europe and Central Asia* (http://go.worldbank.org/C4P2GZR0P0) is projected to continue to recover — albeit at slower rates than during 2010—as the very large adjustment costs of the financial crisis begin to fade. High oil prices should boost demand in regional oil exporters (notably Russia) increasing remittances and exports for other countries in the region. Continued weakness in the banking sector in several countries, and household exposures to foreign currency debt remain significant sources of risk. The region is also among the most exposed to problems that may arise from the Euro-Area fiscal sustainability crisis. Aggregate GDP is expected to ease from the 5.2 pace of 2010 to 4.7 percent in 2011, before a modest easing to 4.5 percent sets in for 2012-13, in-line with underlying fundamentals.

With output gaps for some of the larger countries in *Latin America and the Caribbean* (http://go.worldbank.org/1S4SNDR160) largely closed, continued robust growth in several economies will come head-to-head with increasing inflationary pressures and a tightening of policy. As a result, growth is projected to diminish from the 6 percent pace of 2010 to 4.5 percent in 2011. Activity is projected to remain solid, but to ease toward 4 percent over 2012-13 as policy measures dig deeper. Exchange rate appreciation due to capital inflows and high commodity prices has put a dent in competitiveness, also expected to contribute to the softening of growth. Countries in Central America and the Caribbean will face headwinds from higher commodity prices, offset to varying degrees by a more favorable outlook for tourism and remittances as labor market conditions improve in the United States.

The political turmoil in developing *Middle East and North Africa* (http://go.worldbank.org/IU7FS7QXE0) is projected to cut into near-term growth for a large number of economies in the region. Output already forgone- and continued uncertainty are expected to cause growth to slow in the economies most directly touched by the crisis by between 3 and 4 percentage points in 2011 relative to what would have been observed otherwise. Growth in the remainder of the region will be reduced by 1 to 2 points. Many countries are projected to see tourism revenues, worker remittances, foreign direct investment and other international capital flows decline, further tightening

Developing country growth rates to stabilize at historically elevated rates



Source: World Bank.

Box 5. Synopsis of regional outlooks (cont.)

conditions for regional oil importers. Activity is expected to pick up slowly as turmoil resolves over time, with growth among developing countries in the region rising from 1.9 percent in 2011 to 4 percent by 2013.

GDP growth in 2011 in *South Asia* (**http://go.worldbank.org/VFFA8EDQF0**) is expected to slow from the robust 9.3 percent pace set in 2010 to 7.5 percent, as policy tightens in response to higher inflation and an unsustainably loose fiscal policy stance. These negative factors and high import costs due to commodity prices are likely to be partially offset by strong trade, notably in India, which is reorienting its exports toward China and East Asia. Though investment spending is projected to remain robust (buoyed by infrastructure projects), consumer demand is anticipated to come under pressure due to reduced fuel and food subsidies. Turmoil and economic weakness in the Middle East and North Africa is expected to be a negative for remittances to the region, further dampening household incomes and outlays. Regional growth should revive toward an 8 percent pace by 2013 on the back of domestic reforms and an improved global environment.

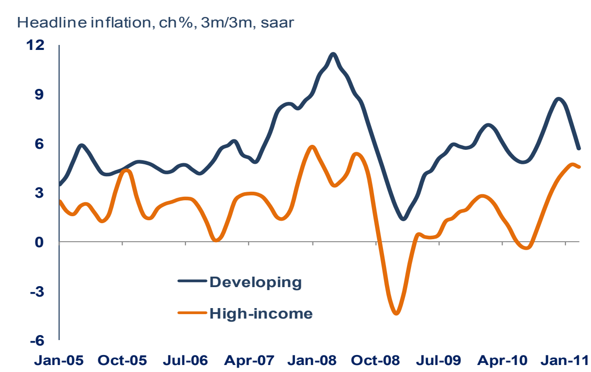
GDP growth in *Sub-Saharan Africa* (**http://go.worldbank.org/PHW504QYG0**) is projected to register 5 percent in 2011—the only developing region projected to enjoy an acceleration of growth in the year—buoyed by favorable terms of trade for oil exporters, and continued large inflows of FDI from China and elsewhere. Activity is expected to continue to firm with growth reaching 5.7 percent by 2013. The region has avoided the worst effects of higher food prices due to strong local crops, but should international prices remain at current or higher levels, local food prices could begin rising in the second half of 2011 and into 2012, with negative consequences for consumer demand and poverty. Inflation pressures may go hand and hand with this development, especially as elections are expected in 13 countries in the region.

and 2013. The slowdown for high-income countries (from 2.7 percent in 2010 to 2.2 percent in 2011) mainly reflects very weak growth in Japan due to the after-effects of the earthquake and tsunami (see earlier box 1). Growth in the remaining high-income countries is expected to remain broadly stable at around 2.5 percent through 2013, despite a gradual withdrawal of the substantial fiscal and monetary stimulus introduced following the financial crisis to prevent a more serious downturn.

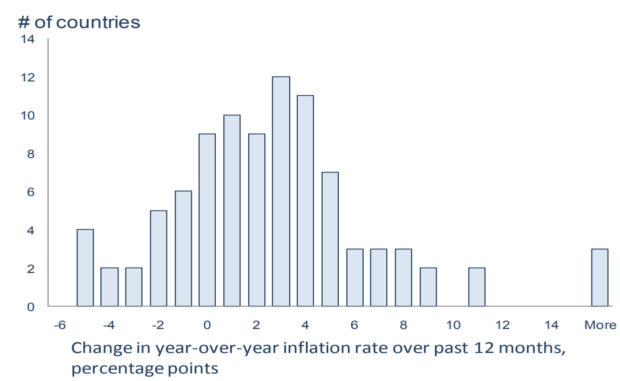
For developing countries growth is projected to decline from 7.3 to 6.2 percent between 2010 and 2012 before firming somewhat in 2013, reflecting an end to bounce-back factors that served to boost growth in 2010 and the tightening of monetary and fiscal policies as capacity constraints become increasingly binding (see box 5 and the regional annexes to this

Figure 13 Headline inflation pressures have picked up since mid-2010

Median headline inflation rates



Distribution of increase in developing country inflation rates

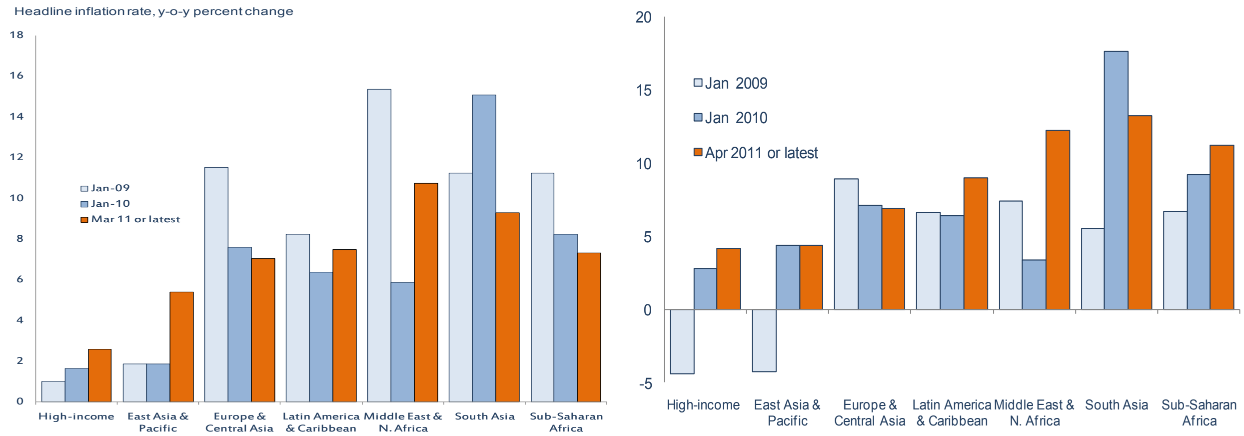


Source: World Bank.

Figure 14 Regional changes in inflation

Year-over-year inflation

Quarterly inflation (3m/3m saar)



Source: World Bank.

document for more details on recent economic developments and the outlook for low– and middle-income countries — including country specific forecasts).

Rising inflation poses macroeconomic policy challenges

Recent developments in inflation is described in more detail in the inflation annex (http://go.worldbank.org/FA0QD707X4).

The rise in commodity prices, combined with the rapid closing of output gaps and strong capital inflows has contributed to an acceleration of inflation throughout the developing world. Headline inflation in developing countries neared 7 percent (year-over-year) in April 2011, a more than 3 percentage point increase since low points in July 2009, when concerns of deflation were paramount. Headline inflation (y-o-y) in high-income countries has also picked up, reaching 2.8 percent in April 2011.

Monthly inflation accelerated more starkly, reaching a 9.1 percent annualized pace among developing countries in the 3 months ending in January 2011. Since then, the pace of inflation has eased to around 6.7 percent in April, and to 4.3 percent in high-income countries (first panel, figure 13).

The extent of the increase and its main determinants varies markedly across countries, with inflation having increased by 10 percentage points or more over the past 12 months in the Democratic Republic of Congo, Ethiopia, the Kyrgyz Republic, Bolivia, and Mongolia. Year-over-year headline inflation increased during this period by 3 or more percentage points in 33 of the 93 developing countries for which data are available (second panel, figure 13). However, the extent of the pickup in inflation in most countries has been modest. Inflation rates in 55 percent of developing countries remain below their average rate of the pre-crisis period (January 2000 through August 2008). And inflation is less than 2 percentage points higher than that average in 80 percent of countries.

The biggest acceleration has been in the East Asia and Pacific- and Middle-East and North African regions, reflecting capacity constraints in the former and food prices in the latter (first panel, figure 14). While on a year-over-year basis inflation has eased in South Asia and Europe and Central Asia, monthly data suggests that price pressures remain strong in South Asia and are rising in Africa, with the pace of increase in the first quarter of 2011 exceeding 15 percent in South Asia and close to 10 percent in Sub-Saharan Africa (second panel, figure 14).

Rising food and fuel prices have also been associated with significant increases in food and fuel subsidies—both implicitly as the gap between market and controlled prices increases

Box 6 Should developing countries accommodate external price shocks?

Several OECD countries produce estimates of core inflation that either exclude food and fuel prices or exclude the most volatile components from the overall consumer price index, and prefer to guide monetary policy with these measures rather than headline inflation. Currently, even as headline inflation is rising rapidly, so-called core inflation indexes remain low at 1.3 percent in high-income Europe and 1.1 percent in the United States.

Most developing countries do not publish separate core inflation measures and, recent research (Walsh, 2011) suggests that in some cases, policy in developing countries may be better advised to focus on headline not core measures. According to this line of argument, the high weight of food and fuel prices in the overall consumption basket of developing countries (more than 50 percent in many cases) means that price increases in these goods spread more easily into other prices than in high-income countries. As a result, accommodating such price increases runs the risk of allowing a second round of price increases to occur — potentially yielding an inflationary spiral.

A second strand of logic argues that because food prices are such a large component of the overall basket, not accommodating them (even if they do pass through to other prices) would pose too harsh an adjustment on real wages. In this case, a credible monetary authority might be better-off to announce that they would accommodate the price increase and allow some second round increases (thereby reducing the real wage shock), but would seek to firmly re-establish its inflation targets within a well specified period of time.

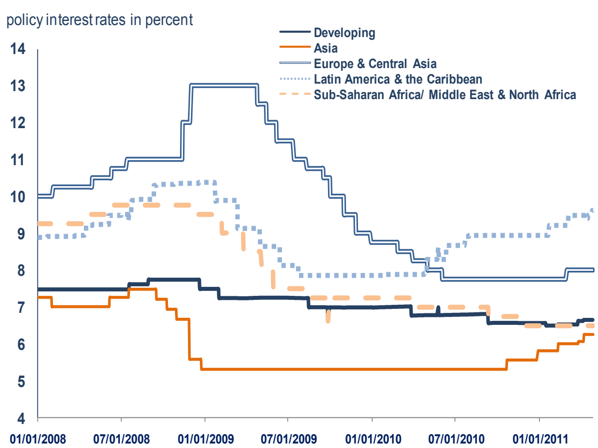
Of course, the success of such a strategy lies in the credibility of the monetary authority. If inflationary expectations adjust upward despite the monetary authority's declaration to re-establish inflation targets by a given date, then the long-term costs of bringing expectations back down may exceed the short-term benefits of easing the real-wage adjustment to permanently higher food prices.

and because of the imposition of new policies to alleviate the impact of the price hikes. Several countries in the Middle-East and North Africa increased food and/or fuel subsidies (Algeria, Egypt, Jordan, Morocco, Syria and Tunisia), with associated increases in government deficits exceeding 2 percent of GDP in many instances. Rising food and fuel prices have also increased subsidy spending in several Asian economies, including India, Pakistan and Indonesia.

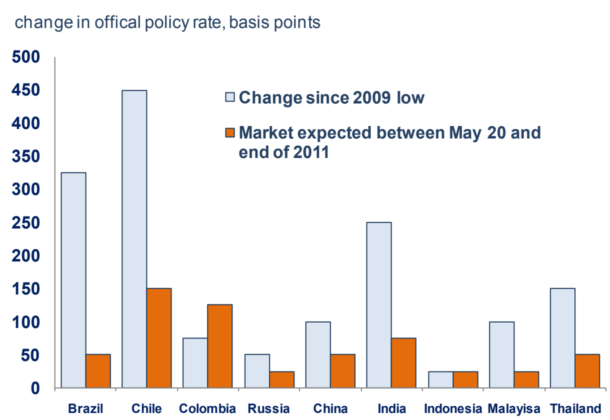
Responding to the rise in inflation and the closing of output gaps, authorities in many developing countries have begun the process of adjusting macroeconomic policy, which had been loosened in the wake of the financial crisis, to a

Figure 15 Policy tightening has begun and markets suggest more is to be expected

Rates are on the rise in many developing regions

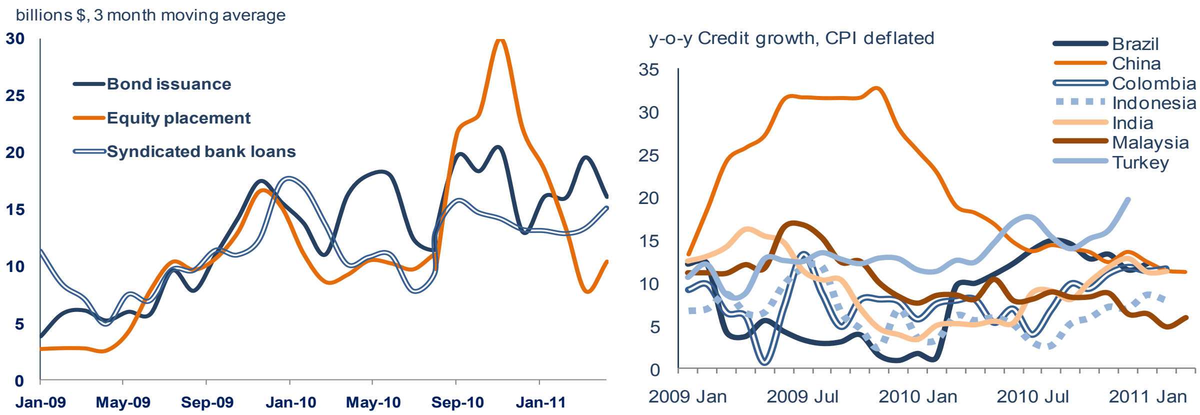


And markets expect further increases



Source: World Bank, Thomson/Reuters, Bloomberg.

Figure 16 Gross capital flows to, and credit growth in, developing countries eased toward the end of 2010



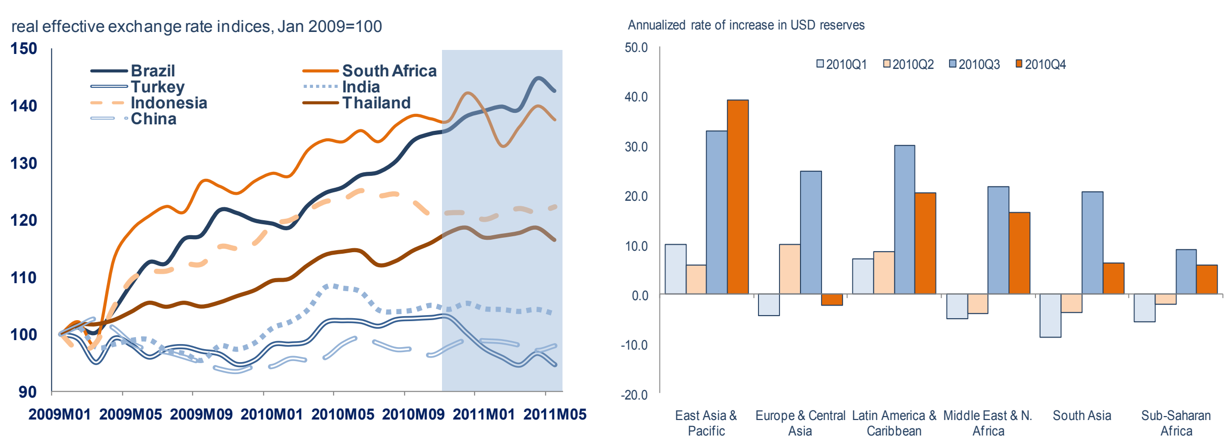
Source: World Bank using Dealogic, IFS.
Note: Data refer to gross flows of new bond and equity issues and syndicated bank loan commitments.

more neutral stance.

Monetary policy interest rates in much of the developing world have been rising (first panel, figure 15). In Latin America, the median policy rate has increased from 7.9 percent in March 2010 to 9.6 percent by May 2011, and in Asia it has increased by 106 basis points to 6.31 percent. Reflecting much larger output gaps, policy rates in Europe and Central Asia have been broadly stable (up only 50 basis points since February 2011). In the Middle East and North Africa and Sub-Saharan Africa rates continue to decline.

Despite the increase in nominal interest rates, real rates (nominal deflated by actual inflation) remain low and even negative in many developing countries. Expected real rates (which is what matters for monetary policy) may not be negative if expectations are that the current pickup in inflation in transitory. However, if some of the recent increase is deemed permanent then additional monetary tightening may be called for (see box 6 for a fuller discussion of how monetary policy in developing countries should respond to increases in commodity prices). Indeed, expected inflation has increased in several developing countries where data exist, for example in Argentina, Belarus, Brazil, Chile, Ethiopia, and India among others.

Figure 17 Upward pressure on middle-income currencies and reserve accumulation also eased in 2010Q4



Source: World Bank, IFS.

As discussed in length in the previous edition of *Global Economic Prospects*, efforts to tighten monetary policy and rein-in credit growth were complicated in 2010 by strong capital inflows. Some of these flows (mainly short-term debt and equity flows) were perceived as having an important speculative and temporary component. As a result, many countries (notably several large middle-income countries with relatively deep capital markets) sought to resist the associated upward pressures on their currencies, putting into place a wide range of administrative and regulatory measures designed to reduce the attractiveness of short-term financial investments or reduce the extent of credit expansion associated with reserve accumulation.

Measures employed included sterilizing inflows through government bond sales, and interest rate hikes. Many countries employed non-traditional measures that did not increase domestic interest rates in order to avoid increasing the returns to foreigners of making short-term investments in these countries. These included raising reserve requirements[10], and imposing taxes on short-term foreign capital investments. Turkey even went so far as to lower domestic interest rates (and therefore risk a rapid expansion in domestic credit) in order to discourage foreign capital inflows.

Partly as a result of these steps, foreign capital inflows into—and credit growth in—many of these countries eased toward the end of 2010 and into 2011 (figure 16). However, attributing causality is difficult because renewed concerns about fiscal sustainability in high-income Europe; political turmoil in the Middle East and North Africa; rising oil prices, and the crisis in Japan may also have been playing a role. Indeed, profit-taking on the part of investors, and concerns that perhaps emerging market currencies and local stock-markets had reached unsustainably high levels may also have been factors at play.[11]

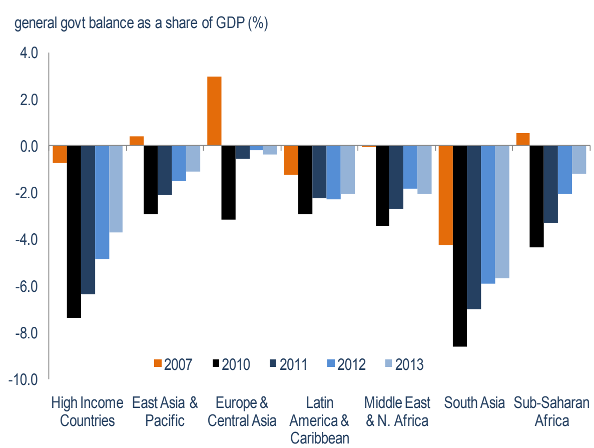
Whatever the reason for the reduced inflows, they were reflected in an easing in the upward pressure on the currencies of many middle-income countries, and a slowing in the pace of international reserve accumulation throughout much of the developing world, East Asia forming a notable exception (figure 17).

Fiscal policy will likely have to do more going forward

Looking forward, policymakers in developing countries will need to make fuller use of all of the tools at their disposal to keep inflation under control. While the more unstable capital inflows that characterized the third quarter of 2010 have abated, many of the underlying conditions that attracted those flows remain in place (low short-term interest rates in high-income countries; stronger growth prospects in developing countries; strong commodity prices, and a long-run tendency for developing–country currencies to appreciate). Moreover, countries are now confronted with additional pressures from growing capacity constraints and rising commodity prices.

If countries are to deal with these (and other as yet unknown) challenges, they may need to take fuller advantage of both fiscal and exchange rate policies. To this point in the recovery, withdrawal of the fiscal stimulus that was put in place during the acute phase of the crisis has been limited. Although government deficits have declined in many developing countries, this mainly reflects improved revenues as activity has recovered and output gaps returned to near

Figure 18 Modest expected improvement in fiscal deficits in some developing regions



Source: World Bank.

zero levels. Discretionary cuts to spending have been limited. Government deficits have declined by less than might have been expected given that output gaps in most countries will be close to, or above zero—suggesting that almost all of the cyclical component of government deficits has been eliminated and that remaining budgetary shortfalls are structural in nature (figure 18).

Importantly, even by 2013 no region is anticipated to see fiscal balances return to the pre-crisis levels of 2007. They will therefore not have in place the kind of fiscal buffers that allowed policy in developing countries to respond counter-cyclically to the financial crisis. Until such buffers are restored, countries will be more vulnerable to future domestic or external shocks.

A more assertive tightening of fiscal policies in developing countries would also allow a given level of macroeconomic tightening to be achieved at lower interest rates. Lower domestic interest rates would both reduce the financial incentive for potentially destabilizing short-term debt inflow, but might also increase investment rates and overall activity by lowering the cost of capital for local entrepreneurs.

Some countries should consider introducing more flexible exchange rate regimes. When countries face temporary and or speculative pressures on their currencies, reserve accumulation and other strategies to resist unwarranted exchange rate appreciation (or depreciation) may well be warranted. However, when those pressures are persistent and enduring, a policy that resists exchange rate adjustment may well be counter-productive.

For example, while Brazil faced strong inflows of short-term debt flows, the authorities were arguably correct in resisting the upward pressure they caused on their currency. However, Brazil has also been—and continues to be a major destination for FDI, which has in large measure been attracted to the country's long-term fundamentals. In this context, the authorities decision to not resist upward pressures stemming from FDI inflows is equally appropriate.

Similarly, countries that have sustained large current account surpluses for an extended period of time may well be better off allowing their currencies to float more freely, rather than continuing to resist upward pressure—especially when domestic inflationary tensions are building.

Risks to the global economy

The recovery is mostly complete in developing countries, with prospects in individual countries increasingly dependent on local conditions and medium-term productivity growth rather than the large, global-level forces that dominated economic activity during and immediately after the financial crisis. While the robust growth outlined in the baseline remains the most likely outcome, several tensions and external events have the potential to disrupt that process.

On the upside, output could come in more strongly than anticipated, or the very strong speculative capital flows that characterized the third quarter of 2010 could return. Either scenario could potentially accentuate inflationary pressures in the global economy — both those stemming from commodity markets and those coming from increasingly binding capacity constraints in a number of emerging markets. In such a scenario, which pre-supposes that policy tightening efforts underway are not sufficient to rein in demand, the authorities would be obliged to tighten more aggressively in 2012, provoking a more pronounced slowdown in 2013.

There are several potential downside risks.

- A much more severe slowing of the global economy could come about if the political turmoil in the Middle East and North Africa were to result in a prolonged period of high oil prices — either through increased uncertainty, or an enduring disruption to global oil supply.
- Conditions in global food markets represent a more focused risk for the poor in developing countries. Another year of poor harvests could see prices rise still higher — especially if combined with higher oil prices — with potentially serious consequences for

Table 3 A further increase in oil prices due to political turmoil in the Middle-east could cut further into growth
(Change in the level of GDP (%) from baseline and change in current account balance (% of GDP)

Impact of a $50/barrel price hike (11q2-12q2) due to uncertainty

	Real GDP				Current account (% of GDP)			
	2010	2011	2012	2013	2010	2011	2012	2013
World	0.0	-0.5	-1.0	-0.4	0.0	0.0	0.0	0.0
Oil exporting	0.0	0.2	0.5	0.9	0.0	1.5	1.4	-0.2
Oil importing	0.0	-0.6	-1.3	-0.7	0.0	-0.2	-0.2	0.1
High income	0.0	-0.6	-1.2	-0.6	0.0	0.1	0.2	0.2
Oil exporting	0.0	-0.4	-0.6	0.3	0.0	1.4	1.7	0.1
Oil importing	0.0	-0.6	-1.2	-0.7	0.0	-0.1	0.0	0.2
Developing countries	0.0	-0.1	-0.4	0.0	0.0	0.3	0.1	-0.3
Oil exporting	0.0	0.9	1.6	1.5	0.0	1.5	1.2	-0.4
Oil importing	0.0	-0.7	-1.5	-0.8	0.0	-0.5	-0.6	-0.2
Middle-income	0.0	-0.1	-0.4	0.0	0.0	0.3	0.1	-0.3
Low-income	0.0	-1.3	-2.4	-0.6	0.0	0.0	0.3	0.1
East Asia and Pacific	0.0	-0.8	-1.7	-1.0	0.0	-0.8	-1.1	-0.3
Oil exporting	0.0	-0.4	-0.3	0.7	0.0	-0.5	-0.4	0.3
Oil importing	0.0	-0.8	-1.9	-1.2	0.0	-0.9	-1.2	-0.4
Europe and Central Asia	0.0	-0.2	-0.2	0.8	0.0	1.6	1.8	0.1
Oil exporting	0.0	0.1	0.7	2.0	0.0	2.3	2.4	-0.1
Oil importing	0.0	-0.5	-1.2	-0.6	0.0	0.1	0.4	0.1
Latin America and Caribbean	0.0	0.5	0.7	0.5	0.0	-0.2	-0.4	-0.2
Oil exporting	0.0	1.2	1.8	0.9	0.0	-0.4	-0.9	-0.1
Oil importing	0.0	-0.3	-0.4	0.2	0.0	-0.1	-0.1	-0.2
Middle East and N.Africa	0.0	0.8	1.3	1.1	0.0	3.3	3.2	-0.9
Oil exporting	0.0	1.5	2.4	1.4	0.0	3.7	3.4	-1.2
Oil importing	0.0	-1.4	-2.3	0.0	0.0	0.4	1.2	0.4
South Asia	0.0	-0.9	-1.7	-0.7	0.0	-0.1	0.3	0.2
Sub-Saharan Africa	0.0	1.0	1.7	1.4	0.0	3.3	2.7	-1.3
Oil exporting	0.0	3.7	6.6	4.4	0.0	6.2	4.4	-3.6
Oil importing	0.0	-0.9	-1.6	-0.7	0.0	0.0	0.3	0.2

Source: World Bank.

the poor.

- The market nervousness over fiscal sustainability in high-income Europe — although less acute than in the past, still has the potential to disrupt growth in developing countries if it begins to weigh on confidence.

Continued turmoil in the Middle-East and North Africa could push oil prices even higher

The recent turmoil in the Middle East and North Africa lifted oil prices to $112/bbl in late April 2011 (World Bank average), a 40 percent increase on the average price of $79.60/bbl in 2010. In the baseline, oil prices, which have since declined to around $107/bbl, are expected to gradually moderate toward a long-run equilibrium price of about $80/bbl in constant 2011 dollar terms. This implies annual price levels of $107/bbl in 2011 drifting to $96.7/bbl by 2013. However, if current uncertainties persist, or a major supply disruption occurs, oil prices could remain high or even increase further — with serious consequences for global growth.

- During the Iranian revolution and the Iraq/ Iran War, crude oil prices more-than doubled from $14/bbl in 1978 to $35/bbl by 1981.
- When Iraq invaded Kuwait in 1991, oil prices increased sharply from $20/bbl to a peak of $44/bbl five months later, with the average price rising by one-third to $28/bbl.
- During the extended conflict in Iraq, prices increased by 40 percent.

The current turmoil in the Middle East and North Africa has been associated with a $22/bbl increase in oil prices, from $90/bbl in December 2010 to $112/bbl by late April 2011. Prices could increase further on additional disruption to supplies, notably if this involved a larger exporting country.

Preliminary simulations suggest that a further $50/bbl increase in the price of oil for a period of

1 year (beginning in the second half of 2011, for example) could shave off 0.5 and 1.0 percentage points from global output in 2011 and 2012 (table 3). This overall result masks significant differences between countries and regions.

Oil exporting countries experience significant gains (6.6 percent of GDP in Sub-Saharan Africa and 2.4 percent in the Middle East and North Africa),[12] while oil importing countries experience losses. The largest losses are expected to be among oil-importing countries in the Middle East and North Africa (-2.3 percent) as well as in East Asia and Pacific (-1.9 percent in 2012), reflecting both the direct effects of higher oil prices on incomes in these regions, as well as their greater reliance on exports to other negatively affected oil-importing regions (Europe and Central Asian oil-importers benefit from strong Russian imports).

GDP declines in oil importers reflect real income losses as the cost of oil and related goods and services rise, which leads to lower demand, reduced competitiveness, and output declines — with intensive oil-importing economies experiencing the biggest declines (for example Jamaica and Guyana). Negative impacts among countries with close economic ties to oil exporters (for example those in Europe and Central Asia) tend to be reduced by increased export demand from oil exporters.

In terms of external balances, current account balances (as a share of GDP) are expected to rise by up to 6.2 percent of GDP in oil exporting Sub Saharan Africa, and by about half that much in the Middle East and North Africa, while in East Asia and Pacific, external balances decline by about 1 percent of GDP.

Should the turmoil result in a large and sustained (say 10-15mb/d) reduction in global oil supply, adverse effects could be more than twice as large. Prices might initially rise as high as $200/bbl, cutting sharply into household incomes and firm-level profitability. Moreover, supply shortages could directly constrain production in a way that uncertainty-based price rises would not. In the latter case, oil would not be available at any price; in the former oil would be available — but at higher cost.

A poor crop or higher oil prices could see domestic food prices in developing countries increase further in 2011-2012

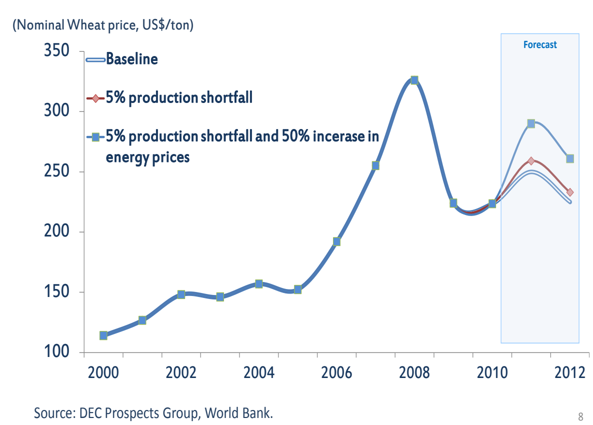
The surge in international food prices during the second half of 2010 provoked concerns of a “second food crisis”, of similar magnitude to that of 2007-08. Indeed, international food prices increased to levels close to their 2008 peaks.

However, effects on the ground have been mitigated by a number of factors— notably, the fact that not all major grain prices have increased as much as they did in 2008. International rice prices remain relatively low, 46 percent lower than peak prices in 2008 — although still twice their average level between 2000 and 2007.

Moreover, 2010 was a good crop year for many developing countries — especially in Africa — so that local prices increased by much less than international prices; and local food price indexes rose by an average of 9.7 percent in the 12 months ending December 2010. Of course, much larger increases were observed in some economies with 33 of 80 countries experiencing food price increases of 10 percent or more in 2010.

Simulations suggest that if the June 2011/May

Figure 19 Another poor crop or higher oil prices could push food prices even higher



Source: World Bank.

2012 crop year is of normal size, then internationally traded grain prices should decline in 2012 (significant price relief is unlikely to be observed until towards the end of 2011, as information on harvests becomes clearer). However, if the crop is poor (i.e. 5 percent—or 1 standard deviation—less than normal), then wheat prices could rise by a further 3.5 percent (figure 19).

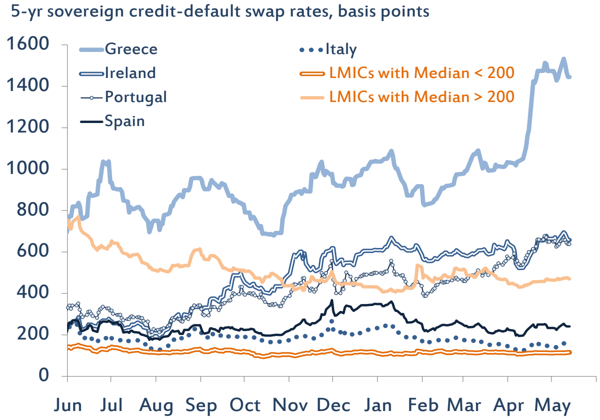
Given the importance of oil and natural gas as inputs to food production, food prices could rise an additional 16 percent should oil prices increase by the $50/bbl outlined in the earlier oil price scenario.

Persistent euro-area uncertainty, and rising high-income country interest rates as monetary stimulus is withdrawn, could reveal further weaknesses in the global economy.

The fiscal situation in high-income countries continues to concern markets. Despite recently announced and anticipated spending cuts, fiscal policy in the United States remains loose due to tax measures introduced or extended in December 2010. The Congressional Budget Office (2011) projects a U.S. federal deficit of 9.8 percent of GDP in fiscal year 2011 based on current policies, and a debt-to-GDP ratio that could climb to 77 percent of GDP by 2021, from its current 62 percent of GDP level. In Japan, the fiscal deficit is expected to exceed 11 percent of GDP in 2011 and gross debt to exceed 230 percent.

Figure 20 Renewed pressure on high-income country debt

5-yr sovereign credit-default swap rates, basis points



Source: World Bank, Thomson/Datastream..

At the same time in Europe, despite substantial steps to reduce deficits in several countries, and the multiple financial rescue-packages brought to bear, markets remain concerned that one or more Euro Area economies might have to restructure its debt. The price of ensuring against default of the sovereign debt of Greece has surged to record highs for the Euro Area, and credit default swap rates for Ireland and Portugal have also given up earlier declines (figure 20). Even the risk premium for traditional "safe haven countries" such as the United Kingdom and Germany have edged upwards.

For developing countries, the situation in Europe is of concern because a serious deterioration in financial and economic conditions could weaken demand for developing country exports. In addition, banks could be forced to reduce credit growth, or even repatriate funds from foreign affiliates — with more direct impacts on credit and economic growth in developing countries—notably in Europe and Central Asia.

A restructuring of the sovereign debt of one or more European countries could adversely affect the capital of some Euro-area banks. Data from the Bank for International Settlements (BIS) suggests that the sovereign debt of Greece, Ireland, Portugal and Spain held by Euro-area banks may represent more than 20 percent of the tier-1 capital of euro area banks. If a restructuring caused capital adequacy ratios to fall below regulatory thresholds, this could have

Table 4 Results of ECB stress test

	2011	2012
Euro Area	-2.0	-2.0
European Union	-2.1	-2.0
Russia	-2.0	-1.3
China	-1.0	-0.1
Rest of Asia	-1.4	-0.1
Brazil	-2.1	-0.1
Mexico	-2.0	-0.5
Rest of Latin America	-2.0	-0.7
Non-EU, Rest of the World	-1.5	-0.3

Source: ECB (2011).

wider implications, given the extensive cross-holdings between banks globally. In such a scenario, European banks (but potentially other banks as well) could be forced to re-consolidate balance sheet in a second round.

In such scenario, banks might be compelled to draw on resources of affiliates and subsidiaries in developing countries (mainly in Europe & Central Asia and Latin America & the Caribbean), with negative effects on lending and activity in those regions that extend beyond the pure trade impacts of a slowing in European growth.

Table 4 reports the results of an ECB simulation[13] where an increase in risk aversion and an ensuing decline in investor and business confidence cuts into European growth by around 2 percentage points, and generates similar impacts on GDP in many developing countries as a result of reduced exports and increased financial costs from increased risk premia and falling asset values.

While authorities are taking steps to ensure against a negative outcome, these persistent risks are a reminder that the global economy has yet to fully recover from the excesses of the pre-crisis financial boom.

Indeed, additional problems and issues may not have been revealed as yet. The very low long-term interest rates engineered by high-income central banks through both orthodox and extraordinary measures such as quantitative easing, may have allowed some firms and banks to survive and prosper in some cases, even if not all underlying structural problems have been resolved. As central banks stop intervening in Treasury-, mortgage- and corporate bond markets and stricter financial regulations kick-in, long-term interest rates are expected to rise, increasing financing costs. Such higher costs may expose vulnerabilities that until now have remained hidden.

Moreover, as outlined in the January edition of *Global Economic Prospects* 2010 (World Bank, 2010), higher long-term rates may be associated with a temporary slowing of trend growth rates in developing countries, as higher borrowing costs are reflected in a less capital-intensive growth path—an effect that is incorporated into the baseline forecast.

Concluding remarks

The recovery from the unprecedented global recession that followed the September 2008 financial crisis has gathered strength, and, despite significant tensions and hurdles ahead, appears likely to continue to mature over the coming three years.

While the dynamic of recovery appears well established and has spread from developing countries to high-income economies, significant challenges and risks remain. Strong growth in developing countries, coupled with political tensions in oil producing regions have once again pushed oil prices to levels where further increases could significantly curb economic growth. Monetary policy has responded, but fiscal and exchange-rate policy may need to play a bigger role if inflationary pressures are to be contained.

High oil prices have contributed to high food prices, with important negative consequences for real incomes of the urban poor. So far, the worst of these impacts has been avoided because domestic food prices in developing countries have not increased as much as international food prices. But if the 2011/12 crop year disappoints, as did the 2008/09 and 2010/11 years, then pressures on the incomes and nutrition of poor families can be expected to intensify.

The maturation of the cycle, and the gradual withdrawal of the extraordinary measures put in place to prevent a collapse of the global economy, suggest that both short- and long-term interest rates will rise. As they do, they are likely to increase pressure on governments, firms- and bank finances, potentially revealing weaknesses that have remained hidden, given the ready availability of cheap money. Should some of these weaknesses emerge in economically sensitive corners of the global economy, they could bring serious consequences.

Notes

1. Global export volumes regained pre-crisis levels, and stood 2.4 percent above pre-crisis peaks as of February 2011. This has largely reflected strong gains by developing countries where merchandise exports stood 9 points above pre-crisis peaks in February. High-income economies regained August 2008 levels in December 2010, and exports are now on par with pre-crisis peaks.
2. See World Bank (2011a) for a description of the methodology used to estimate "no-crisis" levels of activity. Note that these capacity utilization rates are statistically derived and will differ from officially published sources. They refer only to industrial production and are distinct from the similar but "whole-economy" output gap.
3. Grains are the most important source of calories in the diet of the poor, providing between 80 and 90 percent of calories.
4. An additional 0.1mb/d of oil production was shut in March due to unrest and strikes in Yemen, Oman, Gabon and Côte d'Ivoire, but market anxiety attaches the possibility of larger disruptions to major oil producing countries, including Nigeria in the run-up to elections in April (about 1mb/d was disrupted during the 2007 election campaign).
5. IMF (2011) argues that loose monetary policy may have contributed to these conditions by lowering interest rates and thereby reducing the cost of warehousing stocks to facilitate speculation when future prices are higher than spot prices.
6. Stock to-use ratios in major exporting economies are used here to control for distortions caused by large fluctuations in recent years in the stocks of major producing/consuming countries, but which do not participate in global commodity markets.
7. Not all of the food content of maize and sugar used in biofuel production is lost. About 1/3 of maize that is used in biofuel production is returned to the food cycle as feed grain.
8. Relative valuation measures (price-earnings, price-to-book, price -to-sales, and dividend yield) in developing countries had been trading at a substantial discount relative to high-income countries during 2009 and part of 2010. However, the discount vanished by the third quarter of 2010, when developing countries even traded at a small premium over high-income countries. Since then, the pace of initial and secondary public offerings in developing countries (and their take-up by high-income investors) has eased. In addition developing country stock markets have stabilized.
9. New data for China suggest that the decline in FDI in 2009 was less pronounced (37 percent) than earlier thought, and that the rebound in 2010 was somewhat stronger (25 percent).
10. The IMF in its latest World Economic Outlook (2011) projects that global imbalances will rise somewhat over their projection period, both reflecting an assumed nominal depreciation of the renmimbi viz-a-viz the dollar and a significant pickup in Chinese exports as output gaps in high-income countries decline.
11. For example, the Chinese Central Bank has raised its reserve requirements eight times since November 2010.
12. In the World Bank, Global Simulation Model (GSM), the initial effect of an oil price shock mainly impacts on the system as a terms of trade shock. For oil exporting countries, there is a gain in real income, as prices of merchandise exports rise. The impact is strongest in counties where oil exports represents a large share of GDP (for example in Angola and Nigeria), and where import propensities are relatively low. Among oil exporting countries, the import propensity is significantly higher in Vietnam and Papua New Guinea, than in Gabon and Venezuela, RB - thereby reducing the net GDP impact in the latter for a similar size

income gain.

In high-income oil exporting countries, the overall GDP impact is negative due to negative impacts in Canada and the UK, whose non-oil exports are negatively affected by slowing global demand. Excluding these two countries, the impact on the remained of the high-income oil exporting countries is positive, due to their high import intensities. A similar factor explains the negative impact for East Asia and Pacific oil exporters as the negative impact on Malaysian non-oil exports overwhelms the positive impact of higher oil revenues on Malaysian GDP (excluding Malaysia, the net impact is positive).

13. The ECB scenario assumes a spike in risk premia on European sovereign debt, higher short-term and long-term interest rates, and a reduction in European business and consumer confidence

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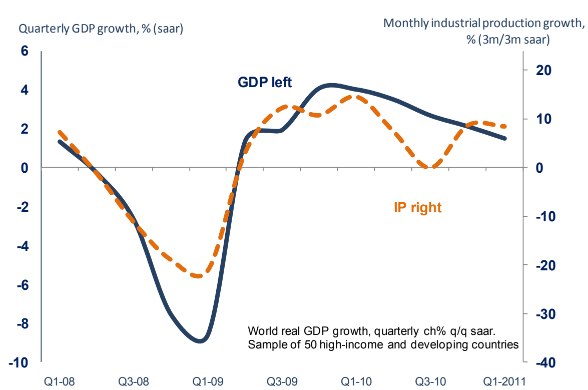
Industrial Production Annex

Global industrial production has rebounded in the fourth quarter of 2010 following the pause in global growth in the third quarter, only to moderate again by the end of the first quarter of 2011. The growth slowdown in the third quarter appears to have mainly reflected an inventory cycle, as underlying demand growth (proxied by GDP) continued to expand at a more-than 1.5 percent annualized rate (figure IP.1). In developing countries output accelerated beginning in the fourth quarter of 2010, and by the end of the first quarter of 2011, industrial activity in developing countries was expanding at a 13.4 percent annualized pace. In high-income countries industrial production growth decelerated sharply to 6.4 percent in the three month to March, from 15.3 percent in the three months to February, on account of a sharp 15.5 percent month-on-month decline in Japanese industrial production in March. Excluding Japan, growth in high-income countries was 7.9 percent in the three months to March, up from 6.7 percent in the fourth quarter of 2010.

The acceleration in the seasonally adjusted annualized rate of growth in developing countries was broadly-based, with the strongest pace recorded among countries in the East Asia and Pacific (18.7 percent in March before easing to 15 percent in April), and Latin America and the Caribbean (10.3 percent). Growth in industrial production in Europe and Central Asia regions was 9.8 percent in the three months to March before decelerating to 3.8 percent by April, while production rose to 8.7 percent in South Asia in the three months to March, and to 6.8 percent in the three months to February in the 4 Sub-Saharan African countries reporting data.

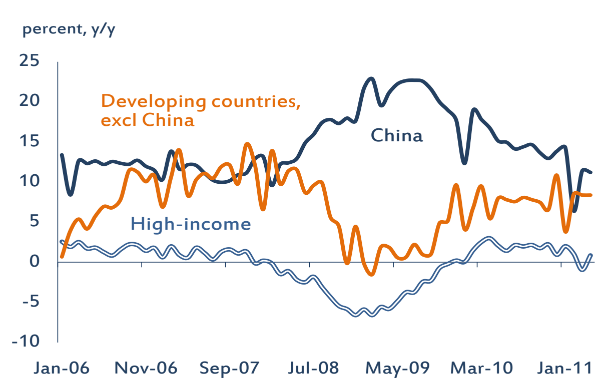
The good performance in industrial production has been underpinned by buoyant domestic demand in developing countries and a moderate recovery in high-income consumer spending. Slowly improving labor markets in several high-income countries have contributed to a return to solid retail sales volume growth. At the same time, the expiration of various incentive programs in both high-income and developing countries has contributed to volatility. For example, Chinese retail sales volumes growth slowed to 11.4 percent by March 2011 from 17.8 percent a year earlier, in part because of the expiry of new-car sales tax incentives. Nonetheless, global retail sales has posted positive annual growth for the last two years, with gains in developing countries (in a range of 7 to 15 percent annualized) while growth in high -income countries remained subdued (figure

Figure IP.1 Recent rebound in Industrial production following mid-year pause reflects inventory cycle



Source: Thomson/Reuters Datastream; World Bank.

Figure IP.2 Retail sales support growth



Source: Thomson Datastream and World Bank.

IP.2).

Many economies are now close to their pre-crisis peaks in industrial production, with emerging economies faring better than high-income countries (first panel, figure IP.3a). Industrial production in China is now more than 40 percent above its pre-crisis peak, and 36 percent higher for the East Asia region considered as a whole. Production in South Asia continues to grow strongly, and stands 21.4 percent higher than before the crisis peak, while Latin America and the Caribbean, Europe and Central Asia, and the Middle East and North Africa have yet to exceed earlier peaks levels.

Manufacturing capacity is now close to or above trend levels in East Asia & Pacific, Latin America and South Asia. In these regions the recovery has entered a new more mature phase where additional investment in productive capacity will be necessary to sustain growth ahead. Ample spare capacity remains in Europe & Central Asia and the Middle East & North Africa, with gaps estimated to be 14 percent and around 12 percent respectively. Spare capacity for the four countries in Sub-Saharan Africa for which data is available is also large at 9.2 percent (second panel, figure IP.3b).

To date only limited data (through February) are available for industrial production in the Middle-East and North Africa region. In Tunisia industrial production reportedly dropped 9.2 percent in the first quarter of 2011 over the same period of 2010, and on a seasonally adjusted annualized basis, output contracted 38 percent. In Egypt industrial production was down 8.3 percent year-on-year in the first two months of 2011, and 51.5 percent on a seasonally adjusted annualized rate relative to the previous two months. Industrial production is likely to begin to recover only modestly in following months.

Accounting for the impact of the Japanese Earthquake, Tsunami and nuclear crisis

The earthquake and Tsunami in Japan have also disrupted global industrial production. Current estimates suggest that damage from the Tohoku earthquake and Tsunami is significantly larger than that sustained following the Kobe earthquake in 1995. The impact of the Kobe earthquake on Japanese and global economic activity was relatively modest (a one-month decline of 1.6 percent in Japanese industrial production and of 8.4 percent in exports—followed by a 14 percent increase—and no discernible effect on quarterly GDP). If anything, the boost to private and public investment associated with the reconstruction effort was a net positive for GDP growth (table IP.1).

The current crisis is different because of the much larger disruption to Japan's electrical

Figure IP.3a Most countries are yet to reach their pre-crisis industrial production peak

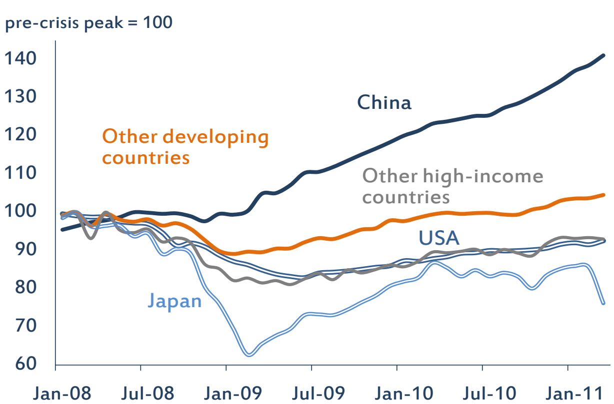
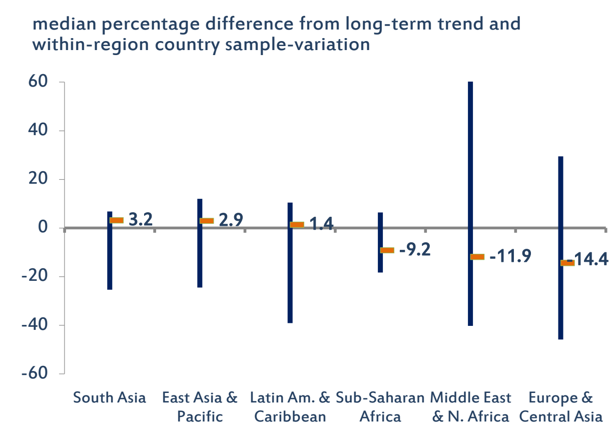


Figure IP.3b Industrial capacity utilization in Asia and Latin America approaches trend rates



Source: Thomson Datastream and World Bank.

Table IP.1 Impacts of the 1995 Kobe and 2011 Tohoku earthquakes

	Kobe	Tohoku
	17-Jan-95	11-Mar-11
Dimension of tragedy		
- size of tremor (Richter scale)	7.3	9.0
- Lives lost	6434	14,435
- Missing		11,601
- people left homeless	300000	450000
- Estimated Property Damage (% of GDP)	2.5	4-5
- Initial disruption to power system (% of generating capacity)		7.3
- Medium-term disruption to power system (% gen. cap.)		3.8

Source: World Bank; Various press reports and official estimates.

generating and distribution capacity, which has forced Japanese utilities to institute rolling blackouts that have contributed to plant shutdowns. About ½ of the disruption to electrical generating capacity concerns geothermic generating capacity and is expected to be fully restored in May, while lost nuclear capacity may be permanent. Currently, generating capacity in the Tokyo area, which represents about 40 percent of Japanese GDP, exceeds demand levels by almost 30 percent—partly because of voluntary conservation efforts. At the peak of the crisis capacity was reduced by 40 percent. TEPCO now expects to have 52m KW hours of capacity in place by the end of July, approximately 84 percent of peak summer demand. For Japan as a whole, the projected shortfall represents 3.8 percent of generating capacity.

March data suggest that the economic impact of the earthquake and tsunami was larger than initially expected. Industrial production declined a sharp 15.5 percent in March, retail sales contracted an annual 8.5 percent, and machinery and business equipment sales plunged 17 percent, while overall GDP declined 3.7 percent (saar) in Q1.

After having declined 6.5 points in March to 46.5 the all-industry PMI plunged further in April to 35 suggesting a sharp decline in output. This reflects port closures, supply-chain disruptions and suspended production at major plants due to uncertain electricity supply—affecting exports of automobiles, electronics, and other industrial products. The disaster and repeated large aftershocks appear to have cut into the demand side as well. Partly out of solidarity for those most immediately affected by the crisis, many Japanese have cut back on consumer demand (including electrical demand). Japanese auto sales declined 30 percent immediately following the quake, and output was down 49.2 percent month-on-month in March. Disruptions in the auto industry are expected to last until the end of the second quarter, and could result in a halving of output.

The disruption to industrial production has been deep, but is likely to be relatively short-lived. GDP is expected to decline in the second quarter due to damaged infrastructure, closure of major industrial plants, disruptions in energy supply, shortages, and consumer restraint, before bouncing back strongly in the third and fourth quarters, as reconstruction efforts start (see main text). The all-industry PMI has increased to 46 in May, suggesting a rebound in industrial output from a very low base. Japanese output is expected to pick up in H2 2011 (the Tankan survey showed improved business sentiment for May after a plunge in April). Nevertheless, activity for the year will be flat, according to the latest Consensus forecast.

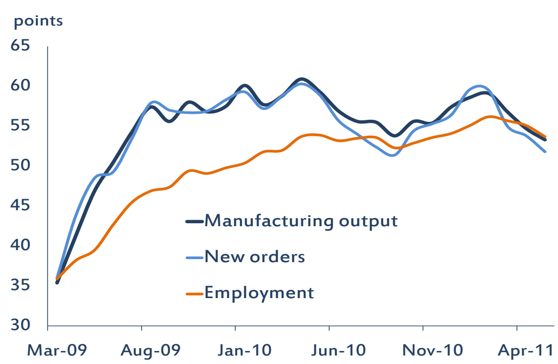
International impacts are limited so far but sectoral impacts are being felt. In the U.S., difficulties in securing parts caused total motor vehicle production to decline 12.2 percent month-on-month in April. A sharp decline in activity would be expected to have an important impact on Japan's main trading partners, both as Japan-sourced supplies become scarce and as demand from Japan declines. Emerging Asia will be the region most affected by the loss in economic activity in Japan, as these countries trade heavily with Japan and depend heavily on manufacturing. The most affected economies will be the ASEAN countries, followed by Korea and Taiwan, China. China and India will also be affected but less intensely (indeed, following the quake, China's purchasing manager index actually improved –reflecting domestic conditions).

Outlook

Both manufacturing and services purchasing manager indexes[1] (PMIs) have been rising strongly at the beginning of 2011, but have weakened starting in March reflecting, we believe, temporary and one-off factors, including the developments in Japan and weaker than expected growth in the United States. The lower PMI readings suggest that industrial production growth will ease markedly in the current quarter before reaccelerating in the second half of 2011, on account of reconstruction efforts in Japan and a lift from lower oil prices. More importantly, outside Japan industrial production is expected to grow at an above-trend pace, albeit decelerating.

The sharp retreat in global PMI in March and April to its lowest level since July 2009 comes after very strong readings in January and February. Global PMI outside Japan has also declined, down 4 points to 54.1 by May, a reading still consistent with near-trend growth. The global new orders component excluding Japan fell an even sharper 4.7 points in April, but inched up 0.5 points in May. Most components of the global manufacturing index declined, and the employment index is now higher than both the new orders and output components. The services PMI indexes have also declined sharply to 51 in April, after having surged to 59.2 by February but has picked up again in May to 52.5 (figure IP.4).

Figure IP.4 Global manufacturing PMI points to deceleration in the broad global recovery



Source: JPMorgan.

Industrial production in the euro area is expected to perform well, supported by strengthening consumer spending, robust business confidence and accommodative monetary policy. Nevertheless growth is expected to ease this quarter, as indicated by recent PMI readings, reflecting a slowdown in global trade expansion, the effects of a stronger euro, and fiscal austerity measures, and debt concerns among some members. Industrial output is expected to expand at a rate close to 5 percent in the second half of 2011, before easing to a more trend-like pace in the outer years of the forecast horizon.

Among developing countries the latest PMI readings suggest robust growth in manufacturing output in India and South Africa, with more moderate growth in Russia, Turkey, China, and Brazil.

Although industrial production growth is projected to surge in Japan during the second half of the year due to reconstruction efforts, elsewhere food and fuel inflation is cutting into real incomes and is expected to contribute to an easing in consumer demand growth and a slowing of the industrial expansion. These influences are already observable in recent data. The annualized pace of real retail sales growth in the United States slowed to 5.2 percent in the first quarter of 2011 from 9.6 percent in the fourth quarter of 2010.

Risks to the outlook

The overall outlook is subject to significant risks, notably the possibility that the situation in the Middle East and North Africa deteriorates, causing oil prices to remain high or rise even further. In this scenario rising input costs and weaker consumer spending would likely lead to weaker growth in industrial output in most developing and high-income economies.

Growing capacity utilization ratios in many developing countries may also restrict growth, especially if inflationary pressures become more marked – forcing an even more pronounced tightening of monetary and fiscal policies moving into 2012.

Finally, though the disruptive capital inflows to several middle-income developing countries have eased, they could return in force – potentially resulting in further appreciation of currencies and additional reductions to competitiveness (and therefore growth) of industry in these countries.

Notes

1. J.P.Morgan, *Global All-industry PMI,* May 2011 survey.

Trade Annex

The outlook for global trade

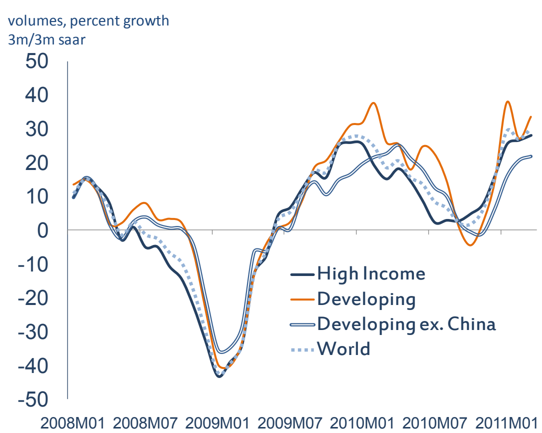
International trade has been volatile during the current recovery, reflecting the wider inventory cycle in global industrial production (see Main text and Industrial Production annex). The recovery in trade has been dominated by strong import demand from developing countries, which has accounted for more than half of the increase in global imports. As the recovery matures, support for trade is shifting from temporary factors (government stimulus and re-stocking of inventories) to more sustainable drivers, notably a rebound in private sector spending on capital goods and consumer durables. Looking forward, world trade is expected to continue expanding at close to 8 percent annual pace, above average in historical context.

Trade volumes are surging again. After a blistering pace of growth in the first half of 2010, global trade growth ground to a halt in the third quarter, only to pick-up again strongly in the fourth quarter. By March 2011 (latest data), global merchandise trade volumes were expanding at a 30 percent annualized rate (3m/3m, saar), the fastest pace in over a decade (figure Trade.1).

The rapid pace of trade growth partly reflects the depth of the decline observed during the recession. Despite faster growth rates, trade volumes regained pre-crisis peak levels 32 months after the crisis, something achieved in only 16 months following the previous major slump in world trade in 2001 (figure Trade.2). As of March 2011, global trade was 8.9 percent above its pre-crisis peak, compared with 10.6 percent higher at the same stage in the previous recovery. And in spite of recovery, global trade volumes remain below trend levels (the level of trade would have been if the crisis did not occur and trade grew at its pre-boom average), though developing countries have regained their trend levels.

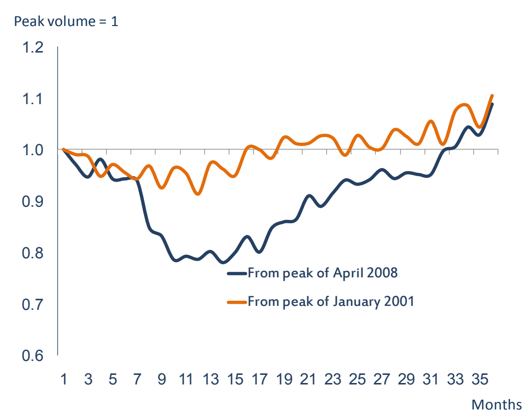
Developing country demand is at the heart of the recovery in global trade. Import demand from developing countries was responsible for more than half of the growth of global trade during the first half of 2010, and again during the fourth quarter of 2010 and the first quarter of 2011. Like other regions (with the exception of the United States) developing countries' support petered out in Q3-2010, but then rose strongly in the fourth quarter (while U.S. imports declined).

Figure Trade.1 After decelerating in Q3, the trade recovery has gathered pace again



Source: World Bank.

Figure Trade.2 Recovery in current crisis lags behind previous crisis



Source: World Bank.

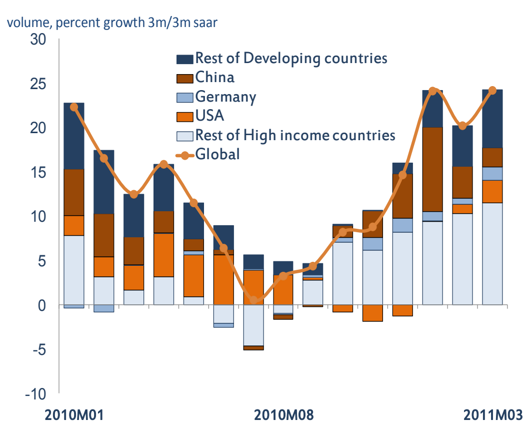
For the first quarter of 2011, developing countries accounted for nearly 50 percent (of which China's contribution alone was 25 percentage points) of the increase in global import demand (figure Trade.3).

Developing country export performance has shown considerable heterogeneity. Trade volume growth in Asia has been extremely rapid. Buoyed by strong growth in Pakistan and India, the annualized pace of export growth in South Asia reached a record 81.7 percent (3m/3m, saar) in February 2011 and moderated to 74.9 percent in March 2011 (figure Trade.4). Spurred by strong performance in China, export volumes in East Asia and the Pacific expanded at a 64.0 percent annualized pace in the 3 months to January 2011 and moderating to 45 percent in March 2011. Strong exports in Russia drove volume growth in Europe and Central Asia to an eight month peak of 15.5 percent (3m/3m saar) by March 2011. And reflecting exchange rate appreciation, export growth in the Latin America and Caribbean region lags other developing regions, having expanded at a 12.2 percent annualized rate in the three months ending March 2011.

The recovery in the dollar value of exports is less advanced than that of volumes. Notwithstanding the sharp rise in the price of commodities in recent months, the dollar value of exports has not recovered as far as volumes, because many prices remain below their pre-crisis peaks of 2008. As of January 2011, global exports were 6.3 percent above their pre-crisis peak in volume terms, but remained 5.7 percent below earlier highs in dollar terms. Nevertheless, price developments have favored commodity exporters, in particular oil. metals and mineral exporters. For example, the terms of trade improvement for oil exporters in Europe and Central Asia amounted to about 1.8 percent of GDP, compared with a deterioration of 1.1 percent for oil importers in the same region (figure Trade.5).

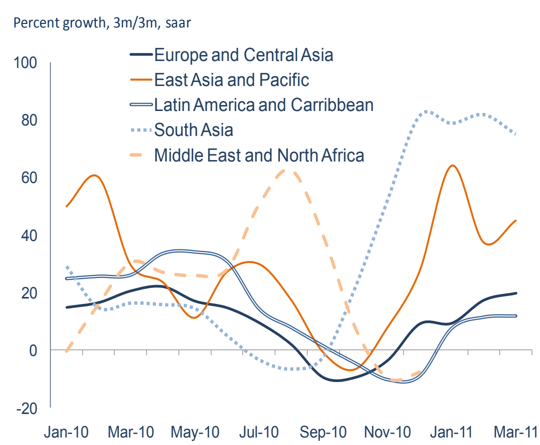
World trade growth is on more solid footing. Capital goods exports have continued to strengthen as the recovery matures, a sign of the increasingly self-sustaining nature of the recovery (figure Trade.6). During the recession, capital goods imports fell by more than imports of consumer durables and agricultural products (although less than oil imports), as falling demand and increasing uncertainty led businesses to cut investment and run down stocks. During the initial phases of the recovery, growth in capital goods imports was driven by massive government stimulus programs (most of which had a heavy infrastructure component) as well as a need for businesses to replenish their

Figure Trade.3 Contributions to global import demand from selected regions and countries



Source: World Bank.

Figure Trade.4 South Asia leads in second phase rebound in global trade

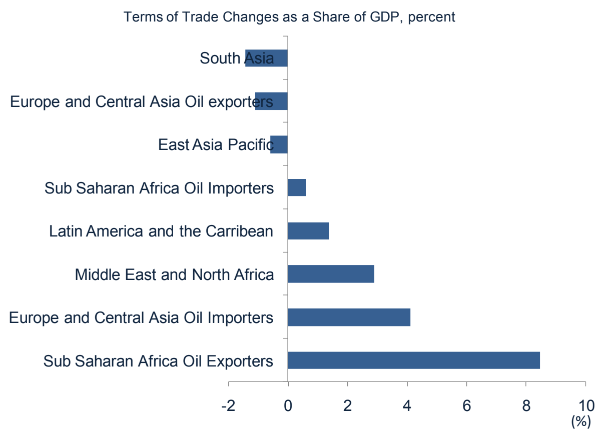


Source: World Bank.

stocks. Since that time, these temporary factors have waned, and imports of capital goods by businesses surged in the fourth quarter of 2010. In the United States, for example, business spending on equipment and software rose at a 7.7 percent annualized pace in the fourth quarter – although it eased to just 1.8 percent growth in the first quarter of 2011.

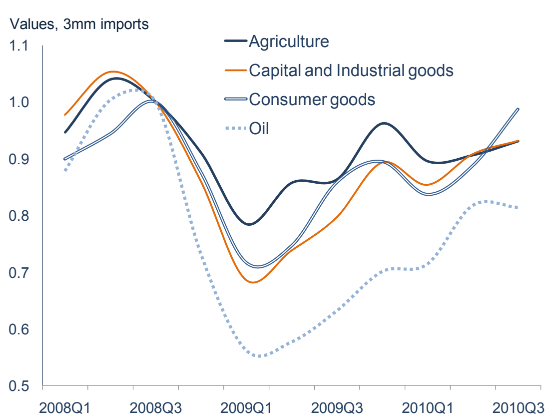
Recently, slowly improving labor market conditions in high income countries have boosted consumer goods imports, with trade in these goods exceeding that of capital goods. Consumer goods imports are now 4.6 percent

Figure Trade.5 The Recovery in Prices has Favored Oil Exporters



Source: World Bank.

Figure Trade.6 Strong recovery in capital goods imports but still below pre-crisis levels



Source: World Bank.

higher than their pre-crisis peak levels, while capital goods imports remain 11.5 percent below pre-crisis peak levels, partly reflecting the much deeper trough they experienced (capital good demand declined 35 percent during the crisis).

The global recovery also is becoming more broadly based. High-income country exports are now growing rapidly, though, consistent with lower potential growth rates, not as quickly as among developing countries. By March 2011 export volumes for high-income countries were increasing at a 28.1 percent (3m/3m, saar) rate, up from the 2.7 percent (3m/3m, saar) in July 2010. In contrast, developing countries' export volumes advanced at 33.4 percent (3m/3m, saar) in March 2011, compared to a decline of 4.6 percent (3m/3m, saar) in September 2010.

Outlook and Risks

Global trade is expected to continue to grow as the recovery matures. Though a moderation of growth from the high first quarter figures is in order, the expansion in global trade is projected to remain above pre-crisis averages over the forecast period. Overall, global merchandise trade is anticipated to grow at about an average of 7.6 percent over the forecast horizon (2011-2013). Developing countries, which were at the forefront of the global trade revival, will continue to be important sources of demand. However, with improvements in high-income country labor markets, ongoing lax monetary policy, and a rise in business and consumer confidence, demand from high income countries is expected to provide increasing support to global trade growth.

Recent business surveys support the view that global trade will continue to expand, at least for the near term. Though the Global Purchasing Manager's Index, as reported by JP Morgan and Markit, has fallen from its peak level in March, it still remained in expansion territory in May, including the sub-index for new export orders. Moreover, the latest OECD Composite leading indicators survey, designed to anticipate turning points in economic activity relative to trend, continues to point to expansion in most OECD countries even if at a lower pace- this should inevitably provide support to further trade growth.

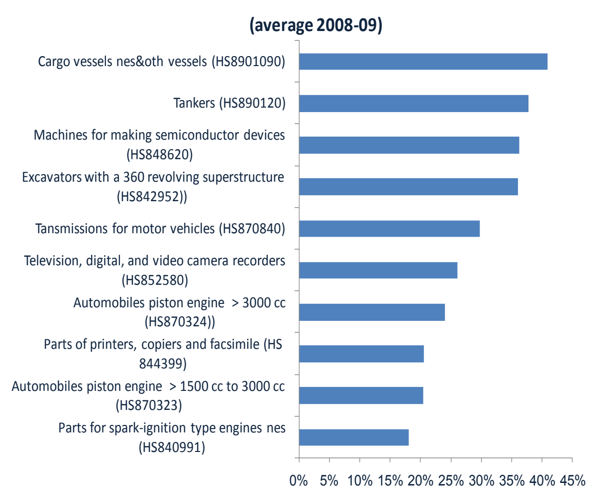
The risk of a faltering in global economic recovery. Nonetheless, significant risks to the continued expansion in global trade remain. The most significant risk is a faltering of the global economic recovery. As outlined in the main text, a key risk to the global recovery is the possibility of higher oil prices – either due to continued uncertainty in the Middle East, or because of a major disruption to supplies. Though this remains a "tail-probability" event, should it occur, it could derail the recovery, since higher oil prices would reduce incomes in oil-importing countries, cutting into consumer and business demand. A further $50/bbl increase in oil prices could shave global GDP by 0.3 percent in 2011 and 1.2 percent in 2012. These could in turn reduce global trade by 0.5-1.5 percent in 2011 and by between 1.9-6.0 percent in 2012. Other risks to the global recovery include a possible slowdown in growth from a tightening of monetary policy in some of the large fast growing developing economies and a resurgence in the euro area sovereign debt crisis (see main text).

Ramifications of the Japan earthquake on global trade. The recent disaster in Japan is another source of concern. Japan's share of global trade is less than 5 percent, so even a recession there is unlikely to derail global trade growth. However, individual countries could be significantly affected. Non-oil exporting countries whose exports to Japan account for a sizeable share of their total exports and GDP, for example Malaysia, Papua New Guinea, Vietnam, Singapore, Thailand and the Philippines, will be most affected. In addition, disruptions in the global supply chain due to the situation in Japan could affect trade in many products, which could have major implications for industry (especially where switching to other suppliers requires significant re-tooling). Against this backdrop, industries whose global supply chains are very much dependent on critical supply of parts from the North East part of Japan (Miyagi prefecture) are likely to be the hardest hit. These could include parts supplies in the semiconductor, auto, camera recorders and office equipment industries (figure Trade.7). Already in the U.S, recent industrial production figures released show that the total motor vehicles assembled dropped from an annual rate of 9.0 million units in March to 7.9 million units in April mainly on account of disruptions to part supplies resulting from the Japan earthquake.

While in the short-run Japanese industrial production and exports are likely to fall, in the medium term reconstruction will require a ramp up in demand for capital goods and for the industrial metals necessary to repair capital stock and build new infrastructure. This new demand from Japan could significantly boost exports from the high-income countries that dominate global exports of capital goods, as well as from developing country metals exporters.

Global Imbalances. The onset of the global crisis accelerated the narrowing of global imbalances that had already begun in 2006. Global imbalances (measured as the absolute value of national current account balances divided by global GDP) peaked at 5.6 percent of global GDP in 2005 and fell to 3.9 percent in 2009 and to an estimated 3.3 percent in 2010. The question is whether this is a short-run change or a structural change brought about by the crisis.

Figure Trade.7 Share of Japan's exports in World exports



Source: Comtrade

The future evolution of global imbalances depends on a constellation of real and financial forces, including exchange rate movements, the extent to which developing country domestic demand remains a major source of growth, and the extent to which high-income countries rein in government deficits and low interest rates as their economies recover. To the extent that surplus countries do not experience real effective appreciations of their exchange rates, and that recovering high-income countries maintain current levels of government dis-saving and low-interest rates, which encourage low private-sector savings rates, the global imbalances that characterized the early 2000s through 2007 could return.

Increased Protectionism. High unemployment rates, global imbalances, and perceptions of exchange rate undervaluation among trading partners puts pressure on governments to take a more protectionist stance on international trade, with the potential to slow the expansion of trade. These pressures have only heightened in the aftermath of the global recession. The WTO reports that between November 2009 and October 2010, new trade restrictive measures covering some 1.2 percent of global imports were introduced.[1] New trade restrictions introduced since the commencement of the crisis in 2008 have affected some 1.9 percent of total trade. Though some of the measures were meant to be temporary, so far only 15 percent of the measures introduced have been removed. Most of the measures that have been introduced affect trade in base metals and products, machinery and mechanical appliances, and transport equipment, all of which are important in helping to rebuild productive capacity to help sustain the recovery. Further, Bown and others (2010), find that increasingly such measures are being applied within the context of South-South trade.[2] They observe that protectionism has been imposed disproportionately by developing world importers on developing world exporters, notably China. Though the current application of such protectionist measures remains limited, the greater threat lies in the continued accumulation of new restrictions, without repealing earlier temporary ones, thereby leading to an increasing share of trade affected by restrictive measures.

Notes

1. WTO, 2010. Overview of Developments in the International Trading Environment. WT/TPR/OV/13, World Trade Organisation, Geneva.

2. Chad P.Bown and Hiau Looi Kee (2010) “Developing Countries, New Trade Barriers, and the Global Economic Crisis” in Mona Haddad and Ben Shepherd (eds), Managing Openness, The World Bank, Washington, D.C.

Financial Markets Annex

Recent trends in capital flows

International capital flows to developing countries have slowed since October…

Gross capital flows (international bond issuance, cross-border syndicated bank loans and equity placements) to developing countries totaled $175 billion in the first four months of 2011, 24 percent less than the last four months of 2010 (figure FIN.1). Most of the decline was in equity placement (foreign investment in IPOs and follow-on offerings), which plummeted by 35 percent. There have been no major IPOs from developing countries this year, after the record breaking equity issuance of 2010. International syndicated bank-loans remained subdued compared with pre-crisis levels—although there was a modest rebound in lending to Europe and Central Asia (notably, Russia and Turkey) and Sub-Saharan Africa (Nigeria and South Africa).

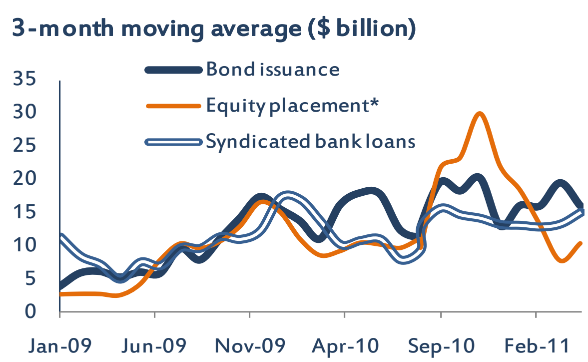
In contrast to equity placement and bank-lending, international bond issuance by developing countries was strong in the first quarter, attaining the highest monthly level on record in January. A combination of relatively favorable pricing conditions and investor's continued search for yield led to a near record pace of borrowing activity. Corporate borrowers continued to dominate bonds with about 80 percent of year-to-date volume, with most issues coming from companies in China, Emerging Europe and Latin America. Chinese companies issued a record volume of international bonds in the first quarter of 2011, partly reacting to the increased cost and rationing of domestic finance following the government's policies to curb credit growth. The pace of issuance has slowed considerably since January, partly reflecting the impact of increased uncertainty in global markets.

…as have the hot money flows, easing some of the pressures for currency appreciation.

Portfolio investment—equity placement, foreign investment in existing stocks and foreign investors' purchase of local debt securities, also referred to as "hot money"—has eased since early 2011 (figure FIN.2). Most of the decline was in equity placements and foreign investment in stock markets, as there were considerable stock-market sell-offs during January and February, aside from the sharp fall in equity placement.

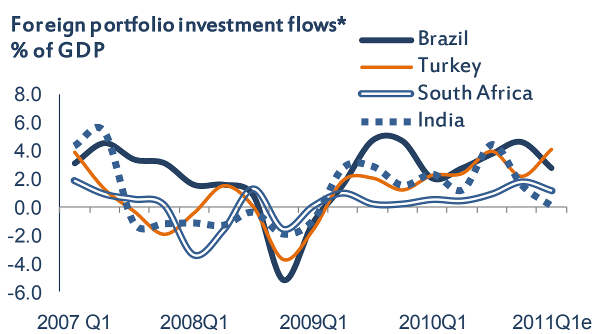
Growing concerns about sovereign debt in high-income countries, inflation, political turmoil in the Middle-East and North Africa, and high

Figure FIN.1 Gross capital flows have eased since November



Source: Dealogic.

Figure FIN.2 Hot money flows slowed down since October



Source: Central Banks and World Bank.

commodity prices have combined to slow the pace of portfolio equity inflows to developing countries. In addition, investors may also have considered that market equity valuations had reached maximum levels and started to take profits. During the first quarter of 2011, there was a net outflow of nearly $25 billion from emerging market (EM) equity funds, compared with a net inflow of $85 billion in 2010. Similarly, foreign investors' interest in emerging market bonds (both in local and other currencies) has also diminished considerably since October 2010 (figure FIN.3). And the EM fixed income funds registered a net outflow in February with a little improvement in March. Most of the decline was in flows to EM local currency funds, which have become quite popular in recent years, and experienced record inflows in 2010 (see box FIN.1: Domestic debt market developments in emerging markets). The outflows from both EM equity and fixed income funds do not necessarily imply a net outflow in terms of balance of payments financing, but highlights the easing in these types of flows to developing countries.

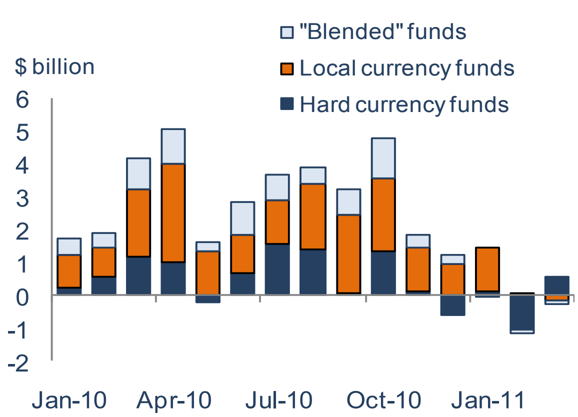
Country specific factors also played an important role in the slowing of capital inflows. South Africa (in November) and Turkey (in December and January) cut their policy interest rates—reducing the attractiveness of the carry-trade with these countries. The impact of the rate cuts turned out to be temporary in Turkey, however. After a slow down, foreign purchases of Turkish local debt securities rose to a record $4.8 billion in March. While Brazil increased the tax on foreign investments twice in October, the fall-off largely reflected at drop in IPO activity following the record sale of Petrobras in September 2010 that attracted large foreign participation.

Several middle income countries experienced sharp appreciation of their currencies in 2010 following the surge in capital inflows. With the easing of these flows during the first quarter of 2011, the upward trend in real effective exchange rates also moderated (Thailand) or even reversed (South Africa and Turkey) (figure FIN.4). Brazil (due to large FDI inflows) and Mexico (flows into local debt securities) did not experience large depreciations. Consistent with the initial slowing of capital inflows, the pace of reserve accumulation among developing countries also slowed from 8 percent in 2010Q3 to 5 percent both in 2010Q4 and 2011Q1.

The fundamental conditions that underpin capital flows to developing countries remain strong…

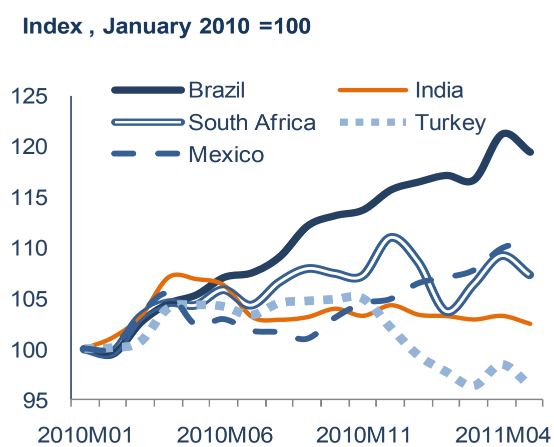
Emerging markets entered 2011 with an improved risk profile, as well as higher growth prospects vis-à-vis the high income countries, and policy interest rates that were rising. Despite some recent increases (the ECB raised its

Figure FIN.3 Inflows to EM fixed income funds have slowed down since October



Source: EPFR Global.

Figure FIN.4 Real effective exchange rate appreciation in selected economies

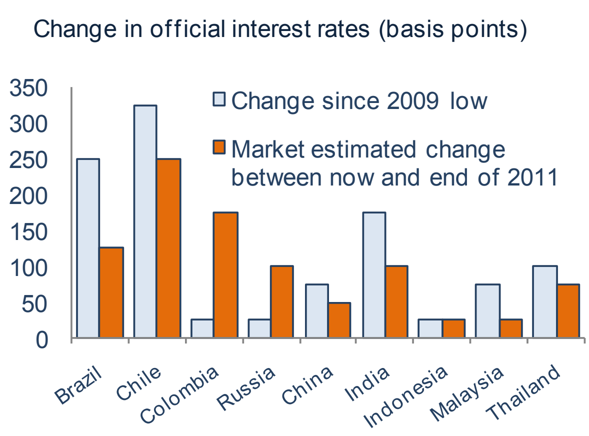


Source: International Monetary Fund.

official rate by 25 basis points (bps) to 2 percent in April 2011), policy interest rates in high-income countries remain low, while those in developing countries are rising. The rates in emerging economies are expected to go up further as these countries tighten monetary policy in the face of heightening inflationary pressures. This will likely increase interest rate differentials in favor of developing country assets—although this effect will be reduced if and when high-income countries begin withdrawing quantitative easing measures and tighten more traditional monetary policy.

Policy interest rates for a number of developing countries have been raised since mid-2009 as strong economic activity has signaled a rapid closing of output gaps and inflation has been moving up. As the inflationary effects of higher oil prices are more evident, policy makers will undoubtedly look toward tightening monetary policy. This is especially likely in Asia and Latin America, where central banks are already grappling with higher inflation amid stronger growth and record food prices. Market-estimated changes in policy rates point to further hikes in official rates for most of emerging market countries this year (figure FIN.5). Rising inflation rates have been pushing real yields down in countries with increasing inflation. Real yields turned negative in several emerging markets, including Russia and Thailand, making local bond less attractive—though yields remain positive in real terms if adjusted for the expectation of currency appreciation.

Figure FIN.5 Accelerating inflation could lead to a further monetary tightening



Source: Bloomberg and World Bank staff calculations.

…and developing countries continue to struggle with mitigating the impact of high capital flows.

In an attempt to limit the high levels of capital inflows and currency appreciation, Turkey reduced its policy interest rate twice in December 2010 (by 50 bps) and later in January 2011 (by 25 bps) bringing the rate to an all time low. While this move surprised the markets and led to portfolio equity outflows in December and January, cross-border flows to local debt markets remained strong. Nevertheless, Turkey's real effective exchange rate eased by 7 percent between December and April 2011. Similarly, South Africa lowered its policy rate by 50 bps on November 13th, with some impact on portfolio investment and the real exchange rate. Both countries will find it difficult to maintain low rates however, as they are facing increasing inflationary pressures.

Other policy responses to mitigate the short-term impacts of hot money flows have included the introduction of capital controls, higher foreign currency reserve requirements for banks, minimum holding periods, or withholding taxes on foreign investment in order to discourage inflows; and improvements in the enforcement of existing restrictions on cross-border inflows. For example, Brazil raised its financial operations (IOF) tax on foreign investment in fixed income securities twice in 2010. The impact of these hikes was limited and short-lived, and they were followed by a further increase in April. Brazil also announced that it will extend the high tax rate on the renewal of foreign loans with maturities of up to a year, while a reintroduction of a 15 percent withholding tax on federal securities is under consideration.

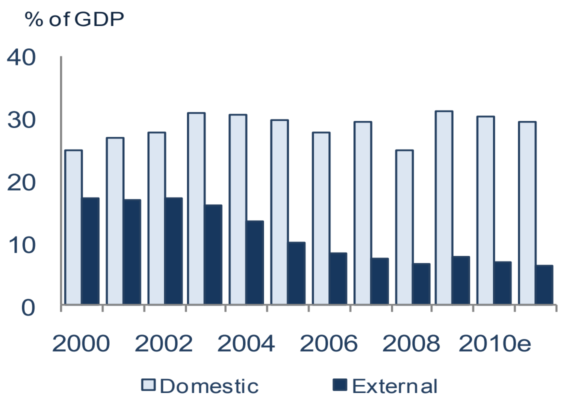
Indonesia imposed a 1-month minimum holding period on central bank money market certificates in July 2010, and introduced new regulations on the net foreign exchange positions of

Box FIN.1. Domestic debt market developments in emerging countries

Domestic debt markets in developing countries have grown markedly over the past decade as many countries shifted from external to local currency financing to lower the volatility of their debt service given their more flexible exchange rate regimes. This shift is particularly true for government bond issuers as domestic public debt now accounts for more than 80 percent of the total public debt for developing countries (box figure FIN.1). In recent years, local-currency bond markets have expanded considerably in several countries—among them Brazil, Colombia, China, India, Malaysia, Mexico, South Africa, and Turkey (World Bank 2009). Growing interest from local investors—particularly from pension funds—has played a key role in the development of domestic debt markets in developing countries.

With extraordinarily easy monetary policy in the high-income countries, international investors are also increasingly drawn to emerging market local currency bonds, with higher yields and prospects of capital gains arising from currency appreciation. As a result inflows to fixed-income funds focusing on developing countries reached a record $65 billion in 2010, with the overall allocation biased toward local currency funds (figure FIN.3 in the text). Despite the recent fall-off, foreign purchases have continued in Latin America, with Mexico posting record $12 billion inflows through March this year.

Box figure FIN.1 External and domestic public debt in developing-countries



Source: JP Morgan.

commercial banks. And Thailand implemented a 15 percent tax on interest income and capital gains earned by foreign investors. And rather than new measures, China announced that it will intensify enforcement of the existing measures on capital inflows.

The IMF published a report in April 2011 providing a framework for managing the impact of high capital flows (IMF, 2011a). The report suggests that, if possible, countries should first respond to higher capital inflows by letting their exchange rates appreciate, easing monetary policy and tightening fiscal policy. If that is not possible, countries are urged to first use controls that do not discriminate between foreign and domestic investors, for example limits on foreign currency borrowing by local banks or minimum holding periods. According to the framework, measures that discriminate against foreign investment, such as taxes on foreign capital inflows imposed by Brazil, should be a last line of defense. At the same time, the report recommends that the use of controls should be proportional to the economic risk, that they should be withdrawn when they are no longer needed; and importantly, that countries should bear in mind the costs of using them.

FDI inflows have gained momentum since the last quarter of 2010...

Foreign Direct Investment (FDI) inflows gained momentum in the last quarter of 2010 (figure FIN.6). FDI flows in early part of 2010 were likely restrained by uncertainty concerning the global recovery. This uncertainty has since eased—especially concerning growth in developing countries—and cross-border mergers and acquisitions (M&A) transactions (which react more quickly to changing economic conditions than greenfield investment) in developing countries accelerated in the second half of the year.

FDI inflows to developing countries increased by 24 percent in 2010, a relatively modest gain (less than the rise in other capital flows to developing countries) considering its 36.5 percent decline in 2009. The rebound in FDI inflows in 2010 was much stronger than the World Bank's January estimate of 15 percent growth (Global Economic Prospects 2011a), mainly because of large revisions by China to its historic and 2010 FDI numbers (box FIN.2). For developing countries excluding China, the rebound in 2010 was slightly above 10 percent.

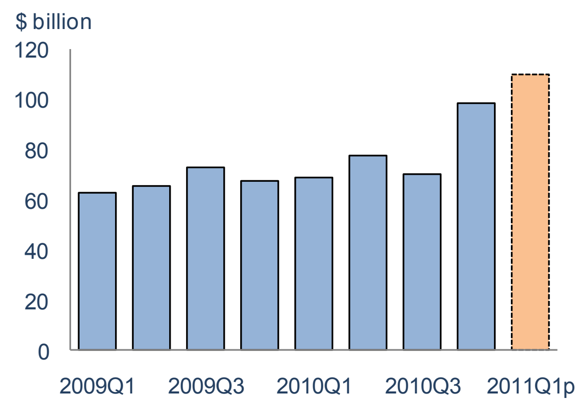
Most of the increase in FDI inflows in 2010 came from higher reinvested earnings. Income generated by FDI projects in developing countries increased 26 percent in 2010, compared to its level in 2009. Multinationals invested 30 percent of this income back into developing country operations in 2010, accounting for 35 percent of FDI inflows. FDI was also supported by increased South-South flows—particularly from Asia. With the sharp decline of FDI outflows from high-income countries since the crisis, investment from other developing countries rose to 34 percent of total inflows in 2010, up from 25 percent in 2007.

Cost of borrowing is on the rise

Long-term yields in developing countries are facing pressures from rising long-term rates in high-income countries…

The implicit yield on emerging market sovereign bonds (EM spread + U.S. 10 year treasury yield) has risen 50 bps since September 2010, mainly due to upward movements in high-income country long-term sovereign yields (figure FIN.7). Long-term interest yields for government bonds rose since early September 2010 in the United States (60 bps), Japan (25 bps) and the European Union (74 bps), reflecting rising government debt, higher inflationary expectations and perhaps reduced demand as the impact and extent of quantitative easing slows.

Figure FIN.6 FDI inflows for selected economies



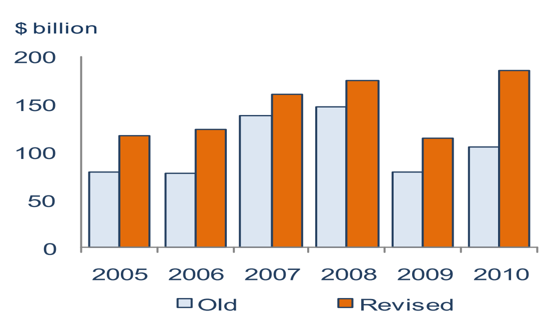
Source: The World Bank.

Box FIN.2 China revised up capital account numbers for 2005-2010.

China's State Administration of Foreign Exchange (SAFE) revised the capital account in their balance of payments report following implementation of a new accounting method. Much of the adjustment is in FDI inflow numbers, which are revised up between 20-75 percent for the period 2005-2010 (see Box figure). SAFE cited better accounting for reinvested earnings by multinationals as the main reason for the upward revision. This portion of FDI does not cross the border, and hence may not be fully recorded in government reports.

According to the new estimates, FDI inflows to China rebounded strongly by 62 percent in 2010, reaching $185 billion. The largest increase was in the financial sector (300 percent) followed by the real estate sector (78 percent), reaching $12 billion and $21 billion, respectively. Nonetheless, the manufacturing sector remains the main recipient of FDI inflows to China. Manufacturing received $70 billion in 2010, 50 percent more than in 2009. With the revisions, China now accounts for 30 percent of total FDI inflows to developing countries, compared to an estimated one-fourth in previous statistics.

Box figure FIN.2 FDI inflows to China



Source: China's State Administration of Foreign Exchange.

Developing country spreads have remained in a tight range despite ongoing geopolitical unrest and economic uncertainties. The events in the Middle East and North Africa region led to a widening in spreads only within the region and among the most affected countries. Credit risk (as reflected in 5-year CDs spreads) for Egypt, Bahrain and Saudi Arabia widened between 50-150 bps immediately after the turmoil in late January and February, but most stabilized in March. Meanwhile, concerns related to the European debt crisis reemerged in early March, when International Credit Rating Agencies downgraded ratings of Greece, Spain and Portugal, citing worries about their ability to reach their fiscal adjustment targets, in some cases linked to political stability concerns. CDs spreads for these economies rose following the downgrades.

While Japanese stocks plummeted following the March 11 earthquake, the impact of the crisis on world financial markets has been limited. Developing countries were little affected by increases in risk aversion owing to the difficulties in Europe and Japan—sovereign bond spreads for the emerging markets as a group remained within a tight range through the end of April 2011 (figure FIN.8).

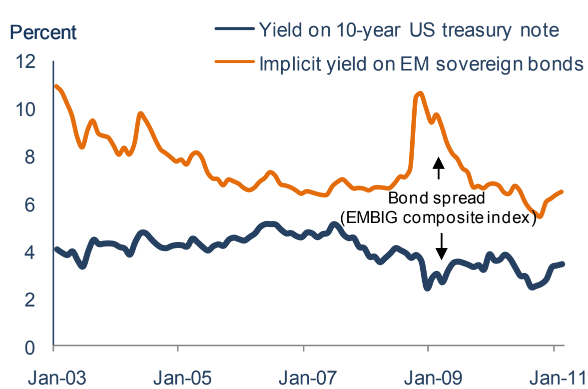
...and are expected to go up further.

Going forward, emerging market yields are expected to increase amid rising long-term yields 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 (Hartelius et al 2008). These easy monetary conditions have suppressed the price of risk in both high-income and developing countries, and prompted a search for yield similar to that observed in the pre-crisis period. Developing country spreads are sensitive to U.S. Treasury yields. A jump in Treasury yields, for example because of a sudden phase-out of quantitative easing, could spark a sharp widening of spreads on emerging market debt. A more gradual policy tightening is likely to result in a more modest and short-lived widening of spreads.

Tighter financial regulation may also contribute to higher long-term interest rates, and will likely increase the cost of capital, potentially hindering trade finance in the medium term.

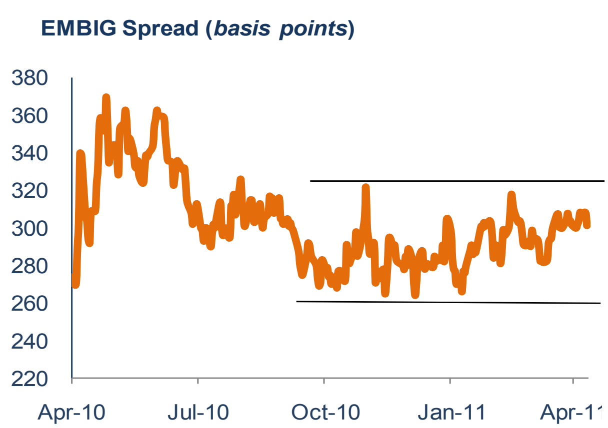
Changes in the financial regulatory landscape that have been implemented, and that are being discussed both at the national and global level, would tend to raise the cost of bank lending and should be reflected in higher long-term interest rates. In the United States, the June 2010 Dodd-Frank bill forbids future government bailouts of banks; places limits on risk-taking by financial institutions, and introduces new clearing and

Figure FIN.7 The implicit yield on EM sovereign bonds is up



Source: JP Morgan.

Figure FIN.8 EMs spreads have remained in a tight range despite the rising geopolitical risk



Source: JP Morgan.

trading requirements for CDS markets. A revised international agreement (Basel III) seeks to strengthen banks' resilience to systemic stresses, by raising capital requirements and imposing stricter definitions of what constitutes bank capital. While the proposals incorporate a generous phase-in period, with capital ratios to be raised gradually, and linear phasing out of ineligible securities between 2013 and 2019, there remains uncertainty related to the implementation of these requirements across countries. The impact of Basel III on trade finance is expected to be significant (box FIN.3 Impact of Basel III: Trade finance may become a casualty).

Higher borrowing costs could reduce both the level and the growth of GDP.

Higher capital costs due to increased long-term interest rates and less abundant capital are likely to cause firms to invest less, which will reduce the amount of capital employed in the economy and lower GDP levels from what they would have been had capital costs remained low. During the transition period from a high capital usage regime to a lower capital usage regime, the rate of growth of potential output in the economy will slow.

Simulations suggest that higher capital costs could lower developing country GDP growth by between 0.2 and 0.7 percentage points over a period of between 3 and 5 years. Global Economic Prospects 2010 estimated that the substitution away from capital intensive techniques would reduce potential output in developing countries over 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 the tightening of global financial conditions through strengthening regional and domestic institutions.

Inefficiency of domestic financial sectors resulting from corruption, weak regulatory institutions, poor protection of property rights, and excessive limits on competition can make borrowing costs in developing countries 1,000 bps higher than in high-income countries. Improvements in the policies and institutions

Box FIN.3. Impact of Basel III: Trade finance may become a casualty

The Basel Committee on Banking Supervision, which sets rules that national banking regulators implement, announced a comprehensive reform package in September 2010 that raises capital requirements and, for the first time, sets global standards for overall borrowing, known as leverage, and liquidity. The "Basel III" rules are designed to make banks more resilient and prevent a repeat of the financial crisis, but several provisions combine to make trade finance, already a low-margin business, much less profitable. Basel III's implementation could have unintended consequences for trade financing through the proposed leverage ratio, which would require banks to set aside 100 percent of capital for any off-balance-sheet trade finance instruments, such as letters of credit. This is five times more than the 20 percent credit conversion ratio used for trade finance in Basel II. New capital regulations would also require banks to set aside capital for one year for any instrument, even though that security may carry a maturity of under a year. Most trade finance instruments have maturities of about 90 days: this would triple the capital cost of such instruments.

Such higher capital requirements are likely to depress trade finance. According to Standard Chartered Bank, the new regulations would lead to trade finance becoming 15 to 37 percent more expensive, with volumes falling by 6 percent—which implies a $270 billion a year reduction in global trade and a 0.5 percent fall in global gross domestic product. Developing countries would be particularly affected by a fall in trade finance. Trade finance is an important source of working capital, particularly for small and medium-sized enterprises. And developing countries rely heavily on international banks for trade finance. In 2010, the largest rebound in capital flows was in short-term debt, which reached $122 billion, and was for the most part trade finance (World Bank 2011).

There is some question as to whether this rise in capital requirements is necessary for trade finance, which is usually collateralized and has low default risk. The International Chamber of Commerce has published a study that examined the trade finance activity of nine global banks from 2005 to 2009, which together arranged 5.2 million transactions accounting for $2.5 trillion. It found that only 1,140 of those transactions defaulted. Of the 2.8 million transactions arranged during the crisis in 2008 and 2009, only 445 defaulted (0.02 percent).

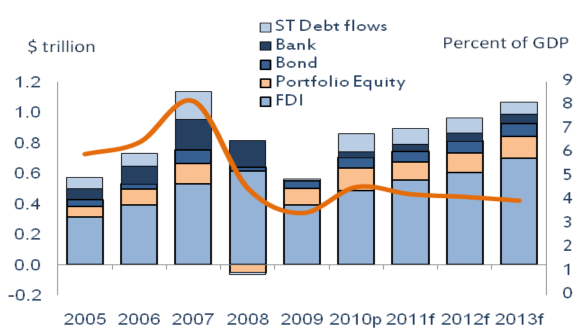
governing the financial sector can thus have a significant impact on domestic borrowing and capital costs in developing countries. Such changes have the potential to outweigh any negative effect of higher costs for internationally sourced capital. Simulations suggest that if developing countries continue to improve policies and other fundamentals, so that their interest spreads fall by an average of 25 bps a year, they would more than offset the long-term effects of the financial crisis—potentially yielding a 13 percent increase in long-term potential output and increases in potential output growth of about 0.3 percent per year by 2020. Developing countries may also further increase domestic savings by following closely their comparative advantages in their industrial upgrading and diversification (Lin 2007).

Prospects

Despite their recent moderation, international capital flows to developing countries are projected to rise further over the forecast period.

Cross-border flows to developing countries are projected to increase further in nominal terms over the medium-term, but at a slightly slower pace than GDP growth, reaching $1.1 trillion (3.8 percent of GDP) by 2013 (figure FIN.9). Much of the increase is expected to be in FDI inflows. FDI inflows to resource rich economies and to developing countries with rapidly expanding domestic markets are expected to recover more firmly in 2011. Bank flows might also rise as the deleveraging cycle has largely

Figure FIN.9 Further increase in capital flows



Source: The World Bank.

come to an end. However, bank lending is expected to remain lower than pre-crisis levels due to approaching regulatory changes.

Other capital inflows that led the initial rebound in 2010 have started to stabilize (or even decline) as the expected monetary tightening in high-income countries and inflationary pressures in emerging markets dampens demand for emerging market assets. Short-term debt and portfolio investment flows in particular, may face considerable weakening or sudden reversals (table FIN.1). When quantitative easing in advanced countries is phased out and global liquidity conditions begin to tighten (or risk aversion rises), developing country local bond markets could be adversely affected, as carry-trade related flows to developing countries slow. Similarly, there may be a contraction in short-term debt flows by 2013 with speculative flows falling, and with trade-related portion hindered by regulatory changes.

Downside risks for the outlook are still considerable, however. First and most immediate is the European debt crisis. While its impact on developing countries has been limited and temporary so far, an unexpected or disorderly resolution of the debt problem might prompt broad-based risk-aversion in global financial markets driving capital flows toward safe-haven assets. This could lead to a sharp reversal in capital flows to developing countries, with a potentially disproportionate impact on countries in developing Europe and Central Asia, whose economies are more closely tied to those in high-income Europe. Second, international capital flows are sensitive to the policy stance in high-income and developing countries. If high-income countries shift toward tighter policy more quickly, or if markets become increasingly concerned by the buildup of debt and central bank liabilities, longer-term interest rates may begin to rise quickly—raising the cost of capital for developing countries and likely weakening flows faster than expected. In fact, a recent IMF study shows that an unanticipated 5 bps rise in U.S. real interest rates might cause a 1/2 percentage point (pp) reduction in net flows (inflows minus outflows) in the first quarter and

1.25 pps cumulative reduction in two years (IMF 2011b). The impact is projected to be larger in countries with higher financial linkages with United States.

With higher oil prices and increased debt-financing requirements, several oil importing economies will remain vulnerable to sudden changes in global markets

Although the impact on credit risk was limited, the events in the Middle East and North Africa resulted in a sharp increase in oil prices. And many oil importing countries now face higher import bills and current account deficits. In addition, developing countries issued international bonds valued at $180 billion in 2010, and entered 2011 with $855 billion in short-term debt. As a result, external financing needs (current account projections and amortization of external debt) for developing countries increased from $0.8 trillion (3.5 percent of GDP) to $0.9 trillion (3.9 percent of GDP).

While international debt market conditions have been robust so far in 2011, high external financing needs make countries vulnerable to

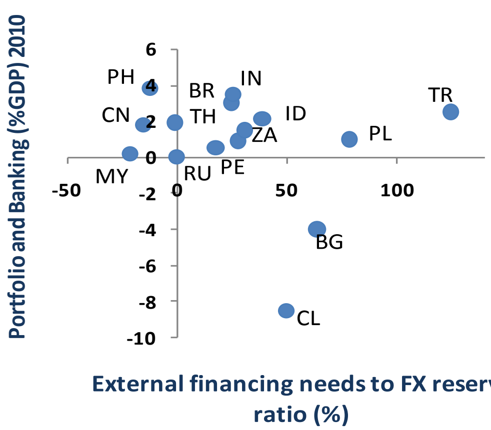
Table FIN.1 Net capital flows to developing countries
$ billions

	2004	2005	2006	2007	2008	2009	2010e	2011f	2012f	2013f
Current account balance	195.2	318.8	450.3	469.1	440.6	284.4	264.5	219.6	159.9	163.1
as % of GDP	2.4	3.3	4.0	3.4	2.6	1.7	1.4	1.0	0.6	0.6
Financial flows:										
Net private and official inflows	342.2	502.9	656.3	1132.1	771.1	633.8	930.2			
Net private inflows (equity+debt)	366.3	567.0	725.9	1132.1	743.3	557.4	857.8	892.7	963.5	1065.3
Net equity inflows	243.6	379.2	497.0	664.9	561.2	498.1	633.2	674.1	733.9	839.8
..Net FDI inflows	206.7	311.7	389.3	529.8	614.4	390.0	485.4	555.0	603.6	696.2
..Net portfolio equity inflows	36.9	67.5	107.7	135.1	-53.2	108.2	147.8	119.1	130.3	143.6
Net debt flows	98.6	123.8	159.3	467.2	209.9	135.6	297.0	218.6	229.6	225.5
..Official creditors	-24.1	-64.0	-69.6	0.0	27.8	76.4	72.4			
....World Bank	2.4	2.7	-0.2	5.2	7.3	17.7	19.3			
....IMF	-14.7	-40.2	-26.7	-5.1	10.0	26.5	16.3			
....Other official	-11.8	-26.6	-42.6	0.0	10.6	32.2	36.8			
..Private creditors	122.7	187.8	228.9	467.2	182.1	59.2	224.6	218.6	229.6	225.5
....Net M-L term debt flows	69.8	113.3	145.0	283.0	196.1	52.8	104.1			
......Bonds	34.3	48.3	31.7	88.2	24.1	51.1	66.5			
......Banks	39.7	70.3	117.9	198.5	176.8	3.2	37.6			
......Other private	-4.1	-5.3	-4.7	-3.7	-4.8	-1.6	0.0			
....Net short-term debt flows	52.9	74.5	83.9	184.2	-14.0	6.4	120.5			
Balancing item /a	-137.5	-406.9	-458.6	-509.5	-733.5	-271.1	-524.4			
Change in reserves (- = increase)	-399.9	-414.8	-647.9	-1091.7	-478.2	-647.0	-670.3			
Memorandum items										
Net FDI outflows	46.1	61.6	130.5	148.7	207.5	153.9	210.0			
Workers' remittances	159.3	191.8	226.3	278.2	325.0	307.6	324.7	348.6	374.5	
As a percent of GDP										
	2004	2005	2006	2007	2008	2009	2010p	2011f	2012f	2013f
Net private and official inflows	4.3	5.3	5.8	8.1	4.6	3.9	4.8			
Net private inflows (equity+debt)	4.6	5.9	6.4	8.1	4.4	3.4	4.4	3.9	3.8	3.8
Net equity inflows	3.0	4.0	4.4	4.8	3.3	3.1	3.3	3.0	2.9	3.0
..Net FDI inflows	2.6	3.3	3.4	3.8	3.7	2.4	2.5	2.4	2.4	2.5
..Net portfolio equity inflows	0.5	0.7	1.0	1.0	-0.3	0.7	0.8	0.5	0.5	0.5
..Private creditors	1.5	2.0	2.0	3.3	1.1	0.4	1.2	1.0	0.9	0.8

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

sudden reversals in capital markets and to a possible increase in borrowing costs. Countries such as Russia, Brazil, Indonesia and Turkey are susceptible to these types of risks (the first three because of high debts, the last because of its high debt and large current account deficit). These risks are further accentuated when a large share of external financing comes in the form of relatively volatile portfolio equity and debt flows (Brazil, Indonesia, and Turkey) (figure FIN.10).

Figure FIN.10 External vulnerability



Source: International Monetary Fund and World Bank.

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Global Commodity Markets Annex

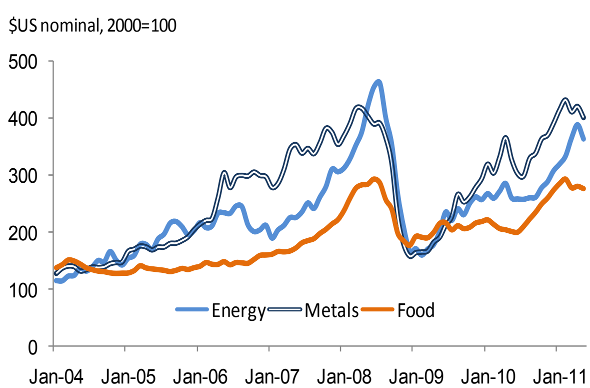
Overview

Commodity prices have surged since their lows during the depth of the financial crisis (figure Comm.1). Since end-2008, energy prices have more- than doubled, but still remain well below their former peaks. Metals prices are up almost 170 percent while agriculture and food prices are 77 and 60 percent higher, respectively.

The 2010/11 spike in commodity markets has been driven by a recovery in demand and numerous supply constraints. Adverse weather (droughts and heavy rains) in many regions has affected several agriculture markets, as well as coal and metals production. Political unrest, mainly in North Africa and the Middle East, has resulted in a loss of oil supply—and fears of further disruptions have pushed oil prices even higher. And in so far as these commodity indexes reflect dollar prices, the depreciation of the dollar has also contributed to their rise. Between July 2010 and April 2011, the dollar has depreciated 12.9 percent against the euro and 7.7 percent against a broader group of trading partners.

Crude oil prices, which were stable during the first three quarters of 2010 (averaging $77/bbl), began to rise as demand growth accelerated and stocks fell late in the year. In 2011, prices rose sharply and exceeded $116/bbl in April following the loss of 1.3mb/d of Libyan oil exports (and smaller losses elsewhere). Fears of further disruptions in major oil producing countries have also underpinned prices. The loss of Libyan light/sweet crude tightened distillate markets, which were further aggravated by the loss of distillate exports from Japan following the earthquake that damaged refineries. OPEC's spare capacity is mainly medium-sour crude, thus the challenge will be to replace light/sweet crude to manufacture sufficient distillate to meet increasingly stringent low-sulfur regulations. Crude oil prices are expected to remain elevated in the near term until product markets are in better balance to meet summer demand, and fears of further crude oil disruptions subside.

Figure Comm.1 Key price indices



Source: World Bank.

Metals and minerals prices recovered sharply in 2009 due to strong demand and restocking in China. While Chinese demand growth slowed in 2010 it was offset by stronger growth elsewhere, mainly in the OECD. By February, prices of metals exceeded their May 2008 peak by 4 percent, with tin and copper reaching all-time highs due to supply constraints. Other metals markets have been less supply constrained, in particular aluminum, where China is a net exporter. Prices are expected to strengthen further in 2011 as demand recovers, notably from China.

Agricultural prices began to rise sharply in mid-2010 due to adverse weather conditions (notably drought conditions in Central Europe which saw Russia's wheat crop decline by 25 percent), and in the case of raw materials, strong demand. High energy prices have also played a role, both by diverting agricultural land to biofuel production, but also as higher fuel and fertilizer prices pushed up production costs.

Overall, agricultural prices increased 45 percent between June 2010 and February 2011 and as of May 2011, they were 6.4 percent above their June 2008 peak. By May, raw materials prices were 33 percent above their 2008 peak due to record high prices for cotton and rubber on strong demand and supply shortfalls. Beverage prices were almost 30 percent above peaks owing to weather-related shortages of Arabica coffee supplies and political disruption of cocoa supplies in Côte d'Ivoire. High sugar prices have pushed the "other" food category to 12 percent above its earlier peak. Grains and edible oils prices remain below their former peaks on improving supply conditions for many of these commodities, although stocks remain relatively low.

Most commodity prices are set to remain high in 2011 and to weaken only modestly through to 2013, reflecting continued robust demand, low stocks and ongoing supply constraints in some cases. Crude oil prices are expected to average $107/bbl in 2011 and weaken slightly over 2012-13, assuming that political unrest in North Africa and the Middle East is contained. Metals prices are expected to rise by 20 percent in 2011 on persistently strong demand, led by China, and weak supply response for some metals, notably copper and tin. Food prices in 2011 are expected to average 20 percent above 2010 levels as well, on the assumption of a normal crop year and no further rises in oil prices (table Comm.1).

The risks to this price forecast are mostly to the upside. The spread of political unrest in the Middle East and North Africa could push crude oil prices much higher in the shorter term, especially if there is disruption to a major oil producer. Stronger demand from China could boost metals prices by more than currently expected, and continued supply constraints could further aggravate markets. Given low stock levels, agricultural (and especially food) prices will remain sensitive to adverse weather conditions and energy prices. Moreover, at current or higher oil prices, biofuels production becomes an increasingly attractive use of land and produce, likely increasing the sensitivity of food to oil prices. Downside risks mainly entail slower demand growth and more favorable supplies.

Table Comm.1 Key nominal price indices
(Actual and forecasts, 2000=100)

	Actual						Forecast	
	2005	*2006*	*2007*	*2008*	*2009*	*2010*	*2011*	*2012*
Energy	188	221	245	342	214	271	*362*	*345*
Non-Energy	149	190	233	275	209	267	*321*	*284*
Agriculture	133	150	180	229	198	231	*277*	*230*
Food	134	147	185	247	205	224	*265*	*222*
Beverages	137	145	170	210	220	254	*286*	*238*
Raw Materials	131	160	175	196	169	237	*304*	*247*
Metals & Minerals	179	275	339	336	222	337	*406*	*395*
Fertilizers	163	169	240	567	293	280	*349*	*283*
MUV	110	112	117	125	118	121	*127*	*123*

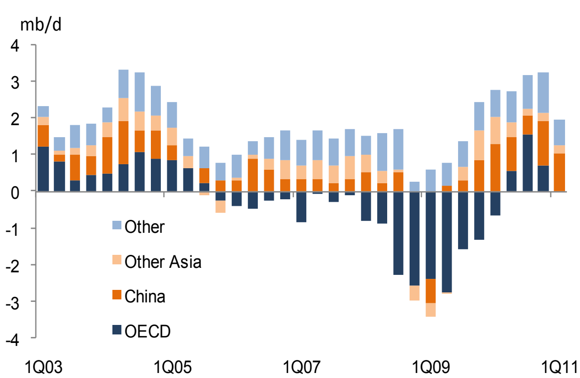
Source: World Bank

Energy: overview and outlook

Crude oil prices were fairly stable through the first three quarters of 2010, averaging $77/bbl, reflecting ample stocks and OPEC production restraint amid strong demand growth (3.3 percent or 2.8mb/d for 2010) versus an average 1.3mb/d over the past decade. In the fourth quarter of 2010, prices began to rise due to an acceleration in demand growth to 3.8 percent and declining stocks; prices averaged $90/bbl in December.

Oil demand in high-income OECD countries which had been declining since the fourth quarter of 2005, advanced by 1.2 percent or 0.6mb/d; while demand in non-OECD countries increased 5.7 percent or 2.3mb/d–with Chinese demand representing about 1mb/d. In the first quarter of 2011, global oil demand was 2.3 percent higher than a year earlier, with year-over -year growth rates expected to ease to near 1.5 percent (1.3mb/d) consistent with the long-term trend of the past decade (figure Comm.2).

Figure Comm.2 World Oil demand



Source: IEA and World Bank

Most of the increase in oil demand was met from increased production by non-OPEC producers and through reductions in inventories. OPEC output growth in recent months has been limited as the cartel has sought to support prices at below their recent amplified levels.

Non-OPEC output increased 2.0mb/d since 2008, reflecting both the exploitation of new fields and more intensive production from existing ones made more profitable by higher prices. The biggest increases came from the United States, Russia, China, Brazil, Colombia, Kazakhstan, Azerbaijan, Canada, and Oman, as well as from a sizeable increase in biofuels. Partially offsetting these gains were large production losses in the North Sea and Mexico.

OPEC production increased 1.9mb/d since April 2009 (prior to the loss in Libya), but still remains below its peak levels of 31.9mb/d in mid-2008.[1] Most of the increase has taken place in Saudi Arabia, Iraq, the UAE, and Nigeria (figure Comm.3).

Despite a drawdown of inventories, global stocks remain high—though outside of the United States, inventory levels at the end of winter were at the lower end of their 5-year range (figure Comm.4).

Political turmoil adds to price volatility

The spikes observed in 2011 mainly reflect political developments in North Africa and the Middle East, which resulted in the loss of 1.6mb/d in Libyan oil production and 1.3mb/d in exports. Some damage to facilities and oil fields occurred, and it is widely expected that exports will be curtailed for some time. In addition more than 0.1mb/d of crude oil production was shut down in March from unrest and strikes in Yemen, as well as smaller volumes in Oman, Gabon and Côte d'Ivoire—all non-OPEC countries. Just as importantly, oil prices were bid up by fears of larger supply disruptions in major OPEC oil producers.

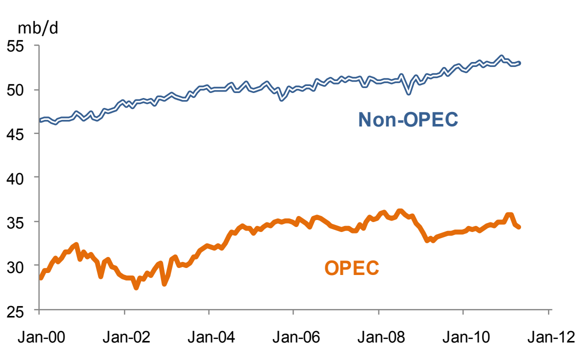
The supply response from other OPEC countries has been limited—mainly because of weak demand for the medium-sour crude that OPEC has in spare capacity (the lost Libyan production is light, sweet and distillate-rich crude oil), and because the supply disruption occurred during the seasonal downturn in demand due to refinery maintenance.

Nevertheless, the pickup in global demand has drawn-down OPEC's spare capacity (excluding Libya, Iraq, Venezuela and Nigeria) to 4mb/d, down from more than 5mb/d at the end of 2010. Because of the loss of Libyan distillate-rich sweet crudes, distillate markets worldwide has tightened. As refinery demand picks up in the second quarter to meet summer demand, further upward pressure on high-quality crudes is likely.

Outlook

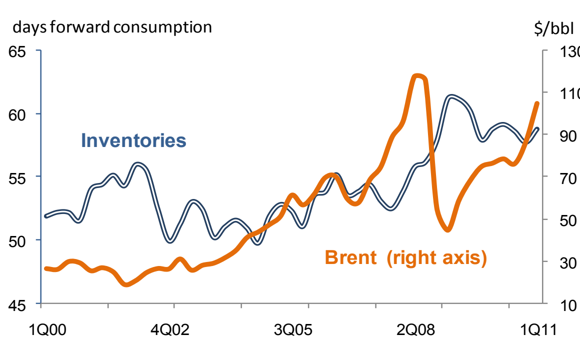
Oil prices are expected to remain elevated as long as physical supplies are disrupted and fears persist of larger disruptions from political unrest in oil producing countries. The loss of Libyan light sweet, crude will continue to affect product

Figure Comm.3 World oil production



Source: IEA

Figure Comm.4 OECD oil inventories and oil price



Source: IEA, World Bank

markets, especially as increasingly stringent regulatory rules on refined products further intensify demand for light, sweet crude.

In the baseline projection, oil production is assumed to normalize toward the end of 2011, and oil prices are anticipated to decline gradually toward $80/bbl in real terms by 2020. This implies a nearer-term price profile of $107.2/bbl in 2011, easing only modestly to $98.7/bbl by 2013. Yet, individual prices may move within a wide range from each other, as has been the case during the past six months (box Comm.1).

At these prices, there are no resource constraints far into the future. At $80/bbl in real terms, production of Canadian tar sands are profitable and reserves from this source are second only to those of Saudi Arabia in crude oil. Such elevated prices should also serve to both foster production

Box Comm.1 Different prices for different fuels

The recent run up in crude oil prices has been associated with an unusual divergence between the price of West Texas Intermediate oil (WTI) and Brent and Dubai crude oil prices. Historically, WTI has traded at a premium of about $1.30/bbl to Brent, but toward the end of 2010 the WTI price began falling below the Brent price because of a build-up in crude-oil inventories in Cushing Oklahoma, the delivery point for WTI oil in NYMEX futures contracts. Currently WTI oil is trading at about 90 percent of the Brent price (box figure Comm.1a).

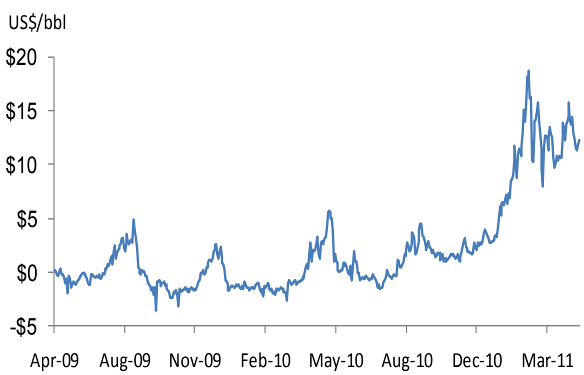
The increase in inventories was mainly due to the inflow of Canadian crude through the new Keystone pipeline, and has little outlet except through refinery processing in Cushing. Bottlenecks are likely to continue until new pipeline capacity to the Gulf coast is available (2013), and from Alberta to the Pacific coast (2015).

The other major price divergence, which has been more durable, has been between oil prices and natural gas prices. Whereas the former have increased nearly fourfold since 2000, natural gas prices linked to oil (in Europe and Japan) have increased only 160percent, while those in the fully competitive U.S. market are essentially unchanged. Relatively lower natural gas prices reflect increases in supply from both new liquefied natural gas (LNG) capacity and unconventional shale gas. LNG capacity, which allows gas to be transported by sea, is projected to increase more than 50 percent between 2009 and 2013. In the United States, natural gas from shale-gas reserves has been growing rapidly due to new extraction techniques, which have not only pushed down U.S. natural gas prices, but also reduced prospective global demand for LNG.

Growing supplies of unconventional gas are expected to keep U.S. natural gas prices well below oil prices. Already, U.S. natural gas now costs less than coal. Contract prices in Europe and Japan, which are tied to oil prices, are expected to come under downward pressure as end-users increasingly push to tie these prices more closely to spot prices for natural gas (box figure Comm.1b).

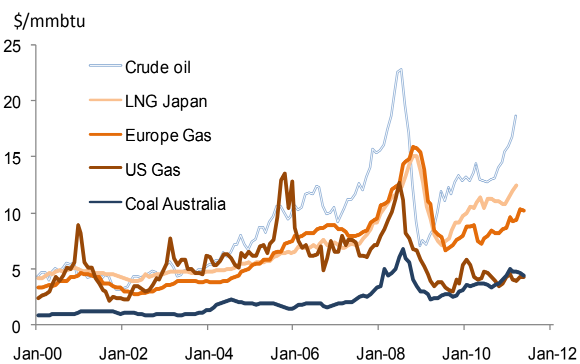
Over time, these large gaps between oil and natural gas prices can be expected to induce shifts in consumption from oil to natural gas, reducing demand for oil, and as a result reducing price pressures.

Box figure Comm.1a Brent/WTI price differential



Source: World Bank

Box figure Comm.1b Energy prices



Source: World Bank

of alternative renewable energies and induce demand-side substitution toward other less expensive forms of energy.

The main impediments to supply growth are above-ground policies and conditions, i.e., taxation, access, environmental constraints, and geopolitical risk.

Risks to the oil outlook

On balance, short term risks are on the upside likely to emanate from further supply disruptions. Large supply-shocks can have significant impacts on oil prices and economic activity, as in the past. Environmental issues may curb non-OPEC production growth in bio-sensitive or resource-intensive areas, e.g., offshore, oil sands, and shale-rock fracturing (these sources account for more than one-third of global oil supplies).

OPEC production policies can also affect price levels. In the past, the group has taken aggressive action to rein-in production when prices fall, but has taken only limited action when prices rise, choosing instead to accept the windfall gains.

An additional risk to energy prices is the longer term impact of the Fukushima nuclear accident. Nuclear energy has played a key role in global energy consumption. Its contribution increased from of 1.6 percent during the 1970s to 6.3 percent during 2000-08 (table Comm.2). During this period crude oil's share declined from 44.7 to 35.0 percent. In effect, the decline in crude oil was compensated almost equally by increases in natural gas and nuclear power. A combination of reduction in the share of nuclear and the likely environmental pressures in crude oil and coal may indeed exert additional pressure in energy prices over the longer term.

Table Comm.2 Shares of global energy consumption
(percent of total)

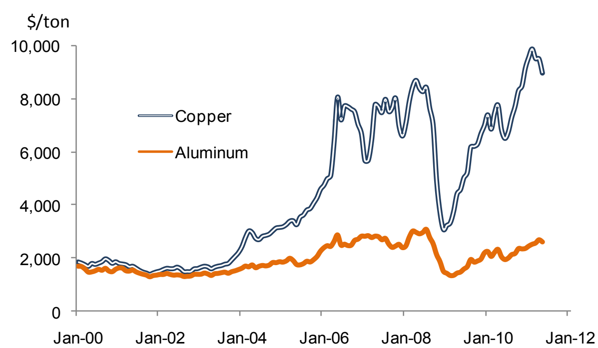
	1971-80	1981-90	1991-2000	2001-08
Crude Oil (total)	44.7%	38.3%	36.6%	35.0%
Natural Gas	16.3%	18.2%	19.9%	20.8%
Coal and Coal Products	24.5%	25.5%	23.7%	24.9%
Nuclear	1.6%	4.8%	6.5%	6.3%
Combustible Renewables and Waste	10.6%	10.7%	10.5%	10.0%
Hydro/Other	2.3%	2.5%	2.8%	2.9%

Source: IEA and World Bank

Metals: overview and outlook

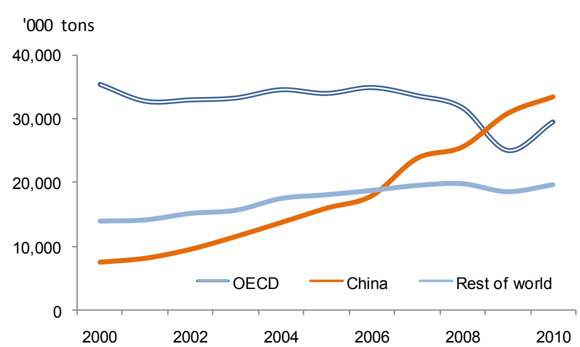
Metals and minerals prices have recovered strongly in the last two years due to robust demand, with the aggregate price index in May 2011 up 155 percent since its recession-induced lows of December 2008. Strong price increases were observed in markets that experienced supply constraints. For example, copper and tin reached all-time nominal highs in 2011 (up 220 and 200 percent, respectively from their 2008/09 lows) (figure Comm.5). Most metals prices have at least doubled, but price increases were more moderate for those where supplies were ample as in the case of aluminum.[2]

Figure Comm.5 Copper and aluminum prices



Source: .World Bank.

Figure Comm.6 World metals consumption



Source: World Metal Statistics

The recovery in metals during 2009 was led by large restocking in China, world's largest metal consumer (figure Comm.6). As can be seen for aluminum (which accounts for nearly half of world consumption of the six base metals), China's demand growth surged in 2009, with significant volumes for restocking, providing the key driver to prices. Demand in China slowed in 2010 but this was offset by strong demand elsewhere, particularly in developed countries, also for restocking (figure Comm.7).

Most metals inventories in 2011 are relatively high, and have increased as China's import demand has slowed (figure Comm.8). For some metals, prices are in 'contango' (future prices above near-by prices) and a large portion of stocks are tied up in warehouse financing arrangements and not available to the market—which gives an appearance of market tightness and has helped support prices. Inventories are expected to remain high until China's import demand strengthens.

Outlook

Over the past decade, global metals markets have struggled to meet the strong demand particularly from China, especially in the copper and nickel markets (box Comm.2). As a result prices have increased to ration demand and balance the market.

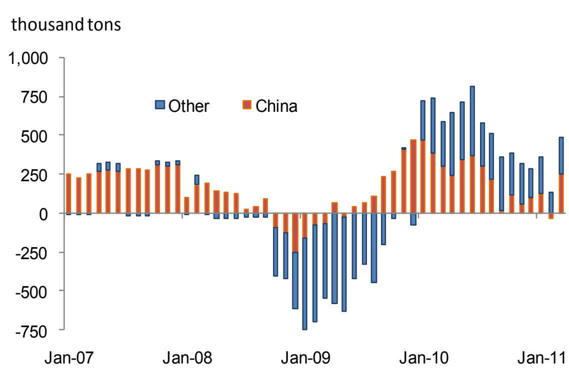
The causes of the supply shortfall are numerous. Inadequate investment early-on has played a role, especially given the long lead times required for new mines. Because of years of low prices and limited expansion, the industry also suffered shortages of skilled labor, equipment and materials during the upturn—which have pushed up costs. In addition, technical problems, strikes, and geopolitical risk prevented new projects form moving ahead quickly.

Looking forward, supply is expected to be more elastic—partly because of higher prices, which have boosted the industry's large cash flow, and is expected to generate record capital expenditures in 2011.

In the copper sector, where supply has been very tight, development of new 'greenfield' and 'brownfield' projects is expected to deliver sufficient capacity to meet moderate demand growth over the medium term. Much of the incremental supply will be in South America and in Africa's copper belt, i.e., Zambia and the Democratic Republic of Congo. High copper prices have also increased recycling and induced substitution toward other, cheaper products (mainly aluminum and plastics). These trends are expected to push the copper balance into surplus later in 2012 and beyond.

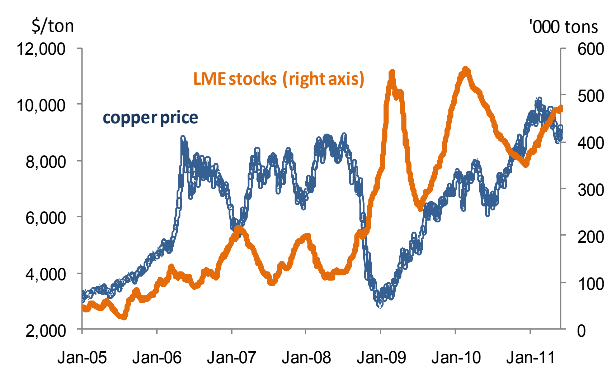
The global market for aluminum is expected to remain in surplus for the foreseeable future. The addition of new capacity and prospects for the reactivation of idle capacity threatens prices in the near term. New plants in China, India, the Middle East and Russia are expected to exploit low-cost power sources and minimize the upward pressure on aluminum prices from

Figure Comm.7 Aluminum consumption growth



Source: CRU

Figure Comm.8 Copper prices and LME stocks



Source: Datastream

higher oil prices. A key uncertainty for supply concerns Chinese authorities' efforts to restrain power consumption in the sector, which may slow the pace of new aluminum plants or result in the closure of older plants.

The nickel market is expected to move into surplus this year and beyond as a wave of new capacity hits the market. Several large-scale projects in Brazil, Madagascar, New Caledonia, and Papua New Guinea, as well as smaller projects elsewhere, are coming on line that are the lagged result of earlier price hikes. In addition, supply will be bolstered by recovering production from strikes in Canada and the steady growth of nickel pig iron in China. One potential uncertainty for the nickel industry comes from new plants 'High Pressure Acid Leach' (HPAL) processes, a complex technology that has resulted in severe production problems in the past.

Box Comm.2: China, global metal demand, and the super-cycle hypothesis

Chinese demand has been the key driver of metal demand over the past decade (see figure Comm.8). China is clearly in an extremely metals-intensive phase of its development. Compared with other developing countries at similar income levels, the metals intensity of China's GDP is well above average (for example, China's copper and aluminum intensity were 1.8 and 4.1 kgs per $1,000 of real GDP for 2007-09, compared with world averages of 0.4 and 0.7, respectively.)

Between 2000 and 2010 Chinese consumption of the main base metals (aluminum, copper, lead, nickel, tin, and zinc) rose by 16 percent per annum. Consumption for the rest of the world was flat for the decade. Currently China accounts for 41 percent of global refined metal consumption (box figure Comm.2a).

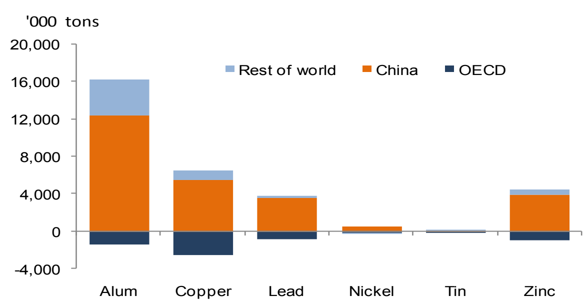
Indeed, metal consumption by China during the past decade has been so strong that it effectively reversed the global metal intensity (metal consumption per unit of GDP), a turnabout that continues today. For example, global metal intensity in 2010 was the same as in the early 1970s (box figure Comm.2b). On the contrary, food and energy intensities continued their downward trend.

Many observers looking at the extremely robust demand for commodities over the past decade, and the rapidly rising metals intensity of the Chinese economy, argue that commodity demand will continue to outstrip supply resulting in a super-cycle where prices stay very high for an extended period (perhaps for a few decades). Such risk seems particularly acute if China continues to increase its metals intensity, or if other developing countries begin to follow a metals intensive development strategy – something that has not as yet occurred.

Super-cycles of this nature have taken place in the past rather albeit infrequently (e.g., the industrial revolution in the United Kingdom. and the early 1900s in the United States). Several authors have argued that some metals (especially copper and iron ore) may be going through a super-cycle period because of Chinese demand (see Heap 2005 and Jerrett and Cuddington 2008).

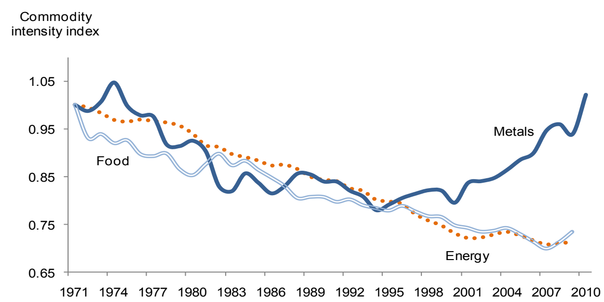
If such a super cycle endures, high prices will be needed to curb demand and generate sufficient supplies to bring the market into balance, and also to stimulate alternative technologies and materials.

Box figure Comm.2a Global metal consumption growth, 2000-10



Source: World Metal Statistics and World Bank

Box figure Comm.2b Global commodity intensity



Source: World Bank

Overall, metals prices are expected to rise in 2011 compared with 2010, owing to increasing demand, but are expected to ease thereafter, as new capacity comes on line and keeps markets in surplus. A key risk to the forecast is continued difficulties within the industry delivering adequate supply to the market, whether related to operations, technology, labor, or government policy.

Agriculture: overview and outlook

By early 2011 most agricultural prices either reached or exceeded their summer 2008 peaks. In April 2011, the agricultural price index averaged 12 percent above its June 2008 peak, while the food index has just matched its 2008 peak. Beverages (tea, cocoa, and coffee) and raw materials are 31 and 57 percent above their 2008 highs.

Yet, the 2010/11 price spike differs from the one in 2007/08 in a number of respects.

1. It is more uniform in terms of commodities involved, in that it includes most food commodities (grains and edible oils, except for rice), beverages, and raw materials. The 2007/08 spike (led by crude oil and fertilizers) saw food and grains prices increase, largely reflecting the surge in rice.

2. The current increase is less steep in the sense that the percent change in 2011:Q1 from a year ago are much smaller than occurred in 2008:Q2 when measured over the same period (figure Comm.9).

3. The supply conditions for grains that led to the 2010/11 spike were less binding than the conditions that led to the 2007/08 spike. The rice market has been very stable—rice is a thinly traded commodity and politically sensitive for food security, especially in East Asian countries.

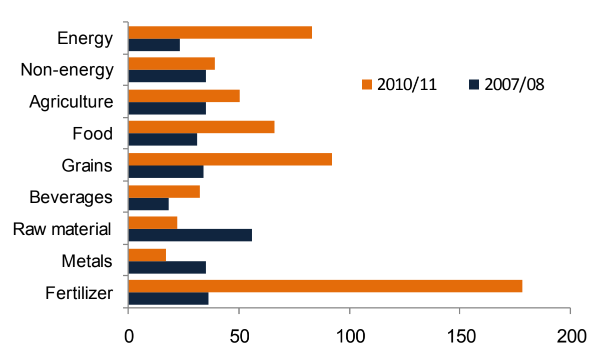
4. The recent price spike did not trigger as broad a policy reaction—apart from the Russian wheat export ban in the summer of 2010. Martin and Anderson (2011) estimated that 45 percent of the increase in rice prices and 30 percent of the increase in wheat prices during the 2007/08 price spike was due to insulating trade measures.

Grain prices, especially maize and wheat, began rising in the summer of 2010 when it became apparent that wheat production in Eastern Europe and Central Asia and was going to be seriously affected by the heat wave running through the region at that time. In the event, countries in the region—which between 2005-2009 accounted for almost a quarter of world wheat exports—were only to supply half of that amount. Later maize prices rose as it became clear that the U.S. crop would disappoint. As a result, the maize stock-to-use ratio declined to 0.15 from the 0.18 average of 2007-09.

By April 2011, maize prices had surpassed their June 2008 highs by 12 percent while wheat prices were just 4 percent short of their 2008 peak. Rice prices, however, have been relatively stable, trading in a band of $450-$550/ton during the past two years—a wide band by historical standards but narrow when comparing rice to other commodities during 2008.

Edible oils prices rose more than 40 percent in the first quarter of 2011 from a year earlier, almost reaching their June 2008 all time highs in February 2011. In addition to suffering sporadic weather-induced production shortfalls (especially soybean oil in South America and palm oil in South-East Asia) and diversion for biodiesel production in Europe, a key factor behind the price rally has been strong demand.

Figure Comm.9 The price spikes of 2007/08 and 2010/11



Source: World Bank

Unlike grains, where demand tends to be relatively stable after incomes reach a certain level, per capita demand for edible oils continues to rise even in high income countries, as a rising share of food consumed is prepared in professional establishments and in packaged form, both of which are oils consuming processes.

Beverage prices increased in 2010/11, unlike in 2008 when their prices were relatively stable. The coffee market—especially arabica coffee—experienced tight supplies and strong demand while the hike in cocoa prices reflected political instability in Côte d'Ivoire (which accounts for almost 40 percent of global cocoa supplies).

The **cotton market** suffered from tight supplies (in addition to a partial export ban imposed by India to protect its domestic textile industry). Strong demand, especially by middle income countries, contributed to high price as well. Cotton prices experienced, perhaps, the sharpest increase in history of the sector; they exceeded $5.00/kg in March 2011, up 350 percent from two years ago. And **natural rubber prices** reached historic highs due to weather-related supply disruptions in South-East Asia rubber producing countries (accounting for almost all global production), strong tire demand from emerging markets, and high oil prices (natural rubber competes with synthetic rubber) a by-product of crude oil.

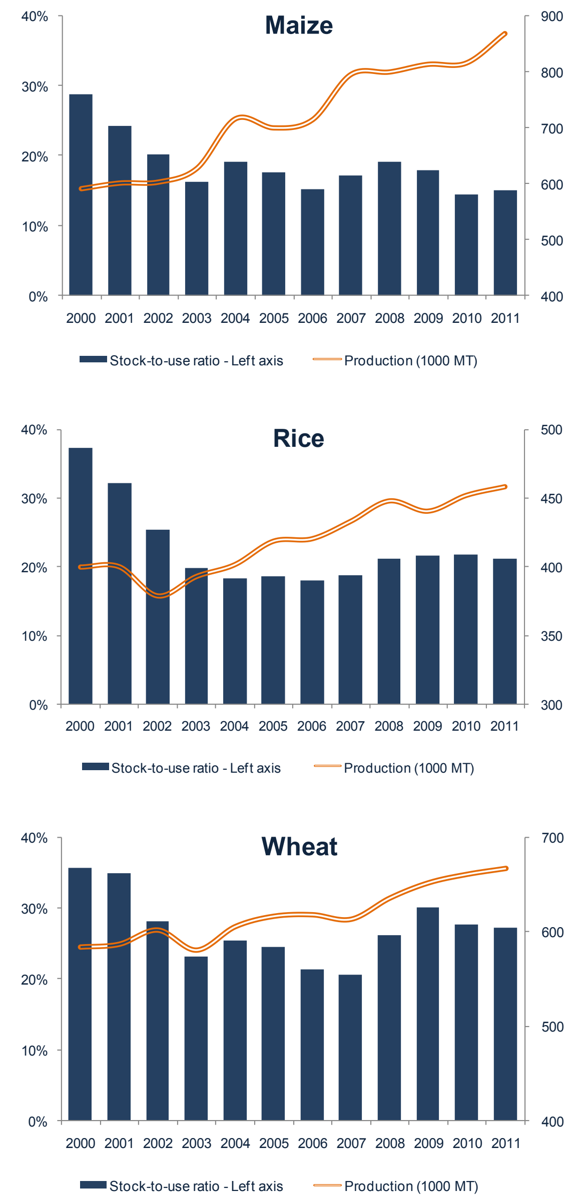
Despite high oil prices, **fertilizer prices**—a key input to the production of food commodities—declined 5 percent in 2010 due to ample supply and relatively stable natural gas prices (nitrogen fertilizer is made directly from natural gas).

Outlook

Agricultural prices increased 17 percent in 2010, slightly exceeding their 2008 levels. They are expected to gain an additional 20 percent in 2011; such increase assumes that prices will ease somewhat during the second half of 2011. Specifically, for 2011 wheat and maize prices are expected to average 34 and 45 percent higher than 2010 levels, while rice prices are anticipated to remain almost unchanged. Soybean and palm oil prices are expected to be 18 and 22 percent higher, respectively.

A number of assumptions underpin this outlook. First among these is that crude-oil prices stabilize and begin to decline. Second, it is assumed that the 2011/12 crop year is a normal one. Actual outturns will depend importantly on

Figure Comm.10 Global balance of key grains



Source: U.S. Department of Agriculture (May 11, 2011 update).
Note: years refer to crop years (e.g., 2011 refers to 20011/12

oil prices and weather. Either another poor crop year or a further hike in oil prices could result in significantly higher prices for many commodities.

During its first assessment for the 2011/12 crop year (published in early May), USDA projected that global production of maize will rise 6.4 percent, wheat by 3.3 percent and rice by 1.4 percent (figure Comm.10). Yet, because of continued tight inventory positions, the USDA argued that prices may remain "volatile with tight exportable supplies of corn and wheat. In contrast, the rice world supplies are relatively abundant." The report also noted that uncertainty continues to cloud these projections because of delayed maize plantings in the United States, reduced U.S. winter wheat production, continued dryness in the EU, and wet conditions in Canada.

Energy is a particularly important determinant of agricultural prices and hence an important risk for higher food prices. While low stocks and poor crops were the major factors underpinning last year's price hikes, the nearly 60 percent increase in food prices since the 1990s has more to do with the 3-fold increase in energy prices that has occurred during that time.

Energy feeds into food prices through three main channels: (i) as a cost of production (fuel for agricultural machinery and transporting produce to markets); (ii) indirectly through fertilizer and other chemical costs (e.g., nitrogen-based fertilizers are made directly from natural gas), and (iii) via competition for land and produce from biofuels—maize in the United States, edible oils in Europe and sugar cane in Brazil (Box Comm.3). Indeed, agriculture is more than four times more energy intensive an activity than manufacturing, with the ratio varying across countries depending on crops raised and intensity of fertilizer use (figure Comm.11).

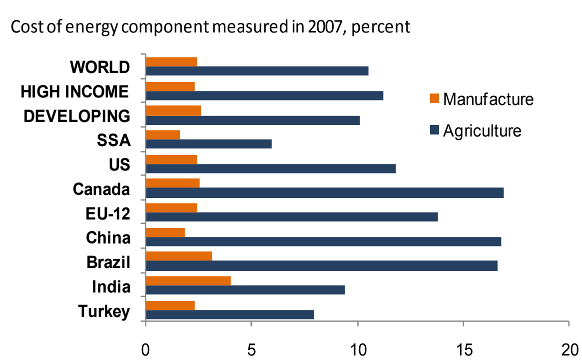
Econometric estimates suggest that for every 10 percent increase in energy prices, food prices will rise by between 2 and 3 percent (Baffes 2009). In fact, this is almost exactly what has been observed: with the 223 percent increase in the average oil price between the period 1986-2002 and 2003-2010 is associated with a 50 percent increase in the average food prices index (figure Comm.12).

Risks to the food price outlook

In an effort to evaluate the sensitivity of food price forecasts to the quality of future crops and oil prices, several simulations were run. Table Comm.3 reports results based on a reduced form econometric model that explains grain prices as a function of cost factors (including oil), and weather events (proxied by deviations of output from trend increases and stock-to-use ratios to allow for non-linear effects when stock levels are low). Other variables include exchange rates, interest rates, time trend as a proxy for technical change, and income growth.

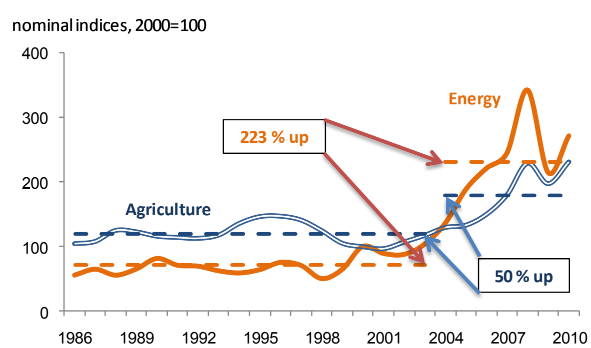
This work suggests that a weather-induced

Figure Comm.11 Energy intensity of agriculture and manufacture



Source: GTAP preliminary release 0, version 6.

Figure Comm.12 Energy and agricultural prices: 1986-2010



Source: World Bank

production shortfall on the order of 5 percent (equivalent to one standard deviation reduction in global output) can be expected to induce an increase in grain prices of between 2 and 8 percent. And a 50 percent increase in crude oil prices above the baseline of $107/bbl, would induce grain prices increases on the order of 6 and 14 percent. Under a scenario where the 2011/12 crop year proves disappointing and oil prices rise by $50/bbl, grain prices could rise between 9 and 22 percent above the baseline scenario.

If any of these scenarios materialize, it will have important budgetary implications for food importing countries as well as poverty implications for consumers who spend a substantial part of their disposable income on food. Consider, for example, that the 2010/11 grain price increases may have pushed as many as 44 million people into poverty according to World Bank latest estimates (World Bank, 2011a).

Table Comm.3 Food Prices: History, baseline, and upside risks ($US per ton)

Year	Wheat	Maize	Rice	Soybeans	Palm oil
Historical Prices					
2006	192	123	305	269	478
2007	255	164	326	384	780
2008	326	223	650	523	949
2009	224	166	555	437	683
2010	224	186	489	450	901
Baseline					
2011	300	270	500	530	1,100
2012	250	230	480	450	900
5% production shortfall (compared to baseline)					
2011	306	279	518	547	1,186
2012	255	238	497	464	970
5% production shortfall and 50% increase in energy prices (compared to baseline)					
2011	336	294	573	602	1,337
2012	280	251	550	511	1,094

Source: World Bank

In addition to higher prices, volatility in commodity prices, especially food commodities, is an issue of increasing concern. For example, during the November 2010 summit, leaders of the G-20 requested that all international financial institutions and research organizations to work with key stakeholders "to develop options for G20 consideration on how to better mitigate and manage the risks associated with the price volatility of food and other agriculture commodities, without distorting market behavior, ultimately to protect the most vulnerable" (see G-20 Report on Price Volatility 2011).

Although it is analytically challenging to distinguish factors that affect price volatility from those affecting price levels, the increasing role of investment fund activity during the past few years (sometimes referred to as the "financialization of commodities") is often cited as a key factor behind the price variability observed during the past few years. It has been estimated that as of the end of 2010 as much as $380 billion was invested in commodities, three

Box Comm.3 The role of biofuels

The mandated increase in the quantity of high-income crops and cropland dedicated to biofuel production (chiefly ethanol-based corn in the United States, and edible oil-based biodiesel in Europe) and the more or less simultaneous rise in food prices, suggests another mechanism by which energy prices are affecting food prices.

During 2010/11, 28 percent of the U.S. maize crop went to biofuel production (in fact, 40 percent of the US maize crop went for biofuel use; however, 30 percent of that went back to the feed industry, resulting in a net of 28 percent). Although that corresponds to about 11 percent of global maize production, it's magnitude is comparable to the global exports of maize. Indeed, most studies concur that the U.S. biofuel mandate was the largest demand-side factor in the run up of grain prices during the 2007/08 price spike (Timilsina and Shrestha 2010).

Perhaps more important than their historic role in shaping the rise in food prices—to the extent that important food crops like maize are economically viable alternative sources of energy—their comportment will cease to be that of a typical agricultural product, where price fluctuations are mainly the result of supply shocks (demand remaining relatively stable), and become more like an industrial commodity, especially at current high energy prices. For example, estimates suggest that maize-based ethanol and edible oil-based biodiesel biofuels may become profitable even without mandates at oil prices between $80-$100/bbl (U.S. Government Accountability Office 2009).

quarters of which in energy markets, compared to less than $20 billion at the beginning of the decade.

The relationship between investment fund activity and commodity prices is a hotly debated topic. Some have argued that such funds have sufficiently large weight to unbalance the market thus impairing the price discovery mechanism (e.g., Soros 2008, Berg 2011). However, others have praised these investment vehicles claiming that they inject liquidity in commodity markets (e.g., Verleger 2010, Sanders and Irwin 2010). Despite such contrasting views, the empirical evidence is, at best, weak.

As was discussed in the January 2011 edition of GEP (World Bank 2011b, p. 26), "Despite the 'smoking gun' … most studies have failed to establish a link between these investment and rise in commodity prices." The report also noted that more recent academic papers and analysis are increasingly leaning towards the view that these new investment vehicles may have been responsible for at least part of the post-2005 volatility in commodity prices. Indeed, a number of academic studies have shown just that (see, for example, Singleton 2011, Silvennoinen and Thorp 2010, Tang and Xiong 2010).

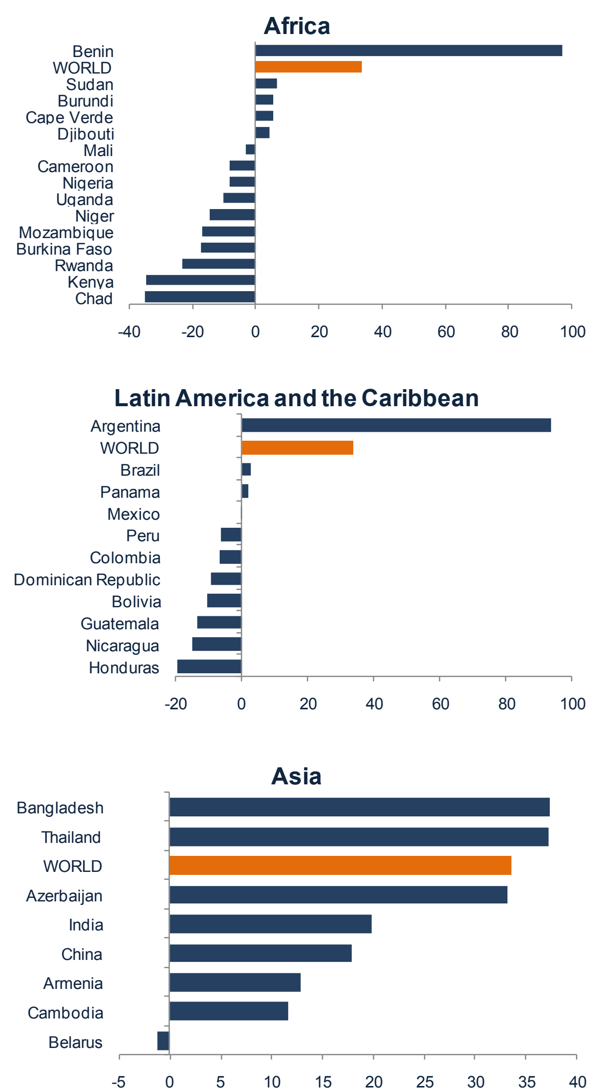
Movements in domestic food prices

The discussion so far has focused on price movements in US$ terms. However, what matters most to consumers is the price they pay for their food basket. It is not uncommon for prices paid by consumers to differ considerably from international prices, at least in the short run. Reasons include exchange rates movements, trade policies that often insulate domestic markets, large distances of domestic trading centers form ports adding considerably to marketing costs, quality differences, and different composition of the food basket.

Figure Comm.13 depict changes in domestic wholesale prices of key food commodity price indices (weighted by the country's caloric intake from such commodities). The period chosen is based on a comparison between 2009:Q1 (the post-financial crisis low price) and 2010:Q4, (the most recent data available for 35 countries). In addition to maximizing the numbers of countries included in the sample, the period was chosen in order to capture most of the 2010/11 food price spike.

During this period, the real (U.S. CPI-deflated) U.S. dollar-based World Bank food price index increased 34 percent. Yet, the results show that—with the exception of Asian countries where real wholesale prices moved in synch with world prices—in both Latin America and the Caribbean and Sub-Saharan Africa regions, real

Figure Comm.13 Price changes—2009:Q1 to 2010:Q4



Source: World Bank

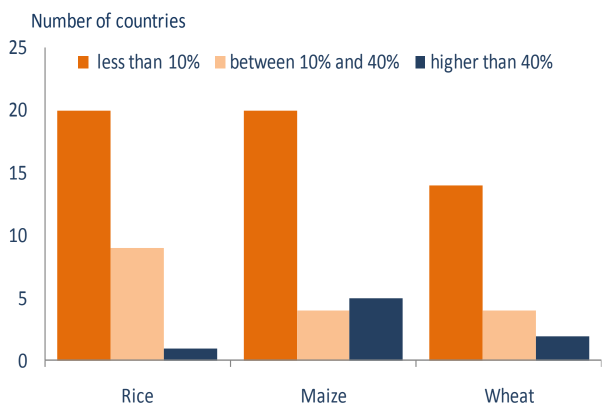
prices either increased modestly or declined. It should be noted that results do not necessarily imply that domestic price movements move independently of world prices. The apparent weak correlation between world and domestic prices most likely reflect low pass-through.

To identify the degree of pass-through, an error-correction model was used to estimate the pass-through price elasticities for wheat, rice, and maize. The countries included in the analysis were categorized into three groups: little pass through, where less than 10 percent of international price variability is transmitted into domestic prices, moderate pass through, with transmission between 10 and 40 percent, and high pass-through, with more than 40 percent transmission (figure Comm. 14).

A number of interesting results emerged from the analysis. First, more countries exhibited very little pass-through compared to moderate or high pass-through combined; this is consistent with the results discussed earlier. Second, price pass-through is higher in rice than maize and wheat. Third, countries that exhibited high pass-through in one commodity are likely to have high pass-through in the other commodities as well (e.g., Argentina, South Africa, Thailand, Uganda).

To summarize, pass-through results based on both econometric estimates and the ones based on simple price change calculations gave a rather mixed picture from both a country and a commodity angle. From a country policy perspective, the results suggest that, to the extent possible, policy responses should not focus entirely on short run price movements observed in international markets. Instead policies should target specific commodity sectors and, above all, target the portions of the population with the highest probability of being affected.

Figure Comm.14 Domestic prices of key commodities do follow world price signals in many countries



Source: World Bank

The policy dimension of low pass-through

Low pass-through may reflect the fact that some countries insulate their domestic food (and fuel) markets by introducing or increasing existing subsidies or taxes. In addition to their distortionary impact on both domestic and world market level, subsidies in these countries may face fiscal sustainability issues. Indeed, taxpayer-funded subsidies in OECD countries increased considerably—between 2000-04 and 2005-09, transfers from taxpayers to consumers of agricultural products increased by more than 25 percent (from $24.6 to $31.0 billion). From a fiscal sustainability perspective, however, more important are fuel subsidies which during 2010 reached globally an estimated $250 billion, up from $60 billion in 2003 (Coady *et al* 2010).

From a policy perspective, addressing insulating trade policies should be a priority, for at least two reasons. In addition to constraining domestic supply response at the time it is most needed, such policies amplify the cycles in world prices, thus destabilizing global markets with negative consequences to countries that play by the rules and, more importantly, the ones that do not have the fiscal space to protect the poorest segments of their populations.

Other avenues to pursue should include adequate funding for research and development in order to arrest the decline in productivity growth observed during the past decade as well as minimizing post-harvest losses, very common in poor countries, especially in Sub-Saharan Africa. Policies and investments addressing the likely impact of permanent shifts in weather patterns, and improving food aid are areas of concern as well. Detailed policies and investment strategies addressing some of these issues were discussed at the Development Committee meeting during the 2001 joint World Bank/IMF Spring meetings (World Bank 2011c).

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Notes

1. OPEC countries account for 72 percent of the world's known oil reserves (*Oil and Gas Journal*, Dec. 6, 2010). However, OPEC's production share of total world liquid fuels is just below 40 percent and its share of crude oil production is 33.5 percent. With OPEC's spare capacity at about 6 mb/d (December 2010) and substantial known reserves, the oil market does not appear afflicted by resource scarcity. Indeed, oil production continues to grow in both OPEC and non-OPEC regions.

2. The divergence between copper and aluminum prices during the past decade has been driven mainly by China, world's largest copper importer. Because of various operational and project development problems, the industry has struggled to keep pace with demand. Meanwhile China has developed substantial aluminum smelting capacity and is a net exporter of aluminum. Bauxite, the raw material to produce aluminum, is one of the most abundant minerals.

Inflation Annex

Rising commodity prices have made a major contribution to the increase in headline inflation rates, which are close to- or have breached the upper limit of central banks' targeted bands in many countries.

However local food prices in developing countries have not increased as much as international food prices. Notwithstanding the 47 percent increase in the dollar prices of internationally traded food commodities between June 2010 and February 2011, local food price indexes in developing countries have risen by only 7.9 percent over the same period. In part, this discrepancy reflects the depreciation of the dollar; the wider range of food commodities consumed locally; and weak pass through of internationally traded food prices to local prices. In developing countries in Sub-Saharan Africa and South America the pass through was less than 10 percent in: 67 percent of countries for rice, 69 percent for maize, and 70 percent for wheat. Government subsidies, price controls, weak infrastructure, and low import dependency impede pass through, while it tends to be higher in countries with closer links to international markets and limited government intervention (e.g. South Africa).

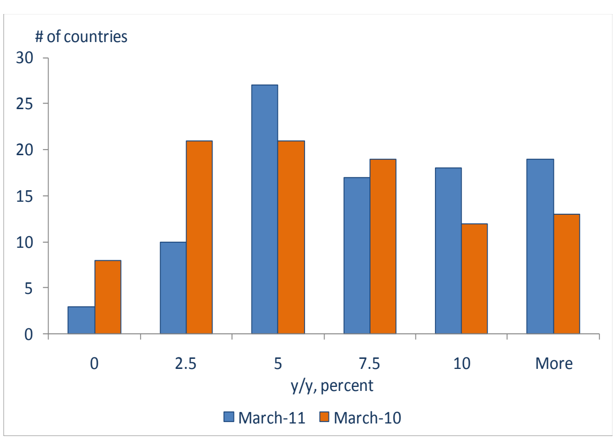
Annual inflation rates have increased in a large number of developing countries over the past year. More than half of developing countries now have annual inflation in excess of 5 percent, with one in five countries reporting inflation in excess of 10 percent. Meanwhile the share of countries with inflation rates in the range of 2.5 percent to 5 percent has also increased.

Headline inflation accelerated by more than 3 percentage points in one in four developing countries between March 2010 and March 2011, compared to more than one in five during the previous year (figure INFL.2). One in five countries have also seen inflation decline by more than 1 percentage point over the March 2010 to March 2011 period.

However, the extent of the pick up in inflation for most countries has been relatively modest, with inflation rates in more than half of developing countries still below average inflation recorded in the pre-crisis period (January 2000 through August 2008). Inflation is less than 2 percentage points higher than that average in 80 percent of countries.

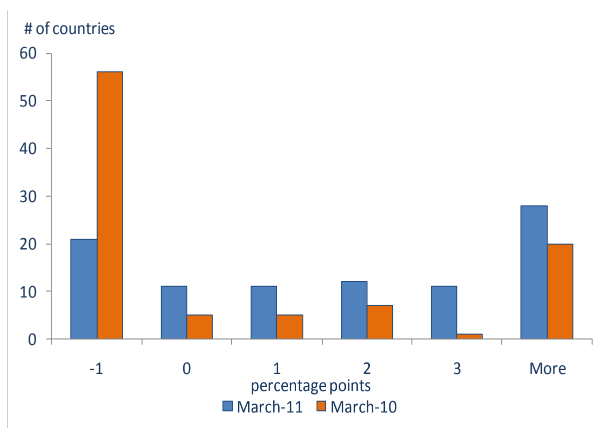
Inflation in high-income countries is rising but remains at relatively low levels. Prices in high-income OECD countries were 3.2 percent higher in April 2011 than a year earlier, an

Figure INFL.1 Headline inflation has accelerated in developing countries over the past year



Source: The World Bank.

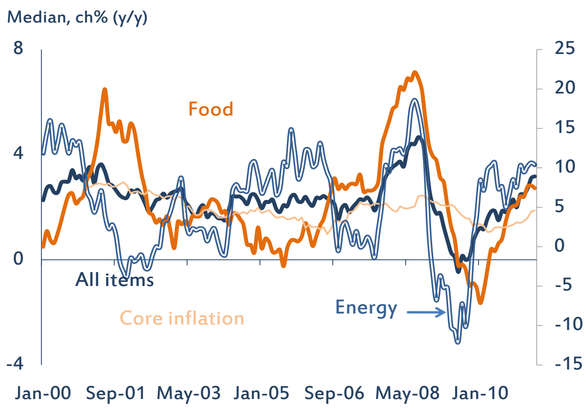
Figure INFL.2 Change in inflation rate over the past year



Source: The World Bank.

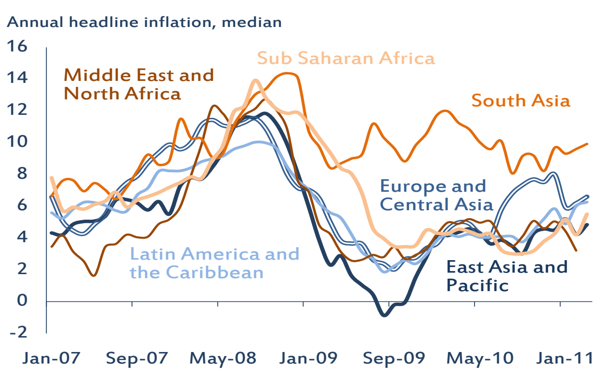
increase of 1.3 percentage points. The energy price component of the CPI index was up 10.4 percent, down slightly from the 10.6 percent increase recorded in March, while the food price component was up 3 percent (year-on-year in April, 2011) (figure INFL.3). In the euro area, headline inflation was 2.8 percent (y-o-y) in April, well above the 2 percent ECB targeted rate, in part due to rising energy prices. In the United States, headline inflation was 3.2 percent by April, pushed higher by energy prices up 19 percent and a weaker dollar (down by more-than 9 percent in nominal effective terms since June 2010). Headline inflation was up yet more strongly in other high-income countries, including Australia, Canada, Korea and Sweden.

Figure INFL.3 Core inflation in high-income OECD countries remains contained as inflationary expectations remained anchored



Source: OECD.

Figure INFL.4 Inflation accelerates in most developing regions on higher food and energy prices



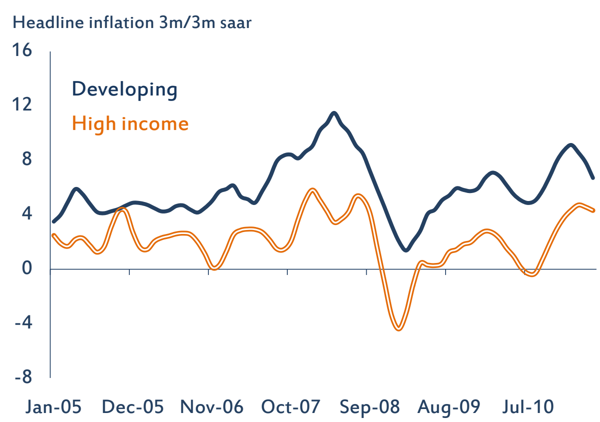
Source: The World Bank.

The rise in headline inflation in high-income OECD countries has had a limited impact on inflationary expectations to date, and core inflation has increased gradually to 1.9 percent as of April 2011, from 1.1 percent in the year-earlier period (to 1.3 percent in the United States and 1.5 percent in the euro zone).

Headline inflation in developing countries has accelerated recently to 6.9 percent by April 2011, from a 6 percent in April 2010, as international food and fuel prices stabilized recently. Food inflation exceeded 9 percent by February 2011 in developing countries.[1] Median headline inflation for these countries was slightly lower at 5.6 percent, reflecting the fact that inflation momentum in some of the larger middle-income countries, whose inflation rates have larger weights in the overall index is close to 6.9 percent (figure INFL.4). In developing countries, rising food and fuel prices, and in some cases tightening manufacturing capacity and lagging policy normalization, have combined to push headline inflation higher. But, most recently, monthly inflation rates have eased in both high-income and developing countries.

Inflation momentum is strong. From a three month over three month perspective, the pace of annualized inflation in both high-income and developing countries has been accelerating until just recently and exceeded year-over-year

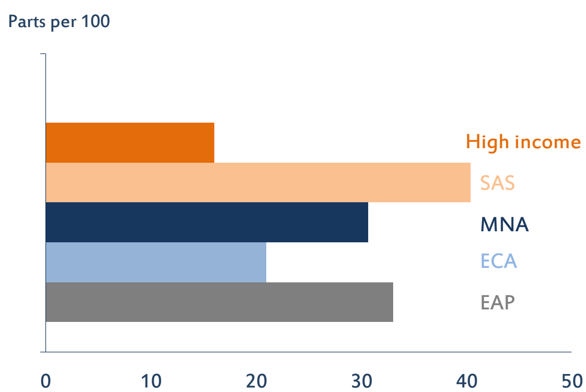
Figure INFL.5 Headline inflation pressures have picked up since mid-2010 but are easing



Source: The World Bank.

measures. At the global level, the annualized pace of monthly inflation was 5 percent (3m/3m saar) in the three months to April 2011, with prices rising at a 4.3 percent annualized rate in high-income countries and a 6.7 percent rate in developing countries (figure INFL.5). Although this momentum measure of inflation is lower in high-income countries than in developing countries, it has accelerated more quickly in high -income countries (up 4.7 percentage points versus 1.8 percentage point). This stronger acceleration likely reflects quicker pass-through of higher international fuel prices in high-income countries, and is observed despite the lower weight of food and fuel in the CPI basket in these economies (figure INFL.6 and figure INFL.7a). More recently however momentum has eased in developing countries, with a broad-based deceleration across income groups and regions. Among developing regions, the easing of inflationary pressures is most pronounced in the East Asia & Pacific, and the Europe & Central Asia regions. The deceleration is less well established in South Asia and in Latin America and the Caribbean, while monthly inflation is rising in the Middle-East & North Africa and Sub-Saharan Africa (figure INFL.7b).

Figure INFL.6 Weight of food in the CPI basket

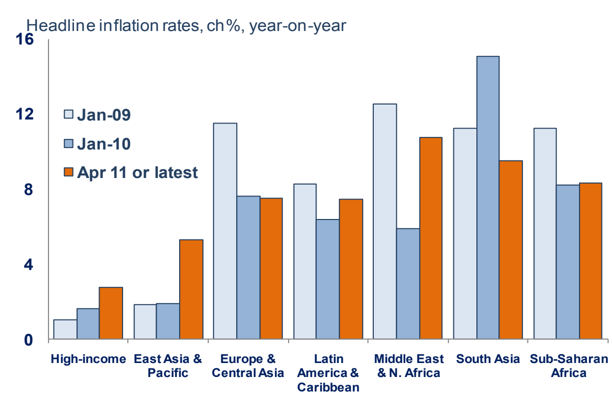


Source: IMF.

In addition to the inflationary pressures coming from higher international commodity prices capacity constraints in many middle-income countries have added to price pressures. In Brazil, headline inflation accelerated to 6.5 percent in April, while in China inflation was more than 5.3 percent (y-o-y), up 2.2 percentage points from a year earlier, as food inflation spiked to over 10 percent. Recent decisions to allow domestic gasoline and diesel prices to rise could push inflation as much as 0.5 percentage points higher. In India, year-on-year inflation continues to remain elevated and has surprised to the upside in March and April 2011 (9 and 8.7 percent respectively) due to accelerating non-food inflation and higher energy prices, and a surge in coal prices in April. There have been sharp upward revisions for three consecutive months, suggesting that actual inflation in March and April could be even higher.

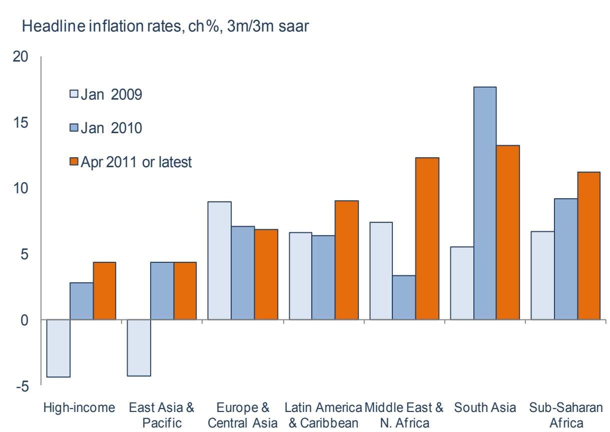
In Thailand, core inflation surprised to the

Figure INFL.7a Headline inflation rates, ch%, year-on-year



Source: The World Bank.

Figure INFL.7b Headline inflation rates



Source: The World Bank.

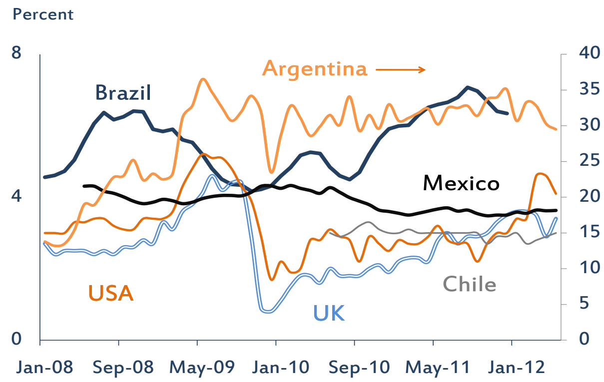
upside in May as well, rising to 2.5 percent year-on-year, suggesting that higher energy and food prices are starting to have second round effects, while tighter labor markets are also putting upward pressure on producer prices. In Indonesia, annual headline inflation stood at 6.2 percent in April, before easing to 6 percent in May, while core inflation rose to a 19-month high of 4.6 percent in April and remained at that level in May. While policy is being tightened in all of these countries, both fiscal and monetary policy remain accommodative, leading to higher risks that headline CPI changes seep into core inflation, given strong domestic demand and elevated capacity utilization rates (see Walsh, 2011 for a discussion, suggesting that commodity prices should not be excluded from core measures of inflation in developing countries).

Outlook

Prospects for inflation in developing countries will vary depending on industrial capacity utilization rates, exchange rate movements and the policy stance. However, risks to inflation are to the upside, and inflation could overshoot the upper limits of central-bank targeted ranges in a number of countries-- that show signs of overheating and where monetary and fiscal policy tightening are behind the curve. Even if the prices of internationally traded food and oil stabilize in the second half of 2011, domestic food and fuel prices are expected to continue to rise in many developing countries, reflecting delayed pass-through to local markets and increased pressures from higher fuel prices from the costs of fertilizers and transportation. As outlined in the main text, in the current economic context it is entirely possible that both food and fuel prices rise further.

Headline CPI momentum suggests that inflation will accelerate further in most developing regions, in particular in South Asia, Sub Saharan Africa, the Middles East and North Africa; and to a lesser degree in Latin America, Europe and Central Asia and East Asia and the Pacific. Moreover, high food and fuel prices are starting to impact inflationary expectations, which in turn may increase pressure on wages, especially in the emerging economies, where labor markets are tightening (figure INFL.7). If policy tightening fails to bring inflationary expectations (figure INFL.8) down, we could see the beginnings of an inflationary spiral.

Figure INFL.8 Expectations for inflation rates twelve months forward are rising



Source: Datastream, Banco central do Brasil.

Notes

1. For example, the weight of food in the CPI basket is 40 points of 100 parts in South Asia, and over 30 in East Asia and Pacific (median value for Thailand, Malaysia, and the Philippines) and MENA. Data for Sub-Saharan African countries is not available but for example in Ghana the weight of food in the CPI basket is 44, while in Cote d'Ivoire it is 24.8. In comparison in high-income countries the median weight of food in the CPI basket is 16 parts per 100 parts.

East Asia and the Pacific

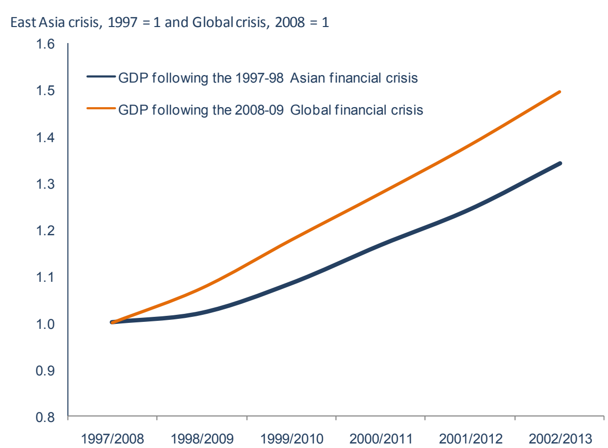
Recent developments

High frequency indicators suggest that growth in the East Asia and Pacific region growth has started moderating as most economies in the region are operating at—or near full capacity, and a gradual withdrawal of monetary and fiscal stimulus combined with a moderation in growth of high-income countries will dampen growth going forward. Real GDP growth of 8.3 percent a year is anticipated over 2011-13 for East Asia (rates of 8.5, 8.1, and 8.2 percent respectively). This follows growth of an estimated 9.6 percent in 2010. Excluding China, the rebound was even more pronounced, increasing from 1.5 percent in 2009 to an estimated 6.8 percent in 2010; but growth is expected to stabilize at slightly lower rates of around 5.5 percent over 2011-2013.[1]

A strong recovery in GDP, production and trade. The post-crisis rebound in 2010 was faster than the recovery from previous crisis episodes in East Asia, including after the 1997-98 Asian financial crisis (figure EAP.1). It was also broadly based, with five countries in developing East Asia growing by 7 or more percent during 2010, including Thailand and Malaysia, the only middle-income countries in the region where GDP had contracted in 2009. Real GDP is estimated to have grown by 7.8 and 7.2 percent respectively in these countries in 2010, driven equally by domestic demand (supported by expansionary fiscal and monetary policies) and external demand. In the Philippines, a surge in consumer and business optimism, in part due to the presidential elections, and stronger and more robust growth in worker remittances were additional factors that underpinned the country's fastest growth in more than three decades. Much of the region's rebound reflected the solid macroeconomic foundations that existed before the crisis: plentiful fiscal space, low external and government debt, and strong balance sheets of companies and commercial banks.

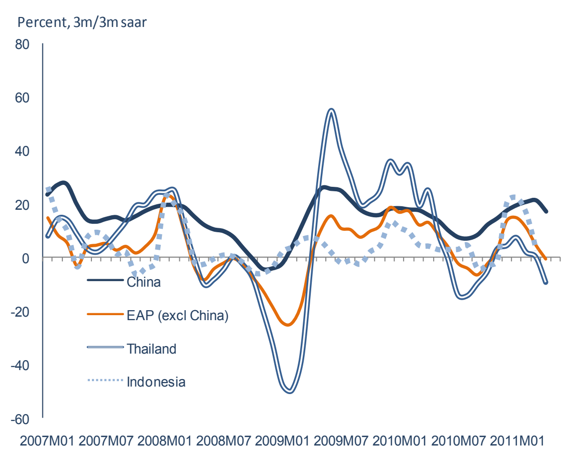
The pace of recovery in GDP (which was particularly strong during 2010) is forecast to slow over 2011-2013. This growth cycle has been accentuated by the evolution of industrial production activity, but with important differences in the depth of post-crisis troughs within the region, and the extent to which output has recovered to pre-crisis levels or growth trends (figure EAP.2). As of April 2011 industrial production levels in the region stood

Figure EAP.1 The post-crisis rebound in 2010 was faster than the recovery from East Asian crisis



Source: World Bank.

Figure EAP.2 China leading recovery in industrial production



Source: World Bank.

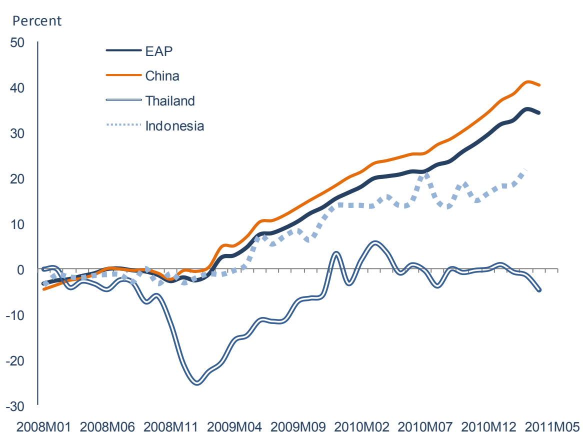
34.2 percent higher than the 2008-peak (defined as the maximum monthly industrial production level attained during calendar 2008) (figure EAP.3). Compared with the level of production that would have been observed in the absence of a boom and bust cycle between 2005 and 2009, the region's production is now about 3 percent above underlying trend levels (figure EAP.4). Thailand represents an important exception to this trend, as industrial production there has struggled to catch up with underlying trend growth due to structural impediments.

The regions' good performance in production has been supported by buoyant domestic demand in most developing countries, moderate recovery in high-income consumer spending, and restocking that started at the end of 2010. Even though there is a lot of noise in the January-February data due to the Chinese Lunar New Year, there are indications that growth is slowing, as Chinese retail sales softened in February – largely on the back of weaker auto sales as incentives were withdrawn. East Asia is operating near full capacity, which means industrial production growth is bound to moderate to potential growth rates; while further downside pressures may arise from monetary tightening in countries where inflationary pressures are building, such as in China and Indonesia. Several countries (e.g. Indonesia, Malaysia and Thailand), also experienced strong currency appreciation as a result of rapid and robust capital inflows. However, with the exception of Indonesia, the real appreciation has been more or less in line with real changes in the Chinese Renminbi, hence the impact on external competitiveness has been relatively limited.

As in the case of industrial production, commencing from the final quarter of 2010, trade entered a second rebound phase. This interval differs somewhat from the previous rebound, in that recovery is being driven less by temporary factors (stimulus, restocking etc.) and more by stronger consumer demand (including from high-income countries). Latest figures indicate that, although economic growth might be slowing somewhat, export growth rates were nearly as strong as the exceptional pace experienced in phase I of the recovery.

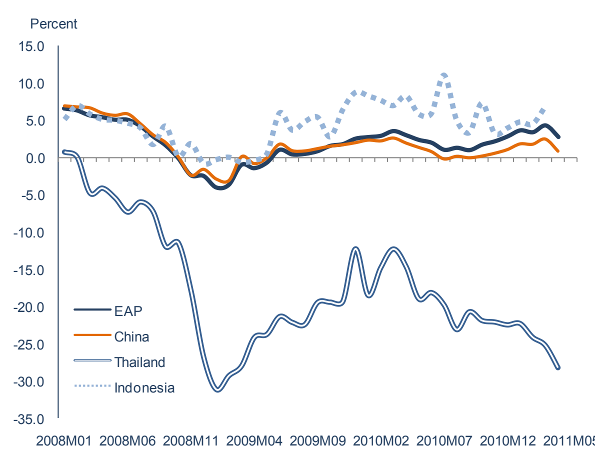
China's export performance is to a large degree shaped by high-income country import demand, while the rest of developing East Asia's exports tends to respond to Chinese demand (figures EAP.5 and EAP.6). The Japanese economy remains a very important trade partner for the developing East Asia region and the impact of the Japanese earthquake/tsunami/nuclear crisis is expected to cut into growth more sharply than the 1995 Kobe disaster, as electricity disruption and the pull-back in consumer spending that has been associated with the first weeks of the current post-crisis period will negatively impact on Japan's growth. Retail sales during March were down 8.5 percent from a year ago,

Figure EAP.3 Industrial production has surpassed previous peaks



Source: World Bank.

Figure EAP.4 But remains below trend in Thailand



Source: World Bank.

machinery and business equipment sales were down 17 percent. For the car industry, disruptions are expected to last until the end of the second quarter, potentially reducing output by one-half. So far, regional impacts have been limited, with slower growth in the initial quarter of at most 0.5 percentage points for countries with closest trade ties (Malaysia, Vietnam and Thailand). As discussed in the main text and in the industrial production annex, the impact of this disaster could be substantial and potentially long(er) lasting.

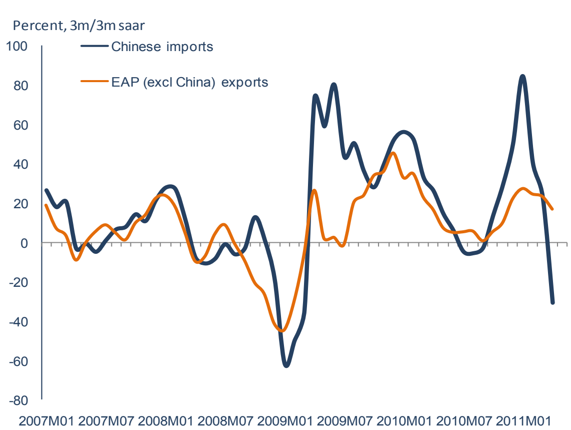
As far as demand in other high-income economies are concerned, U.S. import growth has recently tapered off, but fortunately, demand conditions in Europe have been improving (see trade annex). Notwithstanding the global recovery and demand for Chinese goods, the Chinese trade balance declined rapidly from a surplus of $40 billion in January 2009 to deficit of about $2.1 billion in February 2011, but recovered to a surplus of $22.6 billion in April 2011. With demand in high income countries returning toward levels consistent with output following the global crisis, the Chinese current account surplus is expected to remain at much lower levels than in the recent past (figure EAP.7).

Inflationary pressures building. Consumer price inflation accelerated in East Asia during the second half of 2010, due to a surge in food and other commodity prices, robust domestic demand and the lagged effects of a still loose (though tightening) monetary policy (figure EAP.8). International food prices (see commodities annex) have increased significantly as have local prices of vegetables and other produce. For example, despite a drop in international rice prices, local rice prices have risen in Indonesia and Lao PDR. Nonetheless, with international food prices forecast to ease toward the second half of 2011 and into 2012, food inflation should slow later in the forecast period. But even with (food) inflation forecast to slow, prices will remain high, negatively

Figure EAP.5 Chinese exports strongly correlated with high-income country import demand

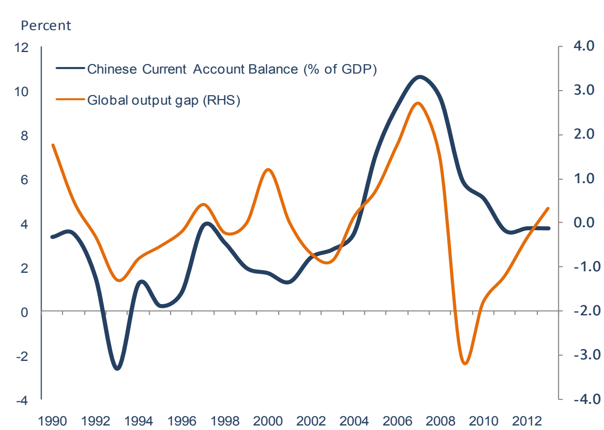
Source: World Bank.

Figure EAP.6 Chinese imports (mostly processing and/ or consumption related) drives East Asia and the Pacific (excl China) exports



Source: World Bank.

Figure EAP.7 Chinese current account surplus to stabi-lize at lower levels as global imbalances subside



Source: World Bank.

impacting on the poor—because of food's substantial weighting in the region's consumer basket.

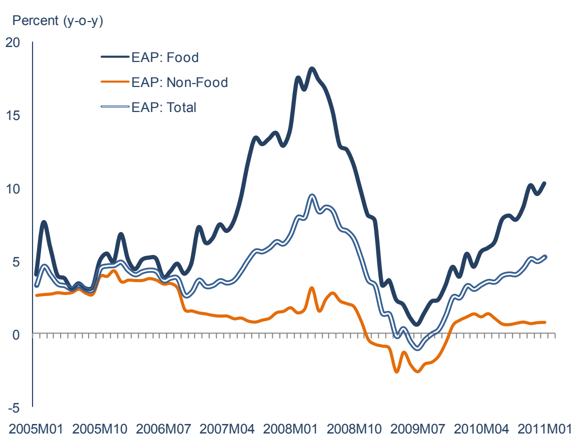
Although non-food inflation has remained moderate, there is a risk in some countries that if the current loose monetary policy setting continues for an extended period, inflationary pressures from food may instigate a wage-price spiral, which over time could push up non-food inflation, hamper competitiveness and slow growth.

Moderate improvement in fiscal balances. Historically, counter-cyclical fiscal policy management has been well executed, with fiscal balances tending to moderate the business cycle (figure EAP.9). In the current context, however, fiscal balances in the region improved by only 0.2 percent of GDP during 2010. Discretionary expenditures added to boost demand during the crisis have by and large not been withdrawn, due to concerns about the strength of the global recovery, and adherence to earlier spending commitments. As a result, almost all of the small improvement in fiscal balances has been cyclical and related to improved revenues, while rough estimates suggest that structural fiscal balances have actually deteriorated during 2010.

Sharp rebound in foreign direct investment. Net foreign direct investment (FDI) inflows to East Asia increased by more-than 60 percent from $138 billion in 2009 to an estimated $225 billion in 2010, with the bulk of the inflow destined for China (table EAP.1). Net FDI inflows to China increased by 62 percent in 2010, with the surge driven by buoyant growth prospects, strong investor sentiment and large interest differentials between China and high-income countries. According to revised estimates from China's State Administration of Foreign Exchange (SAFE), FDI inflows into China rebounded strongly from $114 billion in 2009 to $185 billion in 2010. The largest increase was in the financial sector (300 percent) followed by the real estate sector (78 percent), reaching $12 billion and $21 billion, respectively. Manufacturing remains the main recipient of FDI inflows into China. The sector received $70 billion in 2010, 50 percent more than in 2009. With the revisions, China now accounts for 30 percent of total FDI inflows to developing countries compared with one-fourth previously. Aggregate portfolio flows to the region remained relatively stable between 2009 and 2010, but private debt flows more-than doubled from $58 billion in 2009 to $116 billion in 2010, partly reflecting private borrowers in the real-estate sector turning to external lenders after been shut out of domestic credit markets as the authorities tightened domestic credit conditions.

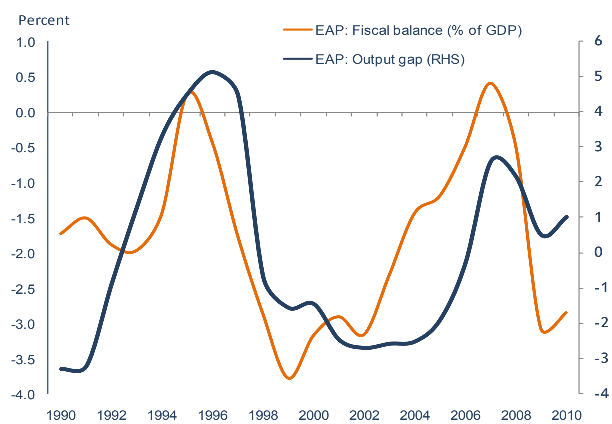
Pace of exchange rate appreciation has slowed. Despite exchange rate market intervention, and measures to deter inflows and

Figure EAP.8 Food inflation exerting upward pressure on total inflation



Source: World Bank.

Figure EAP.9 Counter-cyclical fiscal management has been well executed, but more tightening might have been needed in 2010



Source: World Bank.

encourage capital outflows, the region's currencies appreciated sharply during 2010. As capital inflows have slowed somewhat since late in that year (see Finance Annex), the pace of nominal appreciation for the recipients of the largest capital inflows has also subsided. However, with inflation on the rise, real appreciation pressures remain, albeit also subsiding somewhat. Thus far, currency appreciation has not hampered the recovery, as the region continues to benefit from strong productivity growth.

Medium-term outlook

Growth in the East Asia and Pacific region is projected to remain strong, with GDP gains easing from 9.6 percent in 2010 to 8.5 and 8.1 percent in 2011 and 2012 respectively, before increasing somewhat to 8.2 percent by 2013 (table EAP.2). The region has benefitted from the global economic recovery and the baseline forecast provides for further benefits – particularly as activity in high-income countries that were severely affected by the 2008-09 global financial and economic crisis normalizes. The projected slowing in growth mainly reflects economies operating at or near full capacity and an expected gradual tightening of monetary and fiscal policies over the coming 18-24 months, which should temporarily slow growth to slightly below potential, before GDP reaccelerates marginally again towards potential growth by 2013.

The direct contribution of net trade to overall GDP growth is anticipated to be only marginally positive over the forecast period – a sharp turnaround from negative 4.1 percent in 2009, but significantly smaller than the 2.6 percent net trade contribution observed over the 2005 – 2008 boom period. These earlier net trade benefits were largely associated with unsustainable global excess demand, particularly in high income countries. As global economic activity normalizes and global disequilibria unwind, the net trade contribution to regional growth is forecast to be smaller going forward.

Aggressive policy stimulus underpinned private

Table EAP.1 Net capital flows to East Asia and the Pacific

$ billions

	2003	2004	2005	2006	2007	2008	2009	2010e	2011f	2012f	2013f
Current account balance	69.8	87.9	174.8	297.5	426.3	467.2	360.8	358.3	320.2	358.9	401.1
as % of GDP	3.1	3.3	5.8	8.2	9.3	8.1	5.8	4.8	3.6	3.6	3.5
Financial flows:											
Net private and official inflows	**76.4**	**127.0**	**209.0**	**238.4**	**303.9**	**210.5**	**226.5**	**378.2**			
Net private inflows (equity+private de	**83.6**	**132.2**	**212.3**	**247.7**	**307.8**	**211.6**	**222.8**	**374.5**	**371.1**	**383.7**	**413.5**
..Net private inflows (% GDP)	3.7	5.0	7.0	6.8	6.7	3.6	3.6	5.0	4.2	3.8	3.6
Net equity inflows	69.3	89.7	168.1	207.9	233.9	206.6	168.2	262.2	282.1	300.7	342.5
..Net FDI inflows	56.8	70.4	142.4	151.7	198.8	213.9	138.4	225.2	255.1	267.7	305.5
..Net portfolio equity inflows	12.5	19.3	25.7	56.2	35.1	-7.3	29.9	37.0	27.0	33.0	37.0
Net debt flows	7.1	37.3	40.9	30.6	70.0	3.9	58.3	116.0			
..Official creditors	-7.2	-5.2	-3.2	-9.3	-3.8	-1.1	3.7	3.7			
....World Bank	-1.5	-1.9	-0.6	-0.4	-0.3	1.2	2.2	1.8			
....IMF	-0.5	-1.6	-1.6	-8.5	0.0	0.0	0.1	0.1			
....Other official	-5.2	-1.7	-1.0	-0.4	-3.5	-2.3	1.4	1.8			
..Private creditors	14.3	42.5	44.2	39.9	73.9	5.0	54.5	112.3	89.0	83.0	71.0
....Net M-L term debt flows	-9.8	9.1	9.3	14.8	18.5	16.2	-0.8	22.9			
......Bonds	1.8	9.6	10.1	3.9	0.7	0.2	8.4	16.4			
......Banks	-8.5	1.7	1.6	12.2	18.1	18.3	-8.7	6.5			
......Other private	-3.1	-2.1	-2.3	-1.3	-0.3	-2.3	-0.5	0.0			
....Net short-term debt flows	24.1	33.4	34.8	25.1	55.4	-11.2	55.4	89.4			
Balancing item /a	-6.4	22.2	-166.1	-240.8	-189.2	-245.3	-52.5	-397.0			
Change in reserves (- = increase)	-139.8	-237.1	-217.7	-295.1	-541.0	-432.4	-534.8	-339.5			
Memorandum items											
Workers' remittances	32.3	40.0	50.3	57.4	71.0	85.4	86.2	92.5	98.8	106.7	

Source: World Bank.

consumption, which advanced by an estimated 7.1 percent in 2010. With policy expected to become a bit tighter, household consumption growth is likely to remain at around 7 percent in 2011, before recovering to around 8 percent towards the end of the forecast period. Similarly government spending contribution to growth will wane somewhat, as policy stimuli are withdrawn, while private investment spending eases in response to slower aggregate demand.

China's real GDP expanded by 10.3 percent in 2010, up from 9.1 percent in 2009 (table EAP.3). Stronger growth was driven by rising activity in most segments of the economy, in part as a result of loose credit conditions and a government-backed stimulus package that boosted investment.[2] However, growth momentum slowed throughout 2010, with year-on-year growth falling from 11.9 percent in the first quarter to 9.6 percent in the third quarter, before picking up somewhat to initial estimates of 9.7 percent in the first quarter of 2011. The contribution of net external trade to GDP growth eased in the fourth quarter. Export volumes outpaced import volumes substantially in the first three quarters of 2010, but as domestic demand accelerated, import volumes have risen, which along with high oil and other imported commodity prices has reduced the Chinese trade balance. The slowing GDP growth trend is expected to continue, with growth viewed to

Table EAP.2 East Asia and the Pacific forecast summary

(annual percent change unless indicated otherwise)				Est.	Forecast		
	98-07[a]	2008	2009	2010	2011	2012	2013
GDP at market prices (2005 US$) [b]	7.9	8.5	7.4	9.6	8.5	8.1	8.2
GDP per capita (units in US$)	7.0	7.6	6.6	8.7	7.7	7.3	7.4
PPP GDP [c]	7.8	8.4	7.4	9.6	8.5	8.0	8.5
Private consumption	5.9	7.5	7.3	7.1	7.0	7.3	7.7
Public consumption	7.9	8.6	6.6	7.1	6.8	6.7	6.6
Fixed investment	9.3	9.1	19.2	11.9	11.0	9.2	9.9
Exports, GNFS [d]	13.6	7.1	-10.1	21.9	11.4	10.5	12.0
Imports, GNFS [d]	11.8	4.6	-1.8	18.8	12.6	10.9	13.3
Net exports, contribution to growth	1.4	1.6	-4.1	2.2	0.4	0.6	0.3
Current account bal/GDP (%)	4.4	8.1	5.8	4.8	3.6	3.6	3.5
GDP deflator (median, LCU)	5.2	7.8	2.0	4.6	5.5	4.5	4.2
Fiscal balance/GDP (%)	-2.1	-0.5	-3.1	-2.8	-1.9	-1.3	-0.9
Memo items: GDP							
East Asia excluding China	4.6	4.7	1.5	6.8	5.3	5.6	5.7
China	9.1	9.6	9.1	10.3	9.3	8.7	8.8
Indonesia	4.1	6.0	4.6	6.1	6.3	6.5	6.5
Thailand	4.5	2.5	-2.3	7.8	3.7	4.2	4.3

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

Source: World Bank.

slow to 9.3 percent in 2011, as stimulus spending comes to an end and policy tightening leads to a slowdown in growth in property investment. And as strong growth acceleration in high-income countries moderates, it will dampen China's export growth. But consumption should be buoyed by rising employment and wages, even as higher (food) inflation will suppress purchasing power to a degree. Growth of 8.7 and 8.8 percent is anticipated for 2012 and 2013 respectively. Such slower growth (when compared to the average 11.2 percent over 2005-

Table EAP.3 East Asia and the Pacific country forecasts

(annual percent change unless indicated otherwise)				Est.	Forecast		
	98-07 [a]	2008	2009	2010	2011	2012	2013
Cambodia							
GDP at market prices (2005 US$) [b]	8.8	6.7	-1.9	6.7	6.5	6.5	6.6
Current account bal/GDP (%)	-4.2	-10.2	-8.3	-11.0	-11.8	-10.9	-11.0
China							
GDP at market prices (2005 US$) [b]	9.1	9.6	9.1	10.3	9.3	8.7	8.8
Current account bal/GDP (%)	4.4	9.6	6.0	5.1	3.6	3.8	3.8
Fiji							
GDP at market prices (2005 US$) [b]	2.0	0.2	-3.0	0.6	1.3	0.7	1.2
Current account bal/GDP (%)	-6.3	-18.3	-8.4	-6.8	-7.9	-7.7	-8.2
Indonesia							
GDP at market prices (2005 US$) [b]	4.1	6.0	4.6	6.1	6.3	6.5	6.5
Current account bal/GDP (%)	3.1	0.0	1.9	0.9	1.4	0.5	0.1
Lao PDR							
GDP at market prices (2005 US$) [b]	6.4	7.3	6.4	8.4	8.6	7.6	7.3
Current account bal/GDP (%)	-10.6	-18.7	-13.5	-8.6	-9.4	-10.6	-11.1
Malaysia							
GDP at market prices (2005 US$) [b]	5.1	4.7	-1.7	7.2	4.8	5.0	5.1
Current account bal/GDP (%)	12.5	17.5	16.5	13.6	14.2	13.5	13.9
Mongolia							
GDP at market prices (2005 US$) [b]	6.4	8.9	-1.3	6.1	10.3	7.6	22.9
Current account bal/GDP (%)	-2.9	-12.9	-9.0	-15.2	-15.1	-13.6	1.9
Papua New Guinea							
GDP at market prices (2005 US$) [b]	1.7	6.7	4.5	7.6	5.8	5.1	5.3
Current account bal/GDP (%)	3.3	8.8	-8.5	-6.5	0.0	-2.3	-2.7
Philippines							
GDP at market prices (2005 US$) [b]	4.4	3.7	1.1	7.3	5.0	5.4	5.5
Current account bal/GDP (%)	0.7	2.2	5.5	5.0	4.2	3.2	1.7
Thailand							
GDP at market prices (2005 US$) [b]	4.5	2.5	-2.3	7.8	3.7	4.2	4.3
Current account bal/GDP (%)	4.7	0.8	8.3	4.8	3.6	3.2	3.6
Vanuatu							
GDP at market prices (2005 US$) [b]	2.5	6.3	4.0	4.5	4.1	4.2	4.3
Current account bal/GDP (%)	-9.3	-9.0	-8.1	-7.3	-6.4	-6.6	-7.1
Vietnam							
GDP at market prices (2005 US$) [b]	6.6	6.3	5.3	6.8	6.0	6.8	7.2
Current account bal/GDP (%)	-1.4	-11.9	-6.3	-4.0	-2.7	-3.7	-3.9

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

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

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

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

c. Estimate.

d. Forecast.

Source: World Bank.

2010), is largely due to weaker contributions from net exports (when compared to the boom period) and slower investment growth.

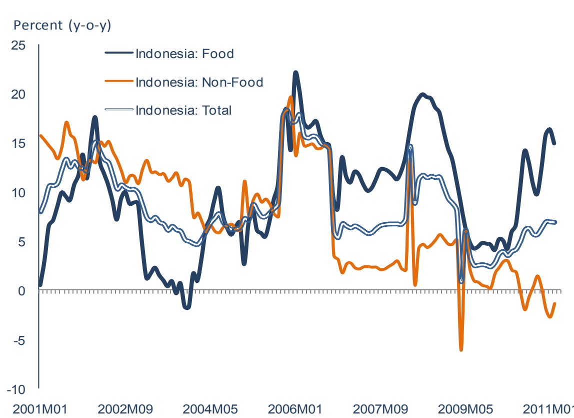
Consumer price inflation in China reached 5.4 percent (y-o-y) in March 2011, before declining marginally to 5.3 percent in April. About two-thirds of this increase was attributable to food prices, which have been driven by problematic weather domestically and by hikes in international food prices. Going forward, upstream price pressures may continue to build because of the hikes in oil and industrial commodity prices. As discussed in the Commodity Annex, international food prices are forecast to moderate. The baseline forecast therefore incorporates a moderation in food price inflation in the coming 12 months, which should offset the rise in non-food inflation, resulting in a slowdown in headline CPI inflation.

Indonesian inflation also started to rise in mid-2010, as consumer prices reflected food supply shocks and an accommodating policy stance (figure EAP.10). Inflation in domestic grain prices, primarily rice, reached almost 30 percent year-on-year in December 2010. Headline inflation moved up to 7 percent while the rate of increase of prices in a "poverty basket" of goods consumed by the poor rose to 13 percent. With the onset of the harvest season and imports of rice by the State Logistics Agency, domestic rice and food prices have declined. Bank Indonesia has also embarked on a process of normalizing rates, following earlier increases in reserve requirements, and the rupiah has continued to appreciate. While headline inflation has come down, core inflation has been increasing gradually. Inflation is anticipated to rise to an average of 6.3 percent in 2011, slightly above Bank Indonesia's 4-6 percent target range.

Indonesia was less severely affected by the 2008-09 global recession than many East Asian countries largely because of a relatively limited exposure to external trade shocks (plus the commodity focus of the export mix) along with strong initial conditions and supportive monetary and fiscal policy responses. Economic growth accelerated in 2010, with real GDP expanding by 6.1 percent in the year as a whole and by 6.9 percent year-on-year in the fourth quarter, the fastest quarterly growth pace in six years. Private consumption will remain a major driving force over the forecast period, while investment strength is set to be supported by the shift in government spending towards capital expenditures and the real impact of the recent FDI upsurge.

Quarterly growth in the *Thai* economy rebounded strongly in the second half of 2010, helping to register growth of 7.8 percent in the year. But with the rebound in the past, the pace of growth is expected to slow to a more subdued 3.7 percent in 2011. Although domestic political uncertainty will continue it is not expected to greatly influence the growth outlook. Japanese multinational corporations plays a significant role in the Thai economy, and the impact of the Japanese earthquake on auto and electrical and electronics supply chains (these two sectors account for over 40 percent of Thai exports) could hamper Thai exports and overall economic performance. Rising commodity prices – particularly those of agricultural produce - have raised export earnings, while the rising farm incomes have supported growth in domestic demand. But fuel (diesel) and fertilizer costs have also risen sharply, thereby eroding the income gains, while rising costs have put upward pressure on inflation. In order to accelerate growth to structurally higher levels, Thailand

Figure EAP.10 Food price increases have contributed to rising inflation in Indonesia



Source: ILO, World Bank.

will have to raise the share of fixed investment in GDP, and improve education outcomes.

Economic growth in *Malaysia* is expected to remain strong and on a sustainable growth path in the forecast period. After real GDP gains of 7.2 percent in 2010, growth is expected to come in around 5 percent per annum over 2011-2013. Fiscal policy played a key role in the post-crisis recovery, but GDP growth sputtered in the third quarter of 2010 as domestic demand growth slowed – largely due to intensified fiscal consolidation efforts, which dampened public consumption. Fixed investment spending also came under pressure, reflecting public expenditure cutbacks as well as uncertainties about economic prospects. Private consumption, however, remained strong, underpinned by a vibrant job market, high commodity prices and consumer lending. Although inflationary pressures have been rising in Malaysia, CPI gains remain moderate, and monetary policy continues to renormalize. Continued current account surpluses and a positive interest rate differential with the United States over the forecast period should support the ringgit.

The *Philippine* economy rebounded sharply in 2010, as GDP expanded by 7.3 percent - the fastest pace since the mid-1970s, with both industry and services recording strong growth. The pace of economic expansion is expected to slow to 5.0 percent in 2011, as global growth moderates, and to average 5.4 percent over 2012 and 2013. Growth will benefit from increased remittances from Filipinos working overseas which will support private consumption. Despite the remarkable growth turnaround, domestic unemployment remains structurally high, and there have been some (though inadequate) trickle -down benefits to the poor, with the depth of poverty and income distributions improving between 2006 and 2009.

After growing 5.3 percent in 2009, *Vietnam*'s economy expanded 6.8 percent in 2010—the fastest pace in 3 years. The rapid recovery has been bolstered by robust domestic demand, which benefitted from a healthy increase in remittances, higher levels of investment supported by strong FDI, and a strong revival in exports as global demand recovered. Looking forward, GDP growth is forecast to average 6.7 percent over 2011-2013. But despite the encouraging growth outlook, policymakers will face stiff challenges in the near term, as they will need to ensure that the recovery remains on track as expansionary fiscal measures are withdrawn amidst building inflationary pressures. The consumer price index has risen by more than 10 percent year-on-year in the past four months, with the most recent (February, 2011) figure at 12.3 percent. Although the Central Bank (State Bank of Vietnam) tightened monetary policy in February 2011, increases in subsidized retail prices for fuel and electricity are likely to continue to put upward pressure on inflation, as will the recent devaluation of the dong.

Growth in *Cambodia* is expected to remain strong, as the country's exports benefit from European Union preferential tariffs, while consumption picks up and investment benefits from the continued rebound in FDI. Growth in *Fiji*, which has become increasingly dependent on tourism, has been disappointingly slow over the last four years, and the government needs to move ahead with several structural reforms to accelerate growth. In *Lao PDR*, real growth is forecast to remain robust over the forecast period, with both natural resources (hydropower and sustained mining extraction) and manufacturing sectors to drive growth over the forecast period. *Papua New Guineas*' strong economic performance since 2007 is forecast to continue, albeit at slower rates than the estimated 7.6 percent in 2010 over the forecast period with growth averaging 5.4 percent over 2011-2013, with growth benefitting from resurgent minerals production and investment in new projects.

Risks

Despite a generally optimistic assessment for East Asia's economic prospects, and though the region's improved immune system has passed the test during the global financial crisis, there are still a number of risks that have the potential to derail the growth outlook.

Developments in the Middle East have contributed to higher oil prices and still have the potential of further disruption on commodity price volatility than is currently appreciated in the baseline. And given the links between energy and food prices, these developments in the Middle East could have implications that extend well beyond energy.

In several countries rising food and fuel prices and the pass through to inflation remains a concern – particularly if these increases spill over to other sectors. Already, inflation is now above central bank targets and/or official projections in China and Indonesia, while it has surged to double digits in Vietnam. Although monetary stimulus is gradually been withdrawn in the region, there is a risk that inflationary pressures may be building faster than provided for in the baseline.

As authorities in the region tighten monetary policy and interest rates rise, many currencies will continue to experience pressure for appreciation. And still strong capital inflows (albeit lower than recent highs) in response to higher interest rate differentials could lead to excess credit expansion, complicating the task of combating inflationary pressures.

The region's public finances have emerged from the global downturn in relatively good shape. But the strong rebound in growth and the rapid closing of output gaps to the extent that domestic demand surpasses potential output in many countries is putting additional stress on monetary authorities in combating inflationary pressures. Furthermore, an over-reliance on the region's central banks to rein-in inflation is likely to attract even more (potentially destabilizing) capital inflows. A better balance between monetary and fiscal policy tightening will not only be more effective in preventing overheating of some economies, but will also be less disruptive to economic activity in tradable sectors.

Among the longer term risks, (see March 2011 East Asia and Pacific Update for a more detailed discussion), inequality is on the rise in several countries, most notably in China. This is contributing to social tensions and those left behind represent a significant waste of human potential. Policies to broaden access to higher levels of education, facilitate labor mobility, and connect leading and lagging regions will serve to simultaneously stem rising inequality and accelerate the pace of economic development and poverty reduction.

Over the longer term the region faces fundamental challenges related to environmental sustainability, energy security and climate change. As a result of fast economic growth and rapid urbanization over a prolonged period of time, energy consumption has more than tripled over the past three decades and is likely to double in the next 20 years. As a result, the region is home to some of the world's most polluted cities. To sustain growth, policy will need to actively encourage a shift towards the usage of clean(er) energy by increasing energy efficiency, low-carbon technologies in power generation and the building of low-carbon cities.

Notes:

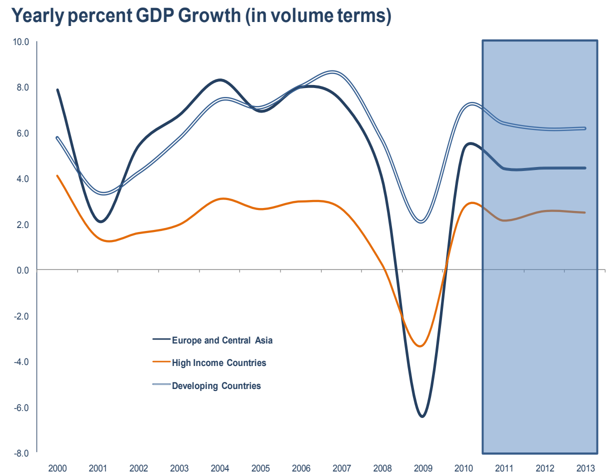
1 For a more detailed discussion and a complete overview of regional and country developments, see "Securing the present, shaping the future", East Asia and Pacific Economic Update 2011, Volume 1. The World Bank, March 2011.

2 China is discussed in more detail in the China Quarterly Update—see "Quarterly Update" The World Bank, April 2011.

Europe and Central Asia

GDP growth in developing Europe and Central Asia[1] rebounded to an estimated 5.2 percent in 2010, following a 6.5 percent contraction in 2009 (table ECA.1 and figure ECA.1). Limited credit growth, the deleveraging of household-sector balance sheets and continued industrial sector restructuring following the easy-credit excesses of the boom period are expected to continue weighing on GDP. Because of that, output is projected to expand at a relatively subdued (by developing countries' standards) growth rate of 4.7 percent in 2011 and averaging 4.5 percent during 2012 and 2013. These aggregate figures hide significant variation across countries within the region, with those most affected during the above-average credit growth period performing least well, while resource-rich economies are benefitting from high commodity prices.

Figure ECA.1 A deep recession followed by a relatively modest recovery



Source: World Bank.

Table ECA.1 Europe and Central Asia forecast summary

(annual percent change unless indicated otherwise)				Est.	Forecast		
	98-07[a]	2008	2009	2010	2011	2012	2013
GDP at market prices (2005 US$) [b]	5.4	4.0	-6.4	5.2	4.7	4.4	4.6
GDP per capita (units in US$)	5.4	3.9	-6.5	5.2	4.7	4.3	4.5
PPP GDP [c]	5.6	4.5	-6.6	5.0	4.5	4.5	4.5
Private consumption	6.3	6.6	-5.7	3.9	4.9	4.3	4.1
Public consumption	2.5	3.2	1.8	1.1	2.8	2.6	2.1
Fixed investment	8.8	6.6	-16.7	7.6	9.5	8.4	8.1
Exports, GNFS [d]	7.2	3.1	-7.3	9.5	6.6	5.9	6.3
Imports, GNFS [d]	10.2	8.7	-24.3	9.2	9.2	7.3	6.9
Net exports, contribution to growth	-0.3	-2.0	6.4	0.4	-0.5	-0.3	0.0
Current account bal/GDP (%)	2.6	0.6	0.7	0.9	-0.1	-1.8	-1.4
GDP deflator (median, LCU)	11.2	12.4	3.5	7.8	10.9	5.8	6.4
Fiscal balance/GDP (%)	-2.1	1.7	-5.4	-3.2	-0.5	-0.2	-0.4
Memo items: GDP							
Transition countries [e]	6.2	5.3	-7.0	3.8	4.2	4.1	4.3
Central and Eastern Europe [f]	4.7	6.1	-7.1	0.0	2.4	3.8	4.0
Commonwealth of Independent States [g]	6.5	5.2	-7.0	4.5	4.5	4.2	4.3
Russia	6.3	5.2	-7.8	4.0	4.4	4.0	4.1
Turkey	3.7	0.7	-4.8	8.9	6.1	5.1	5.3
Romania	4.3	7.1	-7.1	-1.2	1.6	3.7	4.0

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

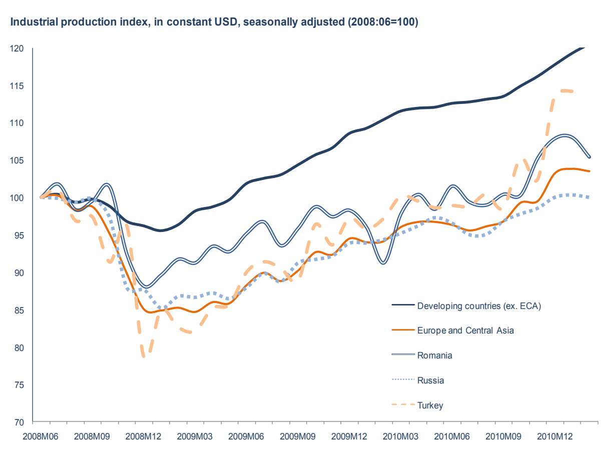
Source: World Bank.

Recent developments

The recession in Europe and Central Asia was much deeper than elsewhere in the developing world, because substantial trade and financial market linkages with high-income Europe. Overall, regional industrial production, which had been growing at a 6.2 percent pace in the four years before the crash, fell 10 percent in 2009–more than three times as much as in other developing regions. Partly as a result of this, output only regained pre-crisis levels at the end of 2010, versus mid-2009 for the rest of the developing world.

As of the first quarter of 2011, industrial production in the region was expanding at a 9.3 percent annualized pace. If sustained, such an expansion should begin to close the still large 20 percent gap between current activity levels and those that might have been observed if the boom and bust not occurred. Progress at the sub-regional level has been mixed, with Russian (which represents over 50 percent of the region's total industrial product) growth of 8.3 percent during 2010 underperforming the regional aggregate, and well below the impressive performance of Turkey, up 13.2 percent in 2010 (figure ECA.2). As a whole, seasonally adjusted industrial production in the region grew almost 8.0 percent, ranging from an over 19 percent increase in Lithuania for the 12 months ending March 2011 to a 5.3 percent contraction in Kazakhstan (for the 12 months ending April 2011).

Figure ECA.2 Only by end-2010 industrial production regained pre-crisis activity levels and remains well below earlier trends

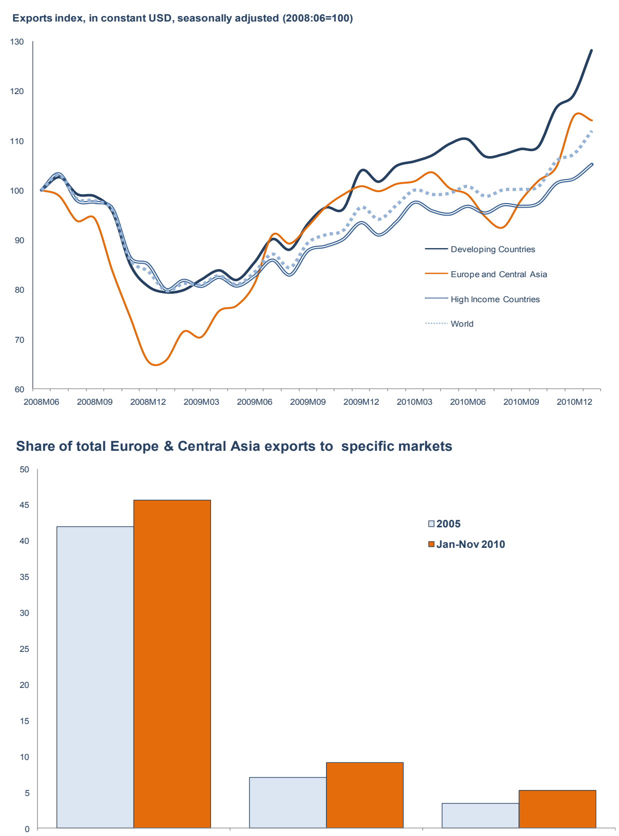


Sources: World Bank.

Much of the initial impetus for recovery in Europe and Central Asia reflected the region's strong export performance, that saw real merchandise exports expanding at a 25 percent annualized pace during the final three months of 2010. Lithuania and Romania, exporters of manufactured goods to the EU market, recorded some of the fastest growth rates (a more than 40 percent increase during the final 3 months of 2010), while economies in the Southern Caucasus and Central Asia sub-region, such as Armenia and Uzbekistan, reported the slowest export growth rates (figure ECA.3).

The acceleration in regional trade reflects the

Figure ECA.3 Regional exports outpaced other developing countries, reflecting growing market share in high-income and Chinese markets



Source: World Bank, IMF.

global recovery, but also the increased trade ties of several countries in the region towards faster growing economies inside and outside the region. Between 2005 and 2010, the share of the exports of countries going to the Commonwealth of Independent States[2] (CIS) and Russia was broadly stable, while shares going to Turkey, the EU (notably, Germany) and China increased significantly (by more than 55 percent in the case of China: figure ECA.3).[3]

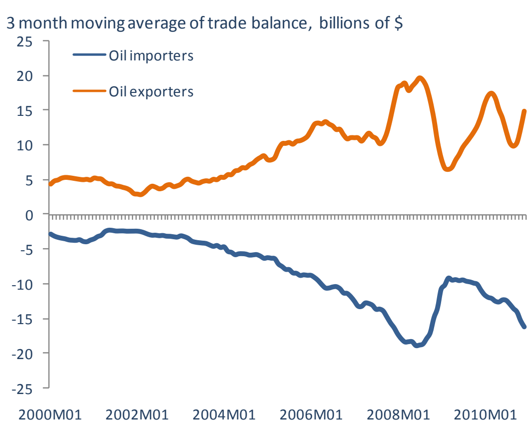
This overall pattern has particular sub-regional dimensions. The EU is a more important trading partner for the western CIS, the Southern Caucasus and countries like Albania, Bosnia and Herzegovina, FYR Macedonia, Kosovo, Montenegro and Serbia, while China is a relatively more relevant trade partner for countries in Central Asia (albeit the EU still remains, on aggregate, the largest trade partner of this sub-region).

The combination of growing exports volumes and rising commodity prices, especially oil, has contributed to a large fall in the region's trade deficit, from \$3.6 billion at end 2010 to \$0.7 billion in early 2011. Higher oil prices were reflected in a sharp increase in the trade surplus of oil exporters, from \$10 billion in August 2010 to \$14 in December, and a deterioration among oil importers, from a \$-13 to \$-16 billion trade deficit over the same period (figure ECA.4).

Despite the depth of the recession and the massive disruption to the construction industry and still large industrial sectors of the regional economy, unemployment rose relatively little from 7 percent in 2007 to a peak of 9.3 percent in 2009 and has fallen relatively rapidly, coming in at 8.6 percent at the end of 2010, a nevertheless still elevated level that makes it a ongoing cause for concern. The regional aggregate is significantly influenced by developments in Russia, Turkey and Ukraine (figure ECA.5), which represent two thirds of the region's total population. Unemployment in these countries rose by 2.6 percentage points between 2008 and 2009, before falling by 1.5 percentage points between 2009 and 2010. In the remaining countries of the region unemployment averages 15.6 percent of the labour force (ranging from close to full formal employment in places like Belarus and Tajikistan[4] to as much as 45 percent unemployment in Bosnia and Herzegovina). Developments in these countries have been equally varied, but there not only the average unemployment rate was considerably higher previous to the crisis, it actually rose somewhat during 2010.

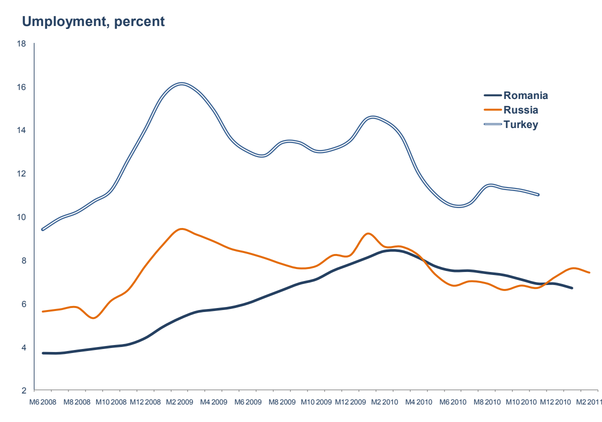
As observed elsewhere (see main text and Financial annex), private capital inflows into Europe and Central Asia, which were strong in the second and third quarters of 2010 eased in the fourth quarter of that year and into 2011 (for

Figure ECA.4 Rising commodity prices improve oil exporter's trade balances



Sources: World Bank.

Figure ECA.5 Unemployment down



Sources: IMF.

the year as a whole they were still up 88 percent, table ECA.3). The decline in portfolio flows was most evident in Turkey, and roughly coincided with the authorities' decision to lower interest rates in an effort to deter capital inflows being attracted by high-interest rate differentials, while restricting credit growth by simultaneously raising reserve requirements. Russia experienced significant outflows, despite high and rising energy prices (figure ECA.6). FDI flows increased the most in Ukraine, reflecting the recapitalization of banks, while they declined more in Kazakhstan and Romania. Significant improvements will likely be delayed until the regional recovery matures further and until there are substantial improvements in the region's investment climate.[5]

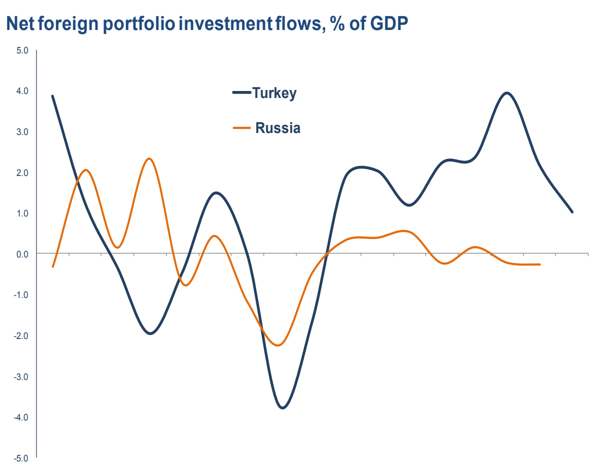
Rising food prices following the extreme drought in the summer of 2010 contributed to a pickup in inflation in the region during 2010.[6] Food prices rose at a 12 percent annualized pace in the three months ending September 2010, which contributed, with a lag, to an acceleration in overall inflation to a 7.6 percent annualized rate in the fourth quarter of the year. Year-over-year, all-goods inflation picked up from 6.3 percent in June 2010, to 7.6 percent in the fourth quarter of the year. Inflation now exceeds 10 percent in almost forty percent of the countries in the region, but it has been easing as the inflationary impact of the 2010 higher food prices fades (figure ECA.7). However, the recent rise in oil prices is likely to yield a second acceleration, which may be exacerbated by planned increases in regulated prices in Belarus and Ukraine (and, in the case of Belarus, by a devaluation of the currency).

Remittances are both an important source of foreign currency for several countries in the region and an important source of income for households, and therefore an important determinant of domestic demand. Remittances are around 10 percent of GDP for countries like Armenia and Bosnia and Herzegovina, and between 18 and 35 percent of GDP for Albania, the Kyrgyz Republic, Moldova and Tajikistan. After falling by almost a quarter between 2008 and 2009, they rose by a meager 1.3 percent in 2010. Looking forward, high commodity prices and stronger growth in migration destination countries are expected to contribute to a 7.5 percent increase in remittances in 2011 and a 9.4 percent increase in 2012 (table ECA.2).

Fiscal and monetary policy

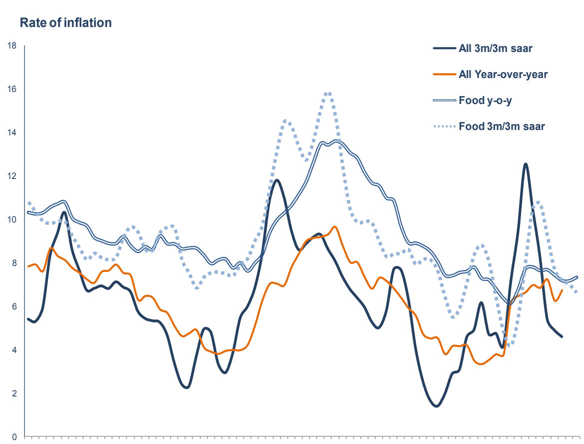
Monetary authorities in the region have responded to the uptick in inflation by tightening monetary policy via both higher interest rates (Belarus, Russia, three times in the case of the later, and four times already in the case of the former) and increased reserve requirement (Turkey). Despite rising policy rates, foreign

Figure ECA.6 Hot money flows easing



Source: World Bank, CBR.

Figure ECA.7 Inflationary impulse from food prices appears to be easing



Source: World Bank.

Table ECA.2 Workers' remittances, compensation of employees, and migrant transfers, credit (US$ million)

	2003	2004	2005	2006	2007	2008	2009	2010p	2011f	2012f
All developing countries	137,500	159,258	191,779	226,297	278,181	324,972	307,569	324,714	348,576	374,501
Europe and Central Asia	11,597	15,998	23,262	28,397	39,332	45,832	35,433	35,879	38,681	42,308
% of developing countries	8.4	10.0	12.1	12.5	14.1	14.1	11.5	11.0	11.1	11.3
					Growth (%)					
All developing countries	23.9%	15.8%	20.4%	18.0%	22.9%	16.8%	-5.4%	5.6%	7.3%	7.4%
Europe and Central Asia	8.2%	37.9%	45.4%	22.1%	38.5%	16.5%	-22.7%	1.3%	7.8%	9.4%
LDCs (UN-classification)	13.9%	12.9%	11.0%	18.5%	22.9%	32.8%	5.2%	5.8%	10.9%	7.3%
Fragile States		26.5%	8.4%	8.2%	12.6%	-2.1%	-9.1%	7.5%	6.7%	
Small States		12.6%	-1.3%	22.8%	27.8%	31.3%	-11.4%	8.4%	7.8%	

Source: World Bank

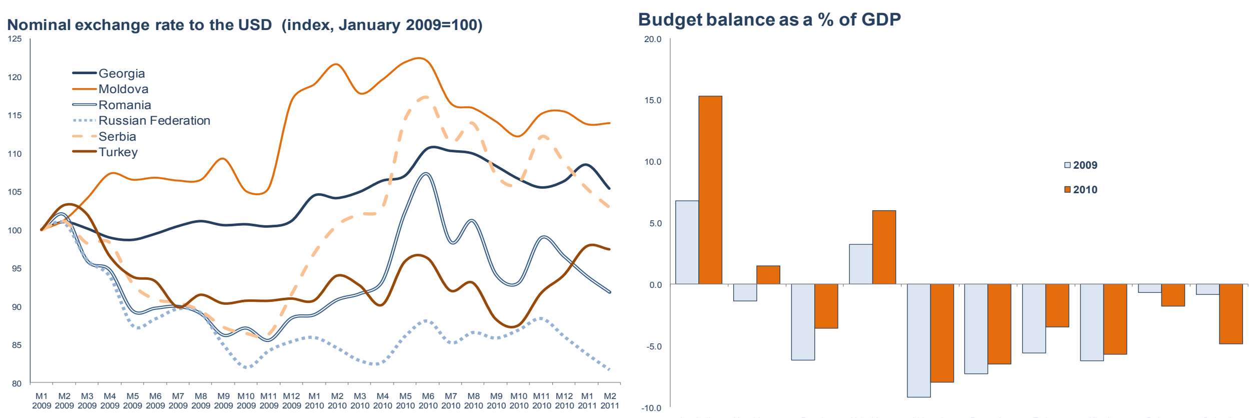
capital inflows to the region have declined and upward pressure on exchange rates eased (figure ECA.8). Domestic bank credit has started to grow again, but so far at moderate rates.

The rebound in commodity prices during the course of 2009 and 2010 helped to reduce government deficits among regional energy exporters from -5.4 percent of GDP in 2009 to -2.4 percent in 2010. Declines among importers were also noticeable, as increased activity helped restore government coffers at the same time as initial attempts towards discretionary fiscal consolidation were announced (especially among EU members). These broad aggregates hide significant differences at the national level, where government balances range from double digit surpluses in Azerbaijan to almost double digit deficits in post-conflict Kyrgyz Republic. A few countries bucked the deficit reduction trend (figure ECA.8), like Belarus, but the country's stock of public debt to GDP is still low, at around 25 percent in 2010 (the largest share in the region is to be found in the Kyrgyz Republic, at 63 percent). Bulgaria also experienced an increase in the cash fiscal deficit, nevertheless fiscal adjustment in that country continued through a reduction in previously accrued and unpaid obligations.

Outlook

GDP in developing Europe and Central Asia grew an estimated 5.2 percent in 2010, a modest rebound given the steep decline in activity that preceded it, but one which nevertheless served to

Figure ECA.8 Exchange rates begin to fall, at the same time that the budgetary position becomes more sustainable



Source: World Bank, IMF.

reduce unemployment and improve fiscal positions. Ongoing household and banking-sector restructuring is expected to continue to constrain growth, with GDP projected to expand by 4.7 percent in 2011, and by around 4.5 percent in 2012 and 2013. While these growth rates are close to estimates of the region's potential growth rate, growth is not likely to be strong enough to make significant inroads into the spare capacity generated by the crisis. As a result, unemployment, although declining, is projected to remain relatively high throughout the projection period.

Overall, the external sector is projected to contribute between -0.5 and 0 percent to overall growth during the projection period. Among oil exporters, the additional revenues from higher prices are expected to boost domestic demand and imports, such that in volume terms the external sector subtracts somewhat from growth in the economy. On the other hand, given strong growth in other developing regions and the projected firming of the recovery in high-income Europe, the pick-up in regional manufacturing export volumes is expected to continue outpacing imports among oil importing countries.

Higher commodity prices will increase current account balances for commodity-rich countries in the region, while having the opposite effect among importers. However, revenues are projected to leak into additional spending and imports relatively quickly such that by 2013 current account surpluses of oil exporters, which reached 5.5 percent of GDP in 2010, are projected to return to 2.3 percent of GDP. Current account deficits among oil importers are projected to exceed -6 percent of GDP in 2011 and to improve only slightly to around -5.7 percent of GDP in 2013.

Higher commodity prices should boost government revenues in resource-rich countries in the region, reducing government deficits from -2.5 of GDP in 2010 to a surplus of 1.1 of GDP by 2013. At the same time, improving activity levels and ongoing fiscal consolidation measures are projected to reduce government deficits in oil

Table ECA.3 Net capital flows to Europe and Central Asia

$ billions

	2003	2004	2005	2006	2007	2008	2009	2010e	2011f	2012f	2013f
Current account balance	20.3	36.7	48.5	37.6	-14.1	13.3	14.1	22.3	-8.3	-76.9	-69.6
as % of GDP	2.0	2.8	2.9	1.8	-0.5	0.4	0.5	0.7	-0.2	-1.8	-1.4
Financial flows:											
Net private and official inflows	**81.0**	**99.9**	**127.8**	**218.2**	**410.4**	**262.1**	**89.8**	**132.1**			
Net private inflows (equity+private deb	**85.8**	**107.2**	**156.2**	**248.9**	**413.5**	**251.0**	**57.6**	**108.4**	**146.9**	**176.1**	**190.4**
..Net private inflows (% GDP)	8.5	8.0	9.3	12.0	15.5	7.6	2.2	3.5	4.0	4.1	3.9
Net equity inflows	25.3	43.7	57.8	104.6	160.2	145.0	90.0	83.4	96.9	116.1	135.4
..Net FDI inflows	23.8	41.9	51.1	92.3	133.2	160.1	85.1	76.4	90.9	107.1	124.4
..Net portfolio equity inflows	1.5	1.8	6.7	12.3	27.0	-15.1	5.0	7.0	6.0	9.0	11.0
Net debt flows	55.8	56.2	70.0	113.6	250.2	117.1	-0.2	48.7			
..Official creditors	-4.7	-7.3	-28.4	-30.7	-3.0	11.1	32.2	23.7			
....World Bank	-0.2	1.0	-0.7	0.2	0.2	0.7	2.8	2.2			
....IMF	-2.0	-5.9	-9.8	-5.8	-5.0	6.2	20.2	10.5			
....Other official	-2.5	-2.5	-18.0	-25.1	1.8	4.2	9.3	11.0			
..Private creditors	60.5	63.5	98.4	144.3	253.3	106.0	-32.5	25.0	50.0	60.0	55.0
....Net M-L term debt flows	34.0	52.2	80.0	108.9	177.5	121.3	5.3	24.0			
......Bonds	7.3	14.4	16.6	32.3	55.9	16.2	-1.7	13.5			
......Banks	27.1	39.0	64.7	77.5	122.6	105.7	7.3	10.5			
......Other private	-0.4	-1.3	-1.3	-0.8	-1.0	-0.6	-0.4	0.0			
....Net short-term debt flows	26.5	11.3	18.4	35.4	75.7	-15.3	-37.7	6.9			
Balancing item /a	-52.3	-67.7	-89.3	-84.2	-170.2	-333.3	-77.9	-107.2			
Change in reserves (- = increase)	-49.1	-68.8	-87.0	-171.6	-226.1	57.8	-26.0	-47.2			
Memorandum items											
Workers' remittances	11.6	16.0	23.3	28.4	39.3	45.8	35.4	35.9	38.7	42.3	

Note:

e = estimate, f = forecast

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

Source: World Bank.

importers from -4.4 percent of GDP in 2010 to about -2.1 percent of GDP in 2013.

Russia, the largest regional economy, is set to grow by around 4.2 percent yearly over the forecast period, fueled in part by higher oil revenues. Improving employment prospects are projected to bring unemployment down to around 6 percent in 2013 and this, together with higher oil revenues, should be reflected in a larger contribution from domestic consumption and investment demand to growth. Parliamentary elections in late 2011, and Presidential ones during the first quarter of 2012 may result in some election-year spending that could reduce the large but mainly cyclically induced expected improvement in the general government balance. The limited diversification of the economy and constraints to the increase of energy-related exports remain key medium-term challenges that are expected to prevent output from expanding much more than 4 percent per annum over the projection period. As a result, much of the additional oil-revenue is expected to fuel an increase in demand that will be met by increased imports, so that the country's current account surplus is projected to decline to around 1.4 percent by 2013.

Growth in Turkey, the second largest developing economy in the region, which rebounded sharply in 2010 when the economy grew by 8.9 percent, is forecast to grow by a still robust 5.5 percent average over the forecast period. Turkey's large current account deficit, and its high oil import bill, at around 5 percent of GDP, represent a source of vulnerability, should investor sentiment sour or oil prices rise (see scenario in main text).

Growth among the European Union's members in developing Europe (Bulgaria, Lithuania and Romania) is projected to accelerate to around 3.4 percent during the projection period, aided by the relatively diversified nature of these economies, significant EU and IMF support programs, and the recovery in the euro area. Lithuania is also projected to benefit from the robust performance of the Polish economy (now a high-income country). Although these countries have so far not been affected by concerns about high-income Europe fiscal sustainability, contagion via financial sector links remains a possibility — placing a premium on restoring an adequate degree of fiscal space to their public finances.

The countries of the Western part of the Commonwealth of Independent States (Belarus, Moldova and Ukraine) are projected to grow by an average of 4 percent between 2011 and 2013. However, these economies face significant potential downside risks, given their large current account deficits (Belarus and Moldova), and their relatively undiversified economies (and, in the case of Belarus, by its over-reliance on the Russian market for its exports). Ukraine is also susceptible to external shocks, notably from higher energy prices. Medium-term growth is expected to be constrained to around 4.3 percent because of weak productivity growth tied in part to the undiversified nature of the economy and lack of competition.

In Central Asia, GDP in Kazakhstan (over two thirds of the sub-regional GDP) is set to expand by around 5.7 percent yearly during the next three years on the back of high commodity prices and deepening links with other developing Asian economies. The sub-region will do even better, growing by 6.1 percent. Strong commodity prices should contribute to improved public and external balances among the sub-regional resource exporters — Kazakhstan, Turkmenistan and Uzbekistan (Tajikistan is also a significant cotton exporter). The Kyrgyz Republic and Tajikistan are projected to make inroads into their large external and fiscal deficits, thanks in part to significant remittances receipts and official aid, linked in the Kyrgyz Republic to post-conflict reconstruction efforts.

Albania, Bosnia and Herzegovina, FYR Macedonia, Kosovo, Montenegro and Serbia are anticipated to grow by around 4.5 percent during the next three years, supported by their close economic ties with the recovering EU, including significant financial and technical support. Despite improved growth, these economies are expected to continue to suffer on average from

Table ECA.4 Europe and Central Asia country forecasts

(annual percent change unless indicated otherwise)	98-07[a]	2008	2009	Est. 2010	Forecast 2011	2012	2013
Albania							
GDP at market prices (2005 US$) [b]	5.5	7.7	3.3	3.5	4.0	4.5	5.0
Current account bal/GDP (%)	-6.2	-14.6	-16.0	-12.4	-10.8	-9.5	-7.9
Armenia							
GDP at market prices (2005 US$) [b]	9.6	6.8	-14.1	2.1	4.6	4.3	4.2
Current account bal/GDP (%)	-8.6	-11.6	-15.8	-13.9	-11.6	-10.3	-9.3
Azerbaijan							
GDP at market prices (2005 US$) [b]	14.2	10.8	9.3	5.0	4.2	4.1	4.4
Current account bal/GDP (%)	-7.2	35.6	21.6	25.7	25.8	22.4	21.5
Belarus							
GDP at market prices (2005 US$) [b]	6.9	10.2	0.2	7.6	2.5	3.0	4.0
Current account bal/GDP (%)	-3.9	-8.6	-13.0	-15.6	-9.3	-9.1	-9.3
Bulgaria							
GDP at market prices (2005 US$) [b]	4.8	6.2	-5.5	0.2	2.9	3.4	3.9
Current account bal/GDP (%)	-8.7	-22.9	-8.9	-1.0	-2.1	-2.4	-2.7
Georgia							
GDP at market prices (2005 US$) [b]	6.6	2.3	-3.8	6.4	5.5	5.3	5.0
Current account bal/GDP (%)	-9.8	-25.3	-11.2	-9.6	-10.8	-9.7	-8.1
Kazakhstan							
GDP at market prices (2005 US$) [b]	8.3	3.3	1.2	7.0	5.7	5.5	5.8
Current account bal/GDP (%)	-2.7	4.7	-3.8	2.9	5.2	4.4	3.9
Kosovo							
GDP at market prices (2005 US$) [b]		6.9	2.9	4.0	5.7	5.2	4.9
Current account bal/GDP (%)		-22.8	-25.0	-24.8	-28.8	-29.3	-26.9
Kyrgyz Republic							
GDP at market prices (2005 US$) [b]	3.9	8.4	2.3	-1.4	5.0	6.0	6.4
Current account bal/GDP (%)	-8.4	-14.6	2.0	-3.6	-10.8	-9.2	-5.0
Lithuania							
GDP at market prices (2005 US$) [b]	5.8	2.9	-14.7	1.3	3.8	3.9	3.5
Current account bal/GDP (%)	-8.5	-12.3	4.4	1.9	-1.0	-2.6	-2.5
Moldova							
GDP at market prices (2005 US$) [b]	4.1	7.8	-6.0	6.9	4.2	4.5	4.8
Current account bal/GDP (%)	-8.4	-17.3	-9.3	-10.5	-10.7	-10.3	-10.8
Macedonia, FYR							
GDP at market prices (2005 US$) [b]	2.6	4.8	-0.7	0.8	2.9	3.7	4.2
Current account bal/GDP (%)	-5.3	-12.8	-6.7	-2.9	-4.9	-5.1	-4.7
Romania							
GDP at market prices (2005 US$) [b]	4.3	7.1	-7.1	-1.2	1.6	3.7	4.0
Current account bal/GDP (%)	-7.0	-11.9	-4.3	-4.2	-5.1	-5.4	-5.7
Russian Federation							
GDP at market prices (2005 US$) [b]	6.3	5.2	-7.8	4.0	4.4	4.0	4.1
Current account bal/GDP (%)	9.5	6.2	3.9	5.0	3.5	0.5	1.4
Serbia							
GDP at market prices (2005 US$) [b]	3.3	5.5	-3.1	1.8	3.0	5.0	5.5
Current account bal/GDP (%)	-7.4	-17.6	-6.9	-7.1	-7.3	-6.5	-5.7
Tajikistan							
GDP at market prices (2005 US$) [b]	8.1	7.9	3.8	6.5	5.7	5.0	5.0
Current account bal/GDP (%)	-3.8	-7.6	-5.9	2.2	-4.3	-6.4	-6.1
Turkey							
GDP at market prices (2005 US$) [b]	3.7	0.7	-4.8	8.9	6.1	5.1	5.3
Current account bal/GDP (%)	-2.4	-5.7	-2.2	-6.6	-7.7	-7.3	-6.9
Ukraine							
GDP at market prices (2005 US$) [b]	5.9	2.1	-14.8	4.2	4.0	4.5	4.6
Current account bal/GDP (%)	3.2	-7.1	-1.5	-2.0	-3.1	-3.4	-3.6
Uzbekistan							
GDP at market prices (2005 US$) [b]	5.2	9.0	8.1	8.5	8.0	7.8	7.5
Current account bal/GDP (%)	7.8	13.0	3.1	8.3	13.2	11.1	11.4

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.

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

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

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

c. Estimate.

d. Forecast.

Source: World Bank.

very large and persistent formal unemployment, limited state capacity and relatively fragile fiscal and external positions (covered by remittances and FDI inflows), which are set to improve only slightly through the forecast horizon.

The economies of the South Caucasus sub-region are expected to expand by an average of 4.5 percent over the next three years, due to higher commodity prices and on the back of the recoveries in the EU and in Russia. Oil-fueled Azerbaijan is project to grow by a robust 4.2 and to experience improvements in its external and fiscal positions. Although both Armenia and Georgia are projected to enjoy growth of, respectively, around 4.3 and 4.9 percent going forward, both these economies will remain sensitive to changes in sentiment given persistent double-digit current account and budget deficits.

Risks

Although the forces of recovery in the global economy and in developing Europe and Central Asia are well established, there are a number of important evolving tensions that have the potential to disrupt the relatively robust recovery that is projected for the region.

Continued uncertainties and political tensions in the Middle-East and North Africa or a further disruption to oil supplies could send oil prices even higher. Simulations reported in the main text suggest that growth among regional oil exporters could accelerate by between 0.1 and 2.0 percentage points in the 2011-2013 period if tensions were to give rise to a sustained $50 increase in oil prices. The estimated 0.5 to 0.6 percentage point reductions in regional oil importers growth between 2011 and 2013 is somewhat less severe than for oil importers elsewhere, partly because of offsetting benefits of higher remittances and increased imports from regional oil exporters, which represent around 60 percent of the regional economy.

A second major risk for the region centers on the evolution of the fiscal sustainability crisis in high-income Europe. So far, these challenges have had limited impact in countries in developing Europe and Central Asia—with spreads having increased relatively little and capital flows recovering in line with domestic conditions. Should events in high-income Europe force banks to repatriate capital or just reduce the pace at which regional profits are reinvested, capital flows to the region could dry up —with potentially large negative effects on those countries with high-levels of debt and/or large current account deficits.

Finally, the region was buffeted by a very poor crop year in 2010. If domestic production does not improve, a second year of disappointing harvests could reinforce recent upticks in inflation —possibly even resulting in second-round effects that would increase inflation expectations, especially if combined with the direct effects of the energy price shock, forcing a further tightening of monetary policies and increasing the already daunting challenges of recovering from the excesses of the boom period.

Notes:

1. For the purposes of this report, the developing Europe and Central Asia region is comprised of only low- and middle-income countries (22 in total). Thus the aggregate excludes high-income Western European countries (among which Croatia, the Czech Republic and Hungary), but includes low- and middle-income EU member states (Bulgaria, Lithuania and Romania).

2. The CIS is a loose organization that includes most of the countries from the former Soviet Union, notably Armenia, Azerbaijan, Belarus, Georgia, Kazakhstan, Kyrgyz Republic, Moldova, Russia, Tajikistan, Turkmenistan, Ukraine and Uzbekistan. Turkmenistan discontinued its membership of the CIS as of 26 August 2005, and is now an associate member, while Georgia has left the group in August 2009. Ukraine has never ratified the CIS Treaty,

3. The ongoing creation process of a Customs

Union between three members of the so-called "Eurasian Economic Community" (EurAsEC), namely Belarus, Kazakhstan and Russia may conceivably increase the regional share of intra-CIS trade (albeit possibly at the cost of welfare-reducing trade diversion).

4. Low measured unemployment likely reflects hidden unemployment due to limited economic restructuring in Belarus, and imperfect official statistics in Tajikistan

5. The World Bank's "Doing Business" indicator, a useful proxy for investment climate, shows that, while the region broadly stagnated between 2010 and 2011 (the average value for the aggregate indicator remained at 78, or over twice the EU average), each of the three largest regional economies worsened their relative positions (and Russia by a significant 7 slots).

6. See also "Rising Food and Energy Prices in Europe and Central Asia" (World Bank 2011) for an analysis of the regional effects of increasing commodity prices.

Latin America and the Caribbean

Recent developments

The Latin American and Caribbean region has rebounded strongly from the global crisis of 2008-09, growing 6.0 percent in 2010 compared with a 2.1 percent contraction in 2009. Strong growth in Argentina, Brazil, and Peru boosted growth in South America to 6.5 percent after a mild contraction in 2009. Central America (including Mexico), the area in the region most affected by the crisis has yet to reach the level of output recorded before the crisis, having expanded 5.2 percent in 2010 after a 5.5 percent contraction in 2009. The rebound in growth in Central America reflects mainly a strong rebound in the Mexican economy, which is closely linked to the United States. The Caribbean region recorded the weakest growth in Latin America at 3.8 percent, after a modest 0.5 percent in 2009.

Industrial production growth picked up in the first quarter of 2011, growing at more than a 10 percent seasonally adjusted annualized rate (or saar) boosted by strong domestic demand and

Table LAC.1 Latin America and the Caribbean forecast summary

(annual percent change unless indicated otherwise)	98-07[a]	2008	2009	Est. 2010	Forecast 2011	2012	2013
GDP at market prices (2005 US$) [b]	2.9	4.0	-2.1	6.0	4.5	4.1	4.0
GDP per capita (units in US$)	1.6	2.7	-3.4	4.7	3.2	2.8	2.7
PPP GDP [c]	2.9	4.3	-2.0	5.9	4.7	4.2	4.1
Private consumption	3.2	5.1	-0.8	5.8	4.6	4.0	3.9
Public consumption	2.2	3.0	4.3	3.9	3.7	4.4	4.3
Fixed investment	3.4	8.7	-10.4	11.9	7.0	7.8	6.7
Exports, GNFS [d]	5.2	1.4	-10.1	12.5	6.6	6.1	6.1
Imports, GNFS [d]	5.5	7.7	-15.5	22.5	7.9	7.8	7.1
Net exports, contribution to growth	-0.1	-1.7	1.7	-2.5	-0.6	-0.7	-0.6
Current account bal/GDP (%)	-0.9	-0.8	-0.6	-1.5	-1.4	-1.9	-2.3
GDP deflator (median, LCU)	5.8	8.0	4.0	5.0	5.2	5.6	5.4
Fiscal balance/GDP (%)	-2.9	-0.9	-4.0	-3.0	-2.2	-2.3	-2.0
Memo items: GDP							
LAC excluding Argentina	3.1	3.8	-2.4	5.7	4.3	4.1	4.0
Central America [e]	3.5	1.8	-5.5	5.2	4.4	4.1	4.2
Caribbean [f]	4.4	3.3	0.5	3.8	4.1	4.3	4.0
Brazil	2.6	5.2	-0.7	7.5	4.2	4.1	3.8
Mexico	3.4	1.5	-6.1	5.5	4.4	4.1	4.2
Argentina	3.0	6.8	0.9	9.2	6.3	4.2	4.3

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, Trinidad and Tobago, St. Vincent and the Grenadines.
g. Estimate.

Source: World Bank.

import demand from other developing countries, China in particular, and more recently from high -income countries where consumer spending has started to recover at a moderate pace. The recovery has been supported to a great extent by strong increases in output and employment in non-traded sectors, including services.

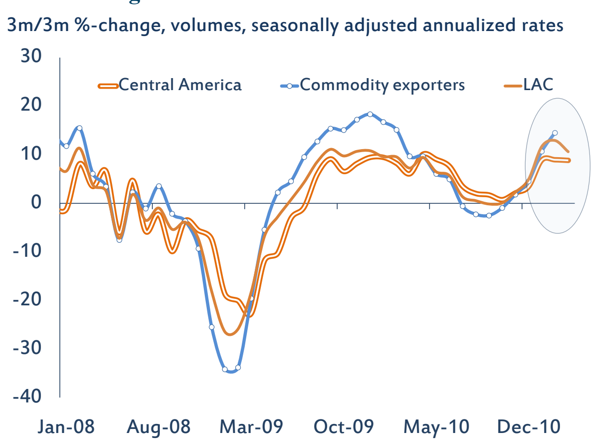
In seasonally adjusted annualized terms acceleration in industrial production growth was particularly pronounced in several resource-rich, globally integrated economies, including Argentina (close to 11 percent), and Mexico (close to 9 percent). Growth in Central America strengthened to close to 9 percent, boosted by strong external demand. In other countries the recovery is more muted or industrial production remains stagnant (figure LAC.1).

Reflecting both differences in initial conditions going into the crisis and in the pace of recovery, output gaps across the region vary widely. Manufacturing capacity utilization is now above trend levels for the region as a whole, with the recovery entering a new more-mature phase, where additional investment in productive capacity will be necessary to sustain growth ahead. Spare capacity has been completely re-absorbed in Uruguay, Peru, Brazil and Colombia due to strong growth in 2010 and relatively shallow slowdowns in 2009. Industrial output gaps have closed in Mexico, and remain positive in Argentina, but are expected to close in the course of 2011 (figure LAC.2). Economic slack remains an issue in the Caribbean economies and Central America, partly because of their reliance on remittances and tourism from the United States and—to a lesser extent—Europe, where the recovery has been relatively slow. Although output in the region as a whole is now 2.2 percent below its pre-crisis peak level, in a few countries it has exceeded that benchmark.

The rebound in industrial production has been mirrored in trade volumes, which have also strengthened in the three months ending in March 2011. The biggest rebound was in regional import demand, which preceded the pickup in exports. Latin American imports now stand 4 percent above earlier pre-crisis peaks, reflecting a strengthening in regional domestic demand--retail sales were up year-on-year 15.3 percent in Argentina, 8.5 percent in Brazil, 5.5 percent in Colombia in February, and momentum is particularly strong in some of these economies. Widespread currency appreciation (notably in Brazil and Mexico) has contributed to this result, as have stronger wages in some cases.

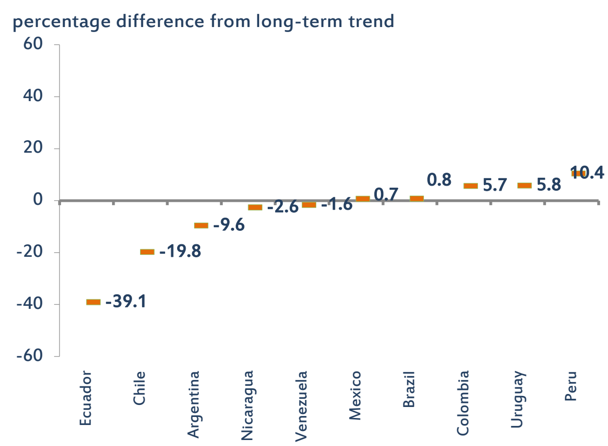
The rebound in imports was followed by an acceleration in regional export growth to a 9.2 percent annualized pace in the three months to March 2011, mainly reflecting strong exports by Argentina, Brazil, Colombia, and Mexico (figure LAC.3). Export volumes are now roughly 1.1 percent above pre-crisis peaks, and exceed the pre-crisis peak by 9.2 percent in Brazil. In

Figure LAC.1 Industrial output annualized growth remains strong in Latin America



Source: Thomson Datastream and World Bank.

Figure LAC.2 Industrial capacity utilization in Latin American countries



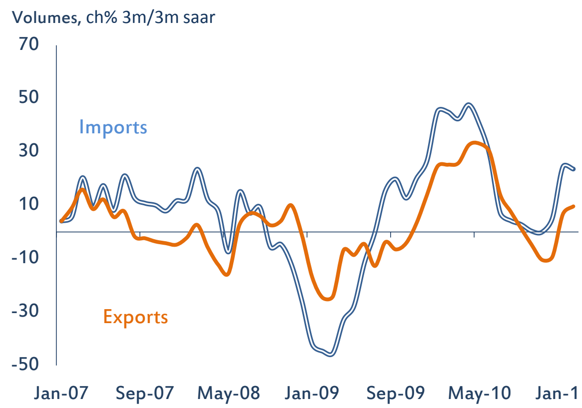
Source: Thomson Datastream and World Bank

Central America, including Mexico, volumes are closing on pre-crisis peaks. The increase in both export revenues and imports is much stronger on account of rising commodity prices for some main export and import commodities.

Capital flows have returned to selected economies in search of higher yields and are putting upward pressures on select currencies (box LAC.1). Net private inflows rose to 4.8 percent of GDP in 2010, after falling to 3.7 percent of GDP in the year of the crisis, but are still shy of the 6.0 percent of GDP recorded in 2007. The largest increase was recorded in FDI inflows, up 57.4 percent, while net portfolio equity inflows increased by almost 30 percent to $54 billion. Net lending by banks totaled $7.4 billion, after an outflow of $5.6 billion the previous year, while short-term debt flows amounted to $16.6 billion.

A large pipeline of sovereign and commercial bond issuance has run through the region in the first months of 2011. Mexico took advantage of historically low U.S. interest rates and sold $1.5 billion of bonds due in 2040 during April, its second dollar issue in two months, pushing its share of regional offerings to 65 percent.

Figure LAC.3 Trade growth reaccelerates in Latin America and the Caribbean



Source: World Bank.

Table LAC.2 Net capital flows to LAC

$ billions

	2003	2004	2005	2006	2007	2008	2009	2010e	2011f	2012f	2013f
Current account balance	8.1	20.2	32.4	44.0	9.9	-35.8	-22.2	-67.1	-78.6	-112.8	-141.7
as % of GDP	0.4	0.9	1.2	1.4	0.3	-0.8	-0.6	-1.5	-1.4	-1.9	-2.3
Financial flows:											
Net private and official inflows	**62.2**	**57.2**	**85.2**	**66.2**	**217.5**	**177.2**	**166.7**	**240.4**			
Net private inflows (equity+private debt)	**57.5**	**67.3**	**116.6**	**86.1**	**218.5**	**170.7**	**147.5**	**220.0**	**237.1**	**243.3**	**258.1**
..Net private inflows (% GDP)	3.1	3.1	4.4	2.8	6.0	4.0	3.7	4.8	4.3	4.2	4.1
Net equity inflows	46.6	65.3	84.4	83.0	138.2	118.2	115.2	169.9	174.1	181.3	199.1
..Net FDI inflows	43.3	65.9	72.2	72.0	109.4	127.9	73.6	115.9	130.1	132.3	147.1
..Net portfolio equity inflows	3.3	-0.6	12.2	11.0	28.8	-9.7	41.6	54.0	44.0	49.0	52.0
Net debt flows	15.7	-8.1	0.8	-16.8	79.2	59.0	51.5	70.5			
..Official creditors	4.7	-10.2	-31.3	-19.9	-1.1	6.5	19.2	20.4			
....World Bank	-0.4	-1.0	-0.7	-3.4	-0.1	2.4	6.6	6.2			
....IMF	5.6	-6.3	-27.6	-12.1	0.0	0.0	0.4	0.2			
....Other official	-0.4	-2.9	-3.0	-4.4	-1.0	4.1	12.2	14.0			
..Private creditors	10.9	2.0	32.2	3.1	80.3	52.5	32.3	50.1	63.0	62.0	59.0
....Net M-L term debt flows	9.2	-0.9	16.4	5.2	47.6	48.4	34.1	40.9			
......Bonds	16.7	3.1	20.6	-11.9	13.4	7.5	40.3	33.5			
......Banks	-7.0	-3.8	-3.9	17.7	34.6	41.4	-5.6	7.4			
......Other private	-0.5	-0.1	-0.3	-0.6	-0.4	-0.5	-0.5	0.0			
....Net short-term debt flows	1.8	3.0	15.7	-2.1	32.7	4.1	-1.8	16.6			
Balancing item /a	-34.6	-52.0	-83.3	-54.7	-89.6	-91.2	-92.5	-110.6			
Change in reserves (- = increase)	-35.6	-25.4	-34.4	-55.5	-137.8	-50.1	-52.0	-62.7			
Memorandum items											
Workers' remittances	36.9	43.4	49.8	58.9	63.0	64.5	56.6	57.6	62.5	68.4	

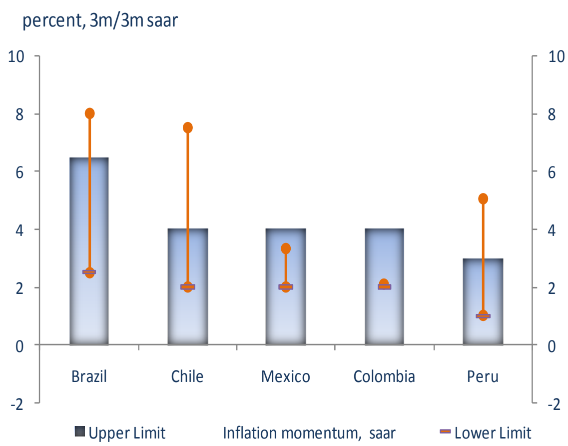
Source: World Bank.
Note: e = estimate, f = forecast
/a Combination of errors and omissions and transfers to and capital outflows from developing countries.

Furthermore international investors bought $21 billion of peso-denominated debt in the six months through March. And Argentina's companies and provinces sold $1.5 billion worth of bonds in the first quarter, a record since 2001 when the government defaulted on $95 billion of obligations and more-than double the $597 million sold a year ago.

Inflationary pressures are rising in several economies on higher food and fuel prices, strong domestic demand, rising wages, and increasingly limited spare capacity. Headline inflation rates are near the upper ends of central bank target ranges in many inflation-targeting economies. Indeed, inflation accelerated to 6.5 percent during April in Brazil (year-on-year) matching the upper-limit of the inflation target range. In Peru, inflation accelerated to the fastest pace in almost three years, while Uruguay's consumer price inflation picked-up to 8.6 percent, the fastest pace in four years, and well above the upper limit of the inflation target range of 3 to 7 percent (figure LAC.4).

In most economies the build-up in inflationary pressures stems from significant increases in international fuel and food prices. Additionally, Brazil, Peru, and Argentina are operating at almost full capacity, and face the risk of cost-

Figure LAC.4 Annualized inflation in the three months to April exceeds the upper limit of the targeted band in three of the five inflation targeting economies in LAC



Source: World Bank, Central Banks.

Box LAC.1 Impacts of and policy responses to strong capital inflows and strong real credit growth

Strong economic performance in the major economies of the region, low interest rates in high-income countries, and interest differentials favoring Latin American assets, have attracted large capital inflows. And along with strong export revenues in commodity-exporting countries, this has resulted in strong upward pressure on selected currencies. In real-effective terms, the Brazilian real and the Mexican peso have appreciated sharply, reducing the external competitiveness of their exports.

To limit short-term volatile capital inflows, countries have implemented a combination of macro policies (monetary, exchange rate policies, and fiscal policies). To stem currency appreciation, which in some cases had started in the pre-crisis period, some countries have intervened in foreign exchange markets. As foreign exchange market interventions were proving increasingly costly and ineffective in stemming currency appreciation, and as massive sterilization efforts led in selected cases to rising interest rate differentials which where attracting still more capital inflows, countries also resorted to some measures of capital control. Argentina, Brazil, Chile, Colombia, Mexico, and Peru have intervened in the foreign exchange markets, while Chile, Colombia, Mexico and Peru have also increased ceilings for foreign pension fund investments. Furthermore Brazil has introduced IOF taxes on financial transactions, short-term loans and issuance of securities. It is now charging a 6 percent levy on international debt sales and loans with an average minimum maturity of up to 360 days, after having tripled a tax on foreigners' purchases of fixed-income securities in October 2010 in a bid to stem the appreciation of the real.

Countries have also taken steps to manage credit growth in a bid to ease domestic demand and prevent overheating, by increasing reserve requirements (Brazil, Colombia, Peru), as real credit growth has been expanding very rapidly in selected economies (14 percent in Brazil and 20 percent in Colombia).

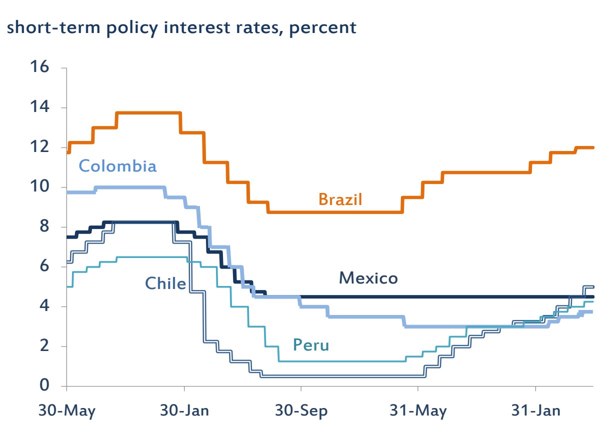
Rapid credit growth increases the risk that in the event of growth slowing down abruptly, banks' balance sheets will come under pressure. Some countries in the region have already implemented measures to strengthen balance sheets and capital by raising countercyclical capital requirements, and capital requirements for credit operations (Brazil), requiring tighter loan-loss provisions (Bolivia, Colombia, Peru), limiting the net open positions of financial institutions (Brazil, Colombia, Mexico, Peru), and through counter-cyclical provisioning (Bolivia, Colombia, Peru, Uruguay).

Source: Crowe 2011, Moreno 2011

push inflation. Indeed, wages in Argentina were rising at a record pace in January. Demand-pull inflation is also a source of concern in countries like Brazil, where domestic demand remains buoyant. Moreover, la Nina-related supply side shocks have compounded the effects of imported food inflation, in countries like Colombia and Venezuela. Inflation remains relatively subdued in many economies, including in Mexico, Chile, and Peru.

Most inflation-targeting countries in the region have begun to normalize monetary policy (Mexico is a notable exception). Brazil's central bank hiked its benchmark rate 125 basis points to 12.00 percent over the past three meetings as inflation is nearing the upper limit of the targeted range; while Peru raised policy rates ten times to 4.25 percent (figure LAC.5). Nevertheless, in many cases policy has not kept pace with inflation and how effective these measures will depend critically on what has happened to inflationary expectations. At the moment, despite hikes in nominal interest rates, real interest rates deflated by actual inflation remain low and even negative in some countries. The task of adopting the appropriate monetary policy is being complicated in selected economies by the surge in capital inflows, which is putting pressure on currencies to appreciate and which lead to increased liquidity in the economy to the extent that these flows are intermediated by the financial sector.

Figure LAC.5 Central banks in Latin America have started the monetary tightening cycle



Source: National Agencies through Datastream

Relative to the pre-crisis period, the currencies of Ecuador, Colombia, Chile, Peru and Brazil have appreciated in nominal effective terms, between 2.5 and 11 percent, while Venezuela and Argentina recorded some of the strongest depreciations. Meanwhile real effective exchange rates have appreciated by more than 10 percent relative to the pre-crisis period in Bolivia, Brazil, Costa Rica, Guyana, and Uruguay, while depreciating in Mexico and Argentina. Nevertheless given relatively stable nominal exchange rate and high inflation rates the Argentine peso appreciated strongly in 2010 and in the early months of 2011. In the first four months of 2011 the currencies of Brazil, Colombia, and Mexico have appreciated in nominal effective terms by between 3.5 and 4.5 percent. In some cases like Brazil and Colombia, the currencies are considered overvalued, while in others like Argentina currencies are estimated to be weaker than warranted by medium-term fundamentals.

Many countries that saw increased pressures on currencies intervened in the exchange markets, including Argentina, Brazil, Chile, Colombia, and Mexico. International reserves rose $37.6 billion to reach $657.1 billion by the end of the first quarter. Some countries have also introduced higher ceilings to foreign investment of pension funds, including Chile, Colombia, Mexico, and Peru (Crowe et al. 2011, Moreno 2011). Several countries, including Brazil and Peru have resorted to capital controls to ease the pressure on currencies.

After deteriorating on average by nearly 3 percent of GDP in the crisis year, as governments engaged in counter-cyclical spending, fiscal balances improved last year in most developing Latin American and Caribbean countries, on average by more than 1 percent of GDP. Government balances deteriorated more in small economies and island economies. General government balances are expected to continue to improve this year, by an estimated 0.8 percentage points of GDP, helped in large part by commodity windfall for commodity exporters. General government balances are expected to deteriorate in Paraguay and Ecuador, among others, as growth decelerates and/or prices of main commodity exports weaken. In Argentina's government balances are expected to deteriorate as government spending grows faster than government revenues, particularly in 2011, an election year. In Haiti the government deficit is projected to deteriorate sharply to 5.3 percent of GDP in 2011, after a surplus of 2.2 percent of GDP in 2010. Continued weak growth and increased discretionary spending is expected to cause deficits in some countries to deteriorate further in 2011.

Nevertheless fiscal policies are becoming pro-cyclical in some countries,[1] and tightening is required especially in countries that have very little spare capacity and that show signs of overheating. For these countries, but even for those where deficits have receded, policy will need to take special care to ensure that the fiscal space that allowed policy to respond counter-cyclically in the most recent crisis is recreated. This, such that should another crisis arise, fiscal policies will once again be in a position to respond. Corrected for cyclical impacts on spending and revenues, the structural deficit in Argentina is estimated to be above 3 percent of potential GDP, in Brazil it is estimated at 2.5 percent, while in Guyana it is more than 5 percent of GDP. Structural deficits are lower in Chile and Peru, at around 1.5 percent of GDP.[2]

Brazil has signaled that it will rebalance its policy mix to help fight inflation. Quasi-fiscal expenditures remain a problem for Brazil however, and public banks need to contain loan expansion to help anchor inflationary expectations. The government announced a 50 billion reais spending cut for 2011, with 68 percent to come from reductions in discretionary spending, and the remainder to come from limiting increases in mandatory expenditure.

Improved economic performance in high-income countries and higher employment helped tourism and remittances recover from the 2009 slump. The recovery in remittances was modest in 2010, but due to the depreciation of the U.S. dollar, in local currency terms, remittances have fallen slightly in many countries. Strong economic performance in Latin America has also boosted tourist arrivals and to a lesser extent, tourism revenues, which tend to lag in a recovery. Still, this has been a positive for growth, especially in countries that rely heavily on tourism revenues. Tourism arrivals increased the most in South America, up 10.4 percent to 23.5 million, followed by Central America, where arrivals rose 8.3 percent to 8.3 million, while growth in the Caribbean region lagged at 3.9 percent, with a total of 20.3 million tourist arrivals.[3] In the first quarter of 2011 tourism arrivals were up 15 percent in Latin America and the Caribbean.

Current account balances deteriorated in the Latin America and Caribbean region by 0.9 percent of GDP in 2010 to a deficit of 1.5 percent of GDP. Current account balances remained relatively stable in the Caribbean region and deteriorated by 0.24 percentage points in Central America. Stronger currencies and rapidly growing domestic demand help explain in part the deterioration in current account balances. In selected economies the deterioration in the services balance has played a significant role in the deterioration of current account positions (for example in Brazil).

Medium-term outlook

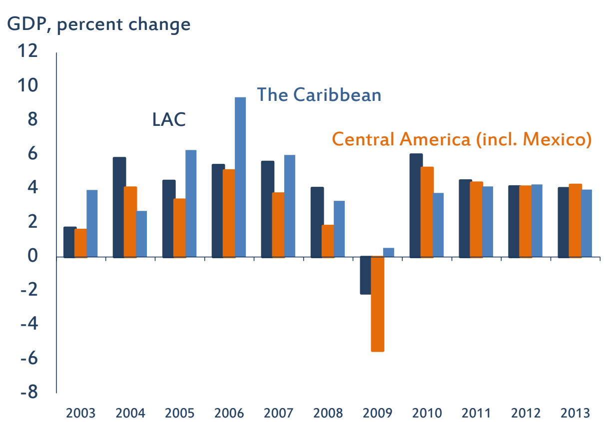
After a strong 2010 recovery from the 2009 economic slump, Latin America and the Caribbean is expected to grow at a somewhat slower pace in 2011. Growing capacity constraints, and high fuel and food prices that cut into real incomes, as well as a gradual tightening of fiscal and monetary policies are all factors that are expected to contribute to the slowdown (figure LAC.6).

Growth in Brazil is expected to ease from the 7.5 percent recorded in 2010, to 4.2 percent in 2011 and around 4.0 percent in 2012 and 2013, as the economy is operating near full capacity, labor market conditions are tight, and wages are starting to increase faster than productivity. The 46 percent real effective exchange rate appreciation observed since January 2009, is expected to continue to weigh on industrial production, both because of weaker exports and increased import demand. Capital flows are projected to be boosted by an increase in FDI (FDI is projected to reach $55 billion this year), even as market sensitivity and government policy serves to dampen more volatile equity and debt-creating flows.

In Mexico, economic activity should slow mildly to 4.4 percent in 2011, and 4.1 percent in 2012, before picking up slightly to 4.2 in 2013. Higher energy prices are projected to cut into consumer demand in both Mexico and the United States, with the latter impact slowing Mexican export growth. Argentina's economy is projected to slow this year to 6.3 percent following a remarkable 9.2 percent gain last year as bounce-back effects recede. Prospects for 2012 and 2013 are for a further slowing of growth as capacity constraints begin to be felt, but outturns will depend importantly on efforts to improve the country's productive potential. Colombia's economy is expected to expand by about 4.7 percent in 2011, picking-up slightly from 4.3 percent recorded in 2010, before easing marginally in 2012 to 4.4 percent and further to 4.2 percent in 2013. There are downside risks to the forecast, as consumer demand is showing signs of weakness, evidenced in weaker retail sales and worsening consumer confidence.

Chile and Venezuela will be also see an improvement in economic performance relative to the previous year, while Peru should be the star performer of the region, expanding by 7 percent in 2011, on the back of strong domestic demand, expansionary fiscal policy and consumption tax cuts, before easing to a more sustainable pace of 5.2 percent by 2013. Venezuela's economy should recover this year, after a two-year recession, but growth will remain anemic, at less than 2 percent, as the business environment continues unattractive for private investors; inflation remains elevated, and supply bottlenecks undermine economic performance.

Figure LAC.6 Growth in Latin America and Caribbean to decelerate over the next two years



Source: World Bank.

Growth in Central America excluding Mexico is expected to accelerate to 4 percent in 2011, and to average about 4.1 percent over the 2012-2013 period, as labor markets in the high-income countries improve only gradually. Stronger external demand will underpin growth over the forecasting horizon, but remittances will grow only modestly as labor income of migrants in the United States and Spain advance only moderately, and as unemployment remains relatively elevated. Poor infrastructure, shortages of skilled labor, expensive electricity and unreliable energy supply will hinder growth in the region.

Economic activity in the Caribbean will accelerate marginally to 4.1 percent in 2011, in large part due to continued strong growth in the Dominican Republic and rebound in growth to 8.7 percent in Haiti on reconstruction efforts. Meanwhile growth in other countries in the region will be more subdued as remittances and tourism are yet to show signs of moderate recovery. Uncertainties regarding the strength of the global recovery among U.S. investors have resulted in major tourism and large-scale investments being put on hold. Jamaica will be one of the weakest performers in the region, due to structural weaknesses and over-dependence on the United States. The Dominican Republic, which accounts for 40 percent of output in the Caribbean region is expected to grow close to 5 percent in 2011 and record slower growth of 4.3 by 2013. Growth in the Caribbean is expected to accelerate marginally to 4.3 percent in 2012 before easing to 4 percent in 2013.

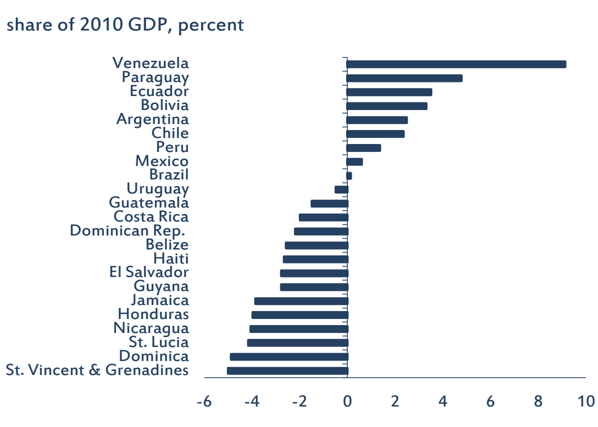
Current accounts are expected to deteriorate in the economies that operate close to capacity and which experienced currency appreciation, as imports become cheaper. Commodity exporters should continue to see improvements in their current account balances, on account of stronger growth in commodity revenues.

Despite the recent rise in oil prices, as a result of the political upheavals in the Middle East and North Africa, income effects in many oil-importing developing countries are expected to be relatively small due, to the partially offsetting effects of high non-oil commodity prices. Resource-rich oil importers in the region will see their terms of trade improve slightly (0.2 percent of GDP), as higher export prices for metals and grains offset the negative impact induced by higher imported oil prices. Saint Vincent and the Grenadines, Dominica, Saint Lucia, Nicaragua, Honduras, and Jamaica will see the largest terms of trade losses, in excess of 3.5 percent of GDP (figure LAC.7). Oil exporting countries will see income gains of 2.0 percent of GDP, while the region as a whole will see positive gains estimated at 0.98 percent of GDP.

Risks

Perhaps the most important downside risk facing the region is that the surge in oil prices will dent global economic growth, as inflationary pressures will take a heavier toll on consumer spending worldwide. Most economies in Latin America face the challenge of fine-tuning monetary policy to help anchor inflationary expectations and keep inflation rates within a targeted range without dampening recovery. If the authorities fail to bring inflation under control in the near term, sharper monetary tightening is the likely course of action, with negative consequences for economic growth in 2012 and 2013.

Figure LAC.7 The terms of trade impacts in 2011



Source: World Bank.

The recent political upheavals in the Middle East, while not having a direct impact on growth for the region have increased the risks of further hikes in energy prices, which will negatively affect growth in oil-importing countries in the region, and in particular growth in Central America, excluding Mexico, and the Caribbean. The impact of a sustained $50 per barrel increase in oil prices is expected to slow growth by 0.3 percentage points in 2012 and 0.4 percentage points in 2013 in Latin America and the Caribbean (excluding Mexico), although the impacts very by country (see Table 3 in the main text).

And with food prices at elevated levels, any disruption in supply risks pushing food prices up further fueling inflation, cutting into household purchasing power and increasing the poverty count, and fueling social tensions. Failure to bring inflation under control could result in sharper tightening of monetary and fiscal policy, which could result in a sharper slowdown in economic activity.

Selected economies in the region face the risk of overheating as they face strong commodity prices and high capital inflows that underpin strong domestic demand. If policymakers in the region fail to rebuild policy buffers, vulnerability to future crisis would be much increased. Furthermore if exit from the fiscal stimulus is delayed, countries will rely more on monetary tightening to keep inflation under control.

The economic fallout from the earthquake and tsunami that hit Japan will likely have a negative impact on FDI flows, given that Japan is an important source of FDI for countries like Brazil. Another risk facing the emerging economies in the LAC region is that of an abrupt reversal of portfolio flows, which could result in sharp depreciations of currencies. A disorderly unwinding of the fiscal sustainability issue in Europe represents a risk to economic activity in the Latin America and Caribbean region through trade and financial linkages.

Table LAC.3 Latin America and the Caribbean country forecasts

(annual percent change unless indicated otherwise)				Est.	Forecast		
	98-07[a]	2008	2009	2010	2011	2012	2013
Argentina							
GDP at market prices (2005 US$) [b]	2.2	6.8	0.9	9.2	6.3	4.2	4.3
Current account bal/GDP (%)	1.3	2.1	2.8	0.8	0.4	-0.6	-0.9
Belize							
GDP at market prices (2005 US$) [b]	5.4	3.8	0.0	2.0	2.1	2.4	2.8
Current account bal/GDP (%)	-13.1	-10.7	-9.4	-2.7	-8.6	-6.6	-5.8
Bolivia							
GDP at market prices (2005 US$) [b]	2.8	6.1	3.4	4.2	4.4	4.5	4.2
Current account bal/GDP (%)	0.8	12.0	4.7	4.8	3.7	4.3	3.8
Brazil							
GDP at market prices (2005 US$) [b]	2.8	5.2	-0.7	7.5	4.2	4.1	3.8
Current account bal/GDP (%)	-1.2	-1.7	-1.5	-2.6	-2.6	-3.3	-3.6
Chile							
GDP at market prices (2005 US$) [b]	3.4	3.7	-1.7	5.2	6.1	5.0	4.5
Current account bal/GDP (%)	0.3	-1.9	1.6	1.9	0.8	0.2	-1.8
Colombia							
GDP at market prices (2005 US$) [b]	3.1	2.7	1.5	4.3	4.7	4.4	4.2
Current account bal/GDP (%)	-1.4	-2.9	-2.2	-3.1	-1.9	-2.6	-2.8
Costa Rica							
GDP at market prices (2005 US$) [b]	4.7	2.6	-1.3	4.2	4.0	4.2	4.5
Current account bal/GDP (%)	-4.6	-9.3	-1.9	-3.6	-4.2	-4.3	-4.7
Dominica							
GDP at market prices (2005 US$) [b]	1.6	3.5	-0.3	1.0	1.9	2.6	2.8
Current account bal/GDP (%)	-19.0	-36.4	-28.3	-26.9	-30.2	-26.4	-24.7
Dominican Republic							
GDP at market prices (2005 US$) [b]	4.9	5.3	3.5	7.8	5.1	4.9	4.3
Current account bal/GDP (%)	-1.4	-9.9	-4.6	-8.2	-8.7	-6.0	-5.4
Ecuador							
GDP at market prices (2005 US$) [b]	3.1	7.2	0.4	3.6	3.1	3.2	3.6
Current account bal/GDP (%)	-0.1	2.0	-0.5	-3.4	-3.1	-3.4	-3.8
El Salvador							
GDP at market prices (2005 US$) [b]	2.6	2.4	-3.5	0.7	2.5	3.0	3.2
Current account bal/GDP (%)	-3.1	-7.2	-1.8	-2.5	-4.4	-3.3	-3.6
Guatemala							
GDP at market prices (2005 US$) [b]	3.4	3.3	0.6	2.5	3.1	3.3	3.0
Current account bal/GDP (%)	-5.4	-4.5	-0.1	-2.2	-3.4	-3.8	-4.1
Guyana							
GDP at market prices (2005 US$) [b]	1.7	2.0	3.3	3.5	4.6	5.1	5.6
Current account bal/GDP (%)	-8.7	-9.9	-7.7	-9.5	-10.7	-21.0	-19.3
Honduras							
GDP at market prices (2005 US$) [b]	4.0	4.0	-2.1	2.8	3.2	3.8	4.0
Current account bal/GDP (%)	-6.7	-12.9	-3.8	-6.2	-6.9	-6.5	-6.5
Haiti							
GDP at market prices (2005 US$) [b]	0.6	0.8	2.9	-5.4	8.7	9.0	8.3
Current account bal/GDP (%)	-22.4	-11.9	-3.9	-3.4	-4.3	-4.8	-5.1
Jamaica							
GDP at market prices (2005 US$) [b]	1.6	-0.5	-3.0	-1.1	1.7	2.2	2.4
Current account bal/GDP (%)	-7.8	-19.6	-10.4	-8.4	-8.7	-8.0	-6.0

(annual percent change unless indicated otherwise)	98-07a	2008	2009	Est. 2010	Forecast 2011	2012	2013
Mexico							
GDP at market prices (2005 US$) b	2.8	1.5	-6.1	5.5	4.4	4.1	4.2
Current account bal/GDP (%)	-1.9	-1.5	-0.7	-0.5	-0.8	-1.0	-1.0
Nicaragua							
GDP at market prices (2005 US$) b	3.4	7.5	-5.6	5.1	3.1	3.5	4.0
Current account bal/GDP (%)	-18.0	-25.8	-12.9	-15.5	-16.2	-16.2	-15.7
Panama							
GDP at market prices (2005 US$) b	4.8	10.7	2.4	4.5	7.4	6.8	6.0
Current account bal/GDP (%)	-5.5	-11.7	-0.2	-11.2	-12.4	-11.8	-11.9
Peru							
GDP at market prices (2005 US$) b	4.1	9.8	0.9	8.8	6.9	6.1	5.2
Current account bal/GDP (%)	-1.1	-3.7	0.2	-1.4	-2.2	-3.1	-3.0
Paraguay							
GDP at market prices (2005 US$) b	1.9	5.8	-3.8	15.3	5.5	4.6	4.3
Current account bal/GDP (%)	-0.1	-1.8	0.3	-3.2	-4.0	-4.0	-3.1
St. Lucia							
GDP at market prices (2005 US$) b	2.0	0.8	-3.6	1.1	3.7	3.7	3.1
Current account bal/GDP (%)	-18.5	-35.2	-14.4	-16.7	-27.0	-21.6	-18.5
St. Vincent and the Grenadines							
GDP at market prices (2005 US$) b	4.2	1.1	-1.1	-2.1	3.1	2.9	3.6
Current account bal/GDP (%)	-20.4	-39.2	-33.8	-33.2	-36.2	-33.4	-32.7
Uruguay							
GDP at market prices (2005 US$) b	0.8	8.5	2.6	8.5	5.2	5.7	4.1
Current account bal/GDP (%)	-1.0	-4.8	0.7	0.6	-1.4	-2.0	-2.4
Venezuela, RB							
GDP at market prices (2005 US$) b	2.8	4.8	-3.2	-1.5	1.6	2.2	2.4
Current account bal/GDP (%)	8.5	12.0	2.6	5.0	7.6	6.6	4.7

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

Barbados, Cuba, Grenada, and Suriname are not forecast owing to data limitations.

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

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

c. Estimate.

d. Forecast.

Notes:

1. World Bank, LAC Success put to the test, April 2011.

2 IMF, World Economic Outlook, April 2011.

3 UN World Tourism Organization, January 2011.

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Middle East and North Africa

Recent developments

Before the start of the political upheaval in the Middle East and North Africa, developing countries of the region had been poised to improve economic performance over 2011-12, returning to GDP gains of near 5 percent.[1] Indeed, lack of tight international connections in finance and non-oil goods trade allowed developing Middle East and North Africa[2] to experience less adverse effects from the financial crisis and global recession of 2008-09 than other developing regions. But recovery in 2010 disappointed, with regional growth falling below expectations to 3.1 percent, the slowest growth among developing regions in a year of buoyant gains for developing economies.

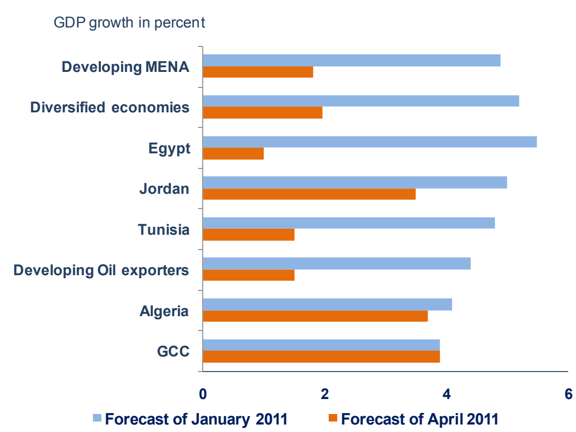
The Arab Spring. Revolutions and unrest have disrupted economic activity across almost every country in the region over the first months of 2011, and will continue to restrain growth in a number of countries at least for the year, and potentially for more. For those parts of the region where unrest has been less marked, higher oil prices (linked tightly to developments in the Middle East and North Africa) will be a boon for some and a drag on growth for others. And higher food prices will exact an increasing toll on external balances across all countries. Economic and social impacts are likely to be substantial in the short term as production, trade, services and other elements of economic activity slip; and fiscal revenues, tourism and FDI receipts come under increasing pressure. Consumers will be further affected as inflation heats up, tied among other factors to developments in oil and food prices.

Taking current- and anticipated developments for 2011 into consideration, a comparison of the January 2011 projections with revised forecasts prepared in April, yields a sobering conclusion. GDP growth for the developing region is likely to suffer a 3.1 percentage point mark-down for the year, from gains of 4.9 percent expected in January to 1.8 percent anticipated in April.[3] Those economies hardest hit include Egypt (down 4.5 percentage points), Tunisia (3.3 points) and Jordan (1.5 points) (figure MNA.1).

Political-economy developments in countries where protests- and authorities' responses occurred earliest—Tunisia and Egypt—could play a strong role in shaping other outturns in the region. And as evidenced from the first months of 2011, there are a variety of political responses across the Arab world. Progress may be more likely in countries like Tunisia, as well as in the monarchies (Jordan and Morocco) where popular pressure will continue to have well-established channels in which to be expressed. In the broader view of the World Bank, if these political events and economic externalities are followed by sound transitions to better governance structures, in looking forward, they should provide a unique opportunity to change Middle East and North Africa's political and social landscape (table MNA.1).[4]

The parameters of political and economic disturbance in 2011. With the exception of several GCC economies, every country in the region has been affected—to varying degrees by

Figure MNA.1 GDP growth marked down by 3.1 points in 2011 for developing Middle East and North Africa



Source: Middle East and North Africa Poverty Reduction and Economic Management Unit, World Bank.

the Arab Spring. Among important observed and anticipated economic developments for 2011:

- Oil prices are likely to remain high amid the Libyan crisis and market fears of potential supply disruptions tied to unrest in larger oil exporters;

- Oil exporters that are less troubled by protest (e.g. Algeria, Kuwait, Oman, Qatar, Saudi Arabia and the UAE) will likely see windfall gains from higher oil prices—but net fiscal revenues will be reduced by use of funds for financial packages intended to address social unrest;

- Oil importers will suffer—especially those that choose to provide energy and food subsidies. Higher food prices will accentuate inflation pressures.

- Egypt, Tunisia, Libya, and potentially Syria, will be most affected, as continued uncertainty, economic disruption and lapse in tourism revenues dampens growth in the former two, while Libya—and to a lesser degree, Syria—may face prospects of prolonged violence or civil war. Those countries which have experienced the longest protests will suffer lower growth- with investment coming to be particularly adversely affected.

Developing Middle East and North Africa's growth edged lower in the second half of 2010—and for the year. Early indicators for 2011 point to a substantial slowdown.

The initial strong rebound in global trade and production, particularly among the regions' main Euro Area trading partners, and rising oil prices underpinned GDP gains for developing Middle

Table MNA.1 Middle East and North Africa forecast summary

(annual percent change unless indicated otherwise)	98-07[a]	2008	2009	Est. 2010	Forecast 2011	2012	2013
GDP at market prices (2005 US$) [b]	4.1	3.7	2.8	3.1	1.9	3.5	4.0
GDP per capita (units in US$)	2.6	1.9	1.1	1.5	0.2	1.9	2.3
PPP GDP [c]	4.3	4.1	3.1	3.0	1.7	3.6	4.0
Private consumption	4.4	5.1	4.5	4.4	3.2	3.5	4.2
Public consumption	3.2	9.1	12.6	8.3	8.6	7.3	7.0
Fixed investment	6.0	7.7	1.0	-3.8	-2.4	3.4	5.9
Exports, GNFS [d]	5.2	4.6	-4.9	4.6	3.7	4.4	2.0
Imports, GNFS [d]	7.1	11.4	-7.8	3.6	2.4	6.9	7.1
Net exports, contribution to growth	-0.2	-2.2	1.0	0.4	0.5	-0.7	-1.7
Current account bal/GDP (%)	7.5	7.7	-1.1	1.4	5.6	5.7	4.3
GDP deflator (median, LCU)	4.8	12.2	3.0	5.5	11.5	7.3	5.3
Fiscal balance/GDP (%)	-1.0	-0.3	-4.1	-4.3	-3.2	-2.3	-1.8
Memo items: GDP							
MENA Geographic Region [e]	3.8	4.4	1.5	3.2	2.8	3.8	4.1
Resource poor- Labor abundant	4.1	6.6	4.8	4.5	2.5	4.0	5.0
Resource rich- Labor abundant	4.2	1.8	1.4	2.2	1.4	3.2	3.2
Selected GCC Countries [f]	3.4	5.3	0.0	3.3	4.0	4.2	4.3
Egypt	4.3	7.2	4.7	5.2	1.0	3.5	5.0
Iran	4.9	1.0	0.1	1.0	0.0	3.0	3.0
Algeria	3.5	2.4	2.4	3.3	3.7	3.6	3.5

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

Source: World Bank.

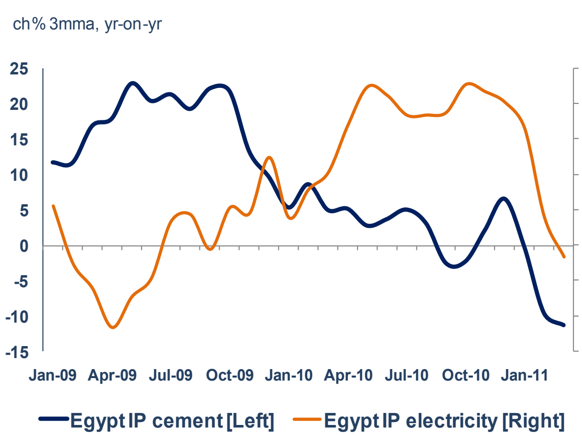
East and North Africa during the first half of 2010. But a world-wide "growth pause" in production during the third quarter- and slumping demand in Europe during the second half of 2010 came to the fore (see Main Text) and dampened the region's non-oil exports to Europe, slowed tourism arrivals from earlier heady rates while crimping remittance flows to the Maghreb and Egypt in particular. These developments preceded the start of popular unrest in early 2011.

Industrial production for the diversified economies (proxied in some cases here by electricity generation) slowed from rapid gains in early 2010 to fall fairly sharply during the first quarter of 2011.[5] Egyptian cement production for example, traced a path of output responding to easing domestic and foreign demand, from growth of 20 percent in late 2009 to declines averaging 15 percent over the first quarter of 2011; on a smoothed basis, cement output dropped 11.3 percent in March (3mma, y/y). In contrast, the decline in Egyptian electricity generation highlights the initial effects of the reform demonstrations in Cairo and the attendant broader disruption to economic activity, halving from robust 8 percent gains in early 2010 to below 4 percent the first quarter (figure MNA.2a)

Among other diversified economies, manufacturing production in Tunisia performed well until late 2010, but by March 2011 had fallen 9.3 percent on a smoothed basis (y/y), with output of textiles and clothing declining at a steeper 15 percent rate. Lebanon highlights a case of faltering production growth over the course of the second half of 2010, due to a cyclical decline after a period of unprecedented boom, especially in construction and real estate. Developments in the region and uncertainty regarding political developments in the country yielded a falloff in electricity generation of 3.3 percent in the first quarter (y/y); Jordan's path of recuperating output growth became more volatile but re-crossed the line to positive growth in March (figure MNA.2b).

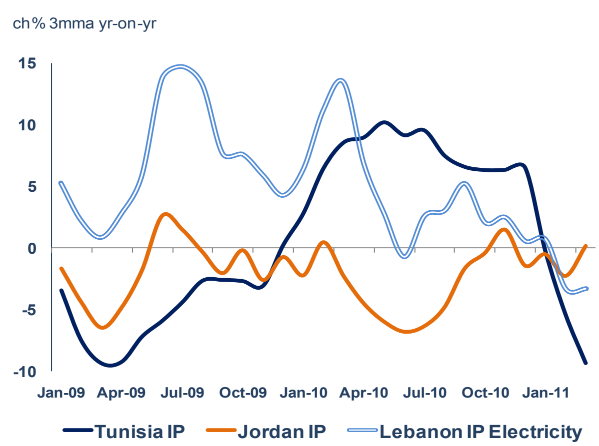
Merchandise trade. Market conditions have been difficult for the diversified group, with main export destinations in the European Union undergoing generally sluggish GDP growth and weak demand for exports from the region. But most recent data suggests a renewal of export growth for several countries, a favorable note in the current environment. Almost mirroring production trends, Egyptian exports shifted from growth near 25 percent at the start of 2010 to modest decline in February 2011, but of encouragement, to a sharp upturn in March reaching an 11 percent smoothed year-on-year pace. Exports of Lebanon dropped by 8 percent as of March, down from 20 percent gains in the

Figure MNA.2a Egypt: Early indicators of disruption to economic activity



Source: Egypt CAPMAS, through Haver Analytics.

Figure MNA.2b: Activity begins to falter in other diversified economies as well



Source: National Agencies through Haver Analytics.

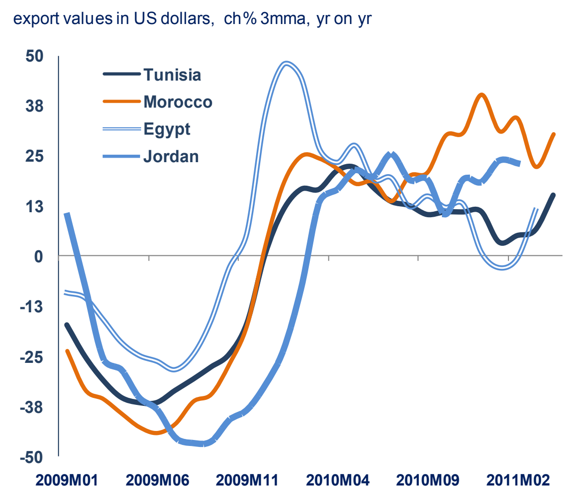
spring of 2010. For Tunisia, textiles and clothing shipments declined by some 7.5 percent in March (smoothed, y/y)—likely a combination of supply difficulties in production and weaker demand in export markets. But overall exports are reviving quickly to a 15 percent pace as of April. Conditions have been difficult for Morocco and Jordan, but both countries have seen exports perform buoyantly, in a 20 to 30 percent range, due to strong global demand for phosphates (inputs to fertilizers and other goods and materials) (figure MNA.3).

Tourism—a mainstay for the region exerting negative economic effects in 2011. For Lebanon, Morocco, Tunisia, Jordan and Egypt, as well as GCC-members Bahrain and the United Arab Emirates, international tourism constitutes a key contributor to GDP, with fiscal revenues benefitting as well. Tourism is a key driver for local employment growth directly—and through second-round effects—while spurring domestic and foreign investment in tourism and related facilities. For the GCC economies, tourism is providing an important path for diversification.

Before the onset of the political uprising, tourism in the broader Middle East and North Africa region was booming, with arrivals in 2010 up by 10.2 percent to 98 million persons; and for the country sample in figure MNA.4a, a jump of 11 percent to 37 million arrivals (figure MNA.4a). This represented an impressive rebound from the 2009 recession, with tourist arrivals improving from 3.5 percent growth in the previous year. Performance in Egypt was particularly vibrant, with a 17.5 percent gain in arrivals and 16.5 percent jump in receipts.

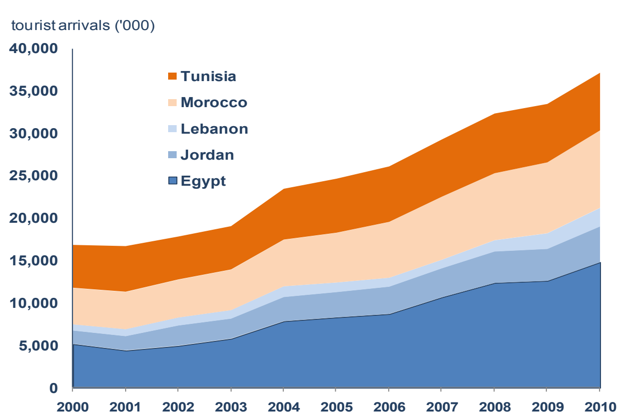
Looking at developments in 2011, with data covering just a few months of the year, tourism

Figure MNA.3 Exports from the diversified economies generally slacken in the second half of 2010 and into early 2011



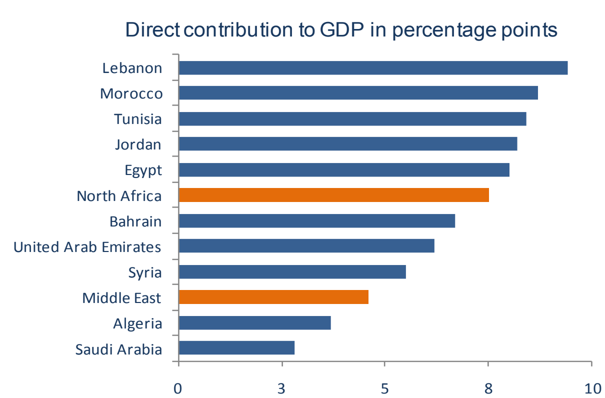
Source: National Agencies through Haver Analytics, Tunisia: INS, Morocco: Customs, Egypt: CAPMAS, and Jordan: DoS.

Figure MNA.4a Middle East and North Africa tourism boomed in 2010



Source: United Nations World Tourism Organization and National Agencies.

Figure MNA.4b Tourism's contribution to GDP was large in several Middle East and North Africa countries (2010)



Source: World Travel and Tourism Council and World Bank..

arrivals appear to have fallen dramatically. Both Egypt and Tunisia, for example, have reported a 45 percent decline in arrivals between the first quarter of 2011 and the like period of 2010. Such large-scale falloff in arrivals (and related receipts), if sustained could exact a heavy toll on growth in countries where tourism contributes a substantial share of GDP (figure MNA.4b). Estimates of the direct contribution of tourism to GDP appearing in the figure are produced by the World Travel & Tourism Council (WTTC), an industry group working closely with the United Nations World Tourism Organization (UNWTO).[6] In addition to the direct impact of tourism on the economy, second-round effects can be quite large, as tourism is a labor intensive sector with many interconnections with other branches of the economy; and in recent years tourism has attracted much related investment, both domestically and from abroad.

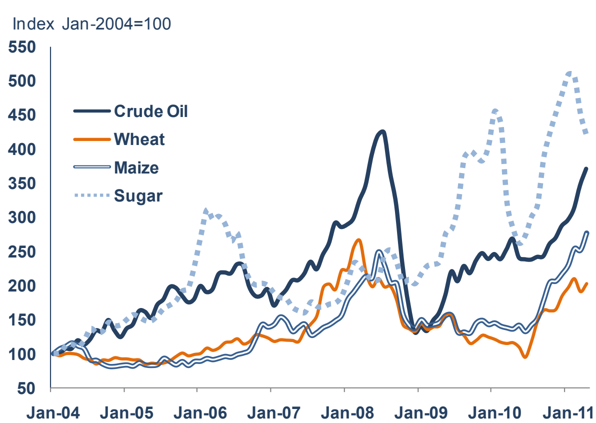
The less-than-favorable tourism reports from Egypt and Tunisia to date, together with preliminary projections of a potential 18 percent drop in tourism-related receipts during Egypt's FY-2011[7], would imply (using WTTC impact factors) a 1.1 percent direct loss in GDP for the year. Second-round and induced effects could carry GDP lower by an additional 1.1 points—an adverse tourism contribution to GDP of 2.2 percentage points. As earlier noted, Egypt's growth—pre-to-post the beginnings of the 'Arab Spring'—had been marked down by 4.5 points (see figure MNA.1), implying non-tourism related factors (disruptions to production and other economic activity) may account for the remaining 2.3 points of the slowdown. A similar range of assumptions for tourism revenues/ arrivals in Tunisia, Morocco, Jordan or Lebanon would likely result in broadly similar outturns.

Worker remittance flows to the developing region faltered during the global recession of 2009 (as remittances did for all developing regions) by some 7 percent to $32.2 billion, as employment conditions in host countries in Europe, the GCC and elsewhere deteriorated.[8] Hardest hit at the time were Egypt and Yemen, each facing a decline of more-than 18 percent. As recovery advanced within the region and abroad in the first half of 2010, remittances for the year grew by 6.5 percent (with Egypt up 8.1 percent to $7.7 billion) stronger than the 5.6 advance for developing countries in aggregate. Looking forward, the World Bank's Migration and Remittances Unit expects Egypt to garner a modest 0.8 percent gain during 2011, while remittance inflows to Tunisia are seen to drop by 2.5 percent. For developing Middle East and North Africa overall remittances increase 3.5 percent, slowest among developing regions, with stronger recovery in 2012 (5.4 percent)—still sub-par contrasted with the region's historic standards (average growth of 14 percent over 2000-2008).[9]

Large shifts in international prices and terms of trade carry differing effects across the region.

Heightened market uncertainty regarding oil supply accentuated by the outage of Libyan crude, served to increase the price of benchmark Brent oil to above $120/bbl in April 2011, a 33 percent increase from December 2010 levels, with the World Bank average price registering $116/bbl for the month (figure MNA.5 and Commodity Annex).[10] A number of commodity analysts suggest that about $20/bbl of the increase in price relates to tension in the region; the remainder reflects strong world demand for oil. Given the continued fluidity of the political economy in the region, the outlook for crude oil

Figure MNA.5 Wheat, maize and sugar double from recent troughs....oil increases 3-fold



Source: World Bank.

prices remains highly uncertain, but under a 'base case' the price of oil is likely to remain at high levels, averaging $107/bbl in 2011, and easing only slightly to $98/bbl by 2013.

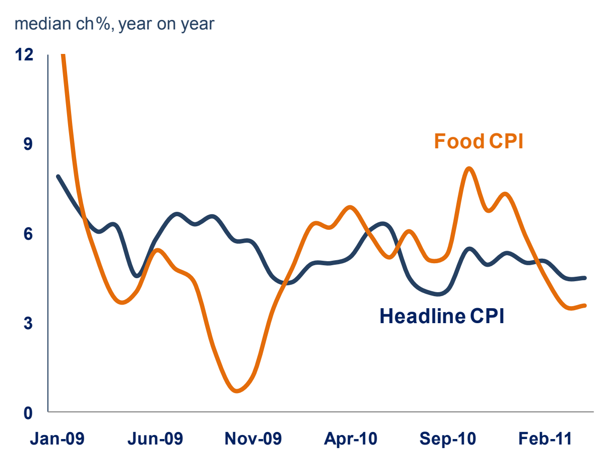
A quickening pace of increase in internationally traded food prices—notably maize and wheat—is tied in good measure to supply disruptions, and together with higher crude oil prices is pressuring inflation across an increasing number of countries (figure MNA.5). A key factor underpinning the rise in food—likely the most important—has been increasing production costs due to higher energy prices. Since June 2010, wheat prices have risen 113 percent and maize 109 percent. Sugar prices had earlier ratcheted upward (86 percent from June 2010 to January 2011) due to Brazilian use of sugarcane in generating bio-fuels, resulting in a degree of shortage of sugar for use in food products. For the region, cereals (notably wheat) and sugar imports account for 58 and 75 percent of domestic consumption, respectively. And for these foods alone, costs to the region have amounted to $19-per capita or 0.3 percent of GDP.[11 12]

Tied to higher wheat and oil prices, as well as government outlays that have tended to increase liquidity within economies, inflation picked up across both diversified economies and oil exporters of the region. For developing Middle East and North Africa in aggregate, median inflation accelerated from 4 percent in August 2010 to 5.1 percent by February 2011 (year-on-year)—but eased to 4.5 percent by April on a recent softening in food prices. Indeed, food prices for the group reached peaks of 8.2 percent in October 2010 before diminishing to 3.6 percent in April 2011 (figure MNA.6a).

Higher inflation is reducing purchasing power and dampening the pace of consumer spending in both oil importers and exporters, augmenting the disruption of economic activity and output otherwise pressuring households in the region. Several economies among the diversified group—Morocco and Tunisia—rely on rain-fed agriculture, with wheat crops often exposed to adverse weather; these economies are now experiencing escalating import bills and pass-through to headline inflation.

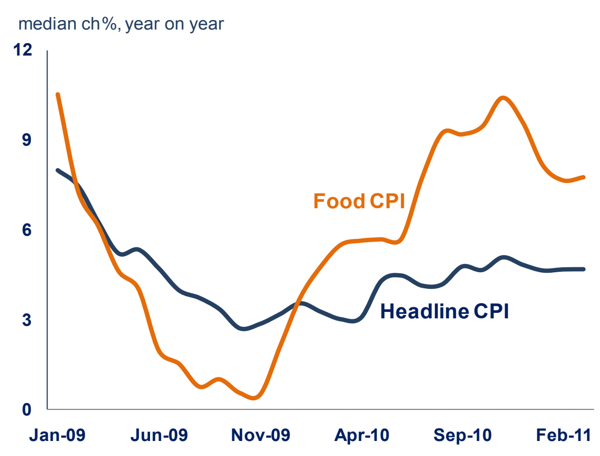
For the diversified economies, food prices led headline prices through most of 2010, but the food CPI eased from 7.7 percent in October to dip below headline CPI by February 2011. As of April food prices were increasing at a median 3.6 percent pace for the group against overall inflation of 4.5 percent—pointing to the likelihood of higher domestic costs emerging in countries in transition—Egypt, Tunisia and others.

Figure MNA.6a Food CPI in developing Middle East and North Africa now lags median headline inflation



Source: World Bank; Haver Analytics.

Figure MNA.6b Middle East and North Africa oil exporters inflation led by rising costs of imported food



Source: World Bank; Haver Analytics.

Among oil exporters, headline and food price inflation have ramped-up much faster, given exceptionally high import dependence for food and feedstuffs in a number of economies (figure MNA.6b). For oil exporters (developing as well as GCC), food prices continue to lead overall CPI, with the former standing 7.8 percent above year-earlier levels in March 2011; the later up 4.7 percent. Food price increases span a wide range from Bahrain (2.7 percent in March (y/y)), Saudi Arabia (5 percent), Kuwait (10 percent), to Iran (26 percent). Price developments in Iran, especially since December 2010, are due to a combination of international food price hikes and a removal of domestic subsidies.

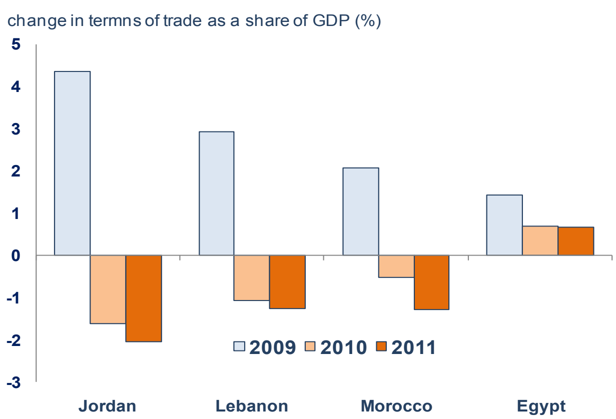
Terms of trade developments for Middle East and North African groups are tightly linked to international price movements and the underlying commodity composition of goods trade. For the diversified economies, the direct impact of the first "food crisis" of 2008 cost the group some 2.2 points of GDP (with Jordan an exception) as prices ratcheted much higher. But the loss was more-than offset during the global recession of 2009 for most countries with softening oil and food prices. During 2010 and 2011, the terms of trade are anticipated to deteriorate in Jordan, Lebanon, and Morocco, with both oil and food prices rising. The diversified economies in aggregate are likely to face a fairly moderate decline of 0.8 percentage points of GDP in 2010-11 (figure MNA.7a).

In contrast with the differentiation of terms of trade displayed across the diversified group, the aggregate of oil exporters (including GCC) experienced cumulative gains of 16.2 percent of GDP over 2010-11, 6.2 percent- and a large 10 favorable movement in 2011 and 2012 respectively (figure MNA7.b). The run-up in hydrocarbons receipts as a share of oil exporter's GDP in 2011 exceeds that of the last boom year of 2008 at 42 percent versus 40 percent. Whether the large boost to domestic incomes will result in stronger GDP growth, will depend on the policy of the authorities in the current environment, to save or dispense the windfalls via subsidies or public works projects. It will also depend on the import propensity of the new spending. Evidence over 2011 to date suggests that substantial portions of these funds will be expended domestically.

FDI and portfolio flows to the region likely to fall sharply amid rising risk aversion.

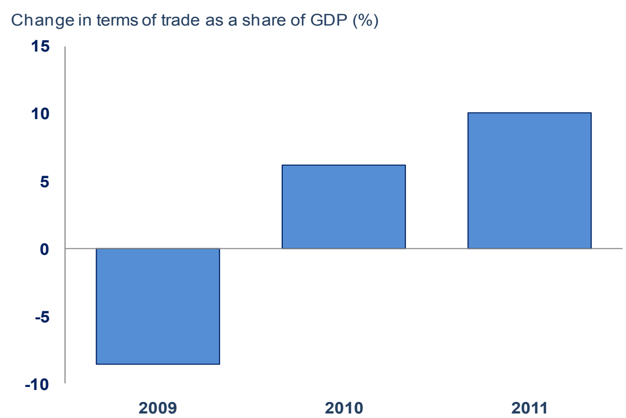
Foreign direct investment (FDI) inflows to the developing region, increasingly originating in the GCC economies, had been a welcome source of new capital, attracted not only to tourism and related facilities but also to industry (oil and gas, and other), services (telecoms) and real estate (table MNA.2). Countries tending to benefit most from FDI were Egypt, Tunisia, Morocco and to a lesser degree, Jordan and Lebanon. At peak dollar volumes in 2008, FDI amounted to $29.3 billion or 3.1 percent of regional GDP.

Figure MNA.7a Several diversified economies suffer terms of trade losses in 2010-11



Source: World Bank.

Figure MNA.7b Oil exporters enjoy two years of windfall revenues in 2010-11



Source: World Bank.

Capital flows to developing Middle East and North Africa held up exceptionally well during the recession of 2009 and over the course of 2010 (figure MNA.8), amounting to $26 billion in 2009, an increase of $6 billion, and the equivalent of 0.6 points of GDP. Other flows stepped up to offset a $4 billion falloff in FDI during 2010—including issuance of sovereign bonds from among others Tunisia and Lebanon, and an increase in official lending to the region.

Following the onset of political disturbance, financial market risk premia increased, implying tighter financing conditions for sovereign- and corporate borrowers. Spreads on Egyptian sovereign credit default swaps (CDSs) increased by 100 to 150 basis points through February and March 2011. Equity bourses were hard hit from Egypt to Dubai (UAE) to Morocco, with MSCI dollar-based indexes dropping by double digits. Egypt's market capitalization plummeted 14.5 percent during the week before the exchange was closed on January 28.

Financial projections for 2011-2013 prepared by the World Bank suggest a sharp falloff in net capital flows in 2011, followed—under assumptions of a gradual equilibration of political conditions in the region—by fairly rapid resumption of flows to reach recent pre-turmoil levels by 2013 (table MNA.2). In particular, FDI is seen to almost-halve from $20-to $10.7 billion in 2011, as GCC and other investors adopt a 'wait and see' perspective to political–economy developments. Indeed, the focus of the GCC, less affected by political unrest and bolstered with new revenues, may turn "inward" for a time to bolster domestic demand and infrastructure investment. The recently announced $20-billion Gulf Development Program for Bahrain and Oman is an example of this emerging trend.

Net private flows in 2011 are viewed to drop by a substantial 83 percent to $4.1 billion from $28

Table MNA.2 Capital flows to the Middle East and North Africa

$ billions

	2003	2004	2005	2006	2007	2008	2009	2010e	2011f	2012f	2013f
Current account balance	34.7	49.5	58.9	68.9	74.2	70.5	-10.8	15.4	68.1	74.2	60.2
as % of GDP	8.2	10.2	10.7	10.8	9.6	7.7	-1.1	1.4	5.6	5.7	4.3
Financial flows:											
Net private and official inflows	**13.5**	**13.0**	**19.4**	**14.4**	**29.4**	**21.1**	**27.8**	**28.0**			
Net private inflows (equity+private deb	**15.6**	**16.4**	**22.4**	**25.7**	**28.4**	**22.9**	**25.5**	**25.1**	**4.1**	**22.1**	**29.6**
..Net private inflows (% GDP)	3.7	3.4	4.0	4.0	3.7	2.5	2.7	2.3	0.3	1.7	2.1
Net equity inflows	10.2	10.4	19.2	28.2	25.5	29.7	25.6	21.5	11.0	17.9	23.2
..Net FDI inflows	10.0	9.7	16.8	27.2	27.6	29.3	24.4	20.1	10.7	17.4	22.6
..Net portfolio equity inflows	0.2	0.7	2.4	1.0	-2.1	0.4	1.2	1.4	0.3	0.5	0.6
Net debt flows	3.4	2.6	0.2	-13.7	3.9	-8.6	2.2	6.5			
..Official creditors	-2.1	-3.4	-3.0	-11.2	1.1	-1.8	2.3	2.9			
....World Bank	-0.3	-0.6	0.0	-0.8	1.0	-0.3	0.9	1.8			
....IMF	-0.6	-0.5	-0.7	-0.2	-0.1	-0.1	-0.1	-0.1			
....Other official	-1.2	-2.3	-2.3	-10.3	0.2	-1.4	1.4	1.2			
..Private creditors	5.4	5.9	3.2	-2.5	2.8	-6.8	-0.1	3.6	-6.9	4.2	6.4
....Net M-L term debt flows	0.9	2.7	2.9	-1.7	-0.7	-2.7	-1.7	5.0			
......Bonds	0.7	2.8	2.5	0.8	0.7	-0.8	0.5	2.3			
......Banks	-0.2	0.0	1.3	-1.3	-0.2	-0.5	-1.2	2.7			
......Other private	0.4	0.0	-0.9	-1.2	-1.2	-1.3	-0.9	0.0			
....Net short-term debt flows	4.6	3.2	0.3	-0.8	3.5	-4.2	1.6	-1.4			
Balancing item /a	-25.1	-47.8	-39.3	-45.5	-55.6	-48.2	7.3	-32.0			
Change in reserves (- = increase)	-23.2	-14.7	-38.9	-37.8	-48.0	-43.4	-24.2	-11.3			
Memorandum items											
Workers' remittances	20.5	23.2	25.1	26.5	32.1	36.0	33.6	35.6	36.9	38.9	

Note:

e = estimate, f = forecast

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

Source: World Bank.

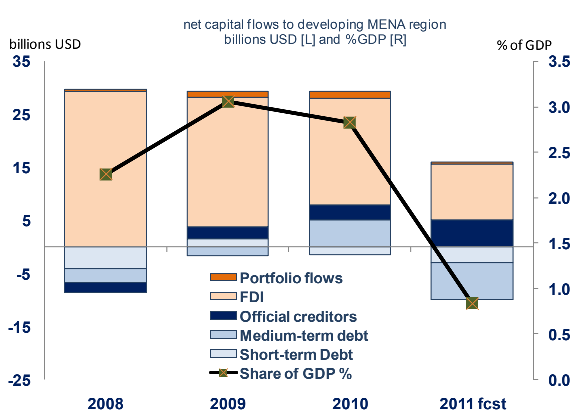
billion in 2010—a falloff equivalent to 2.1 percent of regional GDP. Thereafter, a revival of FDI is hoped to lead private flows back into a range near $20 billion, with new opportunities for investment emerging in the region. Clearly risks to this projection are numerous, and in particular, a more extended period of time may be required before international and local risk aversion regarding the region is diminished.

Economic developments and policy among the diversified economies. [13]

A stronger start to 2010, and a sufficiently diverse set of outturns across countries, meant that GDP growth for the diversified group faltered by just 0.3 points from 2009 outturns to 4.5 percent in 2010—still notable as a 0.4 percentage point mark-down from earlier expectations.

- Until recent political events, the *Egyptian* economy showed strong signs of recovery from the global recession, during which Egypt's GDP advanced 4.7 percent against an increase of 1.9 percent for all developing countries. Consumer spending and increasing activity in construction, tourism and communications were driving forces for growth, which moved up to 5.2 percent in 2010. Egypt is facing a more prolonged period of political uncertainty with signs emerging during early 2011 of disruptions to production, widening trade deficits, falling tourism and weaker worker remittances; FDI flows are likely to decline substantially. Unemployment reached 11.9 percent during the first quarter of 2011, and may increase further as a result of disruptions to activity, but also as some 183,000 overseas workers have returned– and are continuing to return from Libya.[14] Against this background, GDP growth is anticipated to drop sharply to 1 percent in 2011. Recent reports regarding financial support from international organizations and bilateral donors is encouraging.

Figure MNA.8 FDI viewed to halve from $20- to $10 billion in 2011



Source: World Bank.

- The *Tunisian* revolution, removal of former President Ben Ali and dissolution of the ruling party and Parliament have been significant developments. GDP is anticipated to be hard hit by declines in production and in services activity (tourism), such that growth of 1.5 percent is a likely outturn for 2011. The interim government has undertaken short-term measures to support business and the labor market; and a with $1 billion multi-donor package the financial situation should remain manageable.

- In *Jordan*, political tensions are occurring while economic recovery remains weak. GDP growth of 3.1 percent characterized 2010, based on weak consumption and a drop in public investment. In February, Moody's and S&P both downgraded Jordan's debt outlook rating, raising the cost of capital for the Kingdom. To address social concerns the King launched initiatives related to corruption and improving governance and the government increased social spending and subsidies on the order of 2.1 percent of GDP. In *Lebanon,* the government of National Unity formed in November 2010, collapsed on January 12, 2011 blocking further policymaking. Still the economy grew by a rapid 7 percent in 2010 on the back of domestic demand fueled by foreign financial inflows. A key risk is that traditional Lebanese political rifts could re-emerge amid the regional unrest of 2011.

- And in *Morocco*, the King announced potentially significant constitutional and political reforms in response to a series of popular protests in more-than 52 cities during late February 2011. The announced proposals appear to be short of the youth movement's demands, but are supported by political parties. The economic outlook remains generally favorable with a sustainable macro- and financial framework. GDP growth could pick up in 2011 based on gains in domestic demand, in part funded by increased subsidies for food and fuel.

- **Oil exporter's windfall eclipses 2007-08.**

Middle East and North African developing and GCC oil exporters[15] appear set to eclipse the hydrocarbon revenue windfalls of 2007-08 during the course of 2011 (figure MNA.9). The cumulative increase in oil export receipts over 2010-11 amounts to $370 billion or 37 percent of oil exporter-GDP, with total revenues expected to peak at $845 billion in 2011. Several large exporters (including Saudi Arabia) have begun to advance production modestly to offset the loss of Libyan crude, and combined with the 36 percent gain in crude oil price for the year, resulting export receipts are anticipated to increase within a range of $85 billion for Saudi Arabia to $10 billion in Oman. The aggregate result contrasts with top receipts of $735 billion during 2008, with the buildup in revenues having accrued to $245 billion over 2007-08.

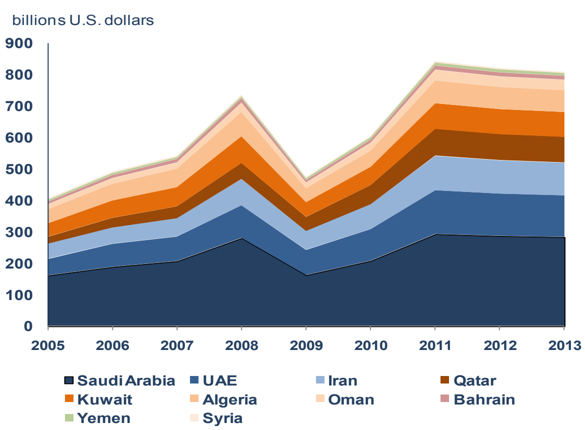
Within the region, such massive revenue gains for oil exporters offer authorities the means to increase spending of various forms to mitigate the potential for protest and social unrest. Saudi Arabia for example, pledged to provide unemployed Saudi nationals with financial support for a year, helping its young population cope with structurally high unemployment. The Saudi Government issued a number of such orders with a total cost of SR135 billion ($36 billion) for the first year; possibly accumulating to $100 billion over 10 years.

Developing oil exporters face economic as well as social challenges against a broadly favorable international background

The group of developing oil exporters in the region, Algeria, Iran, Syria, and Yemen, form a group of economies troubled by political protest and/or forms of repression on the part of authorities over a range of intensity (from most severe in Yemen and Syria, to latent popular dissatisfaction in Iran, and to a lesser degree in Algeria). Growth for the aggregate of oil exporters dipped from 2.2 percent in 2009 to 1.4 percent in 2010. Gains across the group ranged from 1 percent in Iran to 3.3 percent in Algeria, with Yemen an exception, as the coming online of an LNG train boosted growth to 8 percent in the year. OPEC members GDP gains were dampened by constraints in hydrocarbons output in support of price targets, but were supported by stronger growth in non-oil GDP. All oil exporters benefited from the 28 percent gain in oil prices in 2010 (to $79/bbl from $62/bbl in 2009).[16]

- Although protests in *Algeria* have not coalesced into revolutionary style movements as in some neighboring countries, Algeria's anticipated $72 billion in crude oil and natural gas exports in 2011 remains somewhat vulnerable to political unrest which could disrupt shipments. GDP gains in 2010 were grounded in moderate advances for the oil sector and non-oil growth of some 5.3 percent—reflecting strong multiplier effects associated with public infrastructure programs. Authorities have mitigated the chances of unrest by increasing food subsidies and microcredit loans; adding public sector jobs and promising more sustainable employment in other sectors of the economy. Though

Figure MNA.9 Middle East and North Africa oil revenues build by $370 billion over 2010-11



Source: World Bank-COMTRADE and International Energy Agency.

spending has added a degree of stress to the fiscal position, new oil revenues should more-than compensate in the near term. With OPEC likely to expand output over the next years, Algeria should be well placed to participate more fully in energy markets, while keeping domestic demand buoyant.

- The recent upturn in unrest in the Middle East appears to have briefly reinvigorated *Iran's* 'Green Movement', however there was no substantial effects on the economy as protests were quickly suppressed. Despite improvements in global oil markets, Iran's growth has weakened over the last two years as a result of a major tightening of monetary policy in mid-2008 that led to a slowdown in growth in 2009; a large-scale subsidy reform program that went into effect in December 2010, and the effects of the 4th round of international sanctions against the country taking hold. GDP growth registered a meager 0.1 percent during 2009, and remained weak at a 1 percent gain in 2010. The approved 2011 budget contains a major fiscal stimulus package that pushes budgetary spending up sharply (46 percent), to counter subsidy reforms and sanctions, putting additional pressures on already accelerating inflation.
- *Syria* (more recently) and *Yemen* have joined *Libya* closer to the fulcrum of popular protest and severe, violent repression by authorities in the region. Economic developments will likely move into second-tier consideration until some form of resolution is found to the violence and civil-war like conditions in Yemen and repression by Syrian authorities. Neither country is a major exporter of crude oil (Syria about $4 billion) and Yemen just commencing gas production and exports amounting to $8 billion in 2010.

Medium-term outlook

Political economy developments within the region appear likely to result in less disruption to economic activity in those oil-exporting economies least exposed to unrest and more aggressive popular calls for reforms. At the same time, the international environment has come to favor Middle East and North African oil exporters with terms of trade moving largely against regional oil importers, but intensified for all countries by the surge in international grains prices.

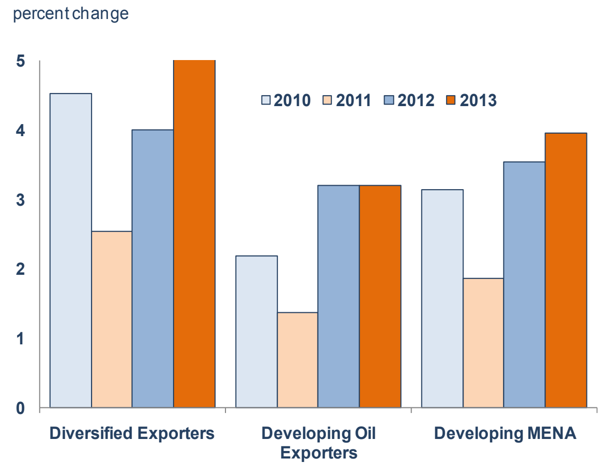
As highlighted in figure MNA.10, the net result of regional and international developments is a strong compression of GDP growth for the aggregate of developing countries in the region, moving down by 1.2 percentage points between 2010 and 2011 to 1.9 percent. The step-down in growth for oil exporters (0.6 points in the year) to 1.4 percent, compounds the sharper downturn for diversified economies (2 points), dominated by markdowns from pre-'social revolution' projections for several countries (figure MNA.1 earlier). The diversified economies in aggregate are expected to fall from growth of 4.5 percent in 2010 to 2.5 percent in 2011.

Differences in current account balances between the groups for 2011 are presented in table MNA.3—with oil exporter surpluses rising from 5.4-to 12.6 percent of GDP from 2010 to 2011, vis-à-vis increased deficits of some 0.8 points for the diversified economies to 4.8 percent of GDP. On fiscal accounts, deficits increase to more-than 7 percent of GDP in 2011 for the diversified exporters given the drain on government revenues associated with declining tourism and potentially increased subsides to cover higher food and fuel costs; for developing oil exporters, fiscal deficits narrow by 1.7 points to 0.5 percent of GDP.

Political economy transitions will be crucial for the economic outlook. Under the assumption that some form of "normalization" takes place across countries—a revival in domestic demand becomes feasible, as does the ability of economies to participate in a rebound in international activity, through goods trade, tourism and investment flows. On these grounds views for GDP growth over 2012-13 are moderately optimistic for the developing region--though still below pre-'Arab Spring' expectations—at 3.5 and 4 percent respectively.

Regional growth in this phase is likely to be driven by the diversified economies, 4 and 5 percent gains over the period respectively, led by 5 percent advances in Egypt by 2013, and by improvements in performance for Morocco, Jordan, Lebanon and Tunisia to similar rates of growth. Domestic demand contributes fully 7.8 points of growth in these years, with net exports influenced by a catch-up in import demand, dampening GDP gains by about 3.3 percentage points. Developing oil exporters experience a more modest growth pickup to 3.2 percent in 2012-13 powered by public spending programs in both Algeria and Iran. As the current run-up in oil prices turns to a modest gradual decline over the period current account surplus for the group eases from 12.6 percent of GDP in 2010 to 9.7 percent by 2013, in part due to strong import growth tied to large infrastructure and social development programs.

Figure MNA.10 Growth returns to 4 percent by 2013 under favorable assumptions



Source: World Bank.

Table MNA.3 Middle East and North Africa country forecasts

(annual percent change unless indicated otherwise)	98-07[a]	2008	2009	Est. 2010	Forecast 2011	2012	2013
Algeria							
GDP at market prices (2005 US$) [b]	3.5	2.4	2.4	3.3	3.7	3.6	3.5
Current account bal/GDP (%)	28.9	20.0	0.3	9.4	17.8	17.4	12.0
Egypt, Arab Rep.							
GDP at market prices (2005 US$) [b]	4.3	7.2	4.7	5.2	1.0	3.5	5.0
Current account bal/GDP (%)	0.9	-0.9	-2.3	-2.0	-2.9	-2.4	-2.0
Iran, Islamic Rep.							
GDP at market prices (2005 US$) [b]	4.9	1.0	0.1	1.0	0.0	3.0	3.0
Current account bal/GDP (%)	10.3	15.7	4.2	6.0	14.5	14.0	12.0
Jordan							
GDP at market prices (2005 US$) [b]	5.6	7.6	2.3	3.1	3.5	4.0	5.0
Current account bal/GDP (%)	-2.3	-9.6	-5.1	-4.3	-8.0	-6.8	-6.0
Lebanon							
GDP at market prices (2005 US$) [b]	2.8	9.3	8.5	7.0	4.8	5.0	6.0
Current account bal/GDP (%)	-17.5	-13.7	-21.5	-15.4	-15.6	-15.6	-15.0
Morocco							
GDP at market prices (2005 US$) [b]	3.7	5.6	4.9	3.3	4.4	4.5	5.0
Current account bal/GDP (%)	1.4	-5.2	-5.0	-4.2	-4.0	-3.5	-3.0
Syrian Arab Republic							
GDP at market prices (2005 US$) [b]	2.9	4.5	6.0	3.2	1.7	3.0	3.0
Current account bal/GDP (%)	3.0	0.3	-5.7	-4.4	-5.3	-4.8	-4.5
Tunisia							
GDP at market prices (2005 US$) [b]	4.5	4.5	3.1	3.7	1.5	3.5	4.5
Current account bal/GDP (%)	-2.8	-3.8	-2.9	-4.8	-6.2	-4.0	-3.8
Yemen, Rep.							
GDP at market prices (2005 US$) [b]	3.5	3.6	3.9	8.0	3.0	4.0	4.0
Current account bal/GDP (%)	2.5	-4.6	-10.7	-4.4	-4.0	-4.0	-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.

Djibouti, Iraq, Libya, West Bank and Gaza are not forecast owing to data limitations.

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

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

c. Estimate.

d. Forecast.

Source: World Bank.

Risks

Among the numerous challenges facing the region at this critical time, are wide variations in the set of possible political-economy outturns that could result from the series of reform movements and differing responses of authorities over 2011, from lower growth scenarios associated with limited or unsuccessful reform, to higher growth scenarios linked to deeper and swift changes. The outturns of such developments in the Middle East and North Africa would carry effects well beyond the geographic boundaries of the area, as the oil market (for one) would act as a powerful channel for transmission to the global economy.

The ongoing fiscal crisis in the Euro Area presents an external risk for the region, which if continued or intensified would imply a longer period of sub-par exports and growth for the Maghreb economies. Moreover, if risk perceptions regarding the broader Middle East and North Africa region have "hardened" due to safety and other concerns, a risk that the flow of tourist arrivals from Western Europe might be lost for an extended period of time is one of concern.

And should oil prices remain at higher levels for a longer period of time, emergence of newer energy sources (affordable at prices over $100/ bbl oil equivalent), such as solar/ocean, Canadian tar sands, U.S. shale gas and improvements to enhanced recovery techniques could yield faster-than earlier anticipated competitive pressures for hydrocarbon exports in the medium to longer terms.

Notes:

1. Global Economic Prospects: "Navigating Strong Currents". The World Bank. January 2011. Internet. And "Sustaining the Recovery and Looking Beyond", A Regional Economic Outlook. Middle East and North Africa Region. The World Bank, January 2011.

2. 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 insufficient for the inclusion of Djibouti, Iraq, Libya and the West Bank and Gaza. The high-income economies included here are Bahrain, Kuwait, Oman and Saudi Arabia. Data is insufficient for the inclusion of Qatar and the United Arab Emirates. The group of developing oil exporters includes Algeria, the Islamic Republic of Iran, the Syrian Arab Republic and Yemen. The diversified economies of the region (oil importers) may be usefully segmented into two groups: those with strong links to the GCC (Jordan and Lebanon), and those with strong EU links (The Arab Republic of Egypt, Morocco and Tunisia).

3. See "Middle East and North Africa Economic Recovery Weakened in the Midst of Arab Uprisings", A Regional Economic Update. Middle East and North Africa Region. The World Bank. April 2011.

4. See Arab World Brief: Shamshad Akhtar. Vice President, World Bank, Middle East and North Africa region. February 2011.

5. The types of growth rates discussed in this section and throughout the report, and appearing in accompanying figures—range from simple year-over-year (y/y) percentage change: *gy/y=((Xt/Xt-12))-1)*100;* a 'smoothed' yr/yr rate, which helps to even out volatility to highlight underlying trends: *sgr=(((average (Xt-2:Xt)/(average (Xt-14:Xt-12))-1)*100*, and a seasonally adjusted annualized rate (saar) which annualizes (i.e. multiplies– or raises to the power-4) the relationship between consecutive 3-month averages to obtain a clearer picture of most recent trend developments. *saar=(((average(Xt-2:Xt)/(average (Xt-5:Xt-3))**4)-1)*100.*

6. See 'World Tourism Impact Data'. World Travel & Tourism Council (WTTC). London. 2011. www.wttc.org for definitions of 'direct-, indirect, and induced' impacts of

tourism on the national economy. And 'UNWTO World Tourism Barometer'. United Nations' World Tourism Organization. Madrid. April 2011.

7. World Bank preliminary projections. Middle East and North Africa Poverty Reduction and Economic Management Unit. May 2011.

8. Worker remittances as presented in this report are sourced from the World Bank's Migration and Remittances Unit (DEC/PREM). The definition of 'remittances' compiled by the Unit differs from that of the IMF's Balance of Payments (BOP) construct: in particular, to the BOP transfer item 'worker remittances' is added BOP factor income items 'compensation of employees' and 'migrant transfers' (on both the credit and debit sides). Data is reported as gross receipts (credit) or payments (debit) presented in calendar-year U.S. dollars.

9. See 'Migration and Remittances Factbook 2011'. World Bank. Migration and Remittances Unit. November 2010.

10. The World Bank average price of crude oil is a simple average of Brent, Dubai, and WTI benchmarks.

11. Middle East and North Africa 'Knowledge and Learning Note'. Number 38. World Bank. Middle East and North Africa Department. March 2011.

12. It should be noted that the high price of sugar on international markets served to shift Brazilian producers of sugar cane from directing output toward ethanol production, to the refined sugar market. Indeed, Brazil is now *importing* ethanol from the United States as an additive to local fuels.

13. 'Economic Monitoring Notes'. World Bank. Middle East and North Africa Department. Spring 2011.

14. As of March 14, 2011.

15. The group is comprised of all GCC members (including Qatar and UAE), Algeria, Iran, Syria and Yemen. Data for Iraq and Libya is not available at this time.

16. Expressed as World Bank average price.

South Asia

Recent developments

After growing a robust 9.3 percent during calendar year 2010, activity in South Asia moderated in the first quarter of 2011—pointing to a projected slowdown in aggregate regional growth to a still buoyant 7.5 percent in 2011. This slowdown partly reflects macroeconomic policy tightening aimed at curbing stubbornly high price pressures and reducing large fiscal deficits. Tighter financing conditions have contributed to a moderation in private investment growth, while private consumption growth has been hit by high and rising food and fuel inflation. The moderate compression of domestic demand has been partly offset by strong exports, as countries in South Asia have benefited from robust import demand in developing countries, recovering demand in high-income countries and resilient worker remittances inflows (table SAR.1).

The regional economic slowdown in 2011 mainly reflects a fall-off in activity in India, which represents about 80 percent of South Asia's GDP, where growth is projected to ease to 8 percent in FY2011/2012 from 8.8 percent in FY 2010/11 (box SAR.1). The slowdown stems from a moderation in domestic demand, as elevated inflationary pressures have cut into disposable incomes and household spending, and as more restrictive monetary conditions have contributed to a dampening of investment activity. In particular, investment growth decelerated sharply in Q1-2011 to 0.4 percent from 7.8 percent in Q4-2010 and 14.1 percent

Table SAR.1 South Asia summary forecasts

(annual percent change unless indicated otherwise)	98-07[a]	2008	2009	Est. 2010	Forecast 2011	2012	2013
GDP at market prices (2005 US$) [b,f]	6.0	5.9	6.2	9.3	7.5	7.7	7.9
GDP per capita (units in US$)	4.4	4.5	4.8	7.9	6.1	6.4	6.6
PPP GDP [d]	6.0	5.8	6.3	9.0	9.5	7.7	7.7
Private consumption	4.9	6.8	6.4	7.0	5.9	5.6	5.9
Public consumption	3.9	16.9	13.6	2.8	6.7	5.4	4.8
Fixed investment	9.5	5.6	3.9	14.3	9.4	12.6	13.1
Exports, GNFS [e]	14.1	13.7	-6.3	12.7	11.3	11.7	12.4
Imports, GNFS [e]	9.3	24.8	-6.5	3.2	8.8	10.5	11.6
Net exports, contribution to growth	-0.2	-3.7	0.6	1.7	0.1	-0.2	-0.4
Current account bal/GDP (%)	-0.4	-3.3	-1.7	-2.4	-2.8	-2.6	-2.4
GDP deflator (median, LCU)	5.7	8.4	7.5	9.8	8.8	8.6	7.0
Fiscal balance/GDP (%)	-7.1	-7.3	-8.9	-8.3	-7.4	-6.9	-6.6
Memo items: GDP at market prices [f]							
South Asia excluding India	4.5	4.8	3.9	5.0	4.7	4.7	5.2
India	6.4	4.9	9.1	8.8	8.0	8.4	8.5
at factor cost	-	6.8	8.0	8.5	8.2	8.5	8.6
Pakistan	5.0	1.6	3.6	4.1	2.5	3.9	4.3
Bangladesh	5.1	6.2	5.7	5.8	6.2	6.4	6.6

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 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.

for 2010 overall (year-on-year). At the sectoral level, a recent good harvest buoyed agricultural production, following poor crops on low rainfall with the 2009 monsoon. In contrast, industrial output growth was weak in early-2011.

Economic growth in Pakistan—the region's second largest economy (representing about 15 percent of regional GDP)—significantly lags much of South Asia, and is projected to slow to 2.5 percent in FY2010/11 (ending June-2011) from 4.1 percent in FY2009/10, reflecting the devastating flooding across much of the country in July and August 2010. The easing of GDP growth is also tied to worsening security conditions, heightened political uncertainty, stalled policy implementation, and extensive infrastructure bottlenecks. While whole year growth numbers are expected to be weak, activity has begun to firm recently, as the effects of the 2010-flooding (which affected an estimated one-fourth of agricultural productive capacity) wear off, supported by a surge in exports in early-2011, and an upswing in worker remittances inflows.

Real GDP growth in Sri Lanka remains buoyant, but has decelerated in early-2011, due to floods

Box SAR.1 GDP reporting practices—market price versus factor cost and calendar year versus fiscal year

There are a number of measures of economic output—including gross domestic happiness as reported in Bhutan. Most governments report headline GDP at market prices in calendar-year terms. In South Asia, many governments report data on a fiscal-year basis using factor costs to weight output rather than market prices. The Indian government reports data in two different ways: factor cost and market prices, both in fiscal-year terms—although it places greater emphasis on the factor-cost measure. Importantly, although these measures are consistent, they can yield large differences.

The differences arise because the weights attached to sectoral growth rates differ, depending on which measure you use. The factor-price measure weights output using prices that are net of indirect taxes less subsidies in a base year, while the market-price measure uses weights that are based on the actual market prices observed in a base year. If the underlying growth rates of sectors with relatively high net tax-rates are different from those of sectors with relatively low net tax-rates in the base year, then there will be a systematic and persistent difference between real GDP growth measured at factor cost and GDP measured at market prices. Indeed such persistent differences between real GDP growth at market prices and at factor cost are observable across most countries that publish both data, including Brazil, Australia and Germany, for example. In India, this difference is historically about 0.3 percentage points over the past twenty years, and by even more in recent years.

There are a number of reasons why countries choose to report different headline measures. Only a small subset of countries (Egypt, Indonesia, Iran, and much of South Asia), report headline GDP at factor cost, in part reflecting that agricultural sectors remain important drivers—albeit typically declining—to their growth outturns. Similarly, countries often report data in fiscal years (instead of calendar years), as this often reflects the given country's crop year.

For the purposes of this report, GDP growth is provided at the country level at market prices in both calendar-year terms and fiscal-year terms for South Asia, while all regional aggregates are provided at market prices in calendar -year terms. The use of GDP at market prices in calendar-year terms enables ready comparison and aggregation across countries. This is because the vast majority of governments outside of South Asia report headline GDP at market prices—as it tends to be easier to monitor (and more reliable) given tax receipts, for example. Additionally, fiscal years can vary significantly across countries. For example, India's fiscal year runs from April 1 through March 31 and Nepal's fiscal year runs from July 16 through July 15.

India's real GDP growth at market prices and factor cost, in calendar year- and fiscal year-terms

	2003	2004	2005	2006	2007	2008	2009	2010
Market Price	6.9	7.9	9.2	9.4	10.1	6.2	6.8	10.3
Factor Cost	7.4	7.2	9.2	9.6	9.7	6.1	8.5	9.0

	2003-04FY	2004-05FY	2005-06FY	2006-07FY	2007-08FY	2008-09FY	2009-10FY	2010-11FY
Market Price	8.4	8.3	9.3	9.3	9.8	4.9	9.1	8.8
Factor Cost	8.5	7.5	9.5	9.6	9.3	6.8	8.0	8.5

Sources: Central Statistics Office, India and The World Bank.

Note: For years 2006 and 2005-06FY onward, the base year is 2004-05FY. For prior years, the base year is 1999-2000FY.

that damaged a significant share of this year's early crop. GDP growth in 2010 (calendar year) registered 8 percent and has been strongly underpinned by the peace dividend following the end of the decades-old civil war. The recovery was led by private consumption and investment. Agricultural output growth was boosted by the return to production of previously fallowed land with the cessation of fighting, while services activity benefitted from an upsurge in tourism. Activity in the first few months of 2011 has slowed due to waning of these rebound effects from the end-of-conflict and more normal growth rates in agriculture (aside from the negative impact of floods).

Afghanistan's GDP (on a fiscal year basis) is expected to have grown 8.2 percent in FY2010/11 (ending June-2011), down from an unsustainable 20.1 percent increase in FY2009/10 that was driven by a record harvest (following a long period of drought) and an upswing in donor grants. Output this year continues to be bolstered by reconstruction and strong aid inflows, which are reflected in a robust expansion of services (including transport) and vibrant construction activity.

Nepal also experienced a moderation in activity in early-2011. Ongoing political uncertainty attached to the post-conflict transition to a new government has extended into its fourth year, with law and order problems, continued extensive infrastructure bottlenecks (particularly widespread load-shedding and unreliable power delivery) projected to limit real GDP growth to 3.5 percent in FY2010/2011 (ending mid-July-2011), down from 4.6 percent in FY2009/10.

GDP growth has been picking up in Bangladesh, where private consumption spending has been supported by higher private sector credit growth and public- and private-sector wage increases. However, the strong boost to consumer incomes from worker remittances in 2009 (up 17.1 percent in dollar terms that year) has given way to a much more modest 2.7 percent gain in 2010, reflecting falling net outmigration since 2009 and fewer remitters following last year's return of workers from several gulf states. At the sectoral level, rising agricultural output reflects good harvests, and strengthened industrial production has been buoyed by a revival in garment exports. However, Bangladesh's output continues to be constrained by widespread power supply outages, which are expected to limit GDP gains to 6.2 percent FY2010/11 (ending June-2011) from 5.8 percent in FY2009/10.

Among the remaining economies in South Asia, Bhutan's real GDP is firming, underpinned by construction of additional hydropower projects, and to a lesser extent by a revival in tourism. In FY2010/2011 GDP growth is projected to rise to 8.3 percent, up from 6.9 percent in 2009/10, (ending June-2010). The recovery in the Maldives appears to have firmed slightly in early -2011 with strong tourism arrivals. In 2011, GDP growth is projected to accelerate to 5 percent (calendar year) following 4.8 percent in 2010. Tourism is expected to remain the key driver for growth, supported by a 17.4 percent expansion of capacity (number of beds) at end-2010 and robust growth in arrivals stemming from diversification to faster-growing new markets. In particular, China surpassed the United Kingdom in 2010 as the largest source of tourists to the Maldives.

Inflationary pressures are elevated across South Asia reflecting various factors, including higher international food and fuel prices, tight capacity utilization, and past macroeconomic loosening, which have led to elevated inflation expectations and higher core prices (figure SAR.1). High international fuel and food prices are key factors in South Asia because of its heavy reliance on imports of oil and some staples, such as edible oils. Additionally, food represents a large share (about 40 percent) of the regional household consumption basket, a key concern from a poverty perspective.

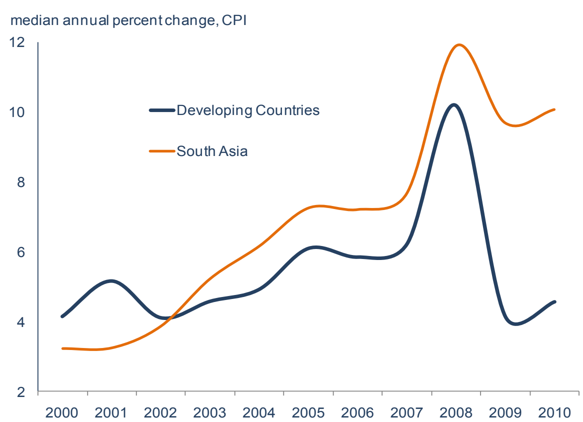
In particular, international wheat and edible oils prices have surged, while rice prices have remained more stable. Afghanistan, the Maldives and Sri Lanka—where at least one-third of domestic consumption of grains (including rice, wheat, pulses) and edible oils is imported—are most exposed to an imported pass-through of higher international commodity prices (figure SAR.2). Indeed, reliance on imported edible oils is high across the region, where at least two-thirds of consumption is imported (in Afghanistan, Bangladesh, India, Pakistan, and Sri Lanka, for which data is available). Some countries are self-reliant in key staples, such as Bangladesh, India and Nepal, where rice-imports represent a very small share of consumption (2 percent or less). Notably, the short-run pass-through (monthly) of international grain prices is generally low in South Asia, partly reflecting administered prices. For example, in India, wheat prices have remained well-below international prices, compared to near complete pass-through in Bangladesh.

The strength of the recovery in South Asia partly explains the persistence of inflation in the region, as little spare capacity remains. Although estimates of potential output can vary depending on methodology and assumptions—especially for countries with ongoing conflict, such as Pakistan, or coming out of conflict, such as Sri Lanka—measures across sources for many of the region's economies (Afghanistan, Bangladesh, India, Sri Lanka) suggest output gaps narrowed (or closed) in 2010, which has likely contributed to price pressures. In addition, a series of local one-off factors have contributed to price pressures including: the economic disruptions from flooding in Pakistan (during the second half of 2010) and Sri Lanka (early-2011); the partial liberalization of petroleum prices in India (mid-2010); and the raising of administered petrol prices elsewhere in the region (including Bhutan, the Maldives, and Pakistan). A recent devaluation of the Maldives' currency, following the introduction of an exchange rate band around the Rufiyaa/US-dollar peg (R12.85/$1) of plus or minus 20 percent, has also contributed to a resurgence of inflation in that country.

To rein-in domestic demand and inflationary pressures, monetary authorities have initiated policy rate hikes in Bangladesh, India, and Pakistan, with the Reserve Bank of India having started raising rates in March 2010. Despite these measures, real policy interest rates are negative—or remain looser than they were prior to the crisis (figure SAR.3). Unfortunately, bringing inflation back down will be complicated by the trend rise in inflation over the past decade, which has contributed to an increase in inflationary expectations in recent years. Household surveys in India, for example, indicate that consumers' inflation expectations have increased over the last four years (from 5.8 percent in Q4-2006 to 13.1 percent in Q4-2010 for year-ahead inflation), and have recently jumped by 1.2 percentage points in the second half of 2010 (figure SAR.4).[1]

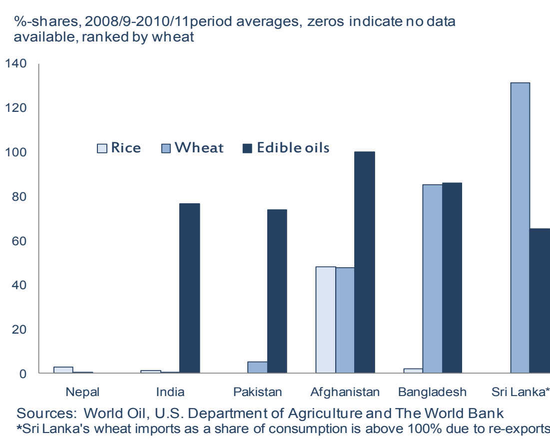
Despite the steps taken earlier to reduce fuel subsidies, the pass-through of higher international energy prices is incomplete,

Figure SAR.1 South Asia's inflationary pressures sharply exceed other developing countries in post-crisis years



Sources: Thomson Reuters and World Bank.

Figure SAR.2 Imports of rice, wheat and edible oils as a share of domestic consumption



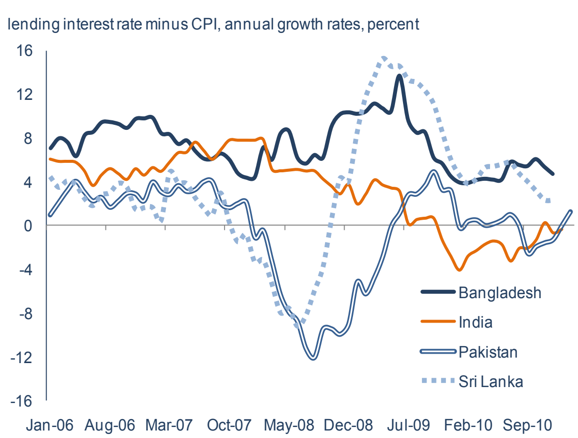
Source: U.S. Department of Agriculture and World Bank.

increasing subsidization costs and contributing to fiscal deficits (figure SAR.5). The region's large general government budget deficits are also complicating efforts to restrict domestic demand and reduce inflation. South Asia's aggregate fiscal deficit continues to outstrip those of other developing regions. And, despite progress toward fiscal consolidation in some countries (India, Maldives and Sri Lanka) in 2010, general government deficits remain very high, at 8.8 percent of GDP in India for FY2010/11, 20.7 percent in the Maldives for CY2010, and 7.9 percent in Sri Lanka for CY2010. Large outlays for interest payments are slowing progress toward fiscal consolidation, and—while improving in some countries (Afghanistan, Maldives, and Sri Lanka, for example)—the region's low tax base makes consolidation particularly challenging.

Elsewhere in the region, fiscal balances have deteriorated. In Pakistan—after rising to 6.3 percent of GDP in FY2009/10—the deficit continued to expand in the first half of FY2010/11 tied to flood-related outlays, high power-sector subsidies and increased defense spending. In Bhutan, the fiscal deficit rose to an estimated 4.4 percent of GDP in FY2010/11, as the government continues to plow money into development and infrastructure projects (including roads, financial services and information technology) that are only partly funded by the Tala hydroeclectic project revenue stream. In Bangladesh, the deficit rose to 4.9 percent in 2010/11, due to large outlays for investment in power generation and higher subsidies. Sizeable foreign aid inflows and improved revenue performance helped contain Nepal's deficit to a relatively modest 2.8 percent of GDP and helped Afghanistan retain a surplus of 0.6 percent of GDP.

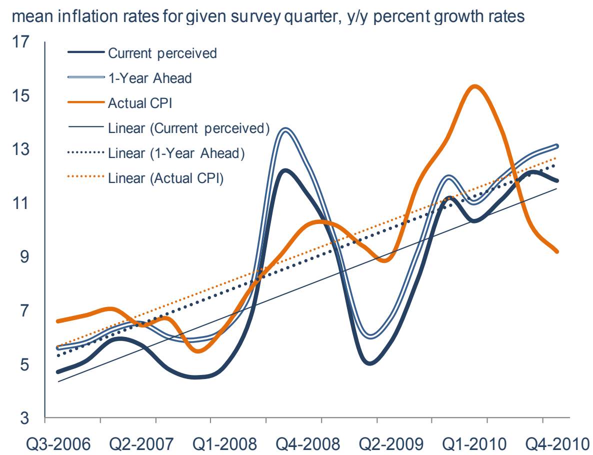
Given high inflation rates—currencies in South Asia appreciated in real effective (trade-weighted and inflation adjusted) terms, with the

Figure SAR.3 Real lending rates remain expansionary in India and Pakistan, despite monetary policy tightening



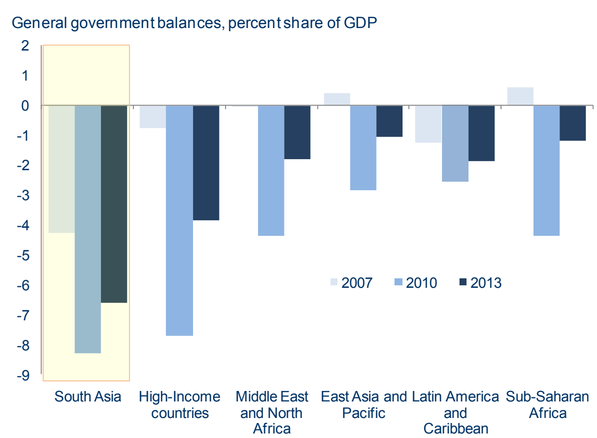
Sources: Economist Intelligence Unit and World Bank.

Figure SAR.4 India's household inflation expectations have increased



Sources: Reserve Bank of India and World Bank.

Figure SAR.5 Elevated food and fuel prices are likely to weigh on fiscal balances and might delay consolidation



Source: World Bank.

largest increases in Pakistan and Nepal, where currencies stood about 15 percent above mid-2008 levels at end-2010. Bangladesh's real effective exchange rate had appreciated strongly as well, but depreciated during much of 2010 and ended the year 12 percent above pre-crisis levels. In India and Sri Lanka, real effective exchange rate appreciation has been less pronounced, about half the rates of appreciation across the rest of the region (8 percent and 6 percent, respectively, over the same period).

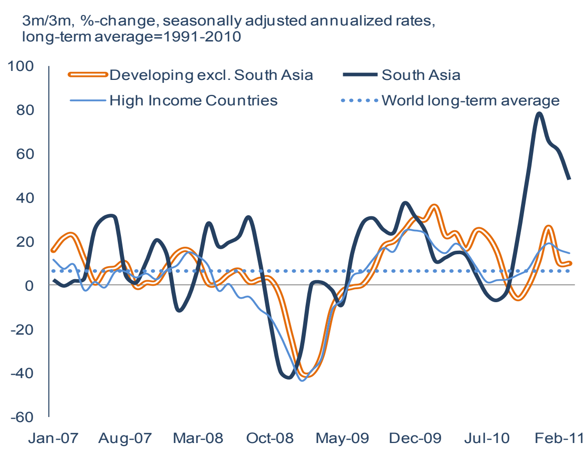
Despite headwinds implied by appreciating currencies, regional merchandise export volume growth accelerated sharply in the second half of 2010 (figure SAR.6). As the global growth recovery has deepened, external demand for South Asia has firmed, with volume growth given an extra impetus following a shift in export market composition toward higher-growth developing countries (China) and away from traditional export markets in slower-growing Europe and the United States (figure SAR.7). In India, the value of exports rose by 37.5 percent year-on-year to reach $245 billion in FY2010/11, exceeding the $200 billion government target. Among other factors, this strong performance reflects the success of the government's strategy to expand export markets in emerging economies, particularly in Latin America and Asia. Regional merchandise import volume growth remained robust as well, which in combination with higher import prices led to a modest deterioration in the region's trade deficit from 6.2 percent of GDP in 2009 to 6.4 percent of GDP in 2010.

Tourism receipts rebounded in 2010 following the 2009 downturn with nearly all countries in the region registering a recovery (Bhutan, India, Maldives, Nepal, and Sri Lanka). Sri Lanka in particular posted a 46 percent upsurge in tourist arrivals following the end of civil war in 2009. In general, higher regional tourist arrivals reflected recovery in high-income Europe and vibrant growth in developing East Asia, especially China.

Worker remittance inflows to South Asia rose in U.S.-dollar terms by 8.2 percent in 2010 to $81 billion, helping to offset sizeable trade deficits, remaining a critical source of foreign exchange.[2] However, when measured in local currency terms, remittances inflows to the region grew by only 4.1 percent in 2010, while high inflation rates meant that the real value of these inflows declined by 3.9 percent.

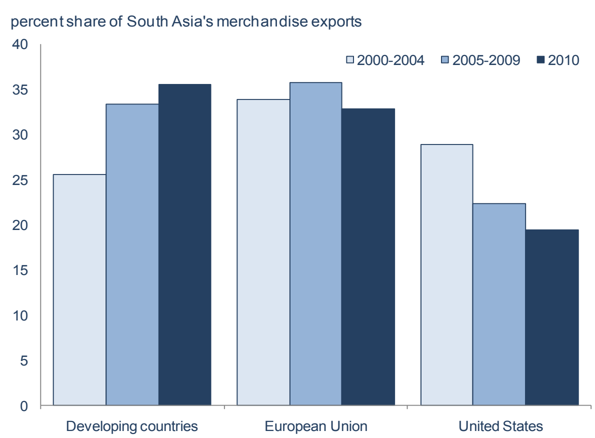
The pick-up in the dollar value of remittances was strongest in Sri Lanka, where they increased 24 percent in 2010—reflecting increased inflows through official channels and the boost in confidence following the end of the civil war. In Nepal, the dollar value of remittances expanded

Figure SAR.6 South Asia's merchandise goods exports recover following sharp deceleration in mid-2010



Sources: Thomson Datastream and World Bank.

Figure SAR.7 Shift toward developing country export markets buoys South Asia's export growth as demand slackens in high-income countries



Sources: CEIC and World Bank.

17 percent, supported in part by vibrant growth in India, a key source-country for Nepalese remittances. In India, the uptick in the dollar value of remittances inflows was more modest (7.4 percent), reflecting larger shares of Indian migrants in high-income countries that have yet to fully recover from the financial crisis. Elsewhere in the region, remittances inflows moderated sharply in 2010 (in dollar terms) by 2.7 percent in Bangladesh, following 19.4 percent growth in 2009. The deceleration appears to partly reflect a delayed impact of the decline in the net outflow of migrants, which nearly halved during the first half of 2009 and continued to decline in 2010 and into early-2011.

South Asia's current account deficit deteriorated in early 2011, reflecting higher oil import bills and strong, albeit moderating, import volume growth. Helping to contain the deterioration in external balances, the region recorded strong export volume growth in early-2011 (led by India, Pakistan and Sri Lanka)—supported by strong external demand from China. During calendar year 2011, the regional current account deficit is projected to expand to 2.8 percent as a share of GDP from 2.4 percent in 2010. In part this reflects a projected shrinking of Bangladesh's current account surplus, due to a stronger pace of growth in imports over exports, falling terms of trade (driven by rising international food and fuel prices) and a major slowdown in worker remittances receipts. Indeed, deterioration in the current account prompted the government of Bangladesh to seek IMF funding to help maintain business and investor confidence. While FDI to the region has fallen (India and Pakistan), the regional current account deficit is expected to continue to be covered by significant foreign exchange reserve holdings, particularly in India, and sustained capital inflows.

Capital Flows

Net private capital inflows to South Asia expanded by an estimated 12.3 percent in 2010 to $76.6 billion, driven by a doubling (110 percent growth) in portfolio equity inflows (table SAR.2). As a share of GDP, however, inflows fell to 3.8 percent from 4.2 percent—roughly half the peak share (7.8 percent) recorded in 2007 when inflows reached $113.3 billion. South Asia accounts for a small share (10 percent in 2010) of total private capital inflows to developing countries, in part reflecting more shallow financial markets—with the exception of equities (India). Capital inflows to South Asia rose in the third quarter of 2010, after which they fell-off in the fourth quarter and into early-2011, very much in line with the overall trend in flows to developing countries in aggregate.

The composition of South Asia's inflows has shifted markedly since the onset of the global crisis, led by a sharp contraction in FDI inflows—which are down 50 percent in 2010 from the 2008-peak. This compositional shift also reflects a recovery in portfolio equity inflows, which have expanded 19 percent above the 2007-peak as of 2010. In comparison, for the rest of the developing countries FDI inflows are down by only 18 percent as of 2010 from the 2008-peak (including a 52 percent decline posted by Europe and Central Asia). Portfolio inflows to South Asia are more in line with developments in the rest of the developing world, standing 12 percent above 2007 peaks as of 2010. As a share of FDI inflows to developing countries in aggregate, South Asia captured 5 percent, roughly in line with those captured by Sub-Saharan Africa and the Middle East and Africa.

In contrast, South Asia attracts a disproportionately large share of total portfolio inflows to all developing countries, equivalent to 28 percent in 2010, for example (or 1.5 percent of South Asia's GDP versus about 0.8 percent for other developing countries). While these flows are more volatile than FDI flows, South Asia has generally accounted for a relatively large share of the total, and for 2010 exceeded the shares of portfolio inflows accounted by other regions, with the exception of Latin America and the Caribbean (with 35 percent in 2010) and just above East Asia and Pacific (24 percent in 2010). Investors have been drawn to South Asia's relatively liquid equity markets—notably in India, where its companies have continued to issue ADRs (American Depository Receipts) and GDRs (Global Depository Receipts) in recent years (in contrast to China for example, where companies have stopped ADR and GDR issuances). In comparison to equities, South Asia's bond markets—including in India—are much less developed, thus effectively channeling foreign investors into equities. Elsewhere, flows to Latin America and the Caribbean tend to be more concentrated in bonds and flows to Europe and Central Asia—prior to the global crisis—were more concentrated in banking instruments.

India continues to account for the bulk of portfolio inflows to the region, which are channeled largely through institutional investors (which tend to squeeze out individuals). Foreign equity inflows into India reached a record $44.8 billion in 2010, exceeding the previous peak of 2007 before the market crash of 2008. The increased participation of many foreign mutual funds in the country has contributed to the success of many new issues by Indian companies, such as the mega, public sector offering of Coal India. In 2010 IPOs were nearly double the level in 2009, with 47 percent of the funds flowing to the energy sector. After India, Sri Lanka and Pakistan also attract significant equity inflows. Following the end of the civil war in Sri Lanka of 2009 capital inflows have surged, contributing to the Colombo Stock Exchange's boom returns of 96 percent in dollar terms in 2010, registering the largest gains in the world in the year.

FDI to India, the region's main recipient, fell by nearly one-third in 2010. In January 2011, FDI continued to decline sharply, down nearly by half from January 2010. This weak FDI performance has occurred despite India's strong growth. A confluence of factors may have contributed to the sharp decline, which has prompted the government of India to form a panel to investigate possible causes. Nevertheless, it appears that increased regulatory scrutiny of the sources of FDI has contributed to a fall-off in flows tied to 'round-tripping' (to avoid taxes, for example) via offshore accounts. Flows from Mauritius and Cyprus—which together account for two-fifths of flows to India—contracted markedly in 2010, by 60

Table SAR.2 Net capital flows to South Asia

$ billions

	2003	2004	2005	2006	2007	2008	2009	2010e	2011f	2012f	2013f
Current account balance	12.5	-1.2	-15.1	-16.8	-17.6	-49.9	-28.0	-49.6	-60.3	-60.9	-63.2
as % of GDP	1.6	-0.1	-1.5	-1.5	-1.2	-3.3	-1.7	-2.4	-2.8	-2.6	-2.4
Financial flows:											
Net private and official inflows	**14.5**	**21.2**	**28.5**	**76.6**	**117.7**	**61.4**	**77.7**	**88.3**			
Net private inflows (equity+private debt	**18.6**	**21.5**	**25.6**	**73.1**	**113.3**	**52.8**	**68.2**	**76.6**	**103.1**	**107.3**	**118.3**
..Net private inflows (% GDP)	2.4	2.4	2.5	6.3	7.8	3.5	4.2	3.8	4.8	4.5	4.5
Net equity inflows	13.5	16.8	23.6	36.4	68.4	32.9	58.8	67.2	73.1	82.8	92.3
..Net FDI inflows	5.4	7.8	11.2	26.0	32.3	48.7	38.3	24.2	36.1	43.8	51.3
..Net portfolio equity inflows	8.0	9.0	12.4	10.4	36.1	-15.8	20.5	43.0	37.0	39.0	41.0
Net debt flows	1.0	4.4	4.9	40.2	49.3	28.5	18.8	21.1			
..Official creditors	-4.1	-0.3	2.9	3.5	4.4	8.6	9.5	11.7			
....World Bank	-2.3	2.3	2.3	2.0	2.0	1.4	2.1	3.9			
....IMF	-0.1	-0.3	0.0	-0.1	-0.1	3.2	3.6	3.8			
....Other official	-1.8	-2.4	0.6	1.6	2.4	4.0	3.8	4.0			
..Private creditors	5.1	4.7	2.0	36.7	44.9	19.9	9.3	9.4	30.0	24.5	26.0
....Net M-L term debt flows	3.1	4.0	-0.2	19.9	32.0	12.0	10.3	3.2			
......Bonds	-3.7	3.9	-2.8	6.4	10.7	1.7	1.7	-2.6			
......Banks	6.8	0.5	2.8	13.5	21.3	10.3	8.6	5.8			
......Other private	0.0	-0.3	-0.2	-0.1	0.0	0.0	0.0	0.0			
....Net short-term debt flows	2.0	0.7	2.3	16.8	12.9	7.9	-1.0	11.1			
Balancing item /a	10.0	7.6	-6.6	-18.2	3.7	-37.8	-11.0	-30.4			
Change in reserves (- = increase)	-36.9	-27.6	-6.8	-41.7	-103.8	26.3	-38.6	-8.3			
Memorandum items											
Workers' remittances	30.4	28.7	33.9	42.5	54.0	71.6	75.1	81.2	88.7	93.8	

Note: Only for Afghanistan, Bangladesh, Bhutan, India, Maldives, Nepal, Pakistan and Sri Lanka.

e = estimate, f = forecast

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

Source: World Bank.

percent and 78 percent, respectively. In contrast, total inflows to India excluding these countries contracted by only 8 percent. Similarly, some projects were delayed for environmental compliance issues. For example, South Korean steel giant POSCO suffered a setback when the Environment Ministry delayed the operation of its $12 billion steel project in Orissa in mid-2010. U.K.-based Vedanta's investment of around $9 billion was also halted in 2010, as it had breached environmental regulations in the mining sector. Other countries in the region generally rank below India in international investor surveys, with Afghanistan often ranked near the bottom, helping to explain relatively weak FDI inflows to South Asia. Remarkably, Pakistan—where security concerns remain a key hindrance—captures a similar share of FDI relative to GDP as India and has exhibited the same pattern of declining FDI inflows as India over recent years (figure SAR.8).

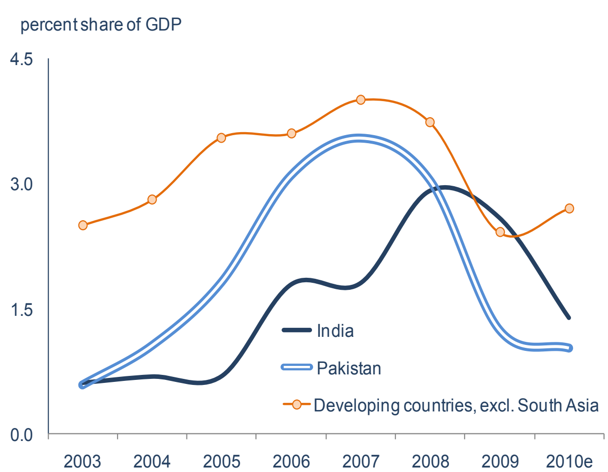
Government debt is elevated across the region—reflecting the impact of long-term structural fiscal deficits—and exceeds the average for developing countries in aggregate (except for Afghanistan) (figure SAR.9). As of FY2009-10, debt as a share of GDP in the Maldives (96 percent), Sri Lanka (82 percent) and India (73 percent), sharply exceeded the average for developing countries (37 percent). Indeed, South Asia's government debt is more closely in line with that of high-income countries (91 percent), although the upward trajectory since the onset of the financial crisis is not as pronounced in South Asia as in high-income countries—with the marked exception of the Maldives.

Medium-term outlook

Regional GDP growth is projected to continue to record strong growth outturns averaging 7.7 percent in calendar terms and at market prices from 2011 through 2013, off 1.6 percentage points from the 9.3 percent outturn of 2010—but 1.7 percentage points above the pre-crisis decadal average from 1998 through 2007. The deceleration from 2010 reflects progressive tightening of monetary policy and fiscal consolidation aimed at a quelling excess demand and inflationary pressures, reducing unsustainably large fiscal deficits and containing deterioration in external balances. Aside from dampening private sector demand, fiscal consolidation is expected to lead to a slowing of public sector consumption.

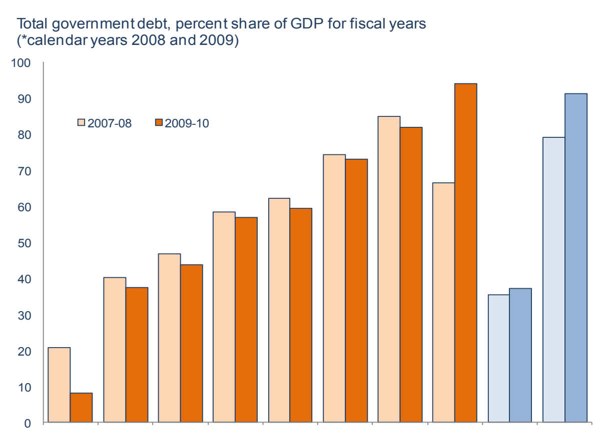
In combination with macro-policy tightening, improving crop production (Pakistan and Sri Lanka) and an expected moderation in international fuel prices over the balance of 2011 should foster some easing of inflationary pressures ahead. But, deceleration in prices is projected to be slow given incomplete pass-

Figure SAR.8 India and Pakistan FDI inflows as a share of GDP lag other developing countries



Sources: .UNCTAD and World Bank

Figure SAR.9 Government debt in South Asia exceeds average for emerging markets -- except in Afghanistan



Sources: CEIC, IMF Fiscal Monitor Jan-2011, and World Bank.

through of higher international prices thus far, particularly for fuel prices. An expected normal crop year (2011/2012) in much of the region and relatively high regional stocks are providing a buffer for grain prices and import demand in 2011 (table SAR.3).[3] However, South Asia is facing the current upturn with some weaker initial conditions compared with the 2007-2008 upswing—given less fiscal space and higher inflation—which is posing additional challenges in addressing risks of increased poverty and malnutrition rates.

External demand for goods and services is projected to moderate in 2011, given policy normalization and fiscal consolidation across most of South Asia's export markets, along with a natural deceleration in demand growth as global demand converges back to trend production levels. Accordingly, the pace of growth of tourism activity is projected to moderate in 2011, as arrivals from high-income countries, particularly from Europe, are expected to slow. However, the slowdown in arrivals from Europe is being partially offset by still strong growth from developing East Asia and high-income Middle Eastern economies. Deceleration in domestic demand growth will be reflected in a moderation in South Asia's imports in 2011. However, given the deterioration in the terms of trade (as higher oil prices weigh on the region's import bill) the current account deficit is projected to expand in 2011.

The recent rise in oil prices is projected to translate into significant terms of trade deterioration for South Asia, compared with oil importers in most other developing regions, with the exception of the Middle East and North Africa (figure SAR.10). Price changes are expected to reduce real incomes in South Asian countries by about 1.1 percent of GDP, largely due to higher oil prices, and partly offset by increases in other commodities. For example, South Asia's cotton producers (such as India) are likely to see marked gains in their terms of trade, as cotton prices are projected to rise by one-third, whereas textile exporters (such as Bangladesh, which imports cotton) are likely to see greater deterioration in their terms of trade.

Remittances are projected to rise 9.1 percent in 2011 in dollar terms, up slightly from 8.2 percent growth in 2010 (growing substantially below pre-crisis boom rates, when they averaged 30 percent over 2007 and 2008), and help provide a cushion to the deterioration in the regional current account balance (figure SAR.11). In particular, worker transfers to South Asia from the high-income Gulf Cooperation Council (GCC) countries (most of the region's 9 million migrants work in these countries) are projected to firm with strengthened activity tied to higher oil-rents, which is boosting labor demand in the oil producers (figure SAR.12).[4] The countries most affected by political upheaval in the Middle East (Egypt, Libya, Syria, Tunisia, and Yemen) are not large migrant host-countries for South Asia, so the net impact on migrant labor demand and remittances appears positive.

Table SAR.3 South Asia's grain supply and demand balances

1,000 metric tons, unless otherwise noted

	2004/2005	2005/2006	2006/2007	2007/2008	2008/2009	2009/2010	2010/2011	2011/2012
Production	251,472	263,234	264,995	284,200	289,168	278,943	290,733	298,683
y-o-y % growth	*-0.6*	*4.7*	*0.7*	*7.2*	*1.7*	*-3.5*	*4.2*	*2.7*
Ending stocks	18,710	20,729	23,117	26,134	40,767	45,389	45,581	43,406
y-o-y % growth	*-20.6*	*10.8*	*11.5*	*13.1*	*56.0*	*11.3*	*0.4*	*-4.8*
*% share of use**	*7.8*	*8.4*	*9.2*	*9.9*	*15.7*	*17.5*	*16.6*	*15.4*
Domestic consumption *	240,445	245,368	251,370	262,857	260,328	259,012	275,288	282,363
y-o-y % growth	*-0.6*	*2.0*	*2.4*	*4.6*	*-1.0*	*-0.5*	*6.3*	*2.6*

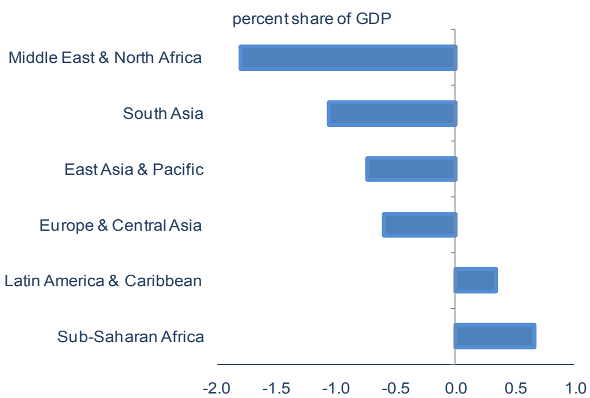
** Excludes feed consumption.*

Countries = Bangladesh, India, Nepal, Pakistan, Sri Lanka.

Sources: U.S. Department of Agriculture (11 May 2011) and World Bank.

GDP growth (in calendar year terms) in South Asia is projected to gain momentum incrementally in 2012 and 2013 to 7.7 percent and 7.9 percent, respectively, from an expected 7.5 percent in 2011, led by firming private sector activity, as inflationary pressures diminish and enable monetary authorities to pursue less restrictive stances in the outer years. In particular, investment is expected to firm as tighter monetary conditions are projected to contribute to an easing of inflation expectations and as fiscal consolidation fosters greater access to credit. Additionally, large programmed investment and reconstruction projects in Afghanistan, Bangladesh, Bhutan, India and Sri Lanka should support acceleration of GDP growth in the outer years, boosting productivity and potential output. External demand is projected to strengthen incrementally in 2012 and 2013—assuming continued increased market penetration to faster growing developing countries—and be supportive of growth as well, as large high-income export markets begin to stabilize macroeconomic conditions.

Figure SAR.10 Projected terms of trade impacts in 2011 for oil-importing countries (by region)



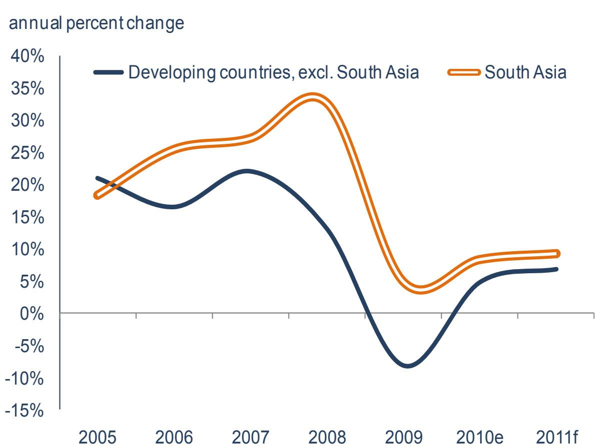
Sources: UN Comtrade and World Bank.

The region's relatively strong projected growth path—reaching 7.9 percent in 2013 compared with the 6.0 percent average from 1998 through 2007 (compound growth rate)—is projected to be led by India, Sri Lanka and Bangladesh, where acceleration of investment activity is expected to support higher growth outturns. In contrast, Pakistan and Nepal are expected to lag, given continued political challenges and associated macro-policy slippage. Indeed, GDP growth in Pakistan is not projected to recover to above the pre-crisis decadal average of 5.0 percent during the forecast period (table SAR.4).

Risks

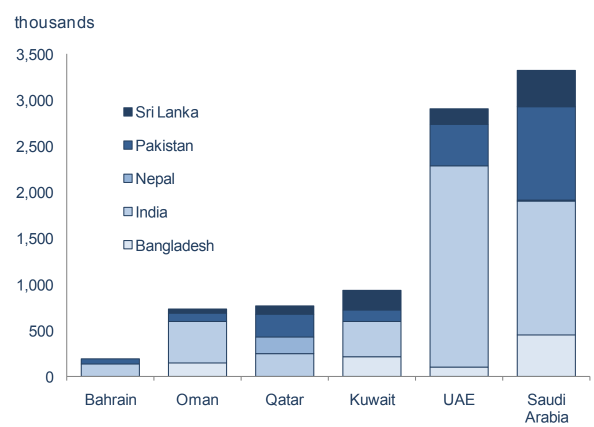
The region has witnessed a build-up in price pressures and is bumping up against potential output, which suggests that it needs to address supply constraints through higher investment. However, large fiscal deficits and public sector

Figure SAR.11 Growth of worker remittances inflows to South Asia projected to level off in 2011



Source: World Bank, Migration and Development Brief No. 16, April 2011.

Figure SAR.12 Most migrant workers from South Asia are based in the high-income Gulf Cooperation Council countries of the Middle East



Source: World Bank, Migration and Development Brief No. 16, April 2011.

debt may be crowding out private sector investment, which is likely being pressured by a relatively poor business climate and relatively shallow domestic financial markets (such as small corporate bond markets). As a consequence, demand is being channeled into higher prices and deteriorating current account balances. In this context, pursuing policy normalization is critical and failure to bring public finances and monetary policy into line could undermine growth projections and progress toward South Asia's urgent development objectives, including an expansion of infrastructure spending and potential output.

Inflation remains a key downside risk to growth, as policymakers face numerous challenges in reducing price pressures. If inflation remains elevated, unless offset by exchange rate depreciation (itself an inflationary impulse) it is likely to begin eating into the region's international competitiveness and discourage foreign investment—creating headwinds to gains in productivity. Elevated international commodity prices are also a negative risk factor, particularly given political resistance to reducing subsidies. In countries such as India that maintain price controls on food, farmers are not fully participating in the global upswing in prices. Higher monetary policy interest rates

Table SAR.4 South Asia country forecasts

(annual percent change unless indicated otherwise)				Est.	Forecast		
	98-07[a]	2008	2009	2010	2011	2012	2013
Calendar year basis [b]							
Bangladesh							
GDP at market prices (2005 US$) [c]	5.0	6.3	6.0	5.8	6.0	6.3	6.5
Current account bal/GDP (%)	0.2	1.4	3.5	2.5	-0.5	-1.3	-1.7
India							
GDP at market prices (2005 US$) [c]	6.4	6.2	6.8	10.3	8.1	8.4	8.5
Current account bal/GDP (%)	-0.3	-2.6	-2.0	-2.7	-2.8	-2.5	-2.3
Nepal							
GDP at market prices (2005 US$) [c]	3.4	6.2	5.3	4.5	4.1	3.7	4.1
Current account bal/GDP (%)	-1.7	3.0	-2.0	-2.8	-2.9	-2.7	-2.6
Pakistan							
GDP at market prices (2005 US$) [c]	4.9	3.6	2.6	3.9	3.3	3.2	4.1
Current account bal/GDP (%)	-0.8	-9.6	-2.5	-1.3	-2.4	-2.5	-2.7
Sri Lanka							
GDP at market prices (2005 US$) [c]	4.4	6.0	3.5	8.0	7.5	6.8	6.4
Current account bal/GDP (%)	-3.2	-9.8	-0.7	-3.5	-4.9	-4.7	-4.2
Fiscal year basis [b]							
Bangladesh							
Real GDP at market prices	5.1	6.2	5.7	5.8	6.2	6.4	6.6
India							
Real GDP at market prices	6.4	4.9	9.1	8.8	8.0	8.4	8.5
Memo: Real GDP at factor cost	-	6.8	8.0	8.5	8.2	8.5	8.6
Nepal							
Real GDP at market prices	3.4	6.1	4.4	4.6	3.5	4.0	4.2
Pakistan							
Real GDP at market prices	5.0	1.6	3.6	4.1	2.5	3.9	4.3

World Bank forecasts are frequently updated based on new information and changing (global) circumstances. Consequently, projections presented here may differ from those contained in other Bank documents, even if basic assessments of countries' prospects do not significantly differ at any given moment in time.
Afghanistan, Bhutan, Maldives are not forecast owing to data limitations.
a. Growth rates over intervals are compound average; growth contributions, ratios and the GDP deflator are averages.
b. National income and product account data refer to fiscal years (FY) for the South Asian countries with the exception of Sri Lanka, which reports in calendar year (CY). The fiscal year runs from July 1 through June 30 in Bangladesh and Pakistan, from July 16 through July 15 in Nepal, and April 1 through March 31 in India. Due to reporting practices, Bangladesh, Nepal, and Pakistan report FY2009/10 data in CY2010, while India reports FY2009/10 in CY2009. GDP figures are presented in calendar years (CY) based on quarterly history for India. For Bangladesh, Nepal and Pakistan, CY data is calculated taking the average growth over the two fiscal year periods to provide an approximation of CY activity.
c. GDP measured in constant 2005 U.S. dollars.
d. Estimate.
e. Forecast.

Source: World Bank.

aimed at crimping price pressures, however, could also prompt a rise in capital inflows and complicate monetary policy—emphasizing the need for fiscal consolidation.

Persistently large budget deficits also pose important downside risks to growth, by crowding out private investment and contributing to excess demand. Fiscal slippage is contributing to inflationary pressures and limits policy options in the event of future crises through limited fiscal space. Regional deficit (and debt) problems will need to be resolved by simultaneous reforms on both revenues and expenditures along with reforms to support expansion of the private sector, including deepening financial markets. Efforts to reduce deficits are being hampered by South Asia's weak revenue collection and a small tax base, while large food-, fuel- and fertilizer subsidies are hindering progress toward cutting expenditures.

Key external downside risks are tied to uncertainty in the Middle East and North Africa. If political turmoil leads to sustained high oil prices, South Asia's oil import bill and price pressures could rise further, while a spreading of turmoil to GCC countries could undermine confidence and economic growth in the Middle East and North Africa, and result in sluggish or even falling remittances inflows. Already, recent political tensions have intensified efforts within the GCC to replace migrant workers with nationals, which if it were to spread, could curb remittances flows to South Asia.

Expansion of the sovereign-debt crisis in the Euro Area represents another important external downside risk, particularly if the crisis were to spread to larger Euro Area economies that would lead to weaker goods and services exports, worker transfer receipts and capital inflows for South Asia. The Euro Area represents about one-fourth of South Asia's merchandise export market, of which Germany and France account for 40 percent and 20 percent, respectively.[5] A spreading of the Euro Area crisis could negatively impact the tourism sectors among the smaller South Asian economies, particularly in the Maldives and Sri Lanka.

Notes:

1. The Reserve Bank of India's Inflation Expectations Survey of Households conducted in Q4-2010 (Round 22) shows households expect inflation to increase 130 basis points to 13.1 percent from the perceived current rate of 11.8 percent—compared with the expected 11.9 percent inflation rate from the Q2-2010 survey (Round 20), (1-year-ahead expected rates).

2. Nepal, Bangladesh, and Sri Lanka, were among the top 15 recipients of remittances in 2009—with inflows representing the equivalent of 23.8% of GDP in Nepal, 11.8% in Bangladesh, 8% in Sri Lanka, 5.4% in Pakistan and 3.6% in India.

3. Sources: India's Meteorological Department (April 2011 first monsoon forecast for 2011/12), and U.S. Department of Agriculture (May 2011).

4. Over two-thirds of South Asia's migrant workers are based in Saudi Arabia (3.3 million) and the U.A.E. (2.9 million).

5. "European Sovereign Debt Crisis: Links to the South Asia Region". December 2010. Francis Rowe, et al.

Sub-Saharan Africa

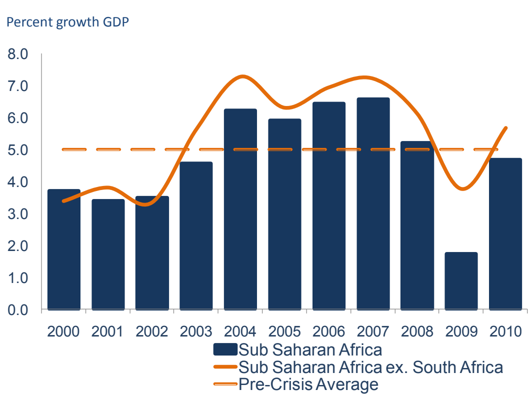
Recent developments

Growth in Sub-Saharan Africa rebounded sharply in 2010. Supported by the global economic recovery and developments on the domestic front, GDP in Sub-Saharan Africa grew by 4.8 percent in 2010—up from the 2 percent advance of 2009 and just shy of the region's 5 percent pre-crisis average growth (figure SSA.1). Excluding South Africa, the largest economy in the region, Sub Sahara Africa grew by 6.0 percent, one of the fastest growth rates among developing regions.

Recovery in exports. African export revenues, which had fallen to some 51 percent of their pre-crisis August 2008 levels by January 2009, had almost recovered by November 2010, reaching 93 percent of earlier peaks. Much of the increase was due to the surge in commodity prices (see Commodity annex) as in volume terms, exports increased by a moderate 7.5 percent in 2010.

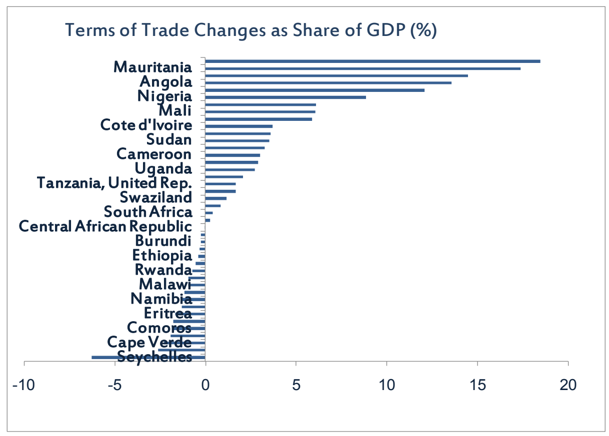
Among the biggest winners from the terms of trade changes were the oil exporters in the region, with incomes gains of upwards 10 percent of GDP in Angola, Congo, and Gabon. Among oil importers in the region the picture was mixed. In general, exporters of commodities whose price increases were higher than the increase in crude oil prices also benefitted (figure SSA.2). This includes exporters of metals such as copper (Zambia), as well as exporters of agriculture products such as rubber (Liberia), and cotton (Burkina Faso, Benin, and Mali). However, even though the prices of the principal merchandise exports of many oil importing Sub- Saharan countries improved in 2010, they still suffered a deterioration in their terms of trade, as in general, the recovery in prices was not sufficient to compensate for the

Figure SSA.1 Growth in Sub Saharan Africa rebounds close to Pre-Crisis Average



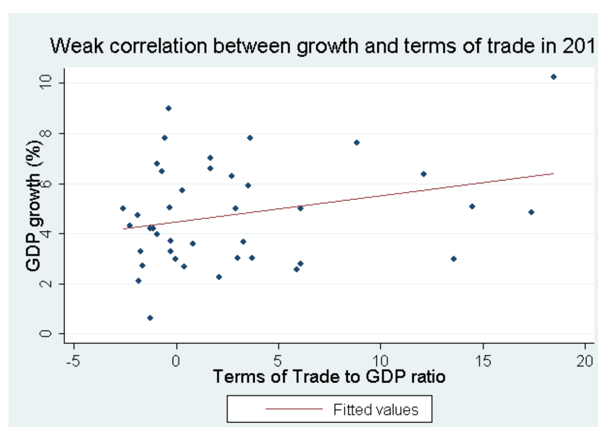
Source: World Bank.

Figure SSA.2 Terms of trade changes in SSA countries



Source: World Bank.

Figure SSA.3 Impact of terms of trade on growth is mixed



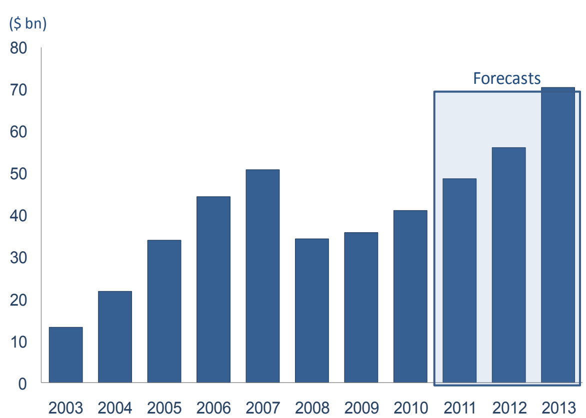
Source: World Bank.

sharp rebound in oil prices. Nonetheless, the impact of terms of trade changes on growth in 2010 remains mixed as stronger growth was associated with countries that recorded both favorable as well as unfavorable terms of trade changes, implying that there is more to the Sub Saharan African growth story than developments in commodity prices (figure SSA.3).

Rebound in capital flows. Thanks to recovery in the global economy, as well as an increasing recognition by investors of the opportunities presented in a rapidly growing developing region, net private capital inflows to Sub Saharan Africa increased from $35.8bn in 2009 to an estimated $41.1bn in 2010 and are projected to rise to $48.6bn in 2011 (figure SSA.4 and table SSA.3).

The leading destination of FDI inflows, in value terms, is to the capital intensive mining sector. Indeed, higher commodity prices and the global competition to secure supplies of commodities have spurred investments globally in the natural resource sector. Sub Saharan Africa, a region with a high proportion of known mineral resources with great potential for further development is benefitting from this trend. This has been facilitated by improvements to regulatory regimes in some countries. Capital raisings by African resource companies are reported to have increased by 240 percent compared to 2009.[1] Much exploratory activity has been ongoing in several countries during 2011, with new discoveries and production coming on stream (table SSA.1).

Figure SSA.4 Net private capital inflows to Sub Sahara Africa rebounds after crisis



Source: World Bank.

These resource flows have supported growth by creating new jobs, increasing government revenues and helping to finance current account deficit. Yet in countries with poor governance and weak institutions, the natural resource sector which exists as an enclave in many countries, can be a deterrent to growth, as rents generated by the sector are appropriated by the elite minority, often leading to conflict. This so-called resource-curse need not be the norm. Twenty-one Sub-Saharan countries have sought to maximize the potential benefit from resource exploitation and reduce the potential for corruption by joining the Extractive Industries Transparency Initiative. Five are currently considered compliant to the initiative (the Central African Republic, Ghana, Liberia, Niger, and Nigeria), while another 16 countries are candidates.

Even though, natural resources and energy are the most important destination for Sub-Saharan FDI by value, combined they represent only 16 percent of the total number of new FDI projects.[2] Motivated by higher GDP growth rates, fast growing populations and a rising middle class, the bulk of new investment projects were in the non-natural resources sector. Developments in the telecommunications (box SSA.1) and retail

Table SSA.1 Recent mineral discoveries and production

Discoveries in Q1 2011	
Natural Resource	**Country**
Oil	Ghana (West Cape Three points)
Gold	Tanzania (Handeni region)
Iron Ore	Liberia (Bopulu and Timbo)
Manganese	Gabon (Ndjole)
Diamond	Sierra Leone (Tongo)
Natural gas	Tanzania (offshore)

New Production to come on stream in 2011	
Natural Resource	**Country**
Coal	Mozambique
Oil	Ghana
Copper	Zambia (Konkola North)
Manganese	Gabon

Source: Africa Mining, various issues.

sectors epitomize the interest in non-extractive industries in the region. In retail for instance, large South African retail firms have been busy opening up shopping malls across the region. Walmart, the world's largest retailer, is currently in the process of acquiring MassMart, a South African chain with operations in 14 countries in the region.

Portfolio equity flows to Sub Saharan Africa rose by 10 percent in 2010, reaching $11 billion. The strong growth performance of Sub Saharan African countries over the last decade (5 percent per year) coupled with increasing political stability and reforms that have lowered barriers to entry, have begun to place Sub Saharan African countries on the radar screens of portfolio equity managers. This is evidenced in the recent establishment of a number of Africa-focused private equity funds (table SSA.2). Not surprisingly, South Africa receives the largest share of such inflows. However other economies, including Nigeria, with its fast growing economy and large population; Kenya, which is often viewed as the gateway to the $84 billion East African economy, and Ghana, with its stable political environment and fast growing economy, are of particular interest.

Table SSA.2 Africa Focused Funds

	Fund size ($m)
ECP Africa Fund	613
Pan African Investment Partners II	492
Aureos Africa Fund	381
Leapfrog Microfinance Inclusion Fund	136
Evolution One Fund	91
Africinvest Financial Sector	43

Source: Africainvestor, November December 2010.

Box SSA.1: Recent Developments in the Telecoms Sector in Sub Saharan Africa – a booming sector

Sub Saharan Africa is the region with one of the fastest growing mobile phone markets (International Telecommunications Union, 2010), partly because of the weak penetration of fixed-lines but also due to the pace of urbanization—the fastest compared to other regions. An estimated 40 million new mobile cellular subscriptions were added in 2010, and as much of the population remains unserved, the potential for further growth remains strong.

The telecommunications sector is one of the strongest recipients of foreign direct investment flows to the region. In 2011 there have been a number of announcements to that effect. MTN, the giant South African telecommunications company, has announced plan to invest $1 billion in Nigeria (Sub Saharan Africa's biggest mobile phone market) and a further $150 million in Zambia. In March 2011, Etisalat, a UAE telecommunications company, announced that it had sealed an agreement for a $680m syndicated loan from eight Nigerian banks. Movitel (Vietnamese company), Mozambique's third biggest mobile phone operator, also announced plans to invest $120 million to build new base stations.

Government policies are supporting these FDI inflows through improvements to regulatory regimes, including opening up the sector to further competition. In the last year, for example, operating licenses have been granted to new entrants to the telecommunications sector in Congo (Brazzaville), Ghana, Liberia, Malawi, Mozambique, and network charges by regulators have been reduced.

These developments, and the arrival of high speed undersea fiber optic broadband cables on the coast of Africa, are a boon to the sector but also the broader economy as they generate significant productivity spillovers. In both East and Western Africa a "price war" is ongoing between rival telecoms operators, and in some cases service charges have dropped by more-than 50 percent – lowering costs for business (and personal) customers. Innovations such as Kenya's pioneering mobile money scheme (M-PESA), Ethiopia's Commodity Exchange, which uses mobile technology to provide real time information to farmers across the country, and Ghana's mPedigree app, which allows patients to check the authenticity of medicines, are only a few examples of how investment in the telecoms sector is supporting innovation and growth in the region.

A recent study finds that increasing access to mobile telephone networks by 1 percent translates into a 0.5 percent increase in real GDP per capita (Djiofack and Keck, 2009). In Nigeria, for instance, though the telecommunications sector share in GDP was about one-quarter of that of the oil sector, its direct contribution to GDP growth was higher than the oil sector's in 2010.

South Africa also dominated bond flows to the region, accounting for almost all of the $4.7 billion in regional bond sales during 2010. However, with an estimated $93 billion annual infrastructural deficit, and a funding gap of $31 billion, a number of countries in Sub Saharan Africa (Ghana, Kenya, Tanzania, Zambia) continue to express interest in tapping the euro-bond market. In January 2011, Nigeria issued a $500 million debut Eurobond, which was oversubscribed. In March 2011 Zambia received a "B+" credit rating from international credit rating agencies. Several other countries are revamping their laws to tap into the nearly $1 trillion Islamic financial market. Senegal has indicated that it plans to raise $200m in Islamic financing in 2011. Increasingly, foreign investors are participating in local bond markets, notwithstanding the foreign exchange risk. Ghana's February 2011 auction of GHS 400 million ($263m), in 3-year bonds attracted significant global interest and was oversubscribed by 88 percent. Kenya auctioned a 9-year infrastructure bond worth 31.6 billion shillings ($380m) in August 2010, and the country is likely to continue to tap the market in 2011. Indeed, local currency bond supply in Sub Saharan Africa is estimated to have increased from $7bn in the 1990s to almost $20bn by 2008. Improving liquidity is also supporting the extension of the yield curve in a number of countries, with Nigeria offering 20-year maturities and Kenya up to 30-year maturities.[3]

Domestic demand reinforced growth prospects for Sub-Saharan Africa. While the increase in external demand supported GDP growth, domestic demand accounted for more than all of the growth in the region) in 2010. Although exports increased 7.5 percent thereby supporting growth, imports increased by even more (9.1 percent), boosted by a solid 4.9 percent rise in consumer demand. Hence, the net exports contribution to growth was negative.

Table SSA.3 Net capital flows to Sub-Saharan Africa

$ billions (April 2011)

	2003	2004	2005	2006	2007	2008	2009	2010p	2011e	2012f	2013f
Current account balance											
as % of GDP											
Financial flows:											
Net private and official inflows	**14.6**	**24.0**	**33.0**	**42.4**	**53.2**	**38.9**	**45.3**	**51.1**			
Net private inflows (equity+private debt)	**13.2**	**21.7**	**33.9**	**44.4**	**50.7**	**34.3**	**35.8**	**41.1**	**48.6**	**56.1**	**70.4**
..Net private inflows (% GDP)	3.0	4.0	5.3	6.0	5.9	3.5	3.9	3.8	4.1	4.4	4.8
Net equity inflows	14.0	17.7	26.1	37.0	38.7	28.9	40.2	34.8	39.1	44.2	55.3
..Net FDI inflows	13.3	11.0	18.0	20.2	28.5	34.5	30.3	23.8	32.1	35.2	45.3
..Net portfolio equity inflows	0.7	6.7	8.1	16.8	10.1	-5.6	10.0	11.0	7.0	9.0	10.0
Net debt flows	0.6	6.4	6.9	5.4	14.6	10.0	5.1	16.3			
..Official creditors	1.4	2.3	-0.9	-1.9	2.5	4.6	9.5	10.0			
....World Bank	2.2	2.5	2.4	2.2	2.4	1.9	3.1	3.4			
....IMF	0.0	-0.1	-0.4	-0.1	0.1	0.7	2.2	1.8			
....Other official	-0.8	0.0	-2.9	-4.1	0.0	2.0	4.1	4.8			
..Private creditors	-0.8	4.0	7.9	7.4	12.1	5.5	-4.4	6.3	9.5	11.9	15.1
....Net M-L term debt flows	0.9	2.7	4.8	-2.0	8.0	0.8	5.6	8.1			
......Bonds	0.4	0.6	1.3	0.3	6.7	-0.7	1.9	3.4			
......Banks	1.2	2.4	3.8	-1.7	2.1	1.7	2.9	4.7			
......Other private	-0.7	-0.3	-0.3	-0.7	-0.8	-0.1	0.8	0.0			
....Net short-term debt flows	-1.7	1.4	3.0	9.4	4.0	4.6	-10.0	-2.1			
Balancing item /a	-4.1	-4.6	-33.5	-26.0	-20.4	-11.1	-28.7	-38.5			
Change in reserves (- = increase)	-3.5	-21.7	-19.9	-32.5	-27.0	-10.9	1.9	-6.1			
Memorandum items											
Workers' remittances	6.0	8.0	9.4	12.7	18.6	21.3	20.8	21.0	22.0	24.0	

Source: World Bank.

Robust consumer demand were supported by higher farm incomes from favorable harvests in much of the region in 2010 (box SSA.2); increased activity in the mining sector and robust growth in the services sector and a relatively low inflation environment—all of which served to boost real incomes.

Improved access to consumer credit (especially in South Africa, where interest rates were at record lows) and stable remittance inflows ($21 billion in 2010) also helped underpin consumer demand. And, in a virtuous circle, that strong demand has been an important factor luring in new investments into the retail, banking and telecommunication sectors, creating new well paid jobs and improving overall productivity. Associated increases in tax revenues supported by higher aid inflows contributed to a 5.5 percent increase in public consumption, even as fiscal balances in the region improved by 1 percentage point from a deficit of 5.1 percent of GDP in 2009 to 4.1 percent in 2010. Countries that benefitted the most from the positive terms of trade changes also had a better turnaround in their fiscal balances.

Though overall growth in Sub Sahara Africa remains strong, there is significant heterogeneity across region. An encouraging

Box SSA.2: The Agriculture Sector in Sub Saharan Africa – Unrealized potential

The agricultural sector, the largest employer in many Sub Saharan African economies, an important foreign exchange earner, and the sector with the greatest potential for poverty reduction was also providing support to growth in several countries in 2010. Studies have found that growth originating in the agricultural sector is two-to-four times as effective as non-agricultural growth in reducing poverty (WDR, 2008), since some 75 percent of the poor live in rural areas. [4]

However, while the past 40 years has witnessed remarkable progress in global agricultural production, with per capita world food production growing by 17 percent and aggregate world food production up by 145 percent, agricultural production in Sub Saharan Africa is 10 percent lower than it was in 1960. Land productivity in Africa is estimated at 42 percent and 50 percent of that in Asia and Latin America, respectively. Factors accounting for low yields in Sub Saharan Africa include the fact that only 4 percent of Africa's crop area is irrigated compared to 39 percent in South Asia, and fertilizer usage is less than 10 percent of the world average. Further, mechanization remains low with an average of only 13 tractors per 100 square kilometers, compared to a world average of 200 tractors per square kilometers. In part this underinvestment in the agricultural sector reflects a weak policy supportive environment. [5]

Indeed much of agricultural production is mostly weather dependent. In 2010, where weather patterns were mostly favorable, good harvests kept food prices in check, even amidst the surge in global food prices. In the Southern Africa region bumper harvests were recorded in Malawi, Zambia and South Africa, with the latter reaching a thirty-year record high maize output of 12.8 million tonnes. These favorable weather conditions are unlikely to repeat themselves regularly, hence for output growth to be sustained other yield enhancing techniques need to be employed. Already in 2011 agricultural output is being hampered in East Africa by poor rains, thus cutting into growth prospects for the region.

Nonetheless there a number of recent encouraging developments in the Sub-Saharan African agriculture sector worth highlighting. One prominent example is the transformation of Malawi from a food importer with dependence on food aid to a food self sufficient and net exporter over the past five years, thanks to a government supported farmer input program. Other Sub Saharan countries including Ghana, Zambia, Nigeria, Rwanda and Tanzania are implementing programs of their own. However, if not managed well, fiscal sustainability could be compromised.

With about 60 percent of the world's uncultivated arable land in Africa and very low yields there exists significant opportunities to scale-up production. By one estimate, if cereal yields were to be doubled to two tons per hectare – still half of the average in the developing world – Africa would grow an extra 100 million tons a year of food. This would be roughly equivalent to adding another US corn belt to world food production, helping moderate world food price increases, shifting Africa to a major food surplus region and helping eradicate hunger and poverty. [6] The benefits of an increase in yields with out improvements to both hard and soft infrastructure to allow the increased output to reach the relevant markets will however curtail the benefits.

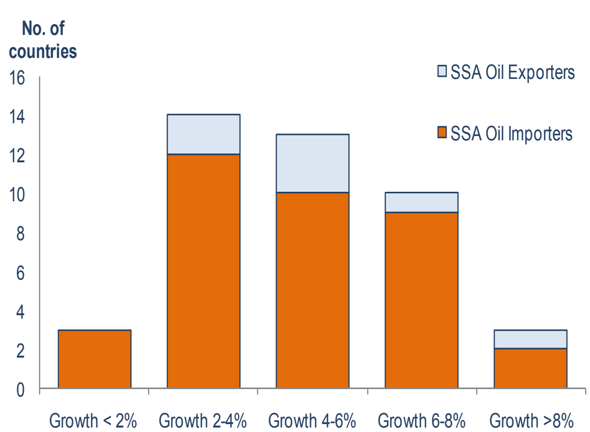
aspect of the trend rise in Sub Saharan Africa growth rates has been the extent to which almost all countries have seen significant improvements in their growth. Strong Sub-Saharan growth does not reflect extremely high growth rates by one or two countries, but solid growth in several economies (figure SSA.5), with the highest growth rates comparable to those of other fast growing developing economies (figure SSA.6). Only two economies grew by less than 2 percent in 2010, while the bulk registered solid growth rates of between 2 and 6 percent, 30 percent of countries in the region enjoyed real GDP growth rates of more than 6 percent. Across sub-regions growth was strongest in West Africa (6.5 percent) powered by Nigeria's robust growth (7.9 percent) and supported by Ghana's 7.7 percent gains in the year. GDP growth in East Africa was almost as strong, with Ethiopia (7 percent), Rwanda (7.5 percent), Tanzania (7 percent) and Kenya (5.6 percent) all recording robust gains.

In contrast, growth for most Central African economies registered below the regional average, save for Congo (Brazzaville) with growth of (9.1 percent), thanks to new oil that came on stream, thus making it the fastest growing economy in sub Saharan Africa in 2010. Though growth rates in several Southern African countries (Botswana, Malawi, Mozambique, and Zambia) exceeded 6 percent, slower growth in Angola, Southern Africa's largest economy (excluding South Africa) dampened growth for the sub-region. South Africa, the largest economy in the region, grew at a 2.8 percent pace in 2010.

Growth among the large economies. **South Africa's** tepid recovery has been driven by higher consumer spending, with business investment lagging in the recovery. Consumer spending has been buoyed by an accommodative monetary policy, with the repo rate at 30-year lows in nominal terms. The lower cost of borrowing lent support to spending on consumer durables, while broader consumer spending was supported by above-inflation wage increases gained by South Africa's unionized workers, and to a lesser extent the wealth effects associated with the recovery in asset prices. Increased government spending on infrastructure, social sectors and wages is also providing stimulus to the recovery. In 2010, government consumption expenditure increased by 4.6 percent. On a more somber note, low business confidence and long running labor disputes caused private investment spending to fall for a second consecutive year in 2010. Fortunately, a recovery may be underway in 2011.

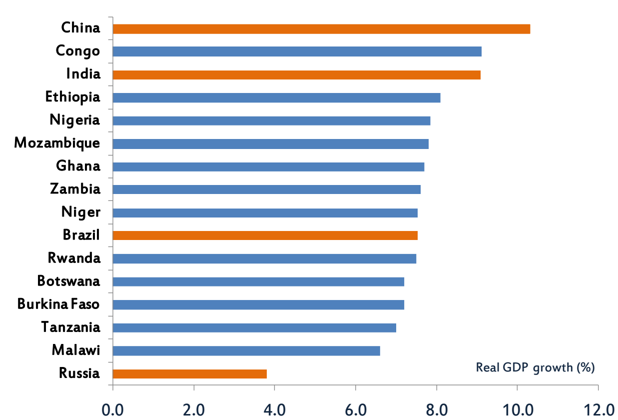
The **Nigerian** economy continued its robust expansion in 2010, with growth estimated at 7.9 percent, up from 5.6 percent recorded in 2009. Nigeria's oil and government sectors benefitted

Figure SSA.5: More than a third of countries in Sub-Saharan Africa achieved growth rates of 6 percent and more in 2010



Source: World Bank.

Figure SSA.6 Fastest growing SSA compares well with other fast growing developing countries



Source: World Bank.

from the global jump in oil prices, as well as from increased output due to relative calm in the Niger Delta region following the government's amnesty program. However, the oil sector, which accounts for some 16 percent of GDP, contributed only a percentage point to the 7.9 percent surge in 2010 GDP, with the remainder attributable to rapid growth in the non-oil sector. The agricultural sector, which accounts for 42 percent of GDP and is the largest employer, benefitted from favorable rains and expanded by 5.7 percent in 2010 Q3 contributing 2.4 percentage points. Productivity in the sector remains low, however, as it is constrained by poor market infrastructure and weak access to basic farm inputs. Much of the dynamic sectoral growth performance in recent years has been in wholesale and retail trade and the services sectors with growth rates in the double digits. In 2010 Q3, these sectors added 2 and 2.1 percentage points to GDP growth, respectively.

Growth in these dynamic sectors has been driven by and contributed to a rising middle class. A survey carried out by the National Bureau of Statistics showed that, while in 1996 the average household spent 63.6 percent of income on food, by 2004 the share had fallen to 47.3 percent. With per capita incomes doubling between 2004 and 2010 the food expenditure share of income has dropped still further, implying Nigerian households have more income to spend on discretionary items--which helps to drive growth in new sectors. One such sector is telecommunications. Using the latest detailed GDP figures available (Q3 2010), the telecommunications sector, which accounts for only 3.7 percent of GDP, contributed 1.3 percentage points to GDP growth (even higher than contributions from oil).

Angola's recovery from the crisis, unlike most Sub Saharan African countries has lagged behind. In 2010 it grew at 3.4%, well below its strong pre-crisis double digit growth rates and that of the Sub Sahara African average (4.8%). Though oil prices rebounded in 2010, oil output was hindered by technical delays. Further, government spending which has helped drive growth in the non-oil sector was curbed due to the need to clear arrears to contractors. Nonetheless, a pick-up is expected over the forecast horizon. The recovery in oil prices and government revenues helped return both the fiscal and current account balances to healthy surpluses in 2010 and tighter monetary policy helped contain inflationary pressures somewhat. Indeed, the improvements to its macroeconomic environment supported the B+/B1 credit rating for its long-term foreign debt issuer default ratings from the three main international credit rating agencies in 2010.

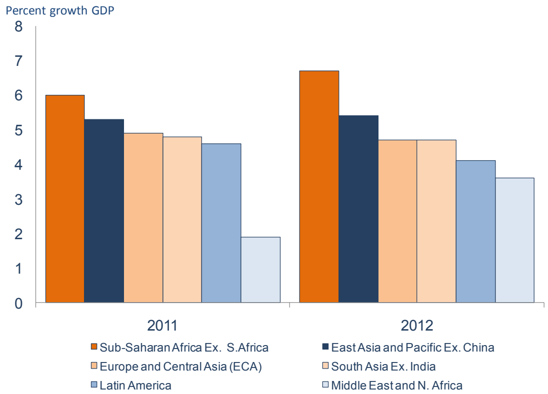
Kenya's growth was stronger than expected at 5.6 percent in 2010. Good rainfall supported harvests in the agricultural sector (including tea and horticulture exports) and boosted electricity and water supply. This helped to alleviate some of the binding infrastructural constraints, allowing Kenyan manufacturers to meet strong demand from its faster-growing regional trading partners in East Africa. Business and consumer confidence was also lifted by the passage of the new constitution. Tourist arrivals were up by 15.6 percent in the first 11 months of 2010 (year-on-year), with tourist receipts increasing 8 percent in the same period. Strong growth in Kenya's other services sectors: finance, telecommunication and real estate also provided support to growth.

Medium-term outlook

GDP growth in Sub-Saharan Africa is expected to remain strong in 2011 and 2012. With the global recovery still on a firm footing; a growing domestic middle class with discretionary incomes to spend, and rising business confidence in the region's prospects, growth in Sub Saharan Africa is expected to step-up to stronger rates in 2011 and 2012, reaching growth of 5.1 percent and 5.8 percent, respectively (figure SSA.7). Excluding South Africa, GDP growth in Sub-Saharan Africa is expected to grow between 5.9 percent and 6.6 percent over the forecast horizon, making it one of the developing regions with the highest growth prospects over the medium term (table SSA.4 and table SSA.5).

Prospects for large economies. Medium term

Figure SSA.7 Growth in Sub Saharan Africa will be among the fastest in developing regions



Source: World Bank.

growth prospects for **South Africa** point to a strengthening economy. With the monetary stance expected to remain accommodative, consumer spending should continue to drive growth. As the global recovery has taken hold, the uncertainty that affected private investment spending is expected to abate, allowing business spending to increase and resume its positive contribution to growth. As businesses demand more labor, employment should rise and consumer spending should strengthen. With government fiscal policy countercyclical, the boost to growth from increased government spending will remain strong in 2011 but is likely to wane thereafter. With South Africa's economy well integrated into the global economy the ongoing global recovery should continue to provide support to South Africa's export growth,

Table SSA.4 Saharan Africa forecast summary

(annual percent change unless indicated otherwise)	98-07[a]	2008	2009	Est. 2010	Forecast 2011	2012	2013
GDP at market prices (2005 US$) [b]	4.2	5.1	2.0	4.8	5.1	5.7	5.7
GDP per capita (units in US$)	1.9	3.0	0.0	2.8	3.0	3.7	3.7
PPP GDP [c]	4.4	5.5	2.2	4.6	5.4	5.7	5.7
Private consumption	2.3	3.8	1.3	3.9	5.1	5.3	5.3
Public consumption	5.5	8.0	4.3	6.9	5.5	5.3	5.3
Fixed investment	8.0	12.0	4.9	8.3	7.3	6.8	8.3
Exports, GNFS [d]	4.2	4.3	-6.5	8.3	6.5	7.2	6.5
Imports, GNFS [d]	6.8	7.0	-4.5	9.5	7.9	6.9	7.1
Net exports, contribution to growth	-0.7	-1.1	-0.5	-0.8	-0.8	-0.3	-0.6
Current account bal/GDP (%)	-0.8	-1.5	-2.8	-1.3	-1.6	-1.6	-1.5
GDP deflator (median, LCU)	6.1	10.6	4.3	6.3	5.8	6.1	6.7
Fiscal balance/GDP (%)	-0.6	1.0	-5.5	-4.4	-3.2	-2.0	-1.2
Memo items: GDP							
SSA excluding South Africa	4.5	6.0	4.2	6.0	5.9	6.6	6.4
Oil exporters [e]	4.9	6.6	4.7	6.0	5.8	6.9	6.7
CFA countries [f]	3.5	4.2	1.6	4.1	3.0	4.9	4.9
South Africa	3.7	3.7	-1.8	2.8	3.5	4.1	4.4
Nigeria	5.0	6.0	6.7	7.8	7.1	7.5	7.3
Kenya	3.4	1.6	2.6	5.6	4.8	5.0	5.2

a. Growth rates over intervals are compound average; growth contributions, ratios and the GDP deflator are averages.
b. GDP measured in constant 2005 U.S. dollars.
c. GDP measured at PPP exchange rates.
d. Exports and imports of goods and non-factor services (GNFS).
e. Oil Exporters: Angola, Cote d Ivoire, Cameroon, Congo, Rep., Gabon, Nigeria, Sudan, Chad, Congo, Dem. Rep.
f. CFA Countries: Benin, Burkina Faso, Central African Republic, Cote d Ivoire, Cameroon, Congo, Rep., Gabon, Equatorial Guinea, Mali, Niger, Senegal, Chad, Togo.
g. Estimate.
h. Forecast.

Source: World Bank.

though strengthening domestic demand will increase imports which will moderate the contribution of net exports to GDP. Over the forecast horizon, South Africa's growth is projected to accelerate to 3.5 percent in 2011,then reaching pre-crisis average growth rates of 4.1 percent and 4.4 percent in 2012 and 2013 respectively.

Prospects for faster and sustained growth in **Nigeria** appear favorable for the forecast horizon, as underlying growth dynamics remain robust. Consumer spending, underpinned by increased bank lending and employment opportunities in the consumer services sector, will continue to drive growth. A number of multinationals already operating in Nigeria have announced plans to increase investments (e.g. food giant Nestle), while new ones seek opportunities to get a foothold in the market. In March 2011, the Carlyle Group–a Washington DC based Global Asset Manager-set up offices in Lagos (and Johannesburg) to conduct buyout and growth capital investments in Sub Saharan Africa. A forecast of favorable rain patterns along with selected government programs in the agricultural sector, should continue to provide support to farm incomes. However, expansionary fiscal policy--if not managed prudently--could compromise macroeconomic stability, especially so as inflationary pressures from food and fuel prices take hold. Over the forecast period, Nigerian GDP is projected to remain robust at 7.1 percent growth in 2011, peaking at 7.5 percent in 2012 before moderating to 7.3 percent in 2013.

Medium term growth prospects for the **Angolan** economy remain strong, with real GDP projected to grow at 6.7 percent in 2011, up from the 3.4% recorded in 2010. Output in the oil sector is expected to climb up to 2.1 million b/d from 1.78 million b/d on the back of new oil production coming on stream. Further, the start of the liquefied natural gas project should further boost export revenues. And with much of the clearance of contractor arrears behind, increased public investment is expected to make a more significant contribution to growth over the forecast horizon. Nonetheless, much of this investment will be capital intensive and thus import dependent, which will reduce the overall contribution of net exports to growth. However, growth in the non-oil sector, will continue to be hindered by infrastructural challenges, a weak business regulatory environment and possible crowding out of private sector investment by the public sector.

And, the medium term outlook for **Kenya** is also favorable, though growth in 2011 will be undercut by recent poor rains. The ongoing global recovery should continue to provide support to Kenya's agricultural exports and tourism sector. Strong growth in its trading partners in the East African Community, should provide support to its manufacturing sector. With the largest and most developed economy in East Africa, a rising middle class and a sizeable population (40 million people), investors are increasingly considering Kenya as the gateway to the rest of East Africa. This augurs well for foreign investment flows. Investor confidence has been reinforced by the passage of the new constitution, though some may postpone investments until after the 2012 elections. Government investment in critically needed in infrastructure, and ongoing reforms at the Mombasa port should underpin growth prospects. Kenya's dynamic Information and Communications Technology sector should also be provided with a windfall opportunity from increased access to higher bandwidth after the arrival of a number of broadband fiber optic sea cables on its coast. And developments in the ICT sector should support productivity gains in other sectors of the economy. Inflationary pressures stemming from higher crude oil prices and inadequate rainfall in the latter part of 2010 threaten to undermine growth prospects. Over the forecast period Kenya's growth is projected to remain robust at 4.8 percent in 2011, rising to 5 percent in 2012 and 5.2 percent by 2013.

Projected fastest growing Sub-Saharan African economies. Over the forecast horizon (2011-2013), Sub-Saharan African economies projected to be amongst the fastest growing in the region, with growth rates averaging higher than 6.5 percent in GDP include Ethiopia, Ghana, Mozambique, Nigeria, Rwanda, and Zambia (table SSA.5).

With real GDP forecast to grow at 13.4 percent in 2011, **Ghana** is projected to be the fastest growing economy in Sub Saharan Africa, thanks to the commencement of oil exports. Over the medium term growth will be driven by the nascent oil sector with production expected to average 120,000 bpd, with the possibility of higher output as recent new discoveries also come on stream. Further, increased investments in the gold mining industry and productivity gains in its cocoa sector should further boost export revenues. Thanks to increased business confidence the services sector will continue to see strong inflows of private investments, particularly in the construction and telecommunications sector, thereby lending further support to growth. However, increased macroeconomic instability remains a downside risk.

Ethiopia's economy is projected to grow between 7.2 and 7.8 percent over the 2011-2013 period. Ethiopia's growth will continue to be driven by developments in its agricultural sector, the largest sector in the economy. Productivity in the sector will benefit from the support provided to small scale farmers via the expansion of road, power and market networks. Increased investment flows to large scale commercial agricultural ventures should lend further support to the sector and the recent addition to hydro electric power capacity should help alleviate some of the binding constraints to growth. However, the current double digit inflationary environment remains a risk to growth.

Zambia is forecast to grow at 6.8 percent in 2011 thanks to developments in its mining, agricultural and services sectors. Record high copper prices continue to support increased investment activity in Zambia's copper industry, thereby generating higher copper production and exports. However, developments elsewhere in the economy are also critical to Zambia's growth prospects, in particular, the agricultural sector, which still remains the major employer in the economy. The agricultural sector is benefitting from increased output and yields thanks in part to government support to the sector via the provision of improved seeds and fertilizers to farmers. Further, against the back drop of rising incomes and low accessibility of important services such as telecommunication and banking services, growth in the services sector is expected to remain strong over the forecast horizon.

Real GDP growth in **Mozambique** is projected at 7.6 percent in 2011. Mozambique is expected to sustain its buoyant growth over the forecast horizon as it continues to benefit from increased investments in its mining sector. Recent discoveries of large deposits of iron ore and commercial quantities of natural gas offshore, in addition to known deposits of coal, has only added to its attraction as a mining investment destination. Growth in Mozambique is already being supported by ongoing mega-projects including the Mozal aluminium smelter, the Moatize coal mine which started production in the second quarter of 2011, the extraction and treatment of natural gas project by South African petro-chemical giant Sasol**,** and the Irish-owned titanium minerals dredge mine in Mona. These investments and the exports that they generate in the coming years will continue to drive growth in Mozambique. However, the tightening of monetary policy to tackle double digit inflation rates is likely to moderate growth in 2011.

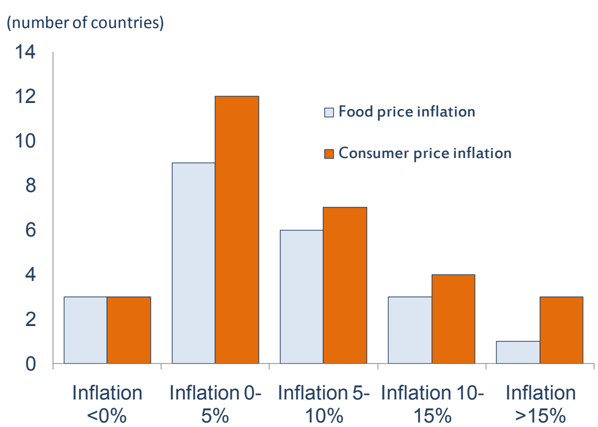
Rwanda's strong growth is projected to continue over the medium term, averaging about 6.9 percent over the forecast horizon, led by the agriculture sector. Food crop production will benefit from government support to farmers via the provision of fertilizer, improved seeds and extensions services. Coffee, Rwanda's main export, should also benefit from the strong rebound in international coffee prices. Lower transactions cost due to increased integration with it's neighbors in the East African Community should lend further support to growth through increased trade and investment flows. Growth in the services sector, particularly construction, finance and insurance, and telecommunications is expected to be supported by increased private credit flows through the forecast horizon.

Risks to the outlook

High food prices pose a risk. Prices of globally traded food products have risen significantly since June 2010. As of April 2011, global prices were up by 103.2 percent for maize (year-on-year), 74.1 percent for wheat, 94.6 percent for Sorghum and 38.4 percent for palm oil. However, for most Sub Saharan African countries, food price increases were moderate for much of 2010, and in a few countries prices declined, thanks to favorable harvests; the local nature of food markets in many countries in the region; and the availability of alternate staples (e.g. cassava) that can substitute for higher priced internationally traded food (figure SSA.8).

However, since November 2010 there has been a rise in headline consumer price inflation rates with increases in price of the food basket helping to drive the increase. The median inflation rate for Sub Saharan Africa increased to 4.5 percent in December 2010 from a 10-year low 3.1 percent in August 2010. The distribution differs across the region however. As of February 2011 24 percent of countries in the region had inflation rates ranging between 5 and 10 percent; and another 25 percent of countries recorded inflation rates above 10 percent (including Ethiopia, Nigeria, Sierra Leone, Guinea, and Mozambique).

Figure SSA.8 Inflation levels remain below 10 percent for most Sub-Saharan African countries



Source: World Bank.

The persistence of food price increases could have negative consequences, including deterioration in the current account and fiscal balances of net food importing Sub-Saharan African countries; as well as higher levels of poverty and malnutrition, with the possibility of unrest in some countries--all of which would cut into growth prospects for the region. The moderate food price increases in 2010 were also helped by the fact that compared to other internationally traded food products, the rise in the price of rice was limited. Given the high import content of domestic consumption of rice in most Sub-Saharan African countries, and as a consequence a much higher pass through of international price changes, if rice prices were to go up more significantly in 2011, this could pose an important threat to food security, even if for some countries this would be moderated by substitution to other staples. Further, if current forecasts of drought conditions in parts of Southern and Eastern Africa come to pass, this will serve to cut back on agriculture output and accentuate the rise in food prices. In some countries the impact of drought will go beyond its effects on food prices, but could impact hydroelectric generation (e.g. Kenya), in an environment in where businesses already consider power supply to be a binding constraint.

Rise in oil prices represents another risk to macro stability. Another price increase of concern is the rise in oil prices. As of April 2011, crude oil prices had risen by 38 percent compared to a year earlier. The result of this increase in price on Sub Saharan African countries is mixed, as the region comprises both net oil exporters and importers. If oil prices are to persist at high levels through 2011, oil exporters in the region will see an improvement in their current account and fiscal balances. Indeed, given the pre-dominance of oil in the economy of Sub Saharan African oil exporters—in both Angola and Congo the oil sector accounts for over 90 percent of exports and over 60 percent of GDP—should oil prices remain at their February levels current account balances could improve by as much as 7 percent of GDP. This could also pose a macroeconomic challenge, since if not managed well, could lead to a “Dutch Disease” effect, thereby making more difficult the ability to diversify the economy.

The downside risks to oil importers in the region are however, greater. With countries facing an increased oil import bill, and given that oil imports are about 18 percent of total merchandise imports among Sub Saharan Africa oil importers, this could lead to a deterioration in the current account to GDP ratio by about 0.5 percent (excluding South Africa), if the February level of prices are sustained. However, were prices to increase even further, by an additional $50 from their February highs, current account balances would deteriorate even further, by as much as 3.5 percent of GDP. Fiscal balances could also deteriorate depending on the degree of petroleum subsidies provided by governments. And depending on the exchange rate regime, deterioration in current account balances could lead to depreciation of the nominal exchange rate, thereby bringing a further bout of inflationary pressures to bear. Higher inflation rates are also likely to prompt further monetary tightening, which could limit credit expansion in an already credit-constrained environment. For instance, in both March and May, Kenya’s Central Bank raised its key interest rate by 25 basis points, the first interest rate hikes since June 2008, on account of rising inflation and the depreciation of the shilling to close to a six and half year low. Other countries in the region to have hiked up interest rates in 2011 include Mozambique and Nigeria. According to World Bank estimates, if the current high oil prices were to increase an additional $50/bbl this could shave between 0.3 percent and 1 percent from GDP growth in Sub Saharan Africa.

Political risks associated with elections in 2011. Over the forecast horizon, elections are scheduled to be carried out in at least a third of Sub-Saharan African countries. Though the past decade has seen an increasing number of smooth transitions of power in many countries in the region, there still remain a number of instances where political developments, leading to elections and in its aftermath, have been a deterrent to economic activity. In 2010, growth prospects in Madagascar, Comoros, Cote d’Ivoire and Guinea were affected adversely by political unrests. Hence the evolution of the political cycle over the forecast horizon will be consequential to individual country growth outcomes. As of June 2011, six presidential elections had been carried out, none of which created disruptions to economic activity. However, the turmoil in Cote D’Ivoire which escalated in 2011 is likely to have led to negative growth in the first two quarters of 2011.

Table SSA.5 Sub-Saharan Africa country forecasts

(annual percent change unless indicated otherwise)				Est.	Forecast		
	98-07[a]	2008	2009	2010	2011	2012	2013
Angola							
GDP at market prices (2005 US$) [b]	9.5	13.3	2.4	3.4	6.7	8.1	7.8
Current account bal/GDP (%)	-0.9	8.5	-10.0	-1.7	4.0	7.4	9.9
Benin							
GDP at market prices (2005 US$) [b]	3.8	5.1	2.7	2.5	3.4	4.3	4.8
Current account bal/GDP (%)	-7.7	-9.3	-9.2	-10.6	-14.8	-12.4	-7.2
Botswana							
GDP at market prices (2005 US$) [b]	4.7	3.1	-4.9	7.2	6.5	5.9	4.9
Current account bal/GDP (%)	9.2	3.5	-4.5	-6.2	-3.1	2.7	7.8
Burkina Faso							
GDP at market prices (2005 US$) [b]	4.8	5.0	3.2	7.9	5.2	5.6	6.0
Current account bal/GDP (%)	-14.0	-24.8	-19.5	-21.3	-19.8	-18.9	-18.0
Burundi							
GDP at market prices (2005 US$) [b]	1.8	4.5	3.5	3.9	4.1	4.6	4.8
Current account bal/GDP (%)	-20.5	-30.2	-16.0	-14.6	-15.1	-14.0	-12.9
Cape Verde							
GDP at market prices (2005 US$) [b]	5.9	6.5	2.8	4.7	5.8	6.6	6.6
Current account bal/GDP (%)	-10.8	-13.4	-9.9	-14.9	-11.8	-18.2	-24.3
Cameroon							
GDP at market prices (2005 US$) [b]	3.4	2.9	2.0	2.8	3.8	4.1	4.6
Current account bal/GDP (%)	-2.4	-1.9	-5.1	-3.8	-2.7	-3.2	-3.3
Central African Republic							
GDP at market prices (2005 US$) [b]	0.8	2.2	2.4	3.0	3.3	3.3	3.3
Current account bal/GDP (%)	-4.6	-9.7	-7.9	-9.0	-8.0	-7.9	-7.0
Chad							
GDP at market prices (2005 US$) [b]	8.0	-0.4	-1.6	5.1	6.0	6.0	4.0
Current account bal/GDP (%)	-36.5	-19.8	-28.9	-24.1	-14.3	-12.7	-5.4
Comoros							
GDP at market prices (2005 US$) [b]	1.9	1.0	1.8	1.7	2.3	2.3	2.3
Current account bal/GDP (%)	-4.0	-10.5	-5.9	-8.5	-9.1	-10.0	-10.3
Congo, Dem. Rep.							
GDP at market prices (2005 US$) [b]	1.9	6.2	2.8	7.3	6.5	6.0	8.0
Current account bal/GDP (%)	-3.6	-17.5	-10.5	-6.8	-2.8	-0.7	0.6
Congo, Rep.							
GDP at market prices (2005 US$) [b]	2.9	5.6	7.6	9.1	7.8	5.4	4.9
Current account bal/GDP (%)	1.2	1.2	-10.6	3.7	9.5	6.6	6.1
Cote d Ivoire							
GDP at market prices (2005 US$) [b]	0.0	2.2	3.6	3.0	-6.0	4.9	5.5
Current account bal/GDP (%)	0.7	1.9	7.2	6.7	-1.5	0.6	-0.8
Equatorial Guinea							
GDP at market prices (2000 USD) [2]	20.7	11.3	-5.4	0.9	2.8	4.0	4.0
Current account bal/GDP (%)	6.7	10.1	-20.0	-6.7	-10.7	-8.6	-6.9
Eritrea							
GDP at market prices (2005 US$) [b]	-0.1	-9.8	3.6	2.7	3.4	3.5	3.5
Current account bal/GDP (%)	-19.0	-5.2	-6.5	-2.5	-2.7	-3.2	-3.4
Ethiopia							
GDP at market prices (2005 US$) [b]	6.5	10.8	8.8	8.1	7.7	7.2	7.8
Current account bal/GDP (%)	-5.3	-7.0	-5.1	-6.8	-7.7	-8.8	-9.6
Gabon							
GDP at market prices (2005 US$) [b]	0.4	2.3	-1.0	5.1	6.0	5.1	4.1
Current account bal/GDP (%)	10.9	22.2	13.3	12.3	16.1	13.1	12.2
Gambia, The							
GDP at market prices (2005 US$) [b]	4.6	6.1	4.6	4.8	5.0	5.0	5.0
Current account bal/GDP (%)	-9.5	-6.1	4.0	3.1	3.1	2.9	2.7
Ghana							
GDP at market prices (2005 US$) [b]	4.6	8.4	4.7	7.7	13.4	10.0	8.0
Current account bal/GDP (%)	-6.4	-12.4	-3.6	-7.7	-6.3	-4.9	-4.0
Guinea							
GDP at market prices (2005 US$) [b]	2.8	4.9	-0.3	3.5	4.3	4.5	4.7
Current account bal/GDP (%)	-6.0	-31.9	-10.4	-8.9	-7.6	-7.4	-7.1
Guinea-Bissau							
GDP at market prices (2005 US$) [b]	1.5	3.5	3.0	3.4	3.9	3.9	3.9
Current account bal/GDP (%)	-7.2	-11.0	-8.5	-9.4	-9.8	-9.2	-8.9
Kenya							
GDP at market prices (2005 US$) [b]	3.4	1.6	2.6	5.6	4.8	5.0	5.2
Current account bal/GDP (%)	-4.9	-6.6	-5.7	-7.8	-9.9	-7.7	-7.1
Lesotho							
GDP at market prices (2005 US$) [b]	2.8	4.5	0.9	2.4	3.1	4.0	3.8
Current account bal/GDP (%)	-12.9	12.6	-2.4	-22.4	-19.5	-19.5	-19.3
Madagascar							
GDP at market prices (2005 US$) [b]	3.2	7.1	-3.7	0.7	2.6	3.9	3.9
Current account bal/GDP (%)	-9.5	-17.4	-15.2	-13.8	-12.7	-11.2	-9.7
Malawi							
GDP at market prices (2005 US$) [b]	2.8	8.6	7.6	6.6	6.1	5.7	5.5
Current account bal/GDP (%)	-4.7	-7.1	-9.6	-2.7	-4.7	-5.1	-5.5
Mali							
GDP at market prices (2005 US$) [b]	5.1	4.9	4.3	5.0	5.8	5.9	5.9
Current account bal/GDP (%)	-7.9	-12.2	-14.1	-15.2	-15.4	-15.8	-15.8

(annual percent change unless indicated otherwise)

	98-07[a]	2008	2009	Est. 2010	Forecast 2011	2012	2013
Mauritania							
GDP at market prices (2005 US$) [b]	4.1	3.7	-1.1	4.9	6.0	6.3	5.4
Current account bal/GDP (%)	-5.8	-12.6	-13.2	-10.6	-11.6	-12.1	-12.7
Mauritius							
GDP at market prices (2005 US$) [b]	3.6	5.1	3.0	4.3	4.1	4.2	4.3
Current account bal/GDP (%)	-1.3	-10.5	-9.5	-13.1	-12.3	-11.5	-10.5
Mozambique							
GDP at market prices (2005 US$) [b]	6.8	6.7	6.3	6.6	7.6	7.7	7.7
Current account bal/GDP (%)	-14.6	-12.0	-12.0	-13.7	-12.0	-10.9	-9.9
Namibia							
GDP at market prices (2005 US$) [b]	4.4	4.3	-0.8	4.6	4.0	4.8	4.5
Current account bal/GDP (%)	4.0	0.5	-1.2	-7.2	-1.8	2.1	6.3
Niger							
GDP at market prices (2005 US$) [b]	2.7	9.5	1.0	7.5	6.0	8.5	6.8
Current account bal/GDP (%)	-7.4	-12.2	-18.9	-19.3	-19.7	-17.1	-14.7
Nigeria							
GDP at market prices (2005 US$) [b]	5.0	6.0	6.7	7.8	7.1	7.5	7.3
Current account bal/GDP (%)	11.0	13.8	12.4	13.5	12.7	11.6	10.3
Rwanda							
GDP at market prices (2005 US$) [b]	6.8	11.2	4.1	7.5	7.0	6.8	7.0
Current account bal/GDP (%)	-6.0	-5.4	-7.3	-5.9	-5.6	-5.1	-4.7
Senegal							
GDP at market prices (2005 US$) [b]	4.0	3.3	2.2	3.2	4.2	4.4	4.4
Current account bal/GDP (%)	-7.0	-14.3	-12.9	-14.0	-14.2	-14.9	-15.5
Seychelles							
GDP at market prices (2005 US$) [b]	2.1	-0.9	-7.6	3.5	4.0	5.0	5.0
Current account bal/GDP (%)	-16.4	-44.0	-37.2	-39.5	-23.1	-16.7	-10.3
Sierra Leone							
GDP at market prices (2005 US$) [b]	7.5	5.5	3.2	5.8	5.6	5.9	6.0
Current account bal/GDP (%)	-12.2	-15.3	-15.0	-14.3	-14.7	-13.6	-12.5
South Africa							
GDP at market prices (2005 US$) [b]	3.7	3.7	-1.8	2.8	3.5	4.1	4.4
Current account bal/GDP (%)	-2.1	-7.1	-4.1	-2.8	-3.2	-3.8	-4.4
Sudan							
GDP at market prices (2005 US$) [b]	6.3	6.8	4.5	5.5	5.3	5.8	5.8
Current account bal/GDP (%)	-7.1	-2.3	-7.1	-3.0	-7.8	-7.9	-7.9
Swaziland							
GDP at market prices (2005 US$) [b]	3.1	2.4	1.2	2.0	0.5	1.5	2.0
Current account bal/GDP (%)	-1.3	-8.1	-13.8	-14.5	-14.2	-13.6	-12.5
Tanzania							
GDP at market prices (2005 US$) [b]	5.9	7.4	6.0	7.0	6.5	6.9	6.7
Current account bal/GDP (%)	-5.7	-13.0	-8.5	-8.7	-9.1	-10.1	-11.3
Togo							
GDP at market prices (2005 US$) [b]	1.8	1.8	3.2	3.4	3.7	4.0	4.1
Current account bal/GDP (%)	-9.5	-7.7	-5.3	-5.7	-4.3	-4.6	-4.7
Uganda							
GDP at market prices (2005 US$) [b]	7.0	8.7	7.1	5.2	6.4	6.6	7.0
Current account bal/GDP (%)	-5.4	-9.1	-6.6	-9.7	-11.9	-15.8	-12.1
Zambia							
GDP at market prices (2005 US$) [b]	4.2	5.8	6.4	7.6	6.8	6.7	6.0
Current account bal/GDP (%)	-13.7	-9.5	-5.5	-3.7	-3.6	-3.0	-2.4

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

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.

c. Estimate.

d. Forecast.

Source: World Bank.

Notes:

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