

Volume 6 | January 2013

Global Economic Prospects



Assuring
growth over
the medium term



The World Bank

Global Economic Prospects

Assuring growth over the medium term

January 2013

© 2013 International Bank for Reconstruction and Development / The World Bank
1818 H Street NW, Washington DC 20433
Telephone: 202-473-1000; Internet: www.worldbank.org
Some rights reserved

1 2 3 4 16 15 14 13

This work is a product of the staff of The World Bank with external contributions. Note that The World Bank does not necessarily own each component of the content included in the work. The World Bank therefore does not warrant that the use of the content contained in the work will not infringe on the rights of third parties. The risk of claims resulting from such infringement rests solely with you.

The findings, interpretations, and conclusions expressed in this work do not necessarily reflect the views of The World Bank, its Board of Executive Directors, or the governments they represent. The World Bank does not guarantee the accuracy of the data included in this work. The boundaries, colors, denominations, and other information shown on any map in this work do not imply any judgment on the part of The World Bank concerning the legal status of any territory or the endorsement or acceptance of such boundaries.

Nothing herein shall constitute or be considered to be a limitation upon or waiver of the privileges and immunities of The World Bank, all of which are specifically reserved.

Rights and Permissions



This work is available under the Creative Commons Attribution 3.0 Unported license (CC BY 3.0) <http://creativecommons.org/licenses/by/3.0>. Under the Creative Commons Attribution license, you are free to copy, distribute, transmit, and adapt this work, including for commercial purposes, under the following conditions:

Attribution—Please cite the work as follows: The World Bank. 2013. *Global Economic Prospects, Volume 6*, January 2013. Washington, DC: World Bank.

Doi: 10.1596/978-0-8213-9882-1 License: Creative Commons Attribution CC BY 3.0

Translations—If you create a translation of this work, please add the following disclaimer along with the attribution: *This translation was not created by The World Bank and should not be considered an official World Bank translation. The World Bank shall not be liable for any content or error in this translation.*

All queries on rights and licenses should be addressed to the Office of the Publisher, The World Bank, 1818 H Street NW, Washington, DC 20433, USA; fax: 202-522-2625; e-mail: pubrights@worldbank.org.

ISBN (electronic): 978-0-8213-9882-1

DOI: 10.1596/978-0-8213-9882-1

Cover photo: Jonathan Guy; *Cover design:* Roula I. Yazigi

The cutoff date for the data used in the report was January 9, 2013. Dollars are current U.S. dollars unless otherwise indicated.

Acknowledgments

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

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

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

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

Several reviewers offered extensive advice and comments. These included Abdul de Guia Abiad, Ahmad Ahsan, Jorge Araujo, Merli Baroudi, Deepak Bhattasali, Andrew Beath, Zeljko Bogetic, Oscar Calvo-Gonzalez, Kevin Carey, Mei Leng Chang, Shubham Chaudhuri, Punam Chuhan-Pole, Tito Cordella, Jose Cuesta, Uri Dadush, Augusto de la Torre, Shantayanan Devarajan, Tatiana Didier, Hinh Truong Dinh, Sebastian Eckardt, Olga Emelyanov, Pablo Fajnzylber, Manuela V. Ferro, Caroline Freund, Bernard G. Funck, Ejaz Ghani, David Michael Gould, Guenter Heidenhof, Bert Hofman, Zahid Hussain, Elena Ianchovichina, Satu Kristina Kahkonen, Markus Kitzmuller, Auguste Tano Kouame, David Kuijper, Roumeen Islam, Jeffrey D. Lewis, Connie Luff, Ernesto May, Denis Medvedev, Juan Carlos Mendoza, Claudia Nassif, Antonio M. Ollero, Kwang Park, Samuel Pienknagura, Miria Pigato, Mohammad Zia Qureshi, Susan R. Razzaz, Christine M. Richaud, Kaspar Richter, Elliot Riordan, David Rosenblatt, Sudhir Shetty, Carlos Silva-Jauregui, Yvonne M. Tsikata, Cevdet Unal, Mark Roland Thomas, Axel van Tortsenberg, Sergei Ulatov, Aristomene Varoudakis, Gallina Vincelette, Ekaterina Vostroknutova, Herman Jorge Winkler, Soonhwa Yi, Juan F. Zalduendo, and Albert Zeufack.

Table of Contents

Main Text	1
Topical Annexes	
Financial markets	33
Industrial production	43
Inflation	49
Global trade	59
Exchange rates.....	65
Prospects for commodity markets.....	75
Regional Annexes	
East Asia & the Pacific.....	91
Europe & Central Asia	103
Latin America & the Caribbean	115
Middle East & North Africa.....	125
South Asia	139
Sub-Saharan Africa	155

Global Economic Prospects January 2013:

Assuring growth over the medium term

Overview & main messages

Four years after the onset of the global financial crisis, the world economy continues to struggle. Developing economies are still the main driver of global growth, but their output has slowed compared with the pre-crisis period. To regain pre-crisis growth rates, developing countries must once again emphasize internal productivity-enhancing policies. While headwinds from restructuring and fiscal consolidation will persist in high-income countries, they should become less intense allowing for a slow acceleration in growth over the next several years.

Financial market conditions have improved dramatically since June

The cumulative effect of national- and EU-wide measures to improve fiscal sustainability, and the augmentation of measures that the European Central Bank (ECB) would be willing to take in defense of the Euro have resulted in a significant improvement in global financial markets. Unlike past episodes of reduced tensions, when market conditions improved only partially, many market risk indicators have fallen back to levels last seen in early 2010 – before concerns about Euro Area fiscal sustainability took the fore.

The decline in financial market tensions has also been felt in the developing world.

- International capital flows to developing countries, which fell by between 30 and 40 percent in May-June, have reached new highs.
- Developing country bond spreads (EMBIG) have declined by 127 basis points (bps) since June, and are now 282 bps below their long-term average levels.
- Developing country stock markets have increased by 12.6 percent since June (10.7 percent for high-income markets)

but the real-side recovery is weak and business-sector confidence low

While signals from financial markets are encouraging, those emanating from the real-side of the global economy are more mixed. Growth in developing countries accelerated in the third quarter of 2012, including in major middle-income countries such as Brazil and China, where mid-year weakness contributed to the global slowdown. Early indications for the fourth quarter point to a continued acceleration in East Asia & the Pacific, Europe & Central Asia and South Asia; but slowing in Latin America & the Caribbean.

Among high-income countries, investment and industrial activity in the United States show unusual weakness – seemingly due to uncertainty over the stance of fiscal policy in the run up to November's elections and the end-of-2012 fiscal cliff. In Japan, the economy appears to be contracting – in part because of political tension with China over the sovereignty of islands in the region and the expiration of automobile purchase incentives. Activity in Europe ceased to contract at alarming rates in Q3, but the economy appears to have weakened again in Q4 — perhaps reflecting weak demand for capital goods from the United States and Japan.

Prospects are for a modest acceleration of growth between 2013 and 2015

Overall, the global economic environment remains fragile and prone to further disappointment, although the balance of risks is now less skewed to the downside than it has been in recent years. Global growth is expected to come in at a relatively weak 2.3 and 2.4 percent in 2012 and 2013 respectively and gradually strengthen to 3.1 and 3.3 percent in 2014 and 2015 (table 1).

Table 1. The global outlook in summary
(percent change from previous year, except interest rates and oil price)

	2011	2012	2013e	2014f	2015f
<i>Global conditions</i>					
World trade volume (GNFS)	6.2	3.5	6.0	6.7	7.0
Consumer prices					
G-7 Countries ^{1,2}	5.3	-0.6	-0.1	0.9	1.0
United States	2.4	2.1	2.4	2.5	2.5
Commodity prices (USD terms)					
Non-oil commodities	20.7	-9.5	-2.0	-3.2	-2.8
Oil price (US\$ per barrel) ³	104.0	105.0	102.0	102.2	102.1
Oil price (percent change)	31.6	1.0	-2.9	0.2	-0.1
Manufactures unit export value ⁴	8.9	-1.9	1.9	2.2	1.9
Interest rates					
\$, 6-month (percent)	0.8	0.5	0.7	1.1	1.4
€, 6-month (percent)	1.6	0.2	0.5	1.2	1.5
International capital flows to developing countries (% of GDP)					
Developing countries					
Net private and official inflows	4.9	4.1	4.2	4.2	4.2
Net private inflows (equity + debt)	4.7	4.1	4.2	4.2	4.1
East Asia and Pacific	4.9	3.5	3.8	4.1	4.2
Europe and Central Asia	5.7	4.8	5.3	5.2	4.8
Latin America and Caribbean	5.5	5.7	5.2	4.7	4.3
Middle East and N. Africa	1.3	1.1	1.4	1.6	1.9
South Asia	3.5	3.3	3.4	3.5	3.4
Sub-Saharan Africa	5.3	5.0	4.7	4.7	4.9
<i>Real GDP growth ⁵</i>					
World					
Memo item: World (2005 PPP weights)	3.8	3.0	3.4	3.9	4.1
High income					
OECD countries	1.5	1.2	1.1	2.0	2.3
Euro Area	1.5	-0.4	-0.1	0.9	1.4
Japan	-0.7	1.9	0.8	1.2	1.5
United States	1.8	2.2	1.9	2.8	3.0
Non-OECD countries	5.0	2.9	3.5	3.8	3.8
Developing countries					
East Asia and Pacific	8.3	7.5	7.9	7.6	7.5
China	9.3	7.9	8.4	8.0	7.9
Indonesia	6.5	6.1	6.3	6.6	6.6
Thailand	0.1	4.7	5.0	4.5	4.5
Europe and Central Asia	5.5	3.0	3.6	4.0	4.3
Russia	4.3	3.5	3.6	3.9	3.8
Turkey	8.5	2.9	4.0	4.5	5.0
Romania	2.5	0.6	1.6	2.2	3.0
Latin America and Caribbean	4.3	3.0	3.5	3.9	3.9
Brazil	2.7	0.9	3.4	4.1	4.0
Mexico	3.9	4.0	3.3	3.6	3.6
Argentina	8.9	2.0	3.4	4.1	4.0
Middle East and N. Africa ⁶	-2.4	3.8	3.4	3.9	4.3
Egypt ⁷	1.8	2.2	2.6	3.8	4.7
Iran	1.7	-1.0	0.6	1.6	2.8
Algeria	2.5	3.0	3.4	3.8	4.3
South Asia	7.4	5.4	5.7	6.4	6.7
India ^{7, 8}	6.9	5.1	6.1	6.8	7.0
Pakistan ⁷	3.0	3.7	3.8	4.0	4.2
Bangladesh ⁷	6.7	6.3	5.8	6.2	6.5
Sub-Saharan Africa	4.5	4.6	4.9	5.1	5.2
South Africa	3.1	2.4	2.7	3.2	3.3
Nigeria	6.7	6.5	6.6	6.4	6.3
Angola	3.4	8.1	7.2	7.5	7.8
<i>Memorandum items</i>					
Developing countries					
excluding transition countries	6.5	5.2	5.8	6.0	6.0
excluding China and India	4.5	3.3	4.0	4.3	4.4

Source: World Bank.

Notes: PPP = purchasing power parity; e = estimate; f = forecast.

1. Canada, France, Germany, Italy, Japan, the United Kingdom, 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. Comparison with the summer 2012 GEP is not included as country coverage.

7. In keeping with national practice, data for Bangladesh, Egypt, India, and Pakistan are reported on a fiscal year basis in table 1.1. Aggregates that depend on these countries 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 FY2011-12 are 6.5, 5.4, 6.4, 7.1, and 7.3 percent – see table SAR.2 in the South Asia

At an estimated 5.1 percent, GDP growth in developing countries during 2012 was among the slowest in 10 years. Improved financial conditions, a relaxation of monetary policy, and somewhat stronger high-income country growth is projected to gradually raise developing-country growth to 5.5 percent in 2013, and to 5.7 and 5.8 percent in 2014 and 2015 — roughly in line with these countries' underlying potential. For high-income countries, fiscal consolidation, high unemployment and very weak consumer and business confidence will continue to weigh on activity in 2013, when GDP is projected once again to expand a mediocre 1.3 percent. Growth should, however, begin firming during the course of 2013, expanding by 2.0 and 2.3 percent in 2014 and 2015.

This modest growth outlook is subject to risks.

- Although the likelihood of a serious crisis of confidence in the Euro Area that would lead to a bloc-wide freezing up of financial markets has declined significantly, continued progress is needed to improve country-level finances, and enact plans to reinforce pan-European schemes for a banking union and sovereign rescue funds. If policy fails to maintain its reform momentum, some of the more vulnerable countries in the Euro Area could find themselves frozen out of capital markets, provoking a global slowdown that could potentially subtract 1.1 percent or more from developing country GDP.
- In the United States, solid progress toward outlining a credible medium-term fiscal consolidation plan that avoids periodic episodes of brinksmanship surrounding the debt ceiling is needed. Policy uncertainty has already dampened growth. Should policymakers fail to agree such measures, a loss of confidence in the currency and an overall increase in market tensions could reduce US and global growth by 2.3 and 1.4 percent respectively.
- While a progressive decline in China's unusually high investment rate over the medium- to long-term is not expected to perturb global growth, there would be significant domestic and global consequences if this position were to unwind abruptly. Impacts for developing commodity exporters

would be especially harsh if commodity prices fell sharply.

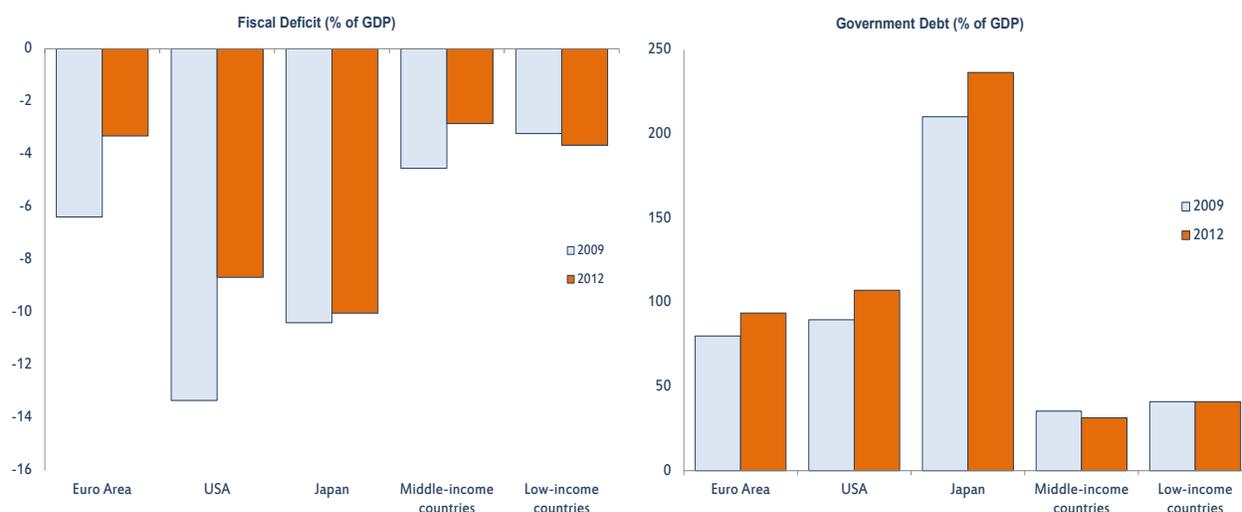
- An interruption to global oil supply and a resurgence in the price of internationally-traded food commodities remain risks, especially given low maize stocks. Should local food prices rise markedly, nutrition and health outcomes for the very poor could be hit.
- On the upside, a rapid resolution to policy uncertainty in the United States, a decrease in tensions in Asia, or an improvement in European confidence could speed the return of high-income countries to stronger growth — with positive effects for developing-country exports and GDP.

Addressing high unemployment and slack capacity remain priorities for countries in developing Europe^{FN1} and the Middle-East & North Africa. However, the majority of developing countries are operating at or close to full capacity. For them, additional demand stimulus could be counter-productive — raising indebtedness and inflation without significant payoff in terms of additional growth.

In what is likely to remain a difficult external environment characterized by slow and potentially volatile high-income country growth over the next several years, strong growth in developing countries is not guaranteed. To keep growing rapidly, developing countries will need to maintain the reform momentum that underpinned the acceleration of growth during the 1990s and 2000s. In the absence of additional efforts to raise productivity through structural reforms, investment in human capital, and improved governance and investment conditions, developing country growth may well slow.

Moreover, given the still uncertain global environment, many developing countries would be well advised to gradually restore depleted fiscal and monetary buffers, so as to ensure that their economies can respond as resiliently as they did during the 2008/09 crisis should a further significant external shock arise.

Figure 1. Substantial progress has been made in reducing fiscal deficits, but debt levels continue to rise



Source: World Bank.

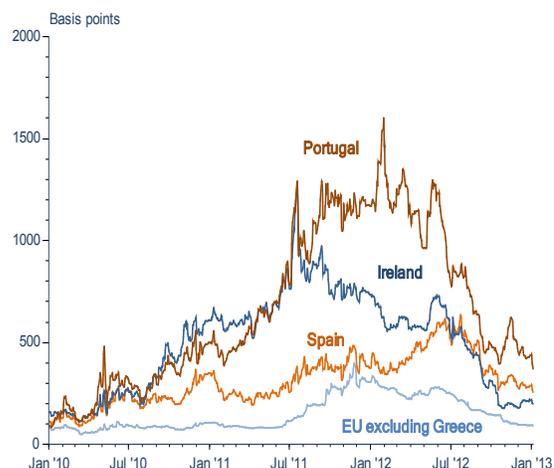
Financial market nerves and conditions have improved markedly

Conditions in global financial markets have eased significantly since July reflecting substantial progress to improve fiscal sustainability and mutual support mechanisms in the European Union. Measures have been taken at the national, pan-European, and international levels. These include: fiscal austerity measures that have reduced deficits in Euro Area economies by an estimated 3.3 percent of GDP since 2009 (figure 1), the agreement to create and provision pan-European institutions to bail out economies in difficulty, agreement to create a pan-European banking-supervision authority and the decision by the ECB to do whatever is necessary to support economies in difficulty. At the same time substantial progress has been made to re-capitalize banks in both the United States and Europe.^{FN2} Finally the decision by the central banks of the United States, the Euro Area and Japan to engage in a further series of quantitative easing have all contributed to an improvement in market sentiment at the global level.

The practical effect of these steps has been a fall in the price of risk worldwide. For example, the cost of insuring against sovereign default on high-spread European countries has fallen by more than 500 basis points from their earlier highs. Credit default swap (CDS) rates for most

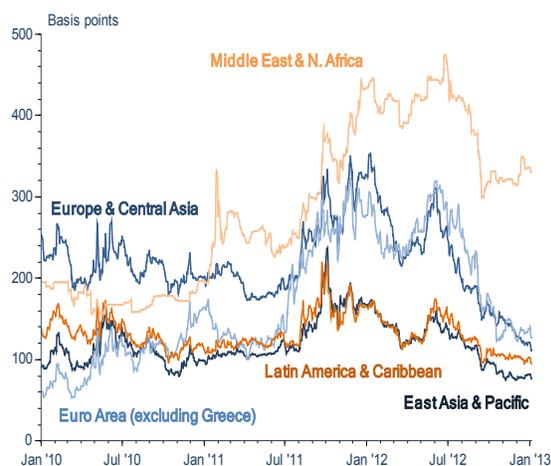
Euro Area countries, which had been rising, seemingly inexorably, since early 2010 are now below their January 2010 levels (figure 2). Although CDS rates for high-spread Euro Area economies remain between 59 and 229 basis points higher than in January 2010, they have declined by between 343 and 1126 basis points from their two-year maximums. Reflecting these same factors, yields on Euro Area sovereign debt have fallen over a wide-range of maturities – implying easier access to private-sector capital and reduced borrowing costs and (assuming the reductions are durable) improved sustainability.

Figure 2. Price of risk is down sharply in the Euro Area



Source: World Bank, Datastream.

Figure 3. Developing-country CDS rates are below their 2010 levels in most regions



Source: World Bank, Datastream, Dealogic.

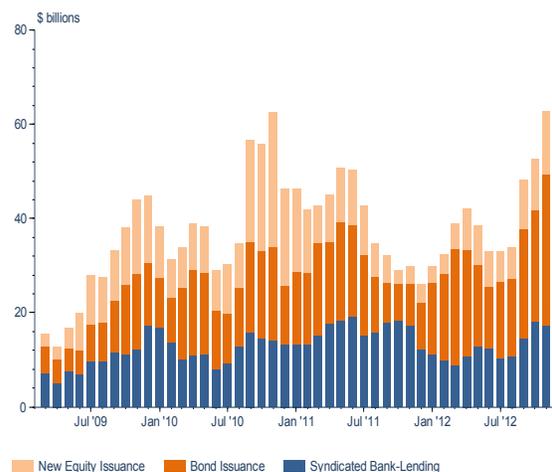
Improved sentiment has contributed to a recovery in high-income stock markets, which are up some 10.7 percent since June and 12.7 percent for 2012. Although a deleveraging cycle continues among Euro Area banks, there are signs that it may be easing. In the Euro Area, bank-lending, which fell 0.7 percent between October 2011 and June 2012 (a period during which Euro Area banks were required to increase capital adequacy ratios and mark-to-market their holdings of Euro Area sovereign debt), has risen 0.24 percent since June, although corporate lending has shown weakness in recent months.

Declines in the price of risk have contributed to much looser financial conditions in developing countries

Perceived credit risk also declined among developing countries, with CDS rates falling by about 112 basis points on average since the end of June (figure 3). High-spread developing countries, such as Romania, Ukraine, and Venezuela, experienced the largest improvements — although Argentina was a notable exception.^{FN3}

Bond yield spreads for developing country debt are now 171 basis points lower than year-earlier levels and are some 282 basis points lower than their average level during the 2000-2010 period.^{FN4} Indeed, developing country credit quality continued to improve in 2012 with

Figure 4. Gross capital flows to developing countries have rebounded



Source: World Bank, Dealogic.

countries having received 27 upgrades (versus 19 downgrades), which compares with a total of 20 downgrades among high-income countries.^{FN5} Stock markets in developing countries have also recovered and are up 12.7 percent since June, and 13.9 percent for 2012 as a whole.

The global decline in the price of risk, coupled with the additional monetary stimulus provided by high-income (and many developing-country) central banks (box 1) helped prompt a rebound in capital flows to developing countries since in the second half of 2012 (figure 4). Gross capital flows to developing countries, which fell by 15.5 percent in the second quarter of 2012 amid Euro Area tensions, have rebounded sharply reaching an estimated \$170 billion in 2012Q4, the highest level of inflows since the crisis began in August 2008.

Bond issuance recovered most forcefully, with state-affiliated investment-grade resource firms (mainly in Latin America and the Europe and Central Asia regions) the biggest beneficiaries of the increase in flows. Relatively easy financial conditions (partly reflecting a search for yield on the part of investors in high-income countries) induced a surge of new sovereign and corporate borrowers entering bond markets for the first time. Angola and Zambia, for example, issued international bonds for the first time ever in August and September, respectively. And Bolivia issued its first overseas bond in 90 years

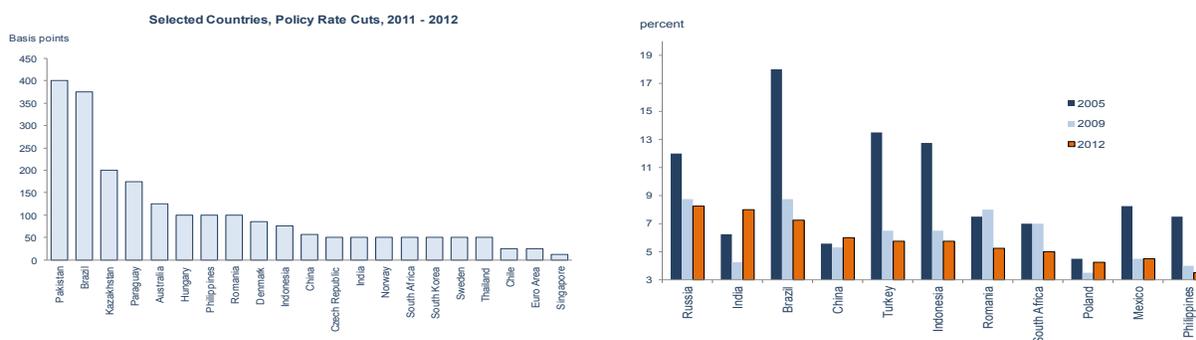
Box 1. Recent monetary policy developments

Central banks around the world intensified their efforts to stimulate growth through policy rate cuts and liquidity injections beginning in the second half of 2011 after an earlier period of monetary tightening. Brazil and Turkey were among the first large developing economies to reduce their policy rates by 50 basis points each in August 2011.^{BFN1} The majority of other monetary authorities have implemented a series of policy rate cuts since then, including the European Central Bank (ECB) and the central banks of Australia, Brazil, China, Indonesia, Kazakhstan, South Africa and many others (box figure 1.1). By the third quarter of 2012, nominal policy rates worldwide were actually lower than in 2009 during the worst of the financial crisis. Key policy rates settled at 7.25 percent in Brazil, at 6 percent in China, at 5.75 percent in Indonesia and at 5 percent in South Africa.

Policy rate cuts were complemented by liquidity injections by major economies, where already low level of interest rates prevented further policy-rate cuts. Currently, policy rates remain below one percent in Japan (since September 1995), in the US (since December 2008) and in the UK (since April 2009). Euro Area policy rates dropped below one percent only more recently — in July 2012. Among the most recent monetary easing actions, a third round of quantitative easing (involving central bank purchases of mortgage backed securities) in the United States, and the European Central Bank's commitment to conduct Outright Monetary Transactions if necessary were particularly notable.

Given the weak economic outlook, G3 and other high income countries' policy rates are expected to be left loose, and central banks are expected to continue with unconventional monetary policy throughout 2013-2014, and possibly till mid-2015.

Box figure 1.1 Policy rate cuts (peak-less trough), Jan. 2011– Sep. 2012
Key policy rates, selected years



Source: World Bank, Bloomberg, Central Bank News, Central Bank Rates.

^{BFN1} In Turkey key policy rate used under the inflation-targeting framework is one week repo auction rate. In addition, interest rate corridor and required reserve ratios are also used as policy instruments.

in October. Meanwhile, the governments of Kenya, Paraguay, Rwanda, Tanzania, and Uganda and numerous companies based in developing countries are preparing to issue international bonds for the first time. Nevertheless, low-risk investment-grade deals outnumbered riskier issues by a ratio of 3 to 1.

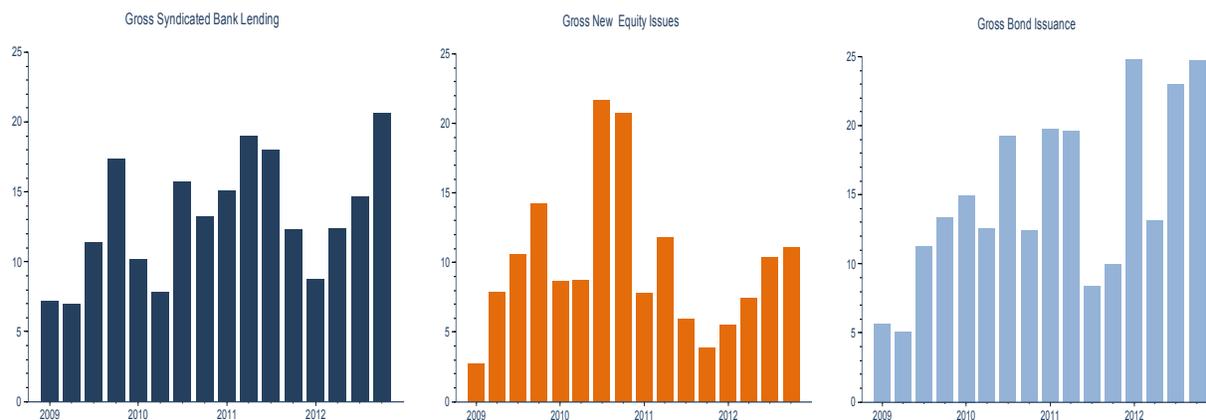
International syndicated bank lending to developing-world borrowers has recovered as well, coming in at a post-crisis high of \$62bn in 2012Q4 (figure 5). The recovery appears to have begun in the second quarter of 2012 and likely

reflects the diminishing impact on new lending of tighter Euro Area capital requirements that banks had to implement between October 2011 and June 2012. Lending to non-investment-grade borrowers has held up relatively well, with flows in 2012Q3 equal to inflows the year before, and these borrower's share in long-maturity deals rising.

Western banks have been gradually increasing their exposures in the developing world. Although European banks are likely to continue to rebuild their balance sheets going forward, the

Figure 5. Bank lending and equity issuance show trend rise, while bond issuance has been more volatile

Quarterly gross capital flows to developing countries, \$ billions



Source: World Bank, Dealogic.

acute phase of deleveraging phase appears to have ended. This should be of particular benefit to countries such as Croatia, Bulgaria, Hungary, Romania, Serbia and Ukraine whose growth has been particularly affected by slow credit growth. Overall bank-lending to investment-grade borrowers may have been held back, as these borrowers instead took advantage of easy access and low rates in bond markets.

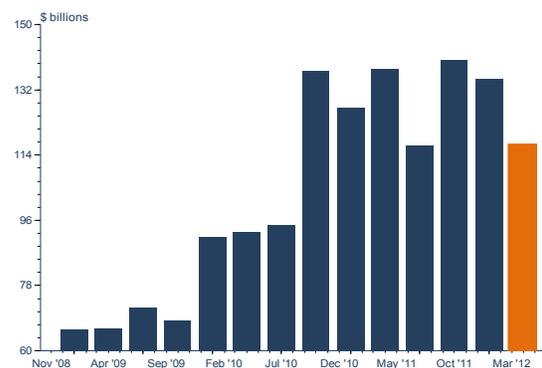
Partly reflecting the uptick in global uncertainty in May and June, foreign direct investment (FDI) inflows to developing countries declined by 15 percent (y/y) during 2012Q2 – the largest drop since 2009 (FDI data for most developing countries are only available through Q2). FDI inflows fell particularly sharply in India and South Africa and several Eastern European countries such as Russia, Latvia and Serbia (mainly due to the economic weakness in Euro Area). In contrast, flows actually strengthened in Latin American countries.

With the easing of financial market tensions in the third quarter, FDI flows are likely to have picked-up in some developing countries. Indeed, available Q3 data shows a rebound in FDI flows to Russia, supported in part by new privatization deals (figure 6). For the year as a whole, FDI inflows to developing countries are estimated to have fallen 6.6 percent.

Portfolio investment flows into emerging market mutual funds also picked up in the second half of

2012, with some \$28 billion flowing into equity funds during the final quarter of the year bringing overall, net inflows for the year to an estimated \$50 billion (versus a \$47.6 billion outflow in 2011). Inflows to emerging-market fixed-income (bond) funds were much less volatile. They totaled about \$44 billion over the same period, nearly twice the 2011 inflow and close to the record high \$61.8 billion received during the same period in 2010 (figure 7).

For the year as a whole, net international capital flows to developing countries fell an estimated 19.7 percent in 2012, with inflows having declined 9.5 percent and outflows rising 15.8

Figure 6. FDI inflows to selected developing countries fell in the second quarter

Source: World Bank, national central banks.

Note: Total FDI for Brazil, Bulgaria, Chile, China, India, Indonesia, Kazakhstan, Latvia, Lithuania, Malaysia, Mexico, Peru, Romania, Russia, South Africa, Thailand, Turkey, Ukraine and Venezuela.

Table 2. Net international capital flows to developing countries
\$ billions

	2008	2009	2010	2011	2012e	2013f	2014f	2015f
<u>Current account balance</u>	412.9	240.5	187.5	152.1	12.6	-8.0	-65.4	-80.4
<u>Capital inflows</u>	812.6	701.7	1,219.1	1,112.4	1,007.2	1,134.1	1,250.9	1,351.5
Private inflows, net	782.2	620.7	1,145.9	1,082.4	993.1	1,123.4	1,244.2	1,348.4
<u>Equity Inflows, net</u>	583.3	542.0	710.8	647.8	644.5	761.2	856.1	902.9
Net FDI inflows	636.9	427.9	582.7	638.8	600.1	693.2	756.5	783.0
Net portfolio equity inflows	-53.6	114.2	128.2	8.9	44.4	68.0	99.6	119.9
<u>Private creditors, net</u>	198.8	78.7	435.1	434.6	348.6	362.2	388.1	445.5
Bonds	-8.6	61.0	129.7	123.8	143.3	126.1	108.4	110.5
Banks	223.3	-11.9	37.2	108.2	71.5	80.6	88.9	105.1
Short-term debt flows	-17.1	17.8	257.6	189.3	126.7	146.3	180.4	220.1
Other private	1.3	11.7	10.7	13.3	7.1	9.2	10.4	9.8
Official inflows, net	30.4	81.0	73.2	30.0	14.1	10.7	6.7	3.1
World Bank	7.2	18.3	22.4	6.6	4.6
IMF	10.8	26.8	13.8	0.5	-3.9
Other official	12.4	35.9	36.9	22.8	13.4
<u>Capital outflows</u>	-321.4	-174.5	-310.0	-320.0	-370.6	-373.4	-414.3	-463.6
FDI outflows	-211.8	-144.3	-213.9	-213.1	-238.0	-275.0	-325.0	-370
Portfolio equity outflows	-32.3	-75.2	-46.5	-15.9	-17.6	-19.4	-22.3	-28.6
Private debt outflows	-78.3	50.7	-57.3	-81.0	-103.0	-72.0	-61.0	-56
Other outflows	1.0	-5.7	7.7	-10.0	-12.0	-7.0	-6.0	-9
<u>Net capital flows (inflows + outflows)</u>	491.2	527.2	909.1	792.4	636.6	760.7	836.6	887.9
<u>Net Unidentified Flows/a</u>	-78.3	-286.7	-721.6	-640.3	-624.0	-768.7	-902.0	-968.3

Source: World Bank

Note: e = estimate, f = forecast

/a Combination of errors and omissions, unidentified capital inflows to and outflows from developing countries.

percent (table 2). The sharpest declines were among bank inflows and short-term debt flows reflecting mid-year weakness caused by deleveraging in high-income Europe and the weakness of global trade in 2012. Both are projected to pick up in 2013 and in the case of bank lending are already on the rise. Overall bank lending is projected to increase 12.7 percent in 2013 (15.5 percent for short-term debt). However, the recovery will be only partial and even as late as 2014 net bank flows are projected to remain below their 2011 levels and less than half of their 2008 levels.

In contrast, bond flows are projected to decline in 2013 because many borrowers have taken advantage of the current low-interest environment to pre-finance future borrowing, and because with reduced deleveraging pressures — some borrowers will return to more traditional bank-financing. Overall, net private capital inflows to developing countries are projected to rise — mainly because of rising levels of foreign direct investment — reaching

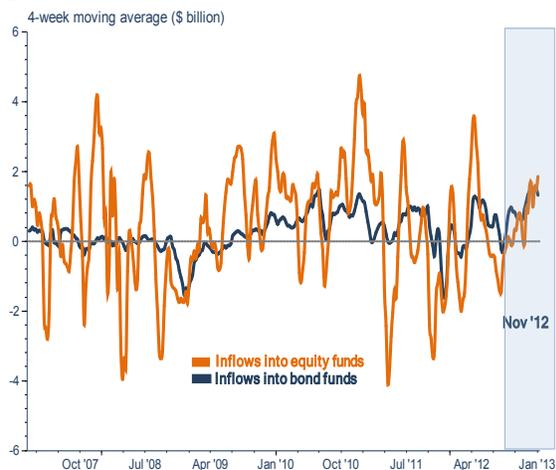
4.1 and 4.2 percent of recipient country GDP in 2013 and 2014 (figure 8).

Improved financial conditions have had only a modest reflection in real-side activity

The increase in financial market uncertainty in May and June of 2012 cut into economic activity at the global level, ending recoveries in some high-income countries and accelerating policy-induced slowdowns that were occurring in several middle-income countries that hit capacity constraints in 2011. Faced with yet another round of market uncertainty, firms, and households cut back on investments and big-ticket expenditures — causing global industrial production, which had been growing at a 5.9 percent annualized pace in the first quarter, to shrink in the second quarter.

Industrial production started to rebound in the third quarter of 2012, but the recovery has been anemic particularly among high-income

Figure 7. Money has come flooding back into developing country mutual funds



Source: World Bank, EFPRI.

countries. And, outside of East Asia & Pacific, the acceleration of activity in developing countries shows signs of flagging in the fourth quarter.

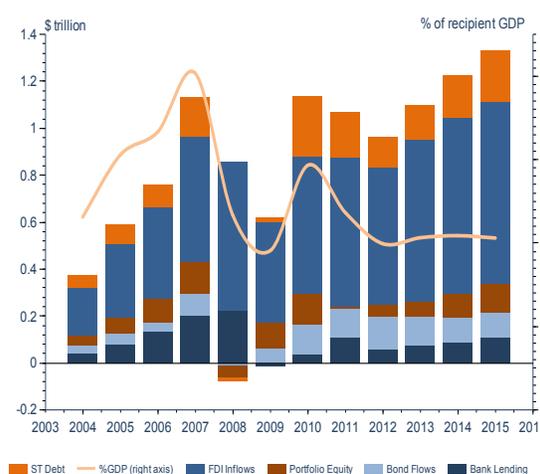
Disappointing outturns in high-income countries partly reflect policy uncertainty

In the *United States*, uncertainty over future policy in the run up to the November elections and from the so-called fiscal cliff contributed significantly to the dampening of the recovery in US growth during the second half of 2012.

Normally, with improving labor market and consumer demand conditions, business investment should be growing quickly, instead it fell at a 1.8 percent annualized pace in the third quarter. Had it instead expanded as might normally have been expected (approximately 3.5 percent), GDP growth would have been much stronger (perhaps growing by 3.4 instead of the recorded 3.1 percent). Initial data for the fourth quarter suggest that it too will be weak despite improving retail sales, housing markets, and employment (orders of capital goods are falling or very weak, figure 9).

In Europe, output slowed sharply in the second quarter amid heightened financial tensions, related to concerns that policy reform was occurring too slowly. In the third quarter, improved market perceptions (as previously

Figure 8. Net private capital flows to slowly recover from 2012 lows

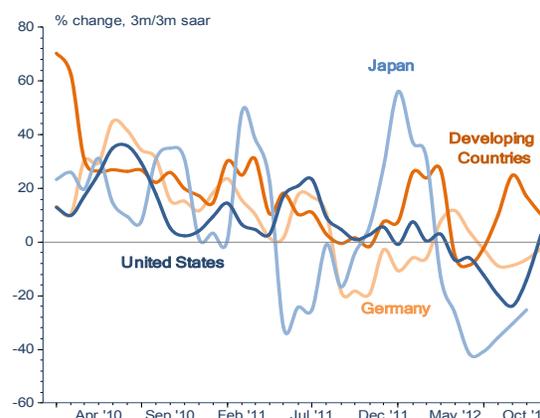


Source: World Bank.

discussed) led to an easing of the pace of contraction in the Euro Area (GDP shrank at a 0.1 percent annualized pace in 2012Q3, versus a -0.6 percent pace in Q2).

However, prospects for the fourth quarter are somber. Industrial production declined sharply in Germany and in the United Kingdom in October and business sentiment indicators remain unusually weak.^{FN6} Despite indications of improving sentiment and order books, GDP is expected to decline further in the fourth quarter and into the first few months of 2013 before the continental economy begins expanding once

Figure 9. Capital goods orders remain weak in high income countries



Source: World Bank, Datastream.
 Note: U.S. capital goods orders exclude defense and aircraft orders.

again. Overall, Euro Area GDP is estimated to have contracted 0.4 percent in 2012.

In Japan, the boost to growth from reconstruction spending in the aftermath of the Tohoku earthquake and nuclear disaster has faded, and as a result GDP fell at a 0.1 percent annualized pace in the second quarter. Political tensions between Japan and China, compounded these woes in the second half of the year, with the yen value of Japanese exports to China falling by 17 percent between June and November 2012 — contributing to a 3.5 percent annualized decline in GDP in the third quarter.

Prospects for the fourth quarter suggest further declines. Industrial production in November continued to weaken, and the export decline accelerated. For the three months ending November 2012 industrial production was declining at an 18.5 percent annualized pace. Overall, the Japanese economy has slowed sharply and GDP is estimated to have expanded only 1.9 percent for the year as a whole 2012.

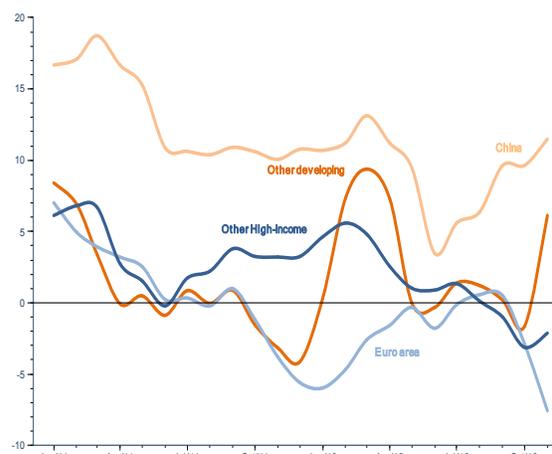
Developing country growth is firm but is being dampened by high-income weakness

Box 2 gives an overview of recent developments in the developing regions, while the regional annexes (<http://worldbank.org/globaloutlook>) provide additional detail as well as country-specific forecasts.

For developing countries, the weak external environment had an obvious moderating influence on growth in the second quarter of 2012. Nevertheless, during the third quarter there were increasing signs of strengthening domestic demand in developing countries. In contrast with high-income countries, developing-country retail sales grew at a 13.9 annualized pace in Q3, and capital goods orders picked up. Industrial production also gained steam.

After weakening sharply in Q2 and even turning negative in several regions, economic activity accelerated in virtually every developing region in the third quarter of 2012, with industrial production growing at a 5.3 percent annualized pace (figure 10). Among those countries for which quarterly GDP data are available, output expanded at a solid 4.2 percent annualized pace. Industrial production data, which is much more

Figure 10. Industrial production in developing countries outside East Asia continues to strengthen



Source: World Bank, Datastream.

widely available, also accelerated and grew at a 5.3 percent annualized pace in the third quarter.

While the improvement in developing country performance was widespread (figure 11), it was most marked among those Sub-Saharan African countries for which data are available (reflecting extractive-industry related investments and the coming on-stream of new capacity generated by earlier investments). In South Asia the improvement was relative, with industrial production stabilizing after strong declines in the second quarter, and GDP in India during the July-September quarter expanding only 5.3 percent from the year before. The sharp fall in industrial activity in the Middle-East and North Africa was the exception to the rule of improved third quarter performance — reflecting renewed political turmoil within the region.

Data for the fourth quarter remains sparse. The pace of industrial production growth in developing countries has picked up to 8.6 percent during the three months ending November 2012, with output accelerating in East Asia & Pacific, Europe and Central Asia, and South Asia toward year's end. Growth remains slow and actually weakened in Latin America and the Caribbean, while Q4 data are not available elsewhere. Business sentiment indicators such as purchasing manager indexes (PMIs) are improving, although they remain very low (figure 12).

Box 2. Following a second quarter slowdown, growth has picked up developing countries

Economic activity in the *East Asia & Pacific* region has rebounded, driven by robust domestic demand in China, Indonesia, Malaysia, Philippines and Thailand and a surge in exports toward the newly industrialized economies (NIE) of the region. Trade in the region surged toward the end of the year, with Chinese exports rising at a 8.6 percent annualized pace during the three months ending November, and imports increasing at a 12.5 percent clip. Reflecting these developments industrial activity in the region East Asia & Pacific has accelerated to an 15.0 percent annualized pace through November, led by China. Inflationary pressures remain contained and well within the targeted rates across the region. Asian equities have outperformed the major global and regional stocks markets and have surged further in December reflecting an improving global and regional economic outlook.

Output in the developing *Europe and Central Asia* region had also a rebound during the final months of 2012 but the economic performance was mixed across countries. While industrial production grew fast in Turkey, Lithuania, and Kazakhstan, it contracted sharply in Bulgaria, Ukraine, Latvia, and modestly in Russia, Serbia and Romania during the three months ending November. And, the summer drought cut into agriculture production in Russia, Romania, Serbia, and Bosnia and Herzegovina. Despite weak import demand from high-income Europe, regional (especially Turkey and Russia) trade rebounded toward the end of the year, reflecting low base effects and increased non-European, including South-South sales. Despite slow growth, inflation gained momentum in the second half of 2012 reflecting increased food prices, supply constraints and increased taxes and administrative tariffs.

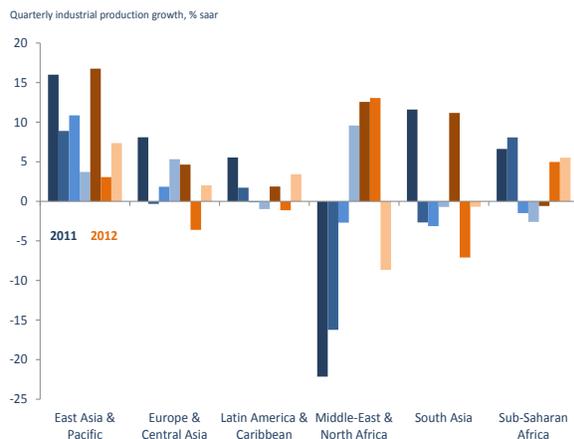
Despite a relatively weak external environment, domestic demand in the *Latin American and the Caribbean* region held-up relatively well, recording GDP growth of 1.9 percent in the third quarter, as slightly stronger (albeit still weak) growth in Brazil compensated for decelerating growth elsewhere, particularly in Argentina and Mexico. The recovery in industrial production was even more marked, with output expanding at a 3.4 percent annualized pace during the third quarter, due to a recovery in Brazil and Argentina. However, growth appears to have slowed once again in Q4. Regional import demand has picked up, rising at a 9.5 percent annualized pace during the 3 months ending November 2012 — following 5 months of decline. Exports growth remaining relatively weak, with merchandise export volumes growing at a 3.8 percent annualized pace during the 3 months ending November.

Economic activity in the *Middle East & North Africa* continues to be buffeted by political turmoil, with aggregate growth rising and falling as individual countries exit/ enter and re-enter periods of domestic turbulence that can be very disruptive of short-term activity. Among oil importers in the region, activity declined sharply at an 9.8 percent annualized pace in the third quarter as political uncertainty in Egypt, Jordan and Morocco weighed on economic activity. And the combination of domestic disruption and weak Euro Area demand has seen export volumes plummet. Output among developing oil exporters, has declined in aggregate as production increases in Libya and Iraq were offset by declines in Iran following the tightening of international sanctions. Many countries in the region face rising fiscal challenges due to heavy spending in an effort to dampen domestic discontent, with fiscal balances in many oil-importers particularly sensitive to oil (and to a lesser extent food) prices due to subsidization policies.

After a very weak April-June quarter of 2012, economic activity in *South Asia* appears to have stabilized, with industrial output growing at a 2.4 percent annualized pace during the three months ending November. While India dominates the regional trend, industrial output in Pakistan also picked up sharply in the second half of the year. After declining in line with weak global growth, South Asia's export volumes have also picked up in recent months — although the US dollar value of regional exports are still down 2.2 percent in November from a year earlier. Inflation in the region has moderated to an annualized 6.2 percent pace in the three months to November, in part reflecting a stabilization and even decline in international commodity prices. Nevertheless, inflation in the region remains high (more than 7.5 percent (y/y) in Bangladesh, and close to 10 percent in India, Nepal, Pakistan, and Sri Lanka), reflecting structural capacity constraints, large fiscal deficits and entrenched inflationary expectations.

Among the 4 economies in *Sub-Saharan Africa* with available monthly industrial production data are available, output in the oil exporting economies (Angola, Nigeria and Gabon) slowed in-line with developments elsewhere. Activity in South Africa was disrupted by labor unrest, with GDP declining in the second quarter and picking up modestly in the third quarter. Still high commodity prices are stimulating investment activity throughout the region, and contributing to increased productive capacity and exports. Thus, despite the mid-year global economic slump, export volumes were expanding rapidly mid-year year (at a 30 percent annualized pace in the second quarter, versus a more modest 2.2 percent annualized growth rate for imports. Since then the pace of the export expansion has eased to 2.5 percent during the three months ending August. Headline inflation for the region decelerated steadily from a 10.4 percent annualized pace at the end of 2011 to a 6.3 percent pace during the three months ending October 2012.

Figure 11. Economic activity picked up in almost every developing region during Q3



Source: World Bank, Datastream.

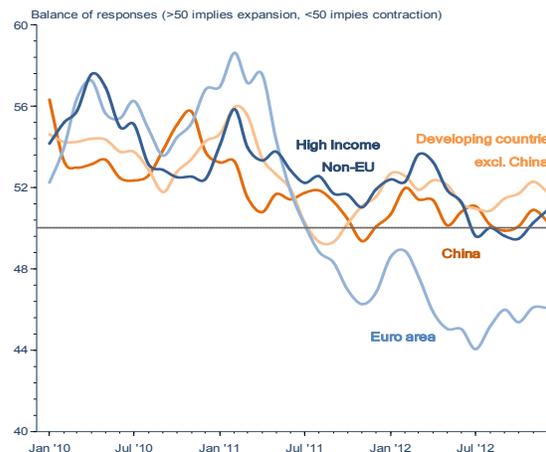
Monetary policy may have exacerbated the cycle in developing countries

The stop-go pattern of developing country growth in the recent past partly reflects the deterioration in international confidence during the second quarter of 2012 and the end of year weakness. However, it also reflects a significant swing in domestic monetary policies (see earlier box 1).

In response to rising inflationary pressures and increasingly binding capacity constraints, many developing countries appropriately tightened policy during the second half of 2011 (figure 13). As a result, real credit growth among several large middle-income economies operating close to capacity has decelerated during 2012. In China, real credit growth dropped to an 11.6 percent annualized rate during the three months ending in July from a peak of 25.3 percent in February (figure 14). Similarly, a tighter monetary stance in Brazil and India contributed to a 5-8 percentage point drop in annualized real credit growth rates.

Although the tightening of domestic policy was initiated in 2011, it only began to affect activity in 2012 and it likely exacerbated the dampening influence of the increase in financial tensions in May/June of 2012.

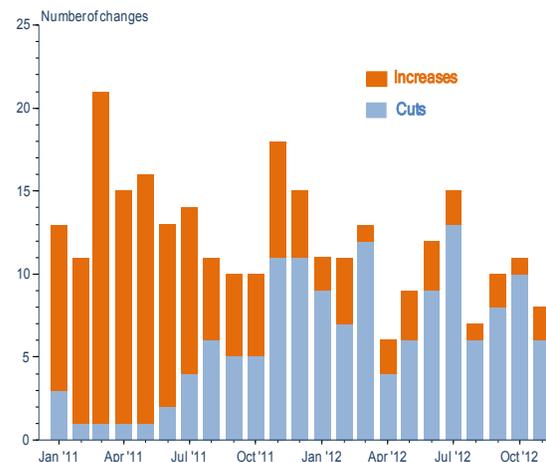
Figure 12. Business sentiment is improving but remains low



Source: World Bank, Markit, and national sources.

The subsequent loosening of policy during the second and third quarters of 2012 will similarly have effect only with a lag. And, while it is impossible to say with certainty its full effects have probably not been felt as of yet. As a result, the strengthening of demand in developing countries can be expected (assuming all else equal) to continue into 2013 as easier credit conditions translate into increased consumer and business sector demand.

Figure 13. Developing-country monetary policy has shifted from a tightening to a loosening phase



Source: World Bank, Bloomberg.

Developing country imports have been a motor for global growth

Global trade has been very weak in 2012, and estimates suggest that developing country exports of goods and services increased by only 4.2 percent for the year as a whole. Developing country imports held up better, rising 5.4 percent reflecting the better economic performance of developing countries. Overall global trade rose only an estimated 3.5 percent in 2012 (compared with a pre-crisis average of 6.2 percent).

The relatively strong import demand of developing countries has helped mitigate recessionary conditions in the Euro Area and other high-income countries (figure 15). Indeed, since 2011 developing countries have been responsible for 2/3 of the increase in extra-EU exports of French and German firms.

Nevertheless, developing countries are increasingly less dependent on high-income countries for their exports. The steady growth of developing country GDP and increased interconnections between these economies means that since 2010, more than half of developing country exports go to other developing countries (figure 16).

Headwinds should diminish, supporting a gradual acceleration of growth

While there have been substantial forces acting to slow the global economy in 2012, and many of these are expected to persist through 2013 and into 2014/15, there are also growing forces of recovery that should support prospects going forward.

In the *United States*, improving labor market conditions (since June 789,000 jobs have been added to the US economy and the unemployment rate has fallen from 8.2 to 7.8 percent) are helping to support income and consumer demand growth. These improvements should, if fiscal uncertainty is lifted, result in a strengthening of investment growth.

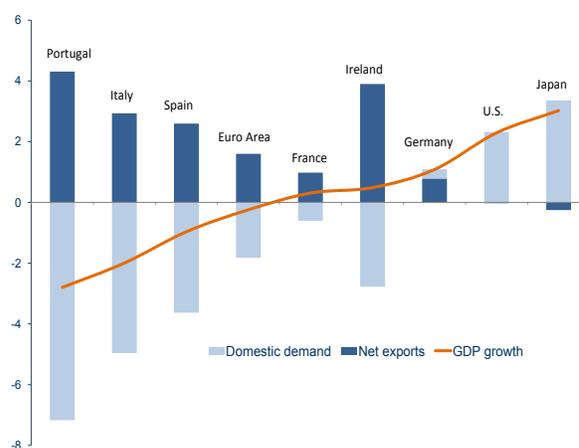
In addition, the restructuring in the housing market, which has been a persistent drag on growth since 2005 (between 2005Q4 and 2011Q1 residential investment activity fell by 58 percent), appears to have reached a turning point. While there are still many problems (including underwater mortgages and regional oversupply), the overall market has begun growing, supported by low mortgage rates. Some observers argue that the housing sector alone could add as much as 1.5 percentage points to US growth in 2013 (Slok, 2012). Indeed, increasingly tight housing market conditions have supported a recovery in

Figure 14. Real credit growth has slowed in many major developing countries



Source: World Bank, IMF IFS.

Figure 15. Developing country imports have compensated for weak domestic demand in high-income countries



Source: World Bank, Eurostat.

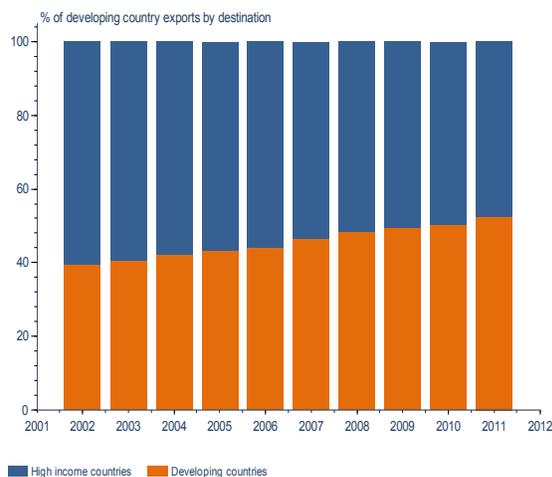
prices and activity.^{FN7} Residential investment is up 14 percent from a year ago, sales of single-family homes rose 9.1 percent in the first 8 months of the year, and existing home sales reached a 27-month high in August. New single-family homes inventories are at an all-time low and, although rising somewhat, inventories of existing single-family homes remain at depressed levels.

Prospects, will depend importantly on how the remaining fiscal challenges of the United States, are dealt with. While the January 1, 2013 agreement on tax measures resolved most of the immediate concerns about the fiscal cliff, the legislation offers only a temporary reprieve (until end of February) before the remaining mandatory cuts to government spending included in the fiscal cliff kick in (approximately \$110bn in 2013 or 0.1 percent of GDP).^{FN8}

If no credible medium-term plan for fiscal consolidation is found by end of February and debt-ceiling legislation is unchanged or only short-term extensions provided for, the economy could be subjected to a series of mini-crises and political wrangling extending over the foreseeable future. This could have potentially strong negative consequences for confidence, and even the credit rating of the United States.^{FN9}

In the baseline forecast of table 1, a deal is assumed to be found before March 2013 that prevents the remaining elements of the fiscal

Figure 16. An increasing share of developing country exports goes to other developing countries



Source: World Bank, IMF Direction of Trade Statistics.

cliff from significantly disrupting economic activity in 2013. It assumes that in the new deal, the total of tax increases and expenditure cuts for 2013 will amount to about 1.6 percent of GDP and that progress is made towards establishing a credible medium-term plan to reduce spending and increase revenues. Moreover, it assumes that the deal includes agreement to provide for a medium-term path for the debt ceiling that is consistent with the medium-term plan.

The fiscal compression of this baseline is about 0.6 percentage points larger than in 2011, which contributes to a slowing of GDP growth from an estimated 2.2 percent in 2012 to 1.9 percent in 2013. In the outer years of the forecast, growth should pick up to around 3 percent, as the contractionary effects of continued consolidation are partially offset by improved confidence that the fiscal accounts are returning to a sustainable path. Should the fiscal impasse remain unresolved, the implications for growth in the United States and the rest of the world could be much more negative (see the more detailed discussion below).

In the *Euro* Area, fiscal consolidation is expected to continue, but its extent should diminish, and as a result its negative impact on GDP and growth should decline — contributing to a modest firming of growth during the course of 2013. Overall, the Euro Area's fiscal stance is expected to tighten by about 1 percent of GDP in 2013, down from a 1.7 percent (of GDP) tightening in 2012 (see earlier figure 1). As a result, depending on multipliers the drag on overall GDP growth from fiscal tightening should ease by between 0.2 and 0.6 percentage points.^{FN10}

That said, the steep weakening of activity in Germany and France toward the end of 2012 serves as a stark reminder of the importance that confidence will play in the Euro Area recovery. The more policy markers persist in pursuing the reform agenda of strengthening Euro Area institutions, improving fiscal balances at the national level and strengthening structural policies to raise the growth potential of member countries, the better the chance that improving confidence will support the recovery.

Looking forward, fiscal consolidation, banking sector consolidation and a lackluster expansion in the United States will continue to weigh on European growth — although to a lesser extent than in 2012. As a result, quarterly GDP growth is expected to turn positive and gradually strengthen during 2013 (although negative carryover from falling GDP in 2012 means that GDP for 2013 is projected to decline slightly).^{FN11} Assuming continued progress in addressing fiscal sustainability issues and reforming institutions, Euro Area growth is projected to strengthen further, expanding by 0.9 and 1.4 percent in 2014 and 2015 respectively.

In Japan, the current dispute with China is sapping growth, while the country's huge fiscal debt requires attention. Assuming that relations with China improve during the course of 2013, output is expected to gradually strengthen but to expand by only 0.8 percent in 2013 before strengthening toward 1½ percent by the end of the forecast period.

Developing country growth should accelerate slowly

Regional outlooks, including country-specific forecast, are outlined in more detail in the regional annexes to this report and are summarized in box 3.

Based on data to date, developing-country GDP is estimated to have expanded a relatively weak 5.1 percent in 2012, largely on account of developments during the first half of 2012. The monetary policy easing undertaken by both high-income and developing countries^{FN12} in 2012 is expected to lift liquidity, consumption and investment spending in both high-income and developing countries in the months to come. This, plus the gradual improvement in demand conditions in high-income countries is projected to underpin a gradual acceleration of growth in developing country growth to 5.5 percent in 2013, before firming further to close to 6 percent in 2014 and 2015.

The acceleration, which is underway is expected to be relatively muted in East Asia & Pacific, Sub-Saharan Africa, Latin America, and South Asia because of capacity constraints (figure 17). In Europe & Central Asia, significant spare

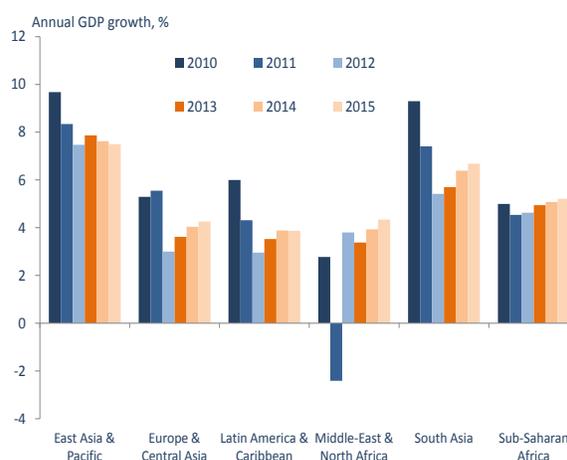
capacity and slowly recovering domestic and external conditions underpin the projected pick up in growth. The recovery in the developing Middle-East & North Africa aggregate principally reflects an assumed gradual decline in political and military turmoil.

Commodity prices should stabilize or decline in this moderate growth environment

Although they have been subject to significant fluctuations during the course of 2012, the average of industrial commodity prices in 2012 was broadly stable as compared with 2011. The barrel price of crude oil was broadly unchanged in 2012 at \$106 versus, \$104 in 2011, while metals and minerals declined 15 percent. On average, internationally traded food prices were up only 1 percent in 2012 from 2011, as prices were roughly equally high in early 2011 and late 2012. As of mid January 2013 internationally traded USD prices of wheat and maize are 19 and 7 percent higher than in early January 2012, down 30 percent from their August 2012 highs.

The surge in maize and wheat prices mid-year was due to hot and dry conditions in the US that mainly affected maize, while adverse weather in Russia and to a lesser extent in Western Europe cut into wheat production. The spike had less severe consequences than the price hike in 2007-08, mainly because fewer crops were involved and because the supply shock was not

Figure 17. Growth is expected to be capacity constrained in several regions



Source: World Bank.

Box 3. Regional outlook

GDP growth for East Asia and the Pacific region is projected to slow to 7.5 percent in 2012 – largely on account of weak external demand and policy actions in China directed towards moderating domestic demand and controlling inflation. Going forward, GDP growth in the region is projected to accelerate to 7.9 percent in 2013 before stabilizing at around 7.5-7.6 percent in 2014-2015 – mirroring a modest acceleration in China in 2013 followed by growth stabilization through 2015. GDP growth in the remaining countries in the region is forecast to average 5.9 percent over 2013-2015 underpinned by accelerating global trade and a rebalancing of regional demand toward consumption. Disposable income in the region is forecast to benefit from appreciating (real) exchange rates, rapid growth in wages in China and ASEAN-4 (Indonesia, Thailand, Malaysia) and an accommodative monetary policy stance in the context of low inflation across the region. However, the envisaged recovery remains vulnerable to a renewed crisis in the Euro Area, weaker than expected recovery in the US, and the possibility that a decline in Chinese investment is not offset by robust consumption growth.

GDP growth in *Europe and Central Asia* is estimated to have eased to 3.0 percent in 2012 from 5.5 percent in 2011 as the region faced significant headwinds including: weak external demand, deleveraging by European banks, a poor harvest and inflationary pressures. Growth slowed most in countries with strong economic linkages to the Euro-area, while it was relatively robust in most resource-rich economies that have benefited from high commodity prices. GDP growth in the region is projected to rebound to 3.6 percent in 2013 and to 4.3 by 2015, supported by: improved agricultural performance, reduced deleveraging pressures, and strengthening external demand. Medium-term prospects for the region will critically depend on progress in addressing external (large current account deficits) and domestic (large fiscal deficit, unemployment, and inflation) imbalances; lack of competitiveness; and structural constraints.

Growth in *Latin America and the Caribbean* decelerated in 2012 to 3 percent, in response to softening domestic demand in some of the largest economies in the region and a weak external environment. Among the larger economies the growth deceleration was particularly sharp in Brazil (-1.8 percentage points) and Argentina (-6.9 pp.). A more accommodative policy environment, stronger capital flows (notably FDI) and more robust external demand are expected to lift regional growth over the 2013-2015 forecasting horizon to an average growth of 3.8 percent. Labor and tax reforms underway in some of the larger economies, and a drive to boost infrastructure investment should help address some of the structural issues that have constrained growth in the region. Risks remains tilted to the downside with the possibility of larger-than-expected fiscal consolidation in high-income countries and a hard landing in East Asia representing central concerns. Striking the right balance between demand stimulus policies and policies that enhance the region's supply potential remains a central challenge.

Output in the *Middle East and North Africa* region has recovered to above 2010 levels, but continuing political uncertainty and unrest in several countries are weighing on economic activity. Regional GDP grew by 3.8 percent in 2012, mostly due to a 4.6 percent rebound among oil exporters as crude oil production in Libya recovered towards 2010 levels and output in Iraq continued to expand. Growth in oil importers in the region was significantly weaker at 2.5 percent in 2012 due to the adverse impact of Euro Area economic contraction on regional exports and tourism, and a combination of domestic problems, including a poor harvest in Morocco, fiscal difficulties in Jordan, and continuing uncertainties in Egypt. Regional GDP growth is projected to slow to a 3.4 percent pace in 2013, as growth in oil producers returns to more sustainable rates, and then rise to around 4.3 percent by 2015 — assuming that the negative influence on growth of ongoing uncertainty and domestic unrest eases during the projection period. The war in Syria and the sanction-fueled downturn in Iran are notable sources of instability and weakness in the region.

South Asia's growth weakened to 5.4 percent in 2012, mainly reflecting a sharp slowdown in India. Weak global demand exacerbated region-specific factors including: subdued investment rates, electricity shortages, policy uncertainties, and weak monsoon rains. Sri Lanka's growth was also dampened by policy efforts to contain overheating and a poor harvest, while growth in Bangladesh slowed in part due to weakening exports. Inflation eased in most South Asian countries during 2012; however, structural capacity constraints and entrenched inflationary expectations suggest limited scope for policy easing to support growth. South Asia's GDP is projected to rise 5.7 percent in 2013 and by 6.4 and 6.7 percent in each of 2014 and 2015, helped by policy reforms in India, stronger

(Continued on page 17)

investment activity, and a gradual improvement in global demand for South Asia's exports. Migrant remittances, in particular from the oil-rich Gulf Cooperation Council (GCC) countries, are projected to remain resilient and support domestic demand in Nepal, Bangladesh and Pakistan.

Growth in *Sub-Saharan Africa* has remained robust at 4.6 percent in 2012 (6.1 percent if South Africa is excluded), supported by resilient domestic demand and still relatively high commodity prices. Strong domestic demand, an accommodative policy environment, increasing foreign direct investment flows, relatively high commodity prices, and increased export volumes in countries with new mineral discoveries (Sierra Leone, Niger and Mozambique) in recent years are expected to underpin a return to the region's pre-crisis growth rate of 4.9 percent in 2013 and even stronger growth in 2014/15. Nonetheless, risks remain tilted to the downside, as the global economy remains fragile. Weaker growth in China, ongoing fiscal consolidation in the Euro Area and the United States could potentially derail the region's growth prospects.

exacerbated by policy moves that served to reduce international supply further.

Given the modest growth environment expected over the next few years, industrial commodity prices are projected to remain broadly stable, while barring a major supply shock, food prices are expected to decline about 15 percent between 2012 and 2015 (figure 18). These projections are very sensitive to supply conditions, especially for maize and wheat, stocks of which are very low. For oil risks exist to the downside due to important supply- and demand-side adjustments that the five fold increase in oil prices since 2000 have unleashed (box 4).

Low maize and wheat stocks make these markets particularly susceptible to additional supply shocks

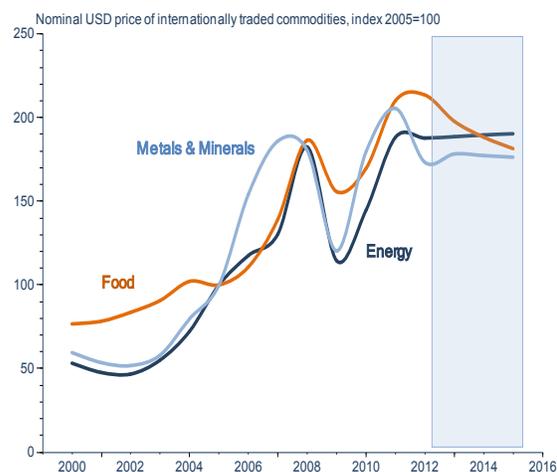
The stock-to-use ratio for maize currently stands at 13.4 percent, the lowest level since 1972/73. The wheat market is better supplied with a stock-to-use ratio of 26.2 percent — more than 5 percentage points higher than in 2007/08. In contrast, rice markets remain well-supplied, with no notable price movements. At these levels, wheat and maize prices could spike sharply once again if there are further significant disruptions to supply.

Higher food prices can have macroeconomic implications, including inflationary and balance of payments pressures, especially for countries (principally small island economies and several countries in the Middle-East and North Africa region) that are heavily dependent on imported food. High prices are also having important fiscal effects in countries that subsidize basic food supplies.

However, the greatest policy concern provoked by high food prices is its impact on the health of the poor for whom food costs represents 50 percent or more of their income. As such, the sharp increases in food prices that have been observed at the international level would if observed in local prices cut sharply into disposable incomes, reducing funds available for quality food, schooling and healthcare. Moreover, even temporary price hikes can have permanent effects as high food prices increase the incidence of malnutrition and cognitive deficiencies (World Bank, 2012b).

Historically, the extent to which international prices pass through to local prices has been limited (see for example World Bank 2011, FAO 2011). However, given the sustained rise in international prices since 2006 (the US dollar price of rice, wheat, and maize prices have increased 85, 81, and 142 percent respectively),

Figure 18. Barring supply disruptions, commodity prices are projected to remain stable or ease



Source: World Bank.

Box 4. How is the global energy landscape evolving in response to high oil prices

The landscape of the global energy map is changing rapidly. The International Energy Agency (2012) recently announced that thanks to increased production of natural gas and shale oil, the United States will become world's largest oil producer surpassing Saudi Arabia by the mid-2020s, while North America (Canada, Mexico and the U.S.A. combined) will become a net oil exporter by 2030.

These developments are to a large extent a natural market reaction to the quadrupling of international oil prices between 2000-02 and 2010-12, which saw a substantial uptick in global exploration efforts and made profitable extraction technologies.

High prices have boosted supply and moderated demand

In the United States, new techniques such as horizontal drilling and hydraulic fracturing (“fracking”), have permitted the wide-spread exploitation of until-now uneconomic shale oil; shale natural gas; and so-called “tight-oil” deposits. As a result, U.S. crude oil and natural gas production has increased 30 percent during 2005-2011. Ultimately, these technologies have already added over 1 mb/d to US crude oil output so far, and they are expected to add much more. Partly as a result of these technologies, global proven reserves have risen by 33 percent since 2000, with 70 percent of the increase coming from increased extraction estimates (reserves growth) as opposed to new discoveries. New discoveries have also been playing an import role, accounting for about 40 percent of production during the same period (IEA, 2012). Associated investment has contributed importantly to growth in a range of developing countries, including in Sub-Saharan Africa (see Sub-Saharan Africa regional annex).

The demand-side has also reacted, with a rapid increase in the energy efficiency of motor vehicle fleets both through the introduction of new more energy efficient technologies such as hybrid cars and reduced demand for energy inefficient vehicles. Since 2000, the average automobile mileage of new cars sold in the United States has increased by 18 percent and that of the existing fleet by 7.7 percent.^{BFN1} Similar trends are observable throughout the high-income world. As a result, OECD demand for oil has declined a total of 7.6 percent since 2005 (IEA, 2012B). Over the long run the IEA now expects OECD total liquids demand (crude and refined hydrocarbons) demand to fall a further 11 to 21 percent depending on policies.

Demand outside of the OECD (mainly developing countries) has been more robust, with total liquids consumption rising 3.5 percent annually since 2005, partly reflecting rising vehicle use. More than half of global oil output is consumed by the transportation industry, which is the fastest growing component of oil demand, especially in China, India, and the Middle East. These trends are expected to continue although at somewhat slower pace after 2020, with global oil and liquids demand rising by an annual average rate of 0.6 and 0.7 percent between 2011 and 2035.

Yet, oil prices have remained resilient

Despite the equilibrating trends in supply and demand, world prices remain in excess of \$100 per barrel, and are expected to remain above \$100 over the medium-to-long term, mainly because of the elevated extraction cost of newly discovered and new-technology oil.

Yet, downside and upside risks exist. On the downside, the process of substitution away from oil and toward new extractive technologies is not yet complete. Currently U.S. natural gas and coal trade at an 80 percent discount to Brent oil — opening up huge arbitrage opportunities, that are likely to exercise increasing downward pressure on international prices as pipeline reversals and liquefied natural gas exports begin to de-compartmentalize international markets. Over the longer-run, changes in battery technology and/or expanded use of natural gas could significantly erode the engineering advantage of crude oil products (see Commodity Annex), allowing abundant and low-cost coal to compete indirectly with liquid fuels through electrical vehicles.

A significant upside risk, stems from the environmental costs associated with new extraction techniques. For the moment, there remains a lively debate concerning the potential for geological damage pollution to aquifers from the chemicals and heavy fresh-water use of fracturing techniques.

^{BFN 1.} Increase in new vehicle passenger car efficiency between 2011 and 2000; Increase in short-wheel base vehicles 2009-2000 Bureau of Transportation Statistics (2012).

there are increasing indications that local prices in developing countries are rising as well. In particular the nominal median price of rice, wheat and maize increased by 18, 6, and 29 percent during 2006-2011 (last year for which comprehensive data exist).

Policy makers should be prepared for continued global volatility

While a great deal of progress has been made in improving fiscal sustainability and crisis-management institutions in the Euro Area, much more needs to be done before the risk of further crises can be taken off the table. In the United States the major fiscal contraction threatened by the fiscal cliff has passed, but uncertainty continues to surround the future path of fiscal policy and the threat of serious economic disruption posed by the persistent possibility that the debt-ceiling will not be raised is also a source of external risk for developing countries.

Developing countries also face home-grown challenges, including managing the transition from today's extremely high investment rates in China to levels more compatible with long-term growth; evaluating their trend output in the post-crisis world; adjusting fiscal and monetary policy in accordance with those prospects; and the still-present possibility of an oil-price spike or that a further hike in international grain prices.

Importantly, the balance of risks is more evenly distributed now and their relative amplitude has declined as compared with the past several years, when tail risks were both large and almost exclusively downside. For the Euro Area the baseline forecast includes significant pessimism for growth prospects assuming that the sharp weakening of activity in core economies persists for several months despite improving sentiment. In the United States significant negative spillover in the first quarter is assumed from even a relatively rapid resolution of fiscal challenges. Should outturns prove stronger in either of these economies, both global and developing country growth could be more buoyant. Similarly a resolution to Japan's conflict with China could help spur a stronger than projected rebound in the world's third largest economy.

Developing countries remain vulnerable to a deterioration of conditions in the Euro Area

As previously discussed, the Euro Area crisis has already significantly impacted developing economies, slowing GDP growth and the pace at which incomes rise — translating directly into slower progress in relieving poverty. Importantly, the range of national and pan-European measures taken over the past several years, including by the ECB, has significantly reduced the risk of an acute crisis.

Nevertheless, a sharp deterioration of conditions remains a possibility. Table 3 reports the results of simulations of a major Euro Area crisis and a prolonged U.S. fiscal policy paralysis scenario. The Euro Area scenario illustrates the impacts on global growth of a deterioration of conditions that causes two Euro Area economies to be frozen out of international capital markets, in turn forcing a sharp decline in government expenditure and business investment spending (equal to around 9 percent of the GDP of each country).^{FN13} In the simulation the shock is assumed to be spread over two years, with 3/4 of it felt in 2013 and 1/4 in 2014.

The impacts for developing countries in this scenario are much less severe than those presented in the June edition of the GEP, both because fewer economies are assumed to be directly involved and because confidence effects in the rest of the world are assumed to be less severe (partly reflecting the smaller size of the overall crisis). Nevertheless, growth in developing countries is reduced by 1.1 percentage points on average in 2013. As economies gradually recover the overall impact declines — but developing-country GDP would still be 0.3 percent lower than in the baseline even two years after the simulated crisis begins. Important transmission mechanisms and some of the vulnerabilities of developing countries in this scenario include:

- *Remittances* to developing countries could decline by 1.7 percent or more, representing as much as 1.4 percent of GDP among countries heavily dependent on remittances.
- *Tourism*, especially from high-income Europe, would be reduced with significant implications

Table 3. U.S. fiscal uncertainty and a deterioration of conditions in the Euro Area would have serious impacts on developing countries

	Euro crisis			US fiscal paralysis		
	2013	2014	2015	2013		
	(% change in level of GDP)			Real GDP	Current account balance	Fiscal balance
				(% change in level)	(change, % of GDP)	
U.S.	-1.0	-0.6	-0.2	-2.3	0.6	-0.5
World	-1.3	-0.8	-0.4	-1.4	0.0	-0.5
High-income countries	-1.4	-0.9	-0.4	-1.5	0.1	-0.6
Euro Area	-2.3	-1.4	-0.8	-1.1	0.2	-0.4
Developing countries	-1.1	-0.7	-0.3	-1.0	-0.1	-0.5
Low-income countries	-0.6	-0.4	-0.1	-0.7	0.1	-0.2
Middle-income countries	-1.1	-0.7	-0.3	-1.0	-0.1	-0.5
Developing oil exporters	-1.3	-0.9	-0.4	-1.2	-1.1	-1.0
Developing oil importers	-0.9	-0.6	-0.3	-0.9	0.3	-0.2
East Asia & Pacific	-1.0	-0.7	-0.3	-1.1	0.4	-0.2
Europe & Central Asia	-1.3	-0.9	-0.4	-0.9	-1.0	-0.8
Latin America & Caribbean	-1.2	-0.8	-0.3	-1.2	-0.4	-0.6
Middle East & N. Africa	-1.0	-0.7	-0.3	-0.8	-0.7	-1.4
South Asia	-0.5	-0.3	-0.2	-0.4	0.6	0.0
Sub-Saharan Africa	-1.0	-0.7	-0.3	-0.9	-1.3	-0.8

Source: World Bank.

for countries in North Africa and the Caribbean.

- *Short-term debt:* Many developing countries have reduced short-term debt exposures in part because of Euro Area deleveraging. Nevertheless, countries that still have high-levels of debt could be forced to cut into government and private spending if financial flows to riskier borrowers become more scarce in such a scenario.
- *Commodity prices:* The weakening of global growth in the Euro Area scenario causes a 7.5 percent decline in oil prices and a 7.4 percent decline in metal prices. Such declines, are likely to cut into government revenues and incomes in oil and metal exporters, but helping to cushion the blow among oil importing economies.
- *Banking-sector deleveraging:* A crisis scenario could accelerate the process of bank-deleveraging in Europe, with economies in Europe and Central Asia most likely (among developing countries) to be affected.

Continued fiscal policy uncertainty in the United States could hit developing countries fairly hard

Following five years of large budget deficits, the United States has yet to agree on a set of policies

to reduce the deficit to manageable levels. While the January 1 2013 legislation resolved some points of contention, others have been left unresolved. A new end-of-February deadline looms when, unless the authorities intervene once again, sequestered spending and the debt-ceiling provisions will kick in.

In the baseline scenario significant progress toward deciding a credible medium-term plan to restore fiscal sustainability and authorize government borrowing in line with that medium-term plan is assumed to be arrived at by the end of February 2013 — implying an overall 1.6 percent of GDP fiscal compression in 2013. An alternative scenario assumes that no medium-term deal is arrived at, but that a partial deal that provides for a \$110bn additional fiscal contraction and only short-term relief from debt-ceiling legislation is reached. Under such a scenario, the uncertainty surrounding future tax and fiscal policy would remain and the likelihood of another debt-ceiling crisis would be high.

The simulation results in table 3 report the impact on GDP, current-account and fiscal balances of developing countries in 2013 from such an alternative scenario. It assumes that the uncertainty generated by prolonged negotiations — including surrounding the debt ceiling — continues to weigh on investment and consumer durable spending in the United States, but also in

the rest of the world as concerns about the implications of a possible U.S. credit rating downgrade increase. Those worries are assumed to increase precautionary savings of U.S. business and consumers by 1 and 2 percentage points, and those of firms and households in other high-income countries by 0.5 and 1 percentage points, and those of developing countries by 0.3 and 0.7 percentage points.

Under these assumptions, growth in the United States could slow by some 2.3 percentage points. The Euro Area would be pushed into a deep recession, potentially increasing the risk of a second crisis there, and developing country GDP would decline by 1 percentage point relative to baseline.

Lower global growth would cause oil prices to decline, which would hit the current accounts and tax revenues of oil exporters, but would benefit importers.

An abrupt fall in China's high investment rates could slow global growth

China has, on average, recorded close to 10 percent annual growth for more than 30 years and 10.3 percent growth during the first decade of this millennium, with growth as high as 14.2 percent in 2007. During most of this high-growth period, investment (and savings) were at a relatively high 30-35 percent of Chinese GDP (figure 19). In the 2000s, investment rates jumped initially to 40 percent of GDP (partly in reaction to the low cost of international capital) and then again to 45 percent of GDP, because of China's fiscal and monetary stimulus plan introduced during the global financial crisis. As a result, the contribution of investment to Chinese growth rose from 2.3 percentage points during the 1980s and 1990s to around 5 percent in the 2000s. And China's capital / output ratio, which in an economy that is in a steady-state growth equilibrium will be broadly stable, has increased since 2000 by 20 percent and is still rising rapidly.

High investment rates are required to sustain the capital stock in a fast growing economy like China's. Nevertheless, such high investment-to-GDP ratios are unprecedented. Neither Japan nor Korea – two countries that also enjoyed lengthy

Figure 19. Recent upswings in Chinese investment rate pose serious challenges going forward



Source: World Bank.

periods of high growth – ever saw investment rates exceed 40 percent. A level of 35 percent of GDP is seen to be more sustainable and consistent with underlying productivity growth and population growth.

China's authorities have identified the need for a more balanced pattern of investment, that implies not just a lower investment rate, but also a shift toward investments and expenditures in the service sector and in intangible assets like human capital. This can be achieved, in part, by reducing implicit subsidies that favor capital investments over investment in labor (World Bank & Development Research Center 2012, p. 19). The gradual rebalancing and reduction in physical capital investment rates, is expected to be compensated for by more rapid consumption growth over an extended period of time.

China's economic history suggests that China, perhaps more than any other country, has the instruments to achieve such a transformation. But the challenge of orchestrating such a transition should not be underestimated. Many other countries have failed to smoothly adjust their investment profiles.

While a smooth transition is the most likely outcome and the one retained in the baseline scenario, there is a risk that the transition to a lower investment rate could happen abruptly, perhaps provoked by a failure of a significant

share of new investments to realize hoped for profits, resulting in a spike in unpaid loans and a rapid tightening of credit conditions.^{FN14} In such a scenario, investment growth would likely come under significant pressure.

Given China's much increased weight in the global economy and its role as an engine of global growth, a sharp decline in investment would likely have serious consequences worldwide. Simulations suggest that a 10 percentage point deceleration in Chinese investment would cause Chinese GDP growth to slow by about 3 percentage points. The high import content of investment implies that a significant share of the slowdown leaks out as reduced imports — reducing the impact on China but extending it to the rest of the world.

Such a strong decline in investment rates, however, is unlikely, in part because of the strong policy response that such an abrupt deterioration in the investment climate would likely elicit. Table 4 presents simulation results from a smaller 5 percentage point decline in Chinese investment growth. In this scenario, the slowing in Chinese investment results in a 6.0 percent decline in Chinese imports (relative to baseline) and a 1.4 percent decline in GDP relative to baseline. Lower Chinese imports in turn reduce global exports, and world GDP declines relative to 2013 baseline by 0.5 percent and 0.3 percent for developing countries outside of China. Reflecting the composition of Chinese import demand, high- and middle-income countries are hit harder than low-income countries.

Among the developing countries in the region, GDP in Vietnam and Thailand, could decline by 0.7 percent (relative to baseline), while in Indonesia the hit would be somewhat smaller at 0.6 percent. Other impacts range between 0.4 percent in Malaysia and 0.2 percent in Lao PDR.

But these regional impacts are not the largest. China currently consumes 40 percent or more of many of the world's metals. A sharp decline in its investment rate would have significant impact on commodity prices, with large knock on effects for commodity exporting countries. In the above mentioned scenario, oil prices are

Table 4. An abrupt slowing in Chinese investment would slow global growth significantly

	Real GDP (%change in level)	Current account balance (change,% of GDP)	Fiscal balance
China	-1.4	1.7	-0.3
East Asia & Pacific	-1.3	1.3	-0.3
East Asia & Pacific (excl China)	-0.6	0.0	0.0
World	-0.5	0.0	-0.2
High-income countries	-0.4	-0.2	-0.2
Euro Area	-0.4	-0.1	-0.1
Developing countries	-0.7	0.4	-0.3
Developing countries (excl China)	-0.3	-0.3	-0.2
Low-income countries	-0.3	-0.2	-0.1
Middle-income countries	-0.7	0.4	-0.3
Developing oil exporters	-0.4	-0.5	-0.3
Developing oil importers	-0.8	0.8	-0.2
Europe & Central Asia	-0.3	-0.5	-0.3
Latin America & Caribbean	-0.3	-0.2	-0.2
Middle East & N. Africa	-0.3	-0.4	-0.5
South Asia	-0.2	0.0	0.0
Sub-Saharan Africa	-0.3	-0.6	-0.3

Source: World Bank.

projected to decline by 2.8 percent and metal prices by 4.3 percent relative to baseline.

As a result, in oil exporting countries such as Nigeria, Oman, and Saudi Arabia the balance of payments (as percent of GDP) would decline by more than 0.5 percentage points. In metal-exporting countries such as Chile and Peru current account balances could also weaken substantially. The simulations suggest that declining incomes due to weaker export prices, could result in GDP declines ranging from 0.9 percent in Kazakhstan to around 0.5 percentage points in Mexico and Nigeria.

Fiscal balances would also be affected in commodity exporting countries, adding to the drag on growth — especially among those countries running already large deficits. With so many commodity exporters located in Sub Saharan Africa, the region would feel the impact of the Chinese slowdown more strongly than its direct trade linkages might suggest. Simulations suggest that the region's current account and fiscal balances could decline by 0.6 and 0.3 percent of GDP in 2013.

In this potentially volatile environment, developing countries need to rebuild buffers and pursue cautious macroeconomic policies

The major challenges facing high-income countries are predominantly related to fiscal sustainability and high unemployment, and, for now, are largely anchored in the short run. High cyclical unemployment and excess spare capacity are also problems in several developing European countries, while high structural unemployment remains an abiding challenge in many countries in the Middle-East & North Africa.

However, the majority of developing countries are facing a different set of challenges. Unlike high-income countries, they have by and large recovered from the 2008/09 crisis. For most of these countries, the policy focus needs to shift back to structural efforts to enhance potential growth, and away from demand management. At the same time, they need to continue working toward reducing both domestic and external vulnerabilities.

For many developing countries this means rebuilding the fiscal, monetary and social policy buffers that were consumed during the 2008/9 crisis, so that if some of the still-present risks facing the global economy are realized, these economies would once again be in a position to respond forcefully.

Commodity exporting countries may need to take a close look at expenditures and revenues to ensure that long-lasting spending commitments could still be met even if commodity prices and associated revenues were to decline. While many developing countries still have ample reserves, many need to take steps to reduce short-term debt (external and domestic) and build up reserves so that their economies would be able to withstand a freezing up of financial markets that might accompany a flare up of tensions in high-income countries.

Policy in developing countries needs to adapt to an environment where high-income country growth is expected to remain weak and potentially volatile. The increased external volatility alone would make macroeconomic

policy making more challenging than normal. But these difficulties are magnified by uncertainty over both the level and rate of growth of potential output (the level of activity and pace of growth that an economy can maintain without generating inflationary or current account pressures) in developing countries. To the extent that policy makers overestimate potential and follow a more stimulative policy than conditions warrant, they could end up wasting scarce resources by raising future debt burdens and inflation with little or no benefit in terms of additional (sustainable) real GDP growth.

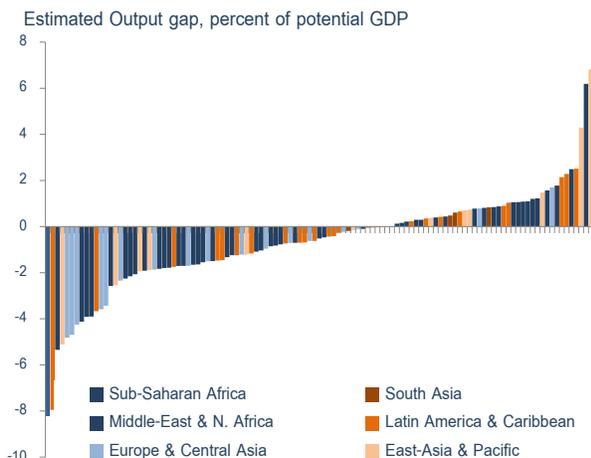
Measuring the level and rate of growth of potential output is fraught with uncertainty. Even in high-income countries, such estimates tend to vary significantly over time (Ehrman and Smets, 2001). For developing countries the issue is particularly difficult because economic reforms and rapid development are constantly changing both the structure of the economy and the pace at which productivity grows. Measures of potential based solely on recent growth trends tend to result in estimates that are significantly higher than those based on more theoretically robust production-function techniques (box 5).

In particular, an estimate based on pre-crisis growth performance might indicate that output was currently some 6 percent below potential in developing countries and that growth could be some 1.5 percentage points higher. In contrast, the production-function based measure of potential suggests a situation where long-term growth potential is much less strong and where output in more than 60 percent of developing countries is close to or above potential (figure 20).

Despite progress in reducing fiscal deficits, more needs to be done

If developing countries are using recent growth performance to evaluate the state of the cycle they could be pursuing a policy that is too expansionary, accumulating significant debt, inflation and current account deficits with little or no pay off in terms of increased real incomes or growth.

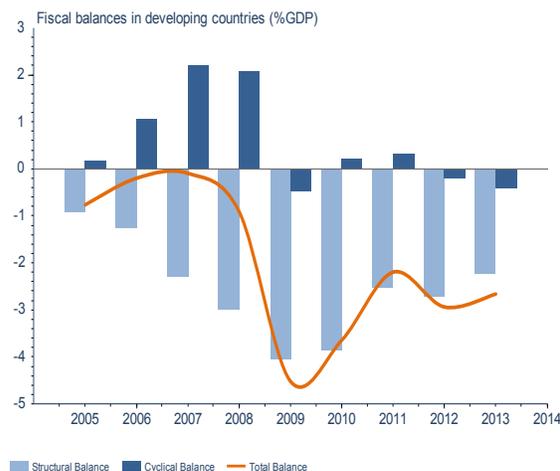
Figure 20. Output in more than 60 percent of developing countries is close to or above potential



Source: World Bank.

Fortunately in most developing economies this does not appear to be the case. In aggregate, developing country fiscal balances have improved markedly from -4.5 percent of GDP in 2009 to an estimated -2.9 percent in 2012 (figure 21). The improvement reflects both improved cyclical tax revenues due to the firming business

Figure 21. Fiscal deficits in developing countries are mainly structural in nature



Source: World Bank.

cycle, and a 1.3 percent of GDP improvement in the structural (cyclically adjusted) budget balance – implying that on average countries are gradually re-establishing buffers (box 6).

Nevertheless, compared with 2007 levels, fiscal deficits as a percent of GDP have widened in

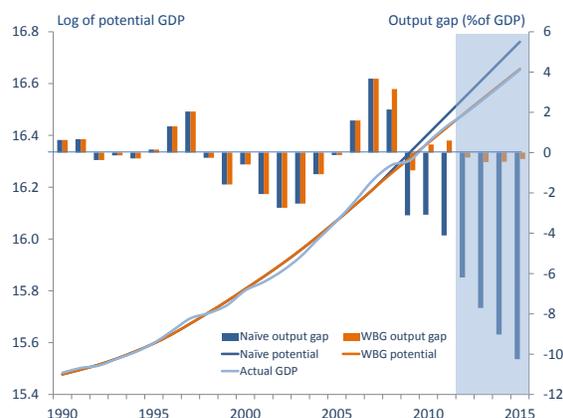
Box 5. Estimating potential output and the cyclical position of developing economies

The boom-bust cycle through which developing (and developed) countries have passed in this millennium complicates the evaluation of both the level and rate of growth of potential output. Based on pre-crisis performance, developing country policy makers could easily conclude that developing-country potential GDP growth is around 7-8 percent per year (average growth for developing countries in the 5 years through 2007 was 7.3 percent).

Naive measures of potential (such as moving averages of aggregate GDP growth or even statistical measures such as the Hodrik-Prescott or Kalman filters) are prone to errors (Giorno and others, 1995) – in part because they are heavily influenced by the most recent observations. If a measure is taken towards the end of a boom period it will tend to over-estimate potential, while if it is taken during a bust phase it will tend to under-estimate (Mise, Kim & Newbold, 2005).

The preferred method is to use a production function method that accounts for changes in labor supply and the capital stock as well as productivity growth (see for example OECD (2008), IMF (2005) CBO (2001)). Measures that rely on a naïve estimate of potential based pre-crisis performance give an excessively optimistic sense of sustainable growth (7.3 percent), versus 5.9 percent based on underlying productivity, labor force and capital growth (box figure 5.1). Importantly, the naïve measure can lead to policy errors, suggesting that substantially more slack exists in the system than do more sophisticated measures.

Box figure 5.1 Using boom period growth as potential results in a substantial over-estimation of slack



Source: World Bank.

Box 6. Output gaps and fiscal space

In the boom years prior to the financial crisis, with GDP growth exceeding potential, large positive output gaps developed, reaching 3.8 percent of GDP by 2008 in developing countries. This strong (cyclical) boost to activity raised tax revenues (in U.S. dollar terms) in developing countries by nearly 26 percent in 2007 alone.

Fortunately, most developing countries were pursuing a cautious fiscal policy, and used the cyclical tax proceeds to reduce fiscal deficits, which actually turned to surpluses of 0.1 and 0.8 percent of GDP in 2007 and 2008 respectively. With this conservative, counter cyclical fiscal policy, developing-countries created the fiscal space that in turn allowed deficits to rise counter-cyclically during the crisis — helping to mitigate the downturn.

The speed with which developing countries recovered from the crisis nicely illustrates the advantages of having ample buffers. Indeed, looking across regions there is a strong negative correlation between the size of fiscal surplus in 2007 and the size of the GDP hit countries took, with regions that were in surplus having generally experienced a larger fluctuation in their fiscal deterioration and a smaller decline in GDP (relative to potential). The notable exception to this pattern was the Europe and Central Asia region, which unlike other regions had been caught up in the financial excess of the boom period and therefore suffered both an external and a domestic shock.

Box table 6.1 Output gaps and fiscal balance responses following the financial crisis

	Developing countries	EAP	ECA	LAC	MNA	SAS	SST
Fiscal Balance in 2007	0.0	0.4	3.0	-1.3	-0.1	-4.1	0.4
Change in output gaps (A)	-4.0	-1.4	-10.7	-5.4	-0.1	-2.0	-3.1
Change in fiscal balances (B)	-3.8	-2.7	-7.2	-3.0	-3.8	-1.6	-6.8
Elasticity (B to A)	0.9	1.9	0.7	0.5	29.4	0.8	2.2

Source: World Bank.

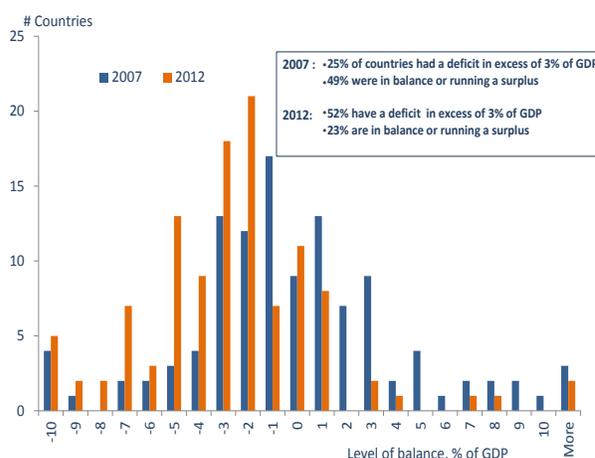
more than 80 percent of developing countries, with an average deterioration among these countries of 4.0 percent. In 2007, 41 percent of developing countries had a fiscal surplus, and only 25 percent of developing countries were operating at a fiscal deficit in excess of 3 percent of GDP. As of 2012, those ratios have reversed with close to 51 percent of developing countries running deficits of 3 percent or more and only 12 percent running surpluses (figure 22).

Significant additional but gradual progress reducing deficits will be required if countries are to be in a position to display the same kind of resiliency that they did in 2007 should external conditions deteriorate once again (see earlier risks scenarios).

For developing countries operating at close to potential, a strong argument can be made for gradually tightening fiscal policy in an effort to replenish buffers. World Bank estimates suggest that some 14 percent of developing countries are operating at close to potential, but have fiscal deficits in excess of 3 percent of GDP. Especially in a global context where the risk of a serious external shock remains elevated, a prudent re-establishment of depleted fiscal space

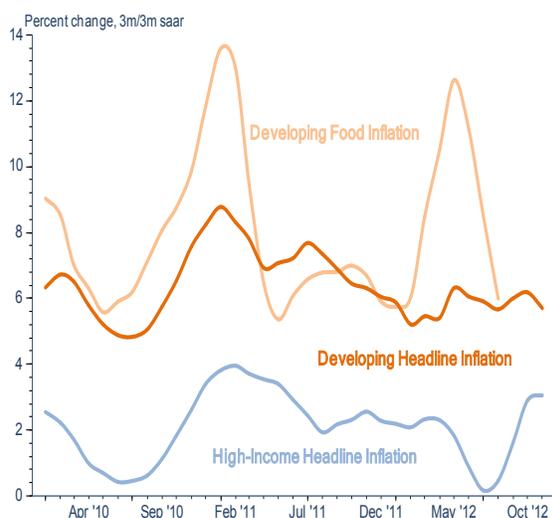
would seem to be in order. For countries where significant output gaps remain and deficits are high, policy makers will want to carefully evaluate the true structural or cyclical nature of their current fiscal condition and the sustainability of their debt situation before deciding on allowing deficits to remain at current

Figure 22. Many developing countries need to continue growing fiscal space



Source: World Bank.

Figure 23. Inflationary pressures are under control



Source: World Bank, Datastream and International Labor Organization.

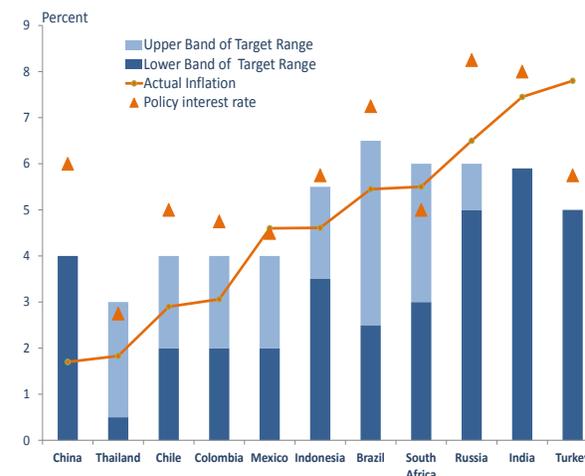
levels or even pursuing a more stimulative policy.

The appropriate stance of monetary policy will also depend on where economies stand in relation to potential. In the majority of developing countries inflation is broadly under control.

Despite the spike in international maize and wheat prices during the summer of 2012, inflation remains under 6 percent in almost 80 percent of the developing countries for which the World Bank collects data.^{FN15} Moreover, overall inflation is moderating rather than accelerating (figure 23). Inflation in most middle-income countries lies within inflation targeting bands (figure 24) and as a result real policy interest rates are appropriately low. Large middle income countries (Brazil, India, Russia, Turkey, and perhaps South Africa) stand as exceptions. In these countries inflation remains relatively high and in some cases real-policy rates are relatively low, suggesting that there may be scope for (additional) policy tightening.

For some of these economies, high inflation may reflect lingering capacity constraints despite slower growth in the recent period. In Brazil, for example, inflation momentum has recently accelerated due to capacity constraints exacerbated by temporary food price pressures

Figure 24. Inflation is above target in some countries indicating limited space for policy easing



Source: World Bank, national central banks.

Note: the real interest rate is implied by the distance between the triangle and actual inflation.

limiting adequate supply response to growing demand in light of monetary easing initiated in late 2011.

There is limited scope for easing in several developing countries in Europe and Central Asia and in South Asia. In Russia, inflation pressures have been reoccurring over the past year because of supply side bottlenecks, food price hikes and utility and other administered price adjustments, although inflation has subsided in recent months. In Turkey, considerable progress has been made in reducing inflation momentum, but headline inflation remains high and still above the central bank's target range. In India, despite repeated increase in policy rates and some easing in inflation, inflation remains high and real interest rates close to zero. Despite negative output gaps in South Africa, prospects for further monetary easing appears limited, because of recent wage hikes in the mining and transport sectors, exchange rate depreciation, and a deteriorating balance of payments.

The payoff from improved macro buffers could be large

The potential benefits of reestablishing fiscal and monetary policy space is difficult to assess unambiguously. However, the resilience with

which developing countries exited the recession of 2008/9 suggests that benefits could be large.

Table 5 reports the results of a set of simulations designed to illustrate the potential benefits of creating additional fiscal space. It shows the impact on developing country GDP of a uniform 5 percent decline in high-income GDP due to an unspecified shock.

In the first set of results, automatic stabilizers are assumed to operate in developing countries — i.e. sufficient funds are assumed to be found on domestic and foreign capital markets to maintain spending at pre-shock levels despite a 3.5 percent decline in tax revenues.

In the second scenario, the same external shock is applied but countries are assumed to be unable to finance more than a 3 percent of GDP deficit. For countries with a baseline exceeding 3 percent of GDP, it is assumed that no additional borrowing can be found. For those where the initial deficit was below 3 percent, but rose to more than 3 percent in the unconstrained simulation, it is assumed that only enough financing to cover a 3 percent of GDP deficit is obtained. In both cases, government expenditure is cut by an amount sufficient to maintain pre-existing deficits or a deficit of up to 3 percent of GDP.

Admittedly, the exercise is inherently artificial and the 3 percent of GDP threshold at which market financing becomes impossible is arbitrary. Nevertheless, it points clearly to the beneficial effects that having adequate buffers confers on countries. Specifically, GDP losses are estimated to be 48 percent larger among countries with limited fiscal space in the finance-constrained scenario versus the unconstrained scenario — suggesting that, if these countries had adequate buffers, their economies would have suffered much less severely (GDP losses in countries with adequate fiscal space also deteriorates in the second scenario — but this reflects the second round effects of the weaker output in the fiscally constrained economies).

Table 5. GDP impact of an arbitrary high-income country shock (equivalent to 5 percent of GDP) on GDP

	Unconstrained scenario (A)	Binding constraint scenario (B)	Difference (B-A)
	(% change in GDP)		(percentage points)
<i>High-income countries</i>	-5.2	-5.5	-0.3
<i>Developing countries</i>			
countries with adequate buffers	-3.4	-3.8	-0.4
countries with inadequate buffers	-2.3	-3.4	-1.1
<i>East Asia and Pacific</i>			
countries with adequate buffers	-3.9	-4.3	-0.4
countries with inadequate buffers	-3.1	-3.5	-0.4
<i>Europe and Central Asia</i>			
countries with adequate buffers	-2.2	-2.4	-0.2
countries with inadequate buffers	-2.8	-4.3	-1.5
<i>Latin America and Caribbean</i>			
countries with adequate buffers	-2.3	-3.0	-0.6
countries with inadequate buffers	-2.5	-4.3	-1.9
<i>Middle East and N. Africa</i>			
countries with adequate buffers	na	na	na
countries with inadequate buffers	-1.9	-2.9	-1.0
<i>South Asia</i>			
countries with adequate buffers	na	na	na
countries with inadequate buffers	-1.5	-1.7	-0.2
<i>Sub-Saharan Africa</i>			
countries with adequate buffers	-1.9	-2.1	-0.3
countries with inadequate buffers	-1.9	-2.7	-0.8

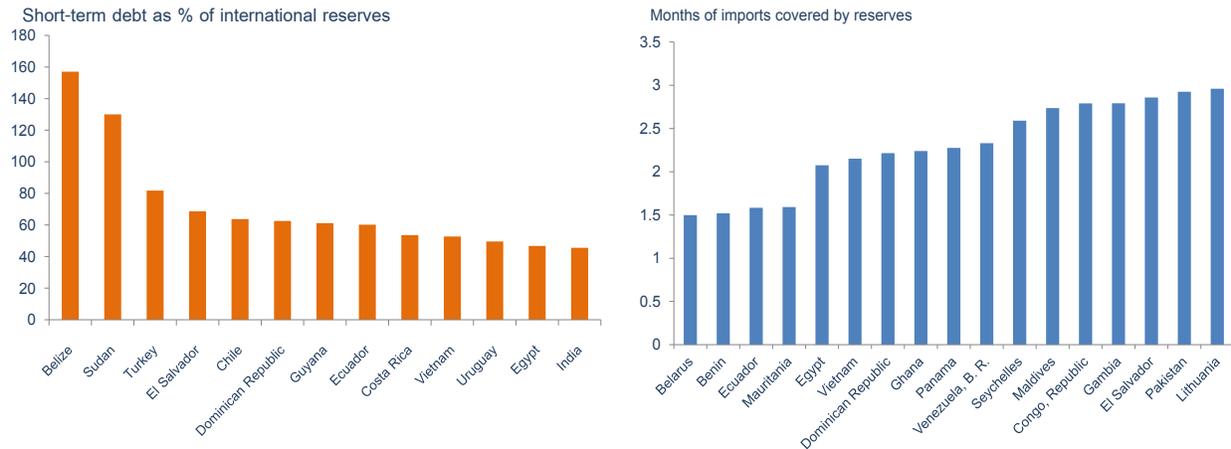
Source: World Bank.

Current account and external debt positions have also deteriorated as compared with 2007

Current account positions of oil-importing developing countries have deteriorated by 3.2 percentage points since 2007. Nevertheless, on average their reserve positions are adequate. Oil-importing developing countries excluding China have an average of 4.5 months of import cover, about the same level observed in 2007 prior to the crisis, and their reserves represent about 94 percent of their short-term external debt.

Nevertheless, 20 developing countries have less than 3 months of import cover (figure 25). Moreover, short-term debt represents 40 percent or more of the foreign currency reserves of some 21 developing countries. For countries with heavy short-term debt exposures or whose reserves are not adequate to cover imports, a sharp decline in export revenues or in the availability of external financing could force significant cuts in imports or internal spending — with potentially serious consequences for growth, and poverty reduction. Vulnerabilities are even more serious among those 30 developing countries that have both a current account and government deficit in excess of 4 percent of GDP (figure 26).

Figure 25. Some countries are vulnerable to external financial shocks due to relatively low levels of reserves



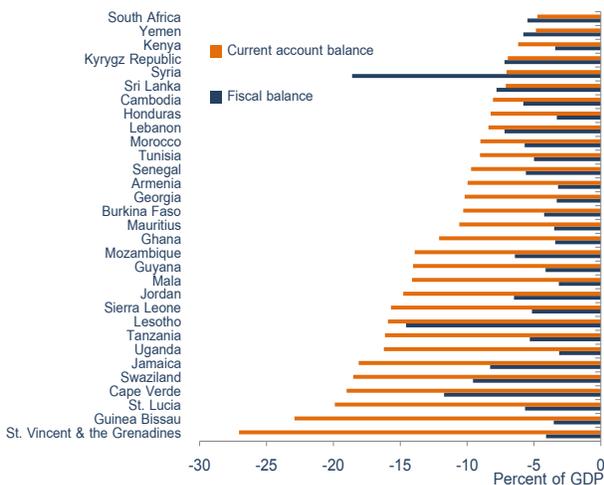
Source: World Bank and Bank for International Settlements.
 Note: Reserve numbers as of September 2012 and short-term debt numbers as of June 2012. Offshore centers such as Panama, Mauritius, Seychelles, Samoa, with large short-term debt levels have been excluded from the first figure.

Several countries have responded to the deterioration in trade balances by drawing down on their international reserves. For instance in the eleven months through November 2012, the trade balance in India, Indonesia and South Africa deteriorated by 33.1 bn, 26.8 bn and 10.3 bn USD respectively when compared with calendar 2011. Largely as a result of these deteriorating trade balances and efforts to limit exchange rate depreciation, international reserves declined by 3.0 bn and 1.4 bn USD in India and Indonesia respectively.

Falling international reserves and high current account deficits may constrain monetary policy in some middle-income countries (e.g. South Africa and India). To the extent that reserves are being consumed to meet external financing requirements and imports, countries may be forced to keep interest rates high in order to attract foreign capital flows (or deter outflows).

Commodity exporters with weak current account positions are particularly at risk if commodity prices ease – either because of better supply conditions or a slowing in global demand. Were oil or metal prices to fall by 20 percent, both foreign currency and government revenues in commodity exporters would be hit hard – potentially forcing them to cut into spending and imports. Simulations show that in such an instance commodity exporters could be hit by declines in fiscal balances as high as 2.8 percent of GDP and a 6.5 percent of GDP declines in their current account positions. GDP impacts will depend on the extent to which fiscal space exists (see earlier discussion), but even in the absence of constraints impacts could be as large as 2.8 percent (table 6).

Figure 26. Dual deficits pose challenges in several developing countries



Source: World Bank.

Table 6. Country vulnerabilities to changes in commodity prices

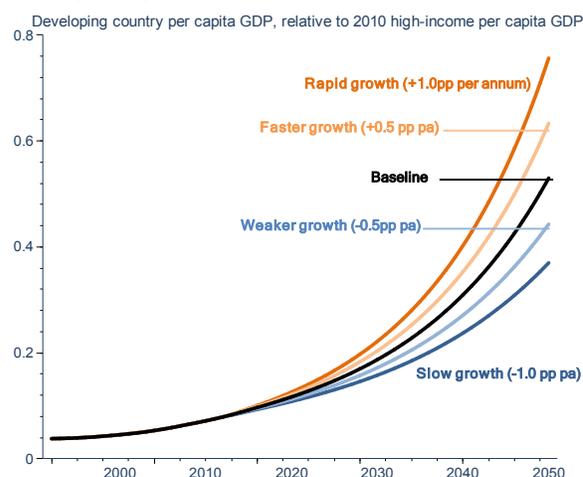
	20% reduction in specified commodity prices in 2013-2015				
	Oil		Food	Metals & minerals	
% change from baseline GDP					
Kuwait	-2.8	Paraguay	-2.0	Mali	-2.3
Yemen, Rep.	-1.9	Uruguay	-1.8	Peru	-1.6
Nigeria	-1.6	Argentina	-1.2	Kyrgyz Republic	-1.0
Kazakhstan	-1.2	New Zealand	-0.7	Chile	-1.0
Iran, Islamic Rep.	-0.7	Belize	-0.6	Botswana	-0.6
Venezuela, RB	-0.7	Uganda	-0.6	South Africa	-0.5
Colombia	-0.4	Bolivia	-0.6	Bolivia	-0.4
Cote d'Ivoire	-0.4	Brazil	-0.4	Mozambique	-0.4
Latvia	-0.3	Guyana	-0.3	Mauritania	-0.4
Trinidad and Tobago	-0.3	Malawi	-0.2	Guyana	-0.4
Georgia	-0.2	Chile	-0.2	Ghana	-0.3
Belarus	-0.2	Kenya	-0.2	Ukraine	-0.3
Ecuador	-0.2	Mauritius	-0.2	Uganda	-0.3
Russian Federation	-0.1	Ecuador	-0.2	Australia	-0.3
Norway	-0.1	Cote d'Ivoire	-0.2	Namibia	-0.2

Source: World Bank.

For the majority of developing countries, supply-side rather than demand-management policies are key to assuring stronger growth

While some demand stimulus may be in order for developing countries that still have large output gaps and where policy space exists, for the majority of developing countries promoting stronger growth will require emphasizing the kinds of deeper long-term structural policies that underpinned the acceleration of growth that they have enjoyed over the past 15 years. The bulk of that acceleration was due to increased productivity growth, which in turn derived from improvements in the overall policy environment, including:

- greater macroeconomic stability (bringing inflation, government deficits and debt under control)
- an opening up to global trade characterized by substantial declines in tariffs (and often initiated unilaterally)
- a similar opening up to FDI, and the technology transfers that accompanied it
- a strengthening of the rule of law; reductions in corruption; and declines in regulatory obstructions to business activity
- substantial investments in human capital (education; health; and gender equality) as well as investment in infrastructure

Figure 27. Small changes in potential growth rates can have large long-run effects

Source: World Bank.

If developing countries are to renew with the fast growth of the pre-crisis period, they will have to continue improving along all of these dimensions. Failure to do so, is likely to see a gradual slowing in the pace of productivity improvement, income growth and poverty reduction.

The longer-term costs of inaction and benefits are potentially large. Even small changes in the potential growth rate of developing countries will, with time, have significant impacts on the speed with which developing countries close the gap with incomes in high-income countries. Indeed, a 1 percentage point increase in the average growth rate of developing countries between now and 2050 could see them achieve 75 percent of the 2010 per capita income of high income countries, versus 53 percent in the baseline or 36 percent in the case where growth underperforms by 1 percentage point (figure 27).

Concluding remarks

While there are signs that growth is picking up in developing countries, the world continues to face a bumpy and uncertain recovery. The pace of recovery in high-income countries is likely to remain disappointing. Uncertainty over future policy, and necessary fiscal and financial restructuring will continue to drag on growth in many countries. A clear and credible program for returning high-income economies to a

sustainable fiscal path could unleash a virtuous circle, of reduced borrowing costs that would reduce the likelihood of default, and lower interest rates. This in turn would allow for faster growth, which would yield additional reductions in risk and an improved fiscal position. However, the significant political, institutional issues and vulnerabilities that remain make a slower more stuttering progress such as in the baseline the more likely outcome.

Developing countries can grow rapidly in this environment. However, to do so they will need to maintain and reinforce the reform momentum evident during the 1990s and 2000s, and which underpinned the acceleration in growth observed. Given the potential volatility of the external environment, this should be complemented by a gradual program of fiscal consolidation among developing countries and where necessary monetary tightening so that countries have the kind of policy space that would allow them to respond forcefully in the face of a serious downturn.

A longer-term structural reform agenda should also include efforts to improve food security, especially in the more vulnerable of developing economies. This would involve increasing local productivity, improving local storage and transportation infrastructure, both to reduce spoilage and to enable improved access to foreign markets in both good and bad times.

Meanwhile developing countries need to continue to be active players in the G-20 process, both in order to assist high-income countries recover from the crisis of 2008/9, but also to ensure that reform efforts (be they in financial or real markets) take into full consideration potential impacts on developing countries.

Notes

1. In this publication the aggregate developing Europe & Central Asia refers to the low- and middle-income countries (countries with per-capita incomes of less than \$12,276 in 2010) of the geographical region. As such, this classification excludes from the aggregate Croatia, Czech Republic, Estonia, Hungary, Poland, Slovakia, and Slovenia — countries

that may be contained within the aggregate in other World Bank documents.

2. The average core Tier 1 capital ratio for the 23 biggest European banks by assets stood at 11.4 percent in the third quarter of 2012, up sharply from the 6.5 percent pre-crisis level. In the United States, the average tier 1 capital ratio of the 30 largest banks rose to 11.9 percent at the end of September 2012, compared with 8.5 percent in the second quarter of 2008.
3. Spreads on Argentine government debt surged to 3675 basis points (2408 bps since June), following court rulings that called into question the nation's 2001 debt restructuring deal. Later in November however, a temporary injunction eased the country's default risk and currently spreads are around 1600 bps.
4. The decline in yields reflects both a 140 basis point fall in EMBIG spreads since June, and a decline in U.S. interest rates in reaction to quantitative easing. Developing country bond spreads are now below their long-term average levels (of around 310 bps).
5. Most of the upgrades took place in Latin America, including Bolivia, Ecuador, Grenada, Panama, Paraguay, Peru, Suriname, and Uruguay. However Argentina, Belize, and El Salvador experienced downgrades. Outside Latin America, Indonesia, Turkey, and Latvia were upgraded to investment grade, while notable downgrades occurred for Belarus, Egypt, Serbia outlook, South Africa, Tunisia, Ukraine, and Vietnam with most downgrades occurring since September. In contrast, high-income countries' creditworthiness continued to deteriorate in 2012 amid the lingering European debt crisis, with Greece, Italy, Portugal, and Spain suffering multiple downgrades. Overall, high-income sovereigns experienced a total of 20 downgrades, with one upgrade for Greece in 2012.
6. For high-income countries, PMI's are lower than would normally be associated with current levels of economic activity. This likely reflects the very difficult period that the global economy has gone through, where

successive waves of financial market tensions have arisen, eased and then arisen once again. Each of these episodes of heightened tensions has been associated with a temporary increase in precautionary savings and a period of weak growth. This experience may have generated a reluctance to commit to new expenditures for fear of a renewed slowing of activity, even though financial conditions appear to have improved much more than during earlier episodes. Weak confidence and uncertainty also have roots in the very real challenges facing high-income countries and concern that political realities will prevent the kind of decisive and medium-term action that might encourage investors and households to believe that economies are likely to return to a stronger and more stable growth track.

7. The Case-Shiller 20-city price index increased at a 2.6 percent annualized pace in the three months ending July and housing starts are up 26 percent during the first eight months of 2012 versus the same period in 2011.
8. The U.S. Office of Management and Budget (Zeints, 2013) provides an estimate of the fiscal savings from measures put in place January 1, 2013 of \$617bn over 10 years against an unchanged policy scenario. This contrasts with the somewhat misleading CBO estimate of \$3.6tn (CBO, 2013) in additional deficits, which was based on the counterfactual of all of the sequesters and tax increases of the fiscal cliff having been fully engaged.
9. On August 5 2011, Standard & Poor's downgraded the sovereign debt of the United States from a AAA to AA+ rating, citing among other reasons, the failure of the authorities to address medium-term fiscal issues — including the debt ceiling (Standard & Poors, 2011).
10. Typically, fiscal multipliers have been estimated in the range of 0.3 to 1 (Spilimbergo, Symansky, and Schindler, 2009). Most recently, the IMF (2012) argued that in the current recession fiscal multipliers in high-income countries have been higher perhaps as high as 1.7. Data derived from the 2008/9 crisis period suggests point estimates for developing regions ranging from 0.5 to 2.6.
11. See box 3 in the June 2012 edition of *Global Economic Prospects* (World Bank, 2012) for a more complete discussion of carryover (the influence of past year's quarterly growth rates on future year's annual growth).
12. Policy rate cuts were complemented by liquidity injections by major economies, for example the Federal Reserve Bank's QE3 and the ECB's commitment to Outright Monetary Transactions. As a result, by 2012Q3, monetary positions worldwide had become very accommodative and policy rates had declined below their 2009 levels. Key policy rates settled at 7.25 percent in Brazil, at 6 percent in China, at 5.75 percent in Indonesia, and Turkey 5.5 and at 5 percent in South Africa.
13. Differences between this scenario and that presented in the June 2012 edition of *Global Economic Prospects* include the timing and amplitude of the modeled deterioration of conditions. In the present scenario, the deterioration is assumed to occur in the first quarter of 2013.
14. See also box 4.2 "How would investment slowdown in China affect other emerging market and developing economies?" IMF 2012.
15. Quarterly inflation is in double digits in 11 of the 38 countries where inflation exceeds 6 percent (Belarus, 30 percent; Burundi, 14.3 percent; Eritrea, 13.5 percent; Ethiopia, 26 percent, Malawi, 30 percent, South Sudan, 41 percent, Sudan, 46 percent; Iran, 30 percent, Syria, 40 percent and Venezuela, 18 percent).

References

- Bureau of Transportation Statistics. 2012. *Table 4-23: Average Fuel Efficiency of U.S. Light Duty Vehicles*. http://www.bts.gov/publications/national_transportation_statistics/html/table_04_23.html Downloaded November 24, 2012.
- CBO (Congressional Budget Office). 2001. "CBO's Method for Estimating Potential Output: An Update." CBO Paper, Congressional Budget Office, Washington DC.
- _____. 2012. *An Update to the Budget and Economic Outlook: Fiscal Years 2012 to 2022*. Downloaded Dec. 3, 2012. http://www.cbo.gov/sites/default/files/cbofiles/attachments/08-22-2012-Update_to_Outlook.pdf
- _____. 2013. *H.R. 8, American Taxpayer Relief Act of 2012*. Downloaded Jan. 2, 2013. <http://www.cbo.gov/publication/43829>
- Ehrman, Michael, and Frank Smets. 2001. "Uncertain Potential Output: Implications for Monetary Policy". European Central Bank Working Paper No. 59.
- Food and Agriculture Organization. 2011. *The State of Food Insecurity in the World: How does international price volatility affect domestic economies and Food Security?* Food and Agriculture Organization of the United Nations, Rome.
- Giorno, Claude, and others. 1995. "Potential Output, Output Gaps and Structural Budget Balances." OECD Economic Studies. No. 24.
- Ilzetki, Ethan, Enrique G. Mendoza, and Carlos A. Végh. 2011. "How Big (Small?) Are Fiscal Multipliers?" IMF Working Paper. WP/11/52. IMF, Washington, DC.
- International Energy Agency (IEA). 2012a. *Oil Market Report* (13 November 2012). OECD/IEA, Paris.
- _____. 2012b. *World Energy Outlook 2012*. OECD/IEA, Paris.
- IMF (International Monetary Fund). 2005. *World Economic Outlook*. Washington, DC: IMF.
- _____. 2012. *World Economic Outlook*. Washington, DC: IMF.
- Mise, Emi, Tae-Hwan Kim, and Paul Newbold. 2005. "On Suboptimality of the Hodrick-Prescott Filter at Time-Series Endpoints." *Journal of Macroeconomics* 27: 53–67.
- OECD. 2008. *Economic Outlook*. Paris, France.
- Sløk, Torsten. 2012. *Fiscal Cliff not going to reverse housing recovery*. Chartbook, November, Deutsche Bank. Downloaded Nov. 25, 2012.
- Standard & Poors. 2011. *Global Credit Portal: Ratings Direct*. "Research Update: United States of America Long-Term Rating Lowered to 'AA+' on Political Risks and Rising Debt Burden; Outlook Negative." <http://www.standardandpoors.com/ratings/us-rating-action/en/us/>. Downloaded Dec. 11, 2012.
- Spilimbergo, Antontio, Steve Symansky, and Martin Schindler. 2009. "Fiscal Multipliers" *IMF Staff Note*, SPN 09/11. Washington DC.
- World Bank. 2011. *Global Economic Prospects: Maintaining Progress amid Turmoil*. June 2011. Washington, DC: World Bank.
- _____. 2012a. *Global Economic Prospects: Managing Growth in a Volatile World*. June 2012. Washington, DC: World Bank.
- _____. 2012b. *Global Monitoring Report: Food Prices, Nutrition, and the Millennium Development Goals*. Washington, DC: World Bank.
- Zeints, Jeffery. 2013. *American Taxpayer Relief Act Reduced Deficits by \$737 Billion*. Office of Management and Budget. Washington DC. Downloaded January 2, 2013 from <http://www.whitehouse.gov/omb/blog>

Financial Markets

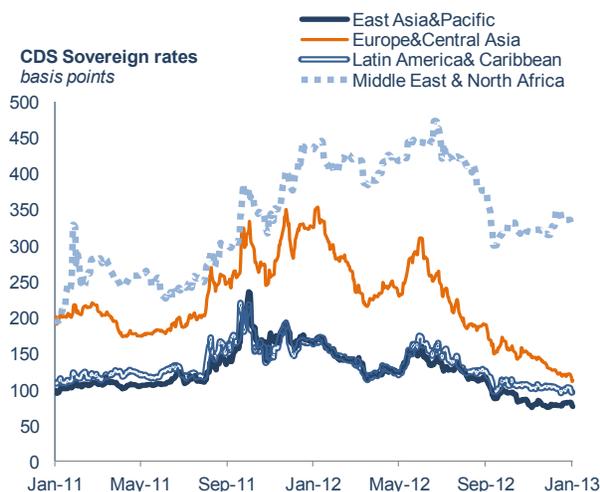
Recent developments in financial markets

Conditions in global financial markets have eased significantly since July following the decisive actions taken by the European Central Bank, US Federal Reserve and to a lesser degree in Japan.

The announcement of possible ECB measures to defend the Euro in late July and the actual launch of ECB's bond-buying program followed by the German Constitutional Court favorable ruling on the European Stability Mechanism in September have lowered the risk of an acute European crisis (box FIN.1: Recent developments in Euro-zone). Also in September, the Federal Reserve began its third round of quantitative easing (QE) with \$40 billion asset purchase per month. A few days later, the Bank of Japan also added ¥10 trillion (\$129 billion) to its asset purchasing program.

Since July 2012 yields of high-spread Euro Area sovereigns have narrowed substantially and financial markets' assessment of risk has improved considerably. The cost of insuring against sovereign default on high-spread European countries has sharply from earlier highs. Credit Default Swap (CDS) rates are now

Figure FIN.1 Developing country CDS rates tightened as risk-aversion eased



Source: Datastream and World Bank.

below their January 2010 levels (prior to the initial bout of Euro Area tensions) in most high-income countries and those of developing countries have declined on average 90 bps since the end of June with largest falls recorded by developing European economies (figure FIN.1).

The reduced likelihood of an acute European crisis, and increased global liquidity contributed to a recovery in global equity markets. After losing about 10 percent of their value between mid-March and mid-May, global stock markets have recovered with a full year gain of 13.9 percent in developing countries and 12.7 percent in developed countries (figure FIN.2). Despite these improvements, investors remain concerned over the US fiscal challenges, global economic growth and implementation of the Euro area rescue plan.

Improved sentiment was accompanied by a recovery in gross capital flows to developing countries

Gross capital flows (international bond issuance, cross-border syndicated bank loans and equity placements) to developing countries have fluctuated widely with investor sentiment over

Figure FIN.2 Global equity markets had a modest rebound since June 2012



Source: Bloomberg.

Box FIN 1. Euro Area developments in the second half of 2012

The Euro Area’s crisis response has progressed significantly during the second half of 2012. In mid-July, markets concerns rose due to uncertainty surrounding several key events scheduled for the first half of September. Investors worried that thin August markets would provide limited opportunity to hedge against possible downside risks.

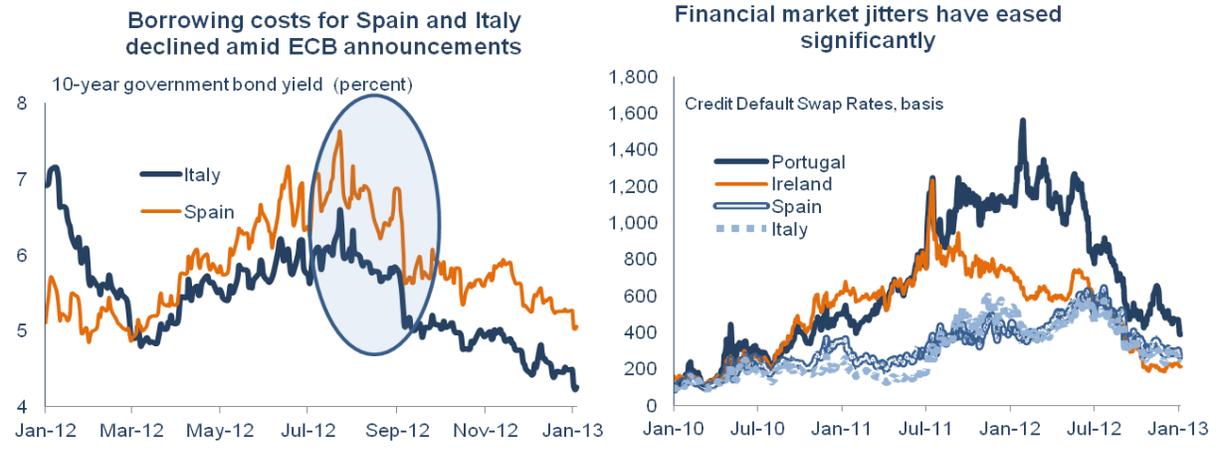
Market concerns were significantly eased when ECB President Draghi delivered a forceful speech in London on July 26th, in which he emphasized that “the ECB is ready to do whatever it takes to preserve the euro. And believe me, it will be enough.” This was followed by a decision at the ECB Council meeting on September 6th to introduce a new facility for Outright Monetary Transactions (OMT). The promise and follow-through actions managed to calm the markets and led to a significant rebound in key markets. Most significantly, 10-year sovereign yields in Spain and Italy fell by 148 and 146 basis points since late-July to 5.27 percent and 4.49 percent in December, respectively (box figure FIN 1.1). Equity markets have also responded very positively, with key Spanish and Italian equity indices up by 23.4 percent and 19.7 percent, respectively since July 27th.

In addition to the ECB’s actions, some other positive developments in September have helped to further improvement in the global financial markets. The German Constitutional Court recognized the legality of the European Stability Mechanism (ESM), thus paving the way for the ESM to begin operations in October. This was crucial as the ECB’s OMT will operate alongside a precautionary ESM facility. The Dutch election produced a solid vote for centrist pro-euro parties. Finally, there has been some early movement in a key institutional reform: the European Commission’s proposal to establish a single bank supervision mechanism for Euro Area banks.

By the end of November, the Troika and the Greek government agreed on a package of measures including a reduction in rates on bailout loans, suspension of interest payments for a decade. In December, the Greek government completed a debt buyback program from its private sector creditors in an effort to cut the country’s public debt level. The country was also cleared to receive a €34.4 billion loan installment in December 2012.

Considerable uncertainties still remain, however. First, markets have already priced in OMT support, though the specifics remain to be worked out. Second, the ambitious plans and timetable for the establishment of single bank supervision mechanism have already raised some tensions both within the Euro Area and between EU governments and outside the Euro Area.

Box figure FIN 1.1



Source: Bloomberg.

the past few years (figure FIN.3). After rebounding during the first quarter, flows fell by about 30 and 40 percent in May-June following the heightened uncertainty related with the Euro-area debt crisis. Nevertheless, flows have rebounded since July—

the easing of flows in August reflecting a normal seasonal lull—as the ECB measures reduced the perceived probability of an acute Euro-area crisis and monetary-easing by Federal Reserve and Japan Central Bank increased global liquidity. With the

highest monthly flows since 2007 in September and robust flows since then, gross flows totaled \$530 billion, recording a 17 percent increase compared to 2011.

Bond issuance by developing countries reached a historic high in 2012 at \$257 billion, almost 50 percent higher than last year's strong flows. Issuances in September (\$32.2 billion) was the highest monthly issuances by developing countries on record followed by around \$30 billion issuances both in October and November. While corporate issuers from Brazil, Russia, Mexico, and China in financial and oil & gas sectors continued to dominate the market, there were also several sovereigns and developing country corporate borrowers that came to the market for the first time—attracted by low borrowing costs due to unprecedented global liquidity and investors' intense search for yield. Bond emissions have also been boosted by the relative weakness of bank-lending and volatility in equity markets (box FIN.2: The changing landscape of international debt markets), both symptoms of the financial turmoil of the past few years.

Equity issuance by developing countries was also weak in most part of 2012 as companies stayed away from initial public offerings (IPO) due to volatility in equity markets. Nevertheless the issuance has picked slightly since

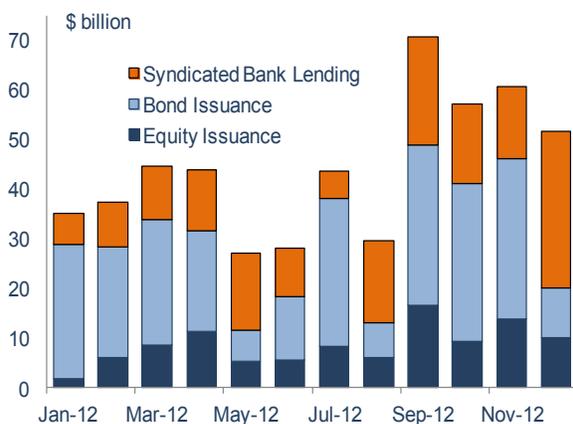
September. The over-subscribed equity placement by Russia's Sberbank for \$5.2 billion in September was followed by few large deals by companies from China, Russia and Turkey in November and December. As a result, total equity issuance totaled \$103.4 billion in 2012, 17 percent higher than 2011.

In contrast to bond and equity issuance, syndicated bank lending to developing countries remained subdued this year at \$169.5 billion recording a 12.4 percent decline compared to last year. While it is difficult to disentangle effects, deleveraging by high-income country banks and the low cost of bonds are among the factors behind these low flows. However, bank-lending has also shown some tentative signs of recovery in recent months perhaps reflecting less intense Euro Area deleveraging. Syndicated bank lending to developing countries between September and December was the higher than like periods in 2010 and 2011.

Foreign direct investment inflows to developing countries fell slightly during the first half of 2012 following the heightened uncertainty in earlier months

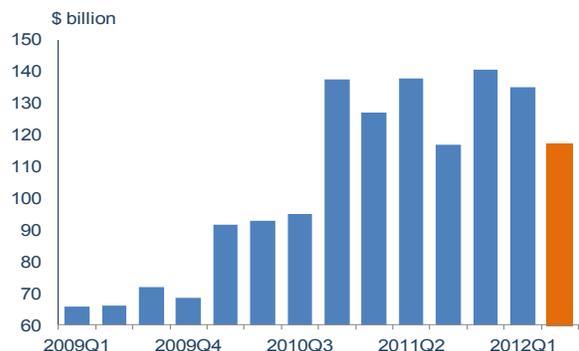
Foreign direct investment (FDI) inflows to developing countries declined by 5% (year-over-year) during the first half of the year following the increased uncertainty in the global financial

Figure FIN.3 September marked the highest monthly flows since 2007



Source: Dealogic and World Bank.

Figure FIN.4. FDI inflows to developing countries slowed down in 2012



Note: Countries include Brazil, Bulgaria, Chile, China, India, Indonesia, Kazakhstan, Latvia, Lithuania, Malaysia, Mexico, Peru, Romania, Russia, Serbia, South Africa, Thailand, Turkey, Ukraine and Venezuela.

Source: World Bank estimates based on data from Central Banks.

markets due to Euro-zone problems in late 2011 (figure FIN.4). The decline in actual flows was much less acute than the 20 percent suggested by high-frequency cross-border mergers and acquisitions and green-field investment data. The relative resilience of overall FDI, likely reflects more stable re-invested earnings and intra-company loans.

FDI performance during the first half of the year varied across regions. Flows were very weak for most Eastern European countries including Russia, Latvia, Lithuania, and Serbia as these countries continued to be affected by the economic weakness in high-income Europe. With the exception of Thailand and Philippines, FDI inflows to most East Asian economies also declined. In contrast, FDI inflows increased in almost all Latin American countries supported by high commodity prices and increased investment from the United States, especially to Argentina and Colombia.

Mixed FDI performance is expected to have continued in the second half of the year. The favorable financial conditions since July have encouraged cross-border acquisitions in some developing countries. Flows to Latin America are expected to be strong in the second half as the Belgian beer company AB InBEv's mega buy-out of Mexico's Mexican beer maker Grupo Modelo for \$20.1 billion is fully reflected in the data. At the same time, several countries in emerging Europe including Russia, and Turkey have announced plans to accelerate privatization efforts. That said, there have already been few postponements and less successful sales in Russia's banking sector since Russia's successful sale of a stake in Sberbank—one of its largest banks—in September, suggesting that investor appetite might be still limited for these assets. In addition, inflows to large middle income countries such as China and India are expected to decline this year. China is experiencing structural adjustments in their FDI flows, including the relocation of labor-intensive and low-end market-oriented FDI to neighboring countries. Slow growth and some regulatory uncertainties held back the investment flows to India. As result, FDI inflows for the whole year

are expected to fall around 6 percent to \$600 billion.

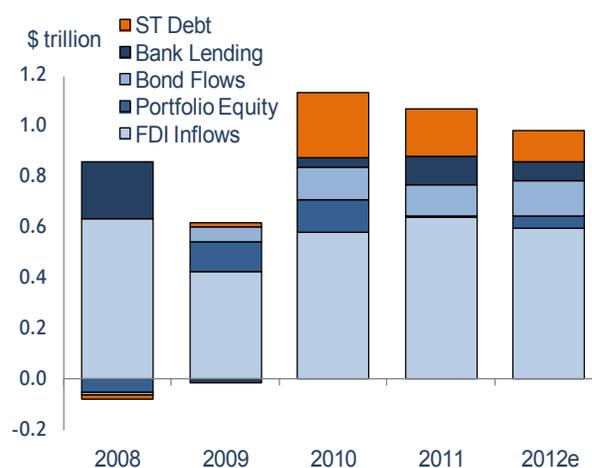
International capital flows in 2012

Net private capital inflows (earlier data referred to gross flows) to developing countries are estimated to have declined to \$0.99 trillion (4.1 percent of GDP) in 2012 from \$1.1 trillion (4.7 percent of GDP) in 2011 (figure FIN.5). Despite the volatility in market sentiment throughout the year, significant progress in Euro Area crisis response followed by monetary easing by the high-income economies ceased the downward trend in capital inflows to developing countries toward the middle of the year. Nevertheless with exception of net bond and portfolio equity inflows, all other flows marked a decline. The largest drop was in net bank lending (disbursement minus repayments). Net bank lending with both types of maturities (short- and medium & long term) declined by 33 percent. The fall in short-term flows partly reflects slower trade growth and reduced demand for trade finance.

Deleveraging by international banks cut into acquisition and trade finance

The 2008/9 financial crisis has put significant deleveraging pressures on global banking system. Banks have been forced to cut their loan

Figure FIN.5 Net private capital inflows fell in 2012



Source: World Bank.

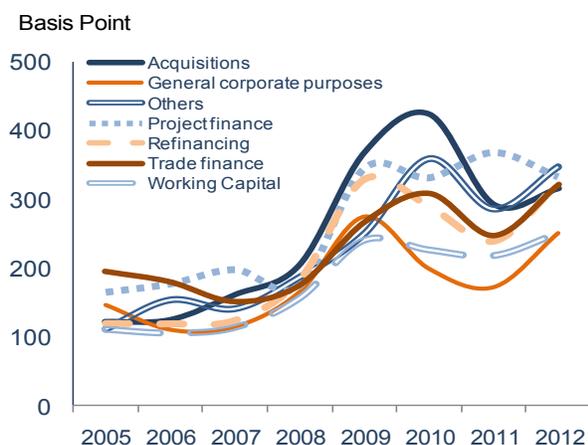
portfolios to offset balance sheets losses from loan and capital losses. The pressures have been particularly strong among high-income European banks as faltering growth prospects and debt problems undermined the value of their sovereign and other assets. Funding conditions were exacerbated toward the end of 2011, when new regulations tightened capital ratio requirements and increased dollar liquidity constraints. Deleveraging was achieved through a combination of reduced lending, sales of non-strategic assets, and exit from riskier businesses subject to tighter capital buffer requirements. High-income bank deleveraging and tightened credit standards cut directly into capital flows to developing countries—most notably those countries and regions with close ties to European banks.

Since 2008 spreads on all types of loans widened sharply from a range of 100 to 150 bps to a range 250 to 350 bps (figure FIN.6). Despite the sharp increase in spreads, borrowing cost actually declined because of the sharp compression in the underlying pricing benchmark six-month Libor rate (box figure FIN 2.2). Most of the reduction in syndicated bank lending to developing countries concerned loans for acquisitions purposes (figure FIN.7). Acquisition loans are usually given to a company to buy specific assets and are typically used of short-term tenor. Some of the 70 percent

fall likely reflects a decline in demand for loans due to weak economic activity and the cancelation or postponement of expansion plans given increased economic uncertainty. Such loans fell most sharply in Europe and Central Asia (93 percent)—the developing region hardest hit by the crisis, and Latin America (73 percent) a region with close ties to the European banking system. Loans to South Asia were broadly stable.

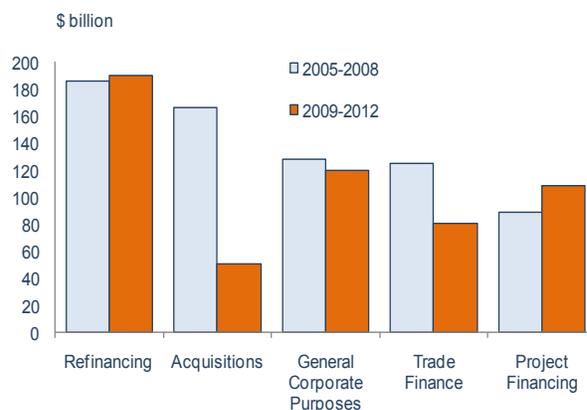
Syndicated lending for trade finance purposes was also considerably affected with a 35 percent fall compared to its pre-crisis levels. The decline mostly reflects retrenchment by the European banks that played a pivotal role in global trade finance provision. In addition to their need to rebuild their capital stock, dollar funding challenges of European banks constrained their ability to fund trade activity. Most of the trade transaction settlements are made in US dollars, and European banks suffered from limited access to dollar funding during the second half of 2011 after US money market funds withdrew some of their investment as the European debt crisis. Trade related funding shortfalls were sharpest for Sub-Saharan Africa (70 percent) and European countries (50 percent), followed by Latin America and Middle East and North Africa (25 percent). Anecdotal evidence suggests that other international lenders (mainly Asian financial institutions such as Japanese banks)

Figure FIN.6 Spreads on bank-loans widened sharply



Source: Dealogic and World Bank.

Figure FIN.7 Funding for acquisitions and trade finance declined



Source: Dealogic and World Bank.

Box FIN 2. The changing landscape of international debt markets: rising bond issuance amid declining bank-lending

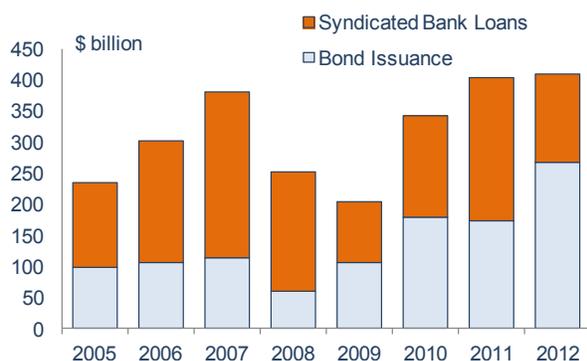
Historically, the majority of developing countries relied more on bank credit rather than bond financing for their external financing needs as cross-border bank lending tended to be cheaper, and developing higher-risk developing countries had better access to bank lending. Information asymmetry plays an important role in differences between bank and bond financing in terms of access and cost. Banks have closer customer relationships with borrowers than bondholders and therefore have an advantage in monitoring creditworthiness – which has traditionally resulted in lower costs. Otherwise high risk borrowers might get access to bank lending, if projects were backed by well-defined revenue streams based on natural resource etc. Another impediment to bond lending were the institutional and legal benchmarks (sovereign credit ratings, etc) required by bond holders. As a result, higher-risk borrowers including some sovereigns, companies rated sub-investment grade and most low-income countries tended to have access only to bank financing.

Since the 2009 financial crisis, bond financing has played an increasingly important role in international debt flows to developing countries. The injection of liquidity into global financial markets, quantitative easing efforts of high-income central banks, continued improvement in developing-country credit quality (both in absolute and relative terms) have made the conditions for bond financing more favorable for developing countries. As a result, developing countries have issued increasing quantities of international bonds. Total bond issuance by developing countries reached \$724 billion during the 2009-2012 period compared with \$374 billion during the boom years of 2005-2008 (box figure FIN 2.1). These improvements as syndicated bank lending to developing countries fell to \$632 billion during 2009-2012 compared with \$793 billion during 2005-2008. While many factors were at play, deleveraging pressures as well as tighter regulations contributed to the contraction in international bank-lending. As a result, international bond issuance now accounts for more than half of the international debt flows to developing countries since 2009, compared to less than one-third between 2005 and 2008.

Declining cost and improved access have contributed to the increased bond flows in recent years. Cost of borrowing through international bond issuance has declined considerably over time with the exception of the spike in November 2008 just after the crisis. Average cost of bond financing (proxied by 10-year U.S. Treasury bond yield + EMBIG cash bond spread) has fallen to a record low level of 460 bps in November 2012 from 680 bps in January 2010. Most of the reduction in cost was due to the fall in benchmark 10-year U.S. Treasury bond yield while the very low policy rates and quantitative easing in high-income countries have kept the price of risk and spreads low for developing countries (Hartelius et al 2008). While cost of bond-financing remains higher than bank-loan, the cost difference between bond and syndicated bank loans (the underlying pricing benchmark, usually the six-month Libor rate + average spread) has also narrowed (box figure FIN 2.2). With the comparable costs, many large developing country companies relied on bond financing as a substitute for declining bank-lending.

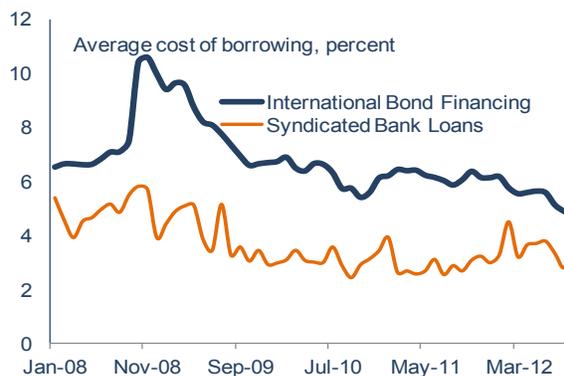
Also, unprecedented investor demand—supported by G3 monetary easing and increased search for yield— has enabled frontier-market and infrequent issuers to tap the international bond market in recent years, especially during the second half of 2012. For example, Angola and Zambia for the first time ever and Bolivia in 90 years issued sovereign bonds. Others governments such as Kenya, Paraguay, Rwanda, Tanzania, and Uganda, as well as numerous companies with sub-investment grade credit ratings are preparing to issue bonds for the first time in coming months.

Box figure FIN 2.1 Increasing bond flows amid declining bank lending



Source: Dealogic and World Bank.

Box figure FIN 2.2 The difference in cost of bond financing and bank-lending narrowed



Source: Dealogic and World Bank.

and domestic banks (mostly in Latin America) filled the funding gap in their corresponding regions. The WBG has increased its support to trade finance in low income countries, through the IFC’s Global Trade Finance Program, and a program to support commodity traders from low income countries.

Despite the decline in total loans, average maturity for all types of syndicated bank loans remained at their pre-crisis levels, around five to six years. Even for project finance which tends to be funded by longer-term loans—maturities have remained more or less stable at around 9 years since 2005.

One cautionary factor, however, is the increased concentration of bank loans since 2009. Investment grade borrowers accounted for 80 percent of bank loans since 2009, up sharply from 72 percent during 2005-2008. Increased bias toward investment grade borrowers might partly reflect preparation for the upcoming regulatory changes. For example, some banks soon will start operating under Basel III with a range of provisions and tightening of conditions (box FIN.3: Deleveraging in banking sector). These banks may have been adjusting their balance sheets in response to the enhanced recognition of counterparty risk and an increase in risk-weight of certain lines of business. There are concerns that some of the provisions under Basel III may exacerbate further deleveraging and increase the borrowing costs for trade finance and project finance.

Even without the burden of additional regulatory measures, the cost of borrowing for both bond and bank financing will increase in the medium term when developed countries start monetary tightening as low benchmark rates have kept the costs down especially after the crisis.

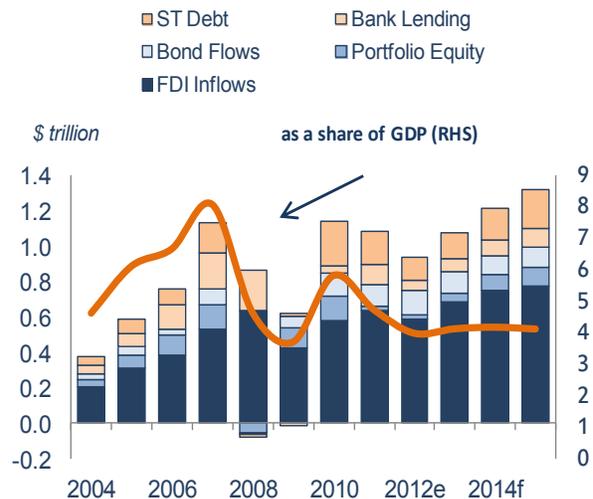
Prospects: Going up but might be a bumpy ride...

Medium-term prospects for capital flows to developing countries are for continued modest increases (as a share of recipient GDP). With more upgrades than downgrades market

assessment of the credit quality this year, the risk profile of developing countries continued to improve compared with high-income countries which experienced further deterioration in 2012—suggesting that they will continue to attract a growing share of international capital flows.^{FN1} Despite the weak growth environment, developing countries are expected to grow between five to six percent in coming years more than twice as fast as high-income countries. Flows are also likely to be attracted by these higher growth prospects and risk-adjusted interest rates (despite the recent easing of monetary policy in many developing economies, interest rates in these economies are expected to remain higher than in rich countries).

Under the baseline scenario that there will not be a major set-back in the resolution of Euro-area crisis and US fiscal challenges, and that there will be no major loss of confidence in the global financial markets, net private capital flows are projected to increase to \$1.12 trillion (4.15 percent of developing-country GDP) in 2013 and gradually reach \$1.35 trillion (4.1 percent) by 2015 (figure FIN.8, table FIN.1). Increased global liquidity and monetary accommodation in major high-income countries (the US Federal Reserve indicates its policy rate will remain low till 2014) are expected to keep high-income country interest rates low, prompting search for yield and supporting capital flows to developing

Figure FIN.8 Capital flows to developing countries



Source: World Bank.

Box FIN.3 Deleveraging in the banking sector: progress has been made but pressure to do more remains

The more comprehensive yet less-up-to date data on bank-lending (discussion in the text is on only syndicated bank lending portion) indicate that the pace of deleveraging slowed down earlier this year. Total international claims—including all cross-border and local claims in foreign currency—by Bank of International Settlements (BIS) reporting banks declined by \$616 billion (3.2 percent) in the second quarter of 2012. While the cut reversed the short-lived rebound of \$956 billion (5.2 percent) in the first quarter supported by ECB's large liquidity provision in December 2011 and February 2012, the reduction was still much lower than \$1.3 trillion (7 percent) decline in international claims in the fourth quarter of 2011. In addition, international claims on developing countries only decreased by \$8 billion during the second quarter, with all the decline coming from short-term claims (debt with an original maturity of one year or less). The fall in short-term debt—most part trade finance in developing countries—partly reflects the sharp decline in trade activities in the second quarter of the year (see the trade annex) and partly confirms the tension in trade financing market.

Several factors helped to curb the pace of deleveraging process earlier this year. An important factor is the completion of the process of meeting the capital ratio requirements by European Banking Authority (EBA) by June 2012. The deleveraging by European banks intensified in October 2011 after EBA introduced 9 percent capital ratio requirement after adjustments for sovereign risk holdings. In fact, most banks announced that they fulfilled the requirement earlier than the deadline. According to EBA's October review report, more than 75 percent of the banks reached the required capital ratio by June 2012 mostly through assets disposal and deleveraging.^{FN2} Second, extraordinary liquidity injection by the ECB LTOR operations in December 2011 and February 2012 eased the funding pressures through boosting confidence in interbank market and helped European banks to reduce their dependence on US money market funds. Several European banks were faced with dollar funding challenges during the second half of 2011 after US money market funds withdrew some of their investment as the European debt crisis escalated.

There are some indications that the slowdown of the deleveraging process has continued also later in the year. First, syndicated bank-lending to developing countries was 67 percent higher in the second half of 2012 compared to the first half of 2012. Second, the recent IIF Emerging Market Bank Lending survey indicates sharp improvement in funding conditions for 2012 Q3, for the first time since 2010 especially in Emerging Europe.

Nevertheless, deleveraging pressures on all international banks are expected to continue in medium-term with strict regulatory changes ahead. Global banks will soon start operating under Basel III with a range of provisions and tightening of conditions including higher risk-weighted capital requirements and non-risk weighted leverage ratio. While qualifying capital requirements gradually phase in through 2019, the adjustments to risk-weighted asset calculations will occur instantaneously. Most banks have been deleveraging to adjust their balance sheets in response to the enhanced recognition of counterparty risk that will lead an increase in risk-weight of certain line of business (fixed income trading businesses) and to reach capital ratios faster in response to market and regulatory pressure. Concerns have been raised about possible unintended consequences of Basel III on developing countries. According to a recent report prepared for G-20 countries, in addition to higher capital requirements some Basel III rules related with counter-party credit risk, the measurement of risk between a parent bank and its subsidiary and capital requirements for certain business activities may exacerbate deleveraging and increase the costs of global banks operating in developing countries, thereby reducing credit and financial market liquidity.^{FN3} The report also suggests Basel III rules may significantly increase the cost of trade finance and project finance, two forms of credit that are particularly important in the developing countries. The other highlighted concern is the possible home bias for banks that operate globally as a result of either the design of the reforms or the way that they are implemented in other jurisdictions.

Any change in lending strategies of international banks may have an important impact in many developing regions. As of June 2012, international claims by the BIS reporting banks were \$2.4 trillion in developing countries. The importance of these claims is still the highest for the Europe and Central Asia region (\$504 billion, 13 percent of GDP) and the Latin America region (\$632 billion, 12 percent) followed by the East Asia and Pacific region (\$855 billion, 9.5 percent). The claims in other regions are smaller but still significant with the Sub-Saharan Africa region (\$131.9 billion, 5 percent) and Middle East and North Africa (\$52 billion, 4.2 percent).

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

	2008	2009	2010	2011	2012e	2013f	2014f	2015f
Current account balance	412.9	240.5	187.5	152.1	12.6	-8.0	-65.4	-80.4
Capital inflows	812.6	701.7	1,219.1	1,112.4	1,007.2	1,134.1	1,250.9	1351.5
Private inflows, net	782.2	620.7	1,145.9	1,082.4	993.1	1,123.4	1,244.2	1348.4
<i>Equity inflows, net</i>	583.3	542.0	710.8	647.8	644.5	761.2	856.1	902.9
Net FDI inflows	636.9	427.9	582.7	638.8	600.1	693.2	756.5	782.96
Net portfolio equity inflows	-53.6	114.2	128.2	8.9	44.4	68.0	99.6	119.90
<i>Private creditors, net</i>	198.8	78.7	435.1	434.6	348.6	362.2	388.1	445.50
Bonds	-8.6	61.0	129.7	123.8	143.3	126.1	108.4	110.50
Banks	223.3	-11.9	37.2	108.2	71.5	80.6	88.9	105.10
Short-term debt flows	-17.1	17.8	257.6	189.3	126.7	146.3	180.4	220.10
Other private	1.3	11.7	10.7	13.3	7.1	9.2	10.4	9.80
Official inflows, net	30.4	81.0	73.2	30.0	14.1	10.7	6.7	3.10
World Bank	7.2	18.3	22.4	6.6	4.6			
IMF	10.8	26.8	13.8	0.5	-3.9			
Other official	12.4	35.9	36.9	22.8	13.4			
Capital outflows	-321.4	-174.5	-310.0	-320.0	-370.6	-373.4	-414.3	-463.6
FDI outflows	-211.8	-144.3	-213.9	-213.1	-238.0	-275.0	-325.0	-370.0
Portfolio equity outflows	-32.3	-75.2	-46.5	-15.9	-17.6	-19.4	-22.3	-28.6
Private debt outflows	-78.3	50.7	-57.3	-81.0	-103.0	-72.0	-61.0	-56.0
Other outflows	1.0	-5.7	7.7	-10.0	-12.0	-7.0	-6.0	-9.0
Net capital flows (inflows + outflows)	491.2	527.2	909.1	792.4	636.6	760.7	836.6	887.9
Net unidentified flows/a	-78.3	-286.7	-721.6	-640.3	-624.0	-768.7	-902.0	-968.3

Note: e = estimate, f = forecast.

/a Combination of errors and omissions, unidentified capital inflows to and outflows from developing countries.

Source: World Bank

countries in coming years. Bank lending is expected to rise gradually as intense deleveraging pressures have now eased. Nevertheless the growth in private debt flows to developing countries in the medium term will be hindered by a tightening of regulatory and a gradual policy tightening after 2014 in developed countries.

FDI inflows to developing countries are expected to increase throughout the forecast period reaching \$783 billion (2.4 percent of GDP) by 2015. Despite the considerable real-side uncertainties in the short-term, multinationals continue to be attracted to developing countries' medium-term growth prospects, large and growing consumer base, natural resources and still low labor costs. In addition, many developing countries are bringing down barriers on foreign investment. For example, following its recent WTO accession

Russia has committed to reducing restrictions on foreign investors in number of services industries. Several countries in Eastern Europe have been pursuing privatization in their services sector. Similarly, India might attract influx of investment in coming years as the cap on foreign ownership in multi-brand retail and aviation businesses has been raised comes in the backdrop of a worrisome decline this year. While China continues to be experiencing rising wages and productions costs, multinationals are investing in China to serve its rising middle income. FDI inflows to developing countries will be supported by increasing South-South flows as the capital outflows increase over the years.

FDI inflows are expected to increase also in low-income countries supported by rising South-South FDI and resource-related investments. This is particularly important as FDI is an

important source of external financing for these economies with limited or no access to other types of capital flows. In addition, the outlook for net overseas development assistance (ODA), which has been a stable source of development financing for the poor economies, looks gloomy. As discussed in detail in the finance annex of the June edition of GEP 2012, many high-income countries continue to struggle with fiscal sustainability, and it is unlikely that they will be able to meet their Monterrey targets of providing 0.7 per cent of their national income in ODA—except in a few instances.

The outlook for private capital flows is still subject to serious downside risks. First despite the recent progress towards a resolution for Euro-area debt crisis, considerable uncertainties remain related to the implementation of the ECB's announced but not-tested OMT plan; its ability to resolve the debt issues of high-spread economies; the speed of economic adjustment in high-spread countries; and the establishment of a single bank supervision mechanism. Any major set-back could lead to a renewed crisis of confidence and potentially a freezing up of financial markets. A lack of progress in dealing with the fiscal challenges in the US and Japan have similar potential to generate confidence issues. These uncertainties are likely to generate volatility on the way even if they do not get to a level to reverse the upward trend in capital flows.

Notes:

1. With 26 upgrades and 17 downgrades market assessments of the credit quality of developing countries improved in 2012. Most of the upgrades took place in Latin America, including Bolivia, Ecuador, Grenada, Panama, Paraguay, Peru, Suriname, and Uruguay. However Argentina, Belize, and El Salvador experienced downgrades. Outside Latin America, Indonesia, Turkey, and Latvia were upgraded to investment grade, while notable downgrades occurred for Belarus,

Egypt, Serbia, South Africa, Tunisia, Ukraine, and Vietnam with most downgrades occurring since September. In contrast, high-income countries' creditworthiness continued to deteriorate in 2012 amid the lingering European debt crisis, with Greece, Italy, Portugal, and Spain suffering multiple downgrades. Overall, high-income sovereigns experienced a total of 20 downgrades, with no upgrades in 2012.

2. EBA reports states that of 37 banks with initial shortfall, 24 of them have achieved the capital requirement and EBA initiated backstops only for four banks. They excluded three banks for further action since they are already going through deep structuring. Also six Greek banks are excluded since their issues are being addressed by the Greek program.
3. "Identifying the Effects of Regulatory Reforms on Emerging Market and Developing Economies: A Review of Potential Unintended Consequences" prepared for G20 Finance Ministers and Central Bank Governors by the Financial Stability Board in coordination with Staff of the International Monetary Fund and the World Bank, 19 June 2012. (http://www.financialstabilityboard.org/publications/r_120619e.pdf)

Industrial Production

Recent economic developments

The financial turmoil in high-income Europe in May and June cut sharply into economic activity worldwide. Faced with yet another round of market uncertainty, firms, and households cut back on investments and big-ticket expenditures – causing global industrial production, which had been growing at a 5.9 percent annualized pace in the first quarter of 2012, to remain broadly flat in the second quarter. Although industrial activity in both developing and developed economies slowed, the deceleration was more marked in developing countries (from 11.1 to 1.5 percent) than in high-income countries where output contracted at an 1.1 percent annualized rate, following a muted expansion in the first quarter.

The sharp decline of industrial activity in developing countries during the second quarter reflected a series of factors, including: a pre-existing policy-induced slowdown in several middle-income countries (Brazil, China, India, Turkey, among others) that had reached capacity constraints; a slowing in the East Asia and Pacific region from an unsustainable pace, as activity rebounded following the Tohoku Tsunami and flooding in Thailand; and perhaps most importantly an increase in precautionary savings as the increased turmoil in Europe sparked concerns about future demand levels and the possibility of a major crisis (box IP.1).

Industrial activity in developing countries is now strengthening, but industrial activity has weakened further in high income countries

Since then the pace of activity developing countries has picked up, but growth in high-income countries appears to be weakening again (table IP.1). Overall, global industrial production rose at an 0.1 percent annualized pace during the third quarter of 2012, but data for November suggest a return to contraction in the fourth quarter, mainly reflecting declining output in

high-income countries. The weakening in overall activity comes despite a strengthening of growth in the developing countries that is equally robust in China and other developing regions.

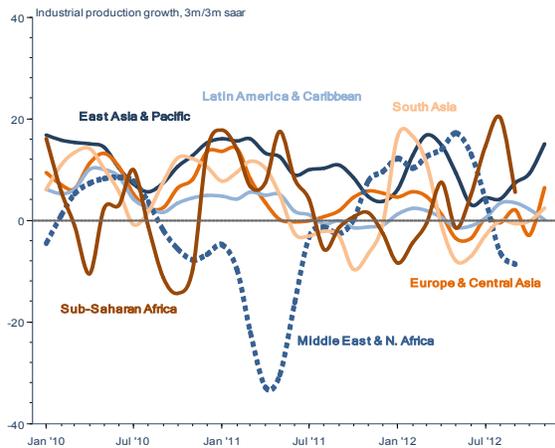
Industrial production in high income countries fell at a 5.9 percent annualized pace in the three months ending in November. A sharp drop in activity in Japan, by an annualized 18 percent in the three months ending in November, reflects an end to post-crisis auto purchase incentives on the one hand, and a decline in exports to China due to tensions over the sovereignty of islands in the region. U.S. weakness appears to reflect the impact of uncertainty about the future conduct of fiscal policy, as it mainly reflects falling investment expenditures, while consumer demand has remained relatively robust with a rebound in the housing market. Euro Area weakness, which has spread from high-spread economies to Germany and France likely reflects weaker external demand for capital goods as well as a reaction to recent policy changes. Industrial production in the Euro Area declined at an 7.1 percent annualized pace during the three months ending November 2012, with output in Germany and France falling 9.2 percent and 7.2 percent (3m/3m saar).

Table IP.1 Industrial production is recovering in most developing regions

	2011Q4	2012Q1	2012Q2	2012Q3	2012Nov
World	1.3	5.9	-0.1	0.1	-0.4
High-income	0.5	2.8	-1.1	-2.7	-5.9
United States	5.1	5.9	2.4	0.3	-1.4
Japan	1.7	5.1	-7.7	-15.8	-18.5
Euro Area	-5.6	-2.6	-1.8	0.5	-7.6
Other high-income	1.4	3.7	-0.6	-2.3	-2.9
Developing	2.6	11.1	1.5	4.6	8.6
East-Asia & Pacific	3.7	16.8	3.1	7.3	15.0
Europe & Central Asia	5.3	4.6	-3.6	2.0	6.4
Latin America & Carriibbean	-1.0	1.9	-1.1	3.4	0.1
Middle-East & North Africa	9.6	12.6	13.1	-8.7	..
South Asia	-0.7	11.2	-7.1	-0.7	2.4
Sub-Saharan Africa	-2.6	-0.6	5.0	5.5	..

Source: World Bank.

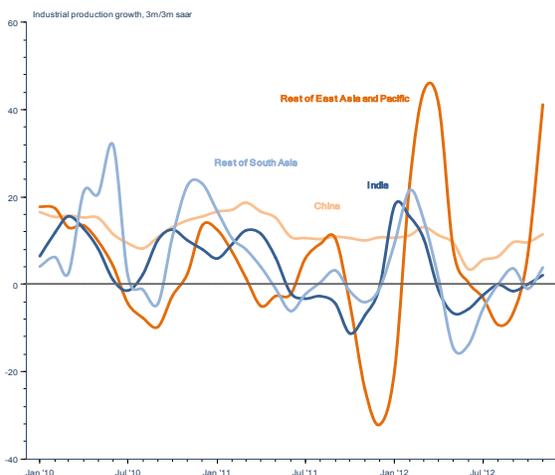
Figure IP.1 Developing-country industrial output growth has accelerated since July



Source: Datastream, World Bank.

Despite the weakness in high income countries, available data for November suggests that industrial activity in the developing countries is strengthening. Developing countries' industrial production grew at an 8.6 percent annualized pace in the three months ending November. Industrial production growth improved across most developing regions, with the exceptions of Latin America and the Caribbean, and the Middle East and North Africa (figure IP.1). In East Asia and Pacific, industrial production has accelerated sharply and is growing at a 11.5 annualized pace in China during the three

Figure IP.2 Industrial output is bouncing back in Asia

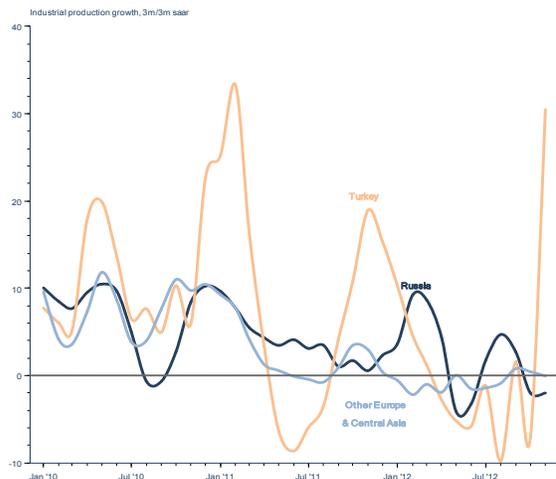


Source: World Bank, Datastream.

months ending November, and by 41.2 percent (saar) through November in the remaining countries in the region (figure IP.2). Notwithstanding weakening external demand, Chinese GDP growth picked up after the first quarter to an 9.1 percent annualized pace in Q3 (q/q saar), in part due to robust growth among services sectors reflecting a gradual reorientation of the economy towards domestic demand. A sharp acceleration in Indonesia, Malaysia, Philippines, and Thailand reflects robust domestic demand supported by accommodative policies, tight production and trade linkages with China (Chinese imports rose at an 12.5 percent annualized pace in the three months ending in November), and a surge in exports towards newly industrialized economies (NIEs) in the region that experienced a rebound during the last quarter of 2012.

South Asia's industrial production contracted at an 7.1 percent annualized pace in the second quarter of 2012, partly due to domestic difficulties and a decline in export demand. But industrial output stabilized in the third quarter, and has picked up in Q4—regional industrial production expanded at a 2.4 percent annualized pace in the three months ending in November, with industrial output in India growing at a 2.1 percent annualized pace. In Pakistan, notwithstanding domestic security problems and electricity shortages, industrial output picked up

Figure IP.3 Activity in Europe & Central Asia is mixed



Source: World Bank, Datastream.

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

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

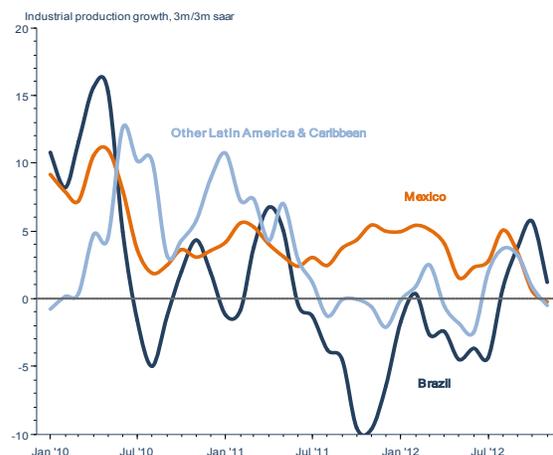
Despite the severe supply chain shocks that disrupted activity in East Asia and Pacific in 2011 (Japanese earthquake and tsunami, severe and prolonged flooding in Thailand), industrial output there is currently 1.9 percent above the level consistent with long-term trends (table IP.1). In Latin America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

to an 12 percent annualized pace in the three months ending in November, mainly due to robust growth of textile exports.

In Europe and Central Asia, industrial production picked up sharply to a 6.4 percent annualized pace in the three months ending in November 2012 (figure IP.3). The rebound in regional production was mainly due a sharp upturn in Turkey, where industrial output grew at a 30.5 percent annualized pace in the three months ending in November, helped by an expansion in exports to non-European economies, and partly due to extra working days in November from a shift in timing of religious holidays (Industrial output in November was 11.3 percent higher from a year earlier). Industrial production also rose in Lithuania at a 26.3 percent annualized pace (rebounding from a closure of the main refinery) and at a 6.9 percent annualized pace in Kazakhstan in the three months ending November. In other countries in the region, however, industrial output was still declining through November, reflecting mainly a downturn in the Euro Area, the region's largest trade partner. Industrial production contracted sharply in Bulgaria (by an annualized 13.1%), Ukraine (8.6% annualized), Latvia (3.7% annualized), and more modestly in Russia (2% annualized) and Serbia (1.2 percent annualized) in the three months ending in November.

In Latin America, industrial production growth appears to have slowed in the fourth quarter, decelerating to an 0.1 percent annualized pace in the three months ending in November from 3.4 percent annualized growth in the third quarter. After strengthening during Q3, industrial production growth is weakening again in several countries. For example, Mexican industrial production growth held up relatively well during most of calendar 2012, but fell at a 0.2 percent annualized pace in the three months to November — in line with the weakening US industrial sector (figure IP.4). Brazil's industrial production rebounded from a 3.7 annualized drop in the second quarter to an 3.8 percent annualized increase in the third quarter

Figure IP.4 A rebound in Latin America & the Caribbean



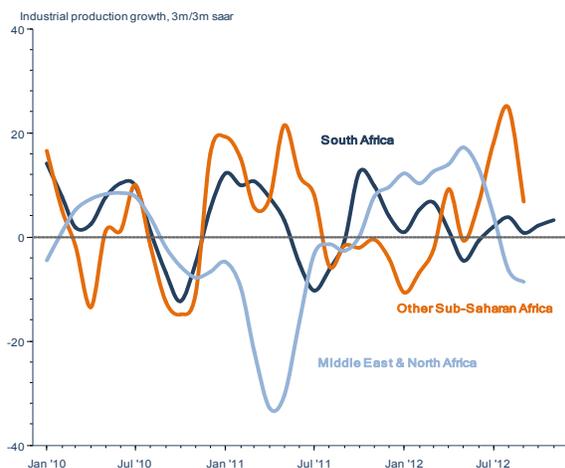
Source: World Bank, Datastream.

(notwithstanding weak GDP growth in Q3). But by November, industrial production growth had slowed to a 1.2 percent annualized pace. And in the rest of the region, industrial production was declining at a 0.6 percent annualized pace in the three months to November.

Data for Sub-Saharan Africa and the Middle East and North Africa regions has a two month lag with respect to other regions, with a few exceptions within the two regions (figure IP.5). Activity in South Africa, the Sub-Saharan Africa region’s largest economy, was influenced by labor unrests, with industrial production growing at a modest 0.8 percent annualized pace during the third quarter. But industrial production growth subsequently picked up to an 3.2 percent annualized pace in the three months ending in November. In other Sub-Saharan African countries where monthly industrial production data are available, industrial production was growing at a robust 6.7 percent annualized pace in the third quarter, despite a mid-year slowdown in several oil exporters (Angola, Nigeria and Gabon).

Data through the third quarter for the Middle-East and North Africa region suggest that the rebound in activity in the first half of 2012 following an easing of political-turmoil may be giving way to additional renewed disruptions, with industrial output declining at an 8.7 percent

Figure IP.5 Data in the Middle-East & North Africa lags



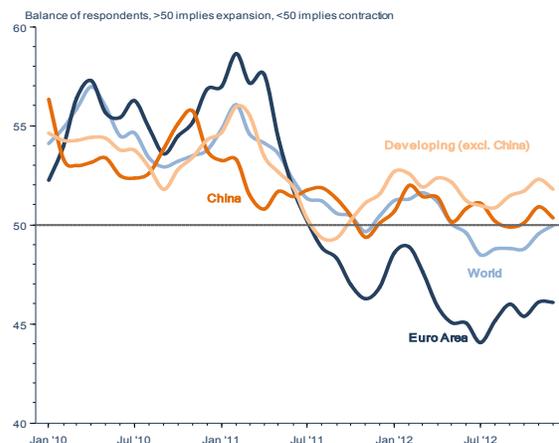
Source: World Bank, Datastream.

annualized pace in Q3—with a larger 9.8 percent decline among developing oil-importers as these countries grapple with ongoing domestic uncertainty and an adverse external environment. Egypt recorded an 18 percent annualized decline in the three month to October, while production in Jordan and Morocco rose at a modest 3 percent annualized pace in the three months to September. Industrial output in developing oil exporters in the Middle East and North Africa also fell, declining at an 8.2 percent annualized pace in the third quarter, as strong production growth in Iraq and Libya was offset by declines in oil output in Iran (as a result of international sanctions) and in Syria (due to civil conflict).

Growth is expected to pick up in early 2013

A pick-up in global retail sales recently has helped inventory adjustments and lays the foundation for stronger industrial sector performance in the early months of 2013. Developing country business sentiment in manufacturing improved in the fourth quarter, with the official Purchasing Manager Index (PMI) for China reaching 50.6 and the Markit PMIs outside of China reaching 51.8 in December — indicating a majority of developing country firms see output expanding (figure IP.6). In the United States, sentiment has held broadly steady in the positive range, with the Markit index picking up to a 6-month high in

Figure IP.6 Business confidence in developing countries remains robust



Source: World Bank, Datastream.

December. A strengthening US housing market, robust business sentiment, and a decline in unemployment signal an underlying recovery, notwithstanding the weak industrial output and risks related to US fiscal policy. In the Euro Area, business sentiment has become significantly less negative. However, it remains extremely low — indeed much lower than actual industrial production data would seem to suggest. Elsewhere, business sentiment has risen in high-income countries outside of the Euro Area, reflecting strengthening external demand. However, business sentiment in Japan continues to remain very low, indicating continued worsening of output and orders, in part reflecting a sharp decline in orders from China.

Risks and vulnerabilities

For countries tightly linked to the U.S. a main downside risk is that of a protracted fiscal impasse related to the US debt limit, as it would result in a sharp weakening in domestic demand in the U.S. Mexico is particularly vulnerable as close to 80 percent of its exports are destined for the U.S.

A sharp deterioration in conditions in Europe, the U.S. or China would likely produce large confidence effects for developing countries that could cause demand for industrial imports, and for capital goods in particular, to decline. Even a more moderate slowdown in China could have significant impacts on the East Asian economies that are integrated with the Chinese supply chain.

Inflation

Global inflation was relatively stable in 2012

Globally, inflation is broadly under control, with consumer prices rising at a 3.9 percent annualized rate at the end of 2012. The experience of countries at different income levels over the past year has been diverse, however (figure INF.1). Inflation dropped dramatically in low-income countries (LICs), with falling food and fuel-price inflation driving declines (figure INF. 2). In contrast, inflation was broadly stable in middle-income countries (MICs) and high-income countries (HICs) through 2012, though with a mid-year dip in HICs and an easing in the last quarter of 2012 in MICs.

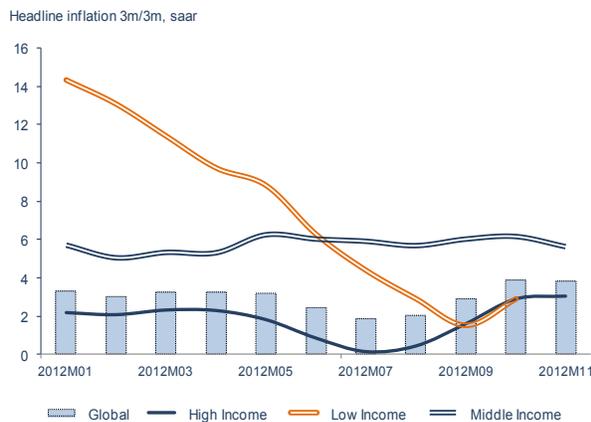
For developing countries as a whole, inflation moderated to a 5.1 percent annualized rate in the three months through December 2012 (saar), from an average 7.2 percent in 2011. By the end of 2012, headline inflation was under 6 percent in 80 percent of the developing countries for which the World Bank collects data. Year-over-year inflation of more than 14 percent was observed in only ten developing countries as of

November 2012: Belarus (30%), Burundi (14.3%), Eritrea (13.5%), Ethiopia (26%), Iran (30%), Malawi (30%), South Sudan (41%), Sudan (46%), Syria (40%), and Venezuela (18%), reflecting disrupted supplies due to political turmoil in some countries and large macroeconomic imbalances in the others.

Looking ahead, inflation is expected to average 3.5-4 percent in 2013 for the world as a whole and 6.3 percent in developing countries, somewhat higher than in 2012, although the outlook is subject to both upside and downside risks. A worsening in global growth due to an intensification of the Euro Area sovereign debt crisis, an extended fiscal policy impasse in the United States, or faster-than-expected unwinding of Chinese investment could all translate into an easing in price pressures. On the upside, supply shocks in food or fuel markets could intensify price pressures — especially in low-income countries, where the weight of these commodities in the CPI basket is high.

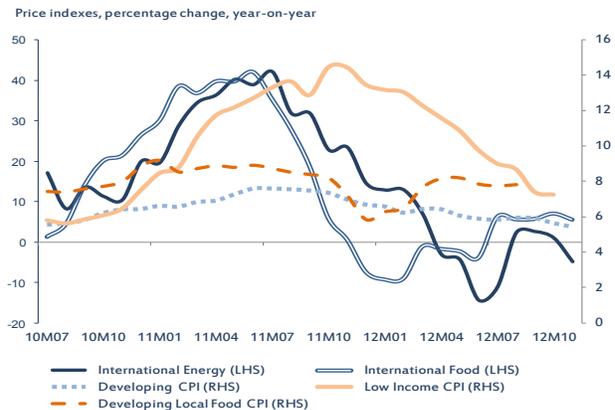
In low-income countries, inflation momentum (the quarterly seasonally adjusted inflation rate expressed at annual rates) dropped considerably over the past year, from an average of 14 percent

Figure INF.1 Reflecting weak economic activity, price pressures remained subdued in 2012 and declined considerably in low-income countries



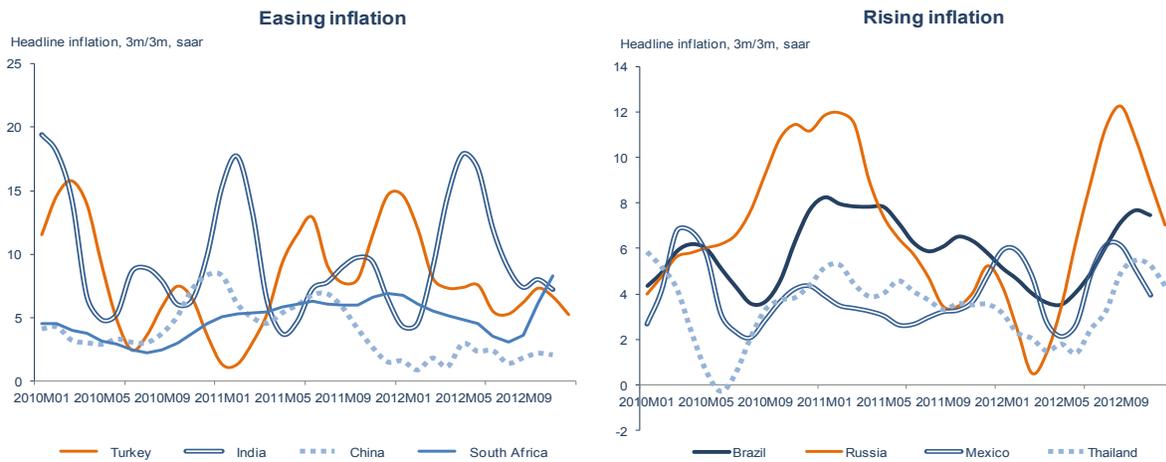
Source: World Bank and Datastream.

Figure INF.2 Low-income country inflation eased on moderating international commodity prices despite limited pass-through of international food prices to local food prices



Source: World Bank and ILO.

Figure INF.3 Flat overall inflation in middle-income countries reflects diverging trends in major economies



Source: World Bank and Datastream.

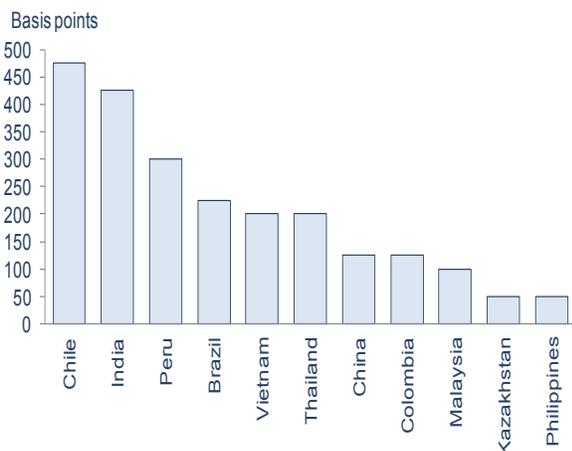
in 2011 to all time low 1.6 percent in the three months through September 2012 before starting an upward trend in the last quarter of 2012. The steep easing reflected the combined effect of a stabilization of local food prices after the 2011 drought-related price hikes, policy tightening, and the easing of fuel and food supply disruptions during episodes of political turmoil in the Middle East and parts of Sub-Saharan Africa.

Though middle-income countries as a group faced generally stable inflation in 2012, with an

easing in the last quarter of 2012, the aggregate reflects diverging trends in major middle-income

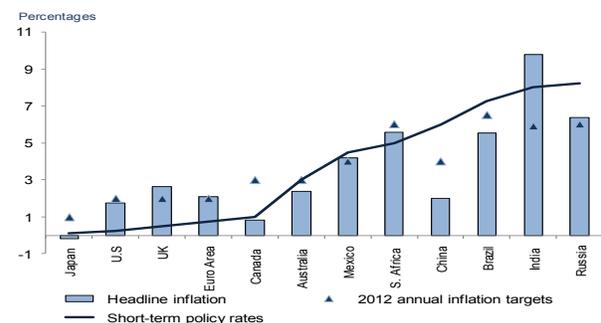
economies (figure INF.3). In China and Turkey, 3m/3m headline inflation eased through much of 2012, while India, experienced a declining inflation momentum during the second half of the year. The easing of inflation observed in 2012 in the middle-income countries followed policy tightening that was undertaken in 2010 and 2011 to address overheating pressures (figure INF. 4). In other major middle-income countries, on the other hand, such as Brazil and Russia, 3m/3m headline inflation rose during

Figure INF.4 Policy rates were tightened substantially over 2010-2011 in some middle-income countries



Source: World Bank and Datastream.

Figure INF.5 Spreads between high-income and middle-income country policy rates, inflation targets and inflation



Notes: Upper band where appropriate. Historical (2001-2011) average wholesale price index inflation is used as a proxy for inflation target in India. Inflation data as of November 2012 unless indicated otherwise. September inflation data for Australia.

Source: World Bank and Central Bank rates.

much of 2012, though with an easing in the last quarter of 2012.

Headline inflation remained high in India and close to or above the central bank inflation targets in Brazil, Mexico, Russia, South Africa and Turkey, despite moderating growth and relatively high nominal policy rates (figure INF.5). Inflation in these countries appears to have been building partly on account of supply bottlenecks, suggesting that despite slower growth, these countries may remain supply constrained such that instead of generating additional output, demand may contribute to overheating.

Food price pressures were also a contributing factor in keeping prices high in 2012 in a number of the countries shown in figure INF.5, including Brazil (maize price hike, together with a bounce back in activity following flooding in the early part of the year), Mexico (maize price hike), India (poor monsoon) and Russia (poor wheat crop). The last quarter of 2012 brought a moderation in inflation momentum in India, Mexico, Russia and Turkey, reflecting a decline in food and fuel prices, tight monetary policies and currency appreciation.

In general, economic growth accelerated or remained robust and inflationary pressures did not escalate in middle-income countries that were able to implement effective counter-cyclical fiscal and monetary policies and which continued to effectively move toward more flexible exchange rate policies and capitalize on trade openness (including China, Chile, Colombia, Peru, and the Philippines).

Among high-income countries, the decline in inflation in the first half of 2012 reflected continued weak economic activity and an escalation of troubles within the Euro Area, but also high unemployment and softening commodity prices. Inflation in high-income countries bottomed out in three months through July, at 0.15 percent, before rising to 3.1 percent in the three months through November (versus an average of 2.9 percent for 2011), following resolute policy actions undertaken by G3

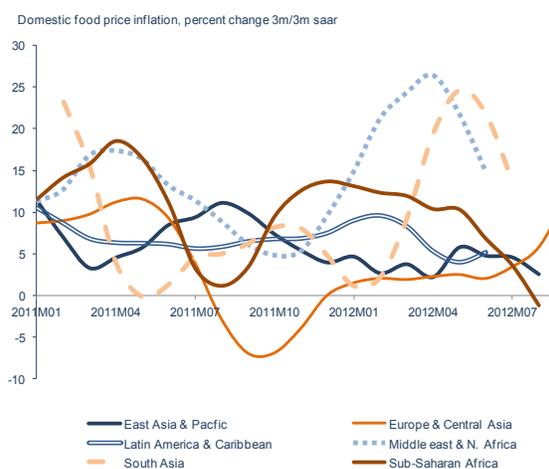
countries, which stabilized the markets, resumed consumer confidence and helped to revive global economic activity.

Declining food prices were a major driver of moderating inflation in low-income countries

Local food price inflation trends in developing regions were mixed during the 2012, with EAP remaining roughly stable, some regions (LAC and SSA) showing price moderation, particularly during the first half of 2012, SAR and MENA experiencing large declines in food prices in the second half of 2012, and food prices accelerating in ECA in the second half of 2012 (figure INF.6).

A mid-year pickup in international grain prices caused temporary headline inflation spikes in ECA and LAC (more recent local food price data are not available but headline inflation in various regions is discussed in the subsequent regional sections of this Annex). By October 2012, headline inflation in the majority of developing countries, including in ECA and LAC, had stabilized, with the food price decline representing a major contributor into this universal price easing trend. For low-income countries as a group, lower food price inflation was also a major factor behind the decline in headline inflation in 2012.

Figure INF.6 Food price inflation eased through June picking up in Q3 particularly in ECA

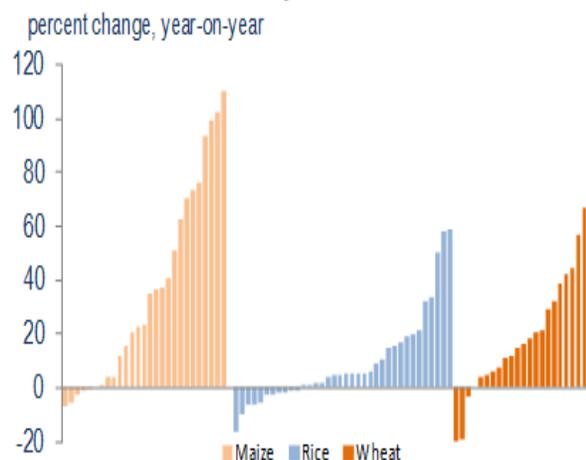


Source: World Bank and ILO.

Notwithstanding the slowing of food price inflation in some developing regions, median local grain prices are up 24 percent year-on-year in real terms in developing countries, according to the United Nations Food and Agriculture Organization (FAO). The median increase in real local currency maize price was 35 percent, while for wheat prices it was 15 percent. Real local currency grain (maize, rice, and wheat) prices were up (year-on-year) in 80 percent of developing countries for which the FAO collects data, and these higher costs, as discussed in the main text, are creating affordability issues for poor households in many developing countries. Developing countries in East and Southern Africa and Latin America saw some of the sharpest increases, with some of these countries heavily dependent on imports. Less than one in five countries reported year-on-year declines in food prices, mostly for rice (figure INF.7).

Despite increase in grain prices, high food and fuel prices which prevailed earlier and drove inflationary pressures in 2011 subsided in 2012. Declining inflation allowed the policy makers worldwide but also in the low-income countries to support growth through monetary easing throughout 2012, with interest rates dropping from 2011 historically high levels to moderate rates by the end of 2012 (see region and country specific discussions in the relevant sections of this Annex).

Figure INF.7 Median developing-country real grain prices rose 24 percent in 2012



Source: World Bank and FAO.

Moderate inflation in a number of developing countries provides scope for policy easing to support growth if external conditions were to deteriorate

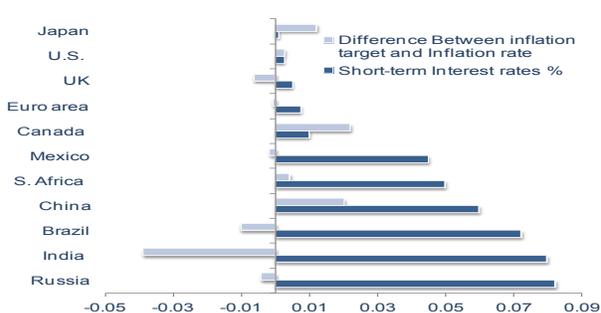
Moderate inflation rates or rates within the central bank targets in China, Indonesia (East Asia and the Pacific), Chile and Colombia (Latin America and the Caribbean), Armenia and Georgia (Europe and Central Asia), Kenya, Mozambique and Uganda (Africa), and Morocco (Middle East and North Africa) provide some space for policy easing through policy rate and reserve requirement cuts and liquidity injections to support growth if external shocks materialize.

In spite of recent downtick in food and fuel prices, inflation remains high in India and close or above the targeted rates in Brazil, Mexico, Russia and Turkey (figure INF.8) in the context of weakening growth. This implies less policy space to boost domestic demand to support growth if external conditions were to deteriorate. Space for countercyclical policies is further limited by high fiscal deficit in India.

Regional inflation developments

Weak and uncertain global economic activity, together with relatively stable commodity prices, provided the overall context for inflation trends during 2012. However, heterogeneous country

Figure INF.8 Room for policy cuts



Notes: Upper band where appropriate. Historical (2001-2011) average wholesale price index inflation is used as a proxy for inflation target in India. Inflation as of November 2012 unless indicated otherwise. September inflation data for Australia.

Source: World Bank and Central Bank rates.

circumstances shaped particular country and regional inflation outcomes.

Headline inflation in East Asia and the Pacific region declined in 2012

Annualized quarterly inflation in the East Asia and the Pacific region declined substantially between end-2010 and the second quarter of 2012, from 8 to 2 percent. Most of this decline was due to a dramatic falloff in inflation in China (figure INF.9) – reflecting, among other things, policy-induced easing in the price of residential housing resulting from new regulations and lending guidelines. Inflation eased significantly in Vietnam as well. For China, appreciation of the renminbi vis-à-vis the dollar, which reduced the price of imports for Chinese firms and consumers while increasing the price of Chinese exports, also helped to moderate domestic prices.

ASEAN-4 countries (Indonesia, Malaysia, Philippines, and Thailand) saw their quarterly inflation ease from a 5 percent annualized pace to 3 percent between end-2010 and the second quarter of 2012 despite robust domestic demand and policy easing. Currency appreciation among ASEAN-4 countries, together with broadly stable food prices in the region, helped to moderate inflation in all countries, although Indonesia saw a temporary mid-year acceleration

in inflation partly related to currency depreciation but also due to the seasonal factors.

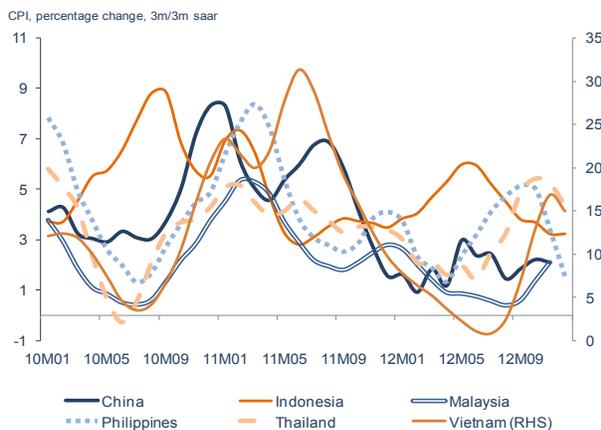
Several other countries in the region have also experienced a temporary acceleration in inflation during the course of the year, including the Philippines in Q3, and Thailand and Vietnam most recently partly reflecting the rapid growth of domestic demand.

On the whole, EAP region saw a decline in the headline inflation rates in 2012, with the sharpest declines observed in China, Malaysia and Vietnam followed by the Philippines and Indonesia. The headline inflation remained within the central bank targeted range in China, Indonesia and Thailand.

Inflation has picked up strongly in Europe and Central Asia

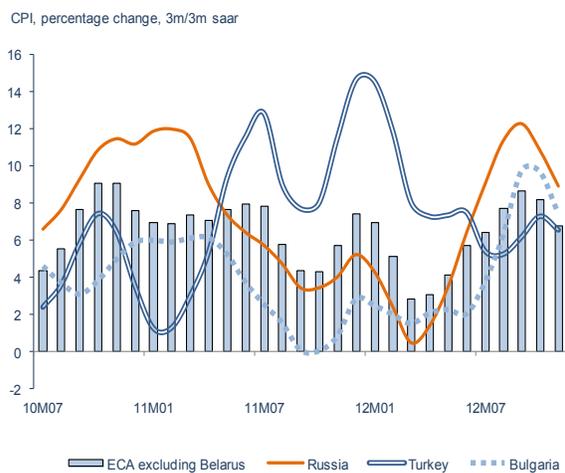
After a considerable fallback in the first quarter of 2012 (the result of slowing economic activity), inflation accelerated in developing Europe and Central Asia region in the second half of 2012 (figure INF.10). Grain price hikes due to droughts and poor crop yields in Russia, Ukraine, and Central Asia were partly to blame, but utility price adjustments in Russia and new tax policies in Turkey also factored into the regional assessment, as did bumping against output capacity in several countries.

Figure INF.9 Inflation eased in the EAP in 2012, but inflation momentum accelerated recently in Thailand and Vietnam



Source: World Bank and Datastream.

Figure INF.10 Inflation momentum accelerated in ECA following poor harvest



Source: World Bank and Datastream.

Inflation in Russia accelerated to 13 percent in the three months to September 2012 (3m/3m saar), prompting a tightening of policy in September 2012. The headline inflation in Russia at 6.4 percent year-over-year in November remains close to the central bank target despite growth having slowed considerably in the third quarter of 2012 and price pressures easing in the last quarter of 2012.

Inflation pressures have been reoccurring because of supply side bottlenecks, food price hikes and utility and other administered price adjustments as well as the earlier fixed exchange rate policy in the wake of strong capital inflows due to rising oil prices. In recent years, Russian central bank has switched increasingly to inflation targeting bringing inflation closer to the targeted rates.

In Turkey, where growth rebounded strongly after the global recession, to 9.2 percent in 2010 and 8.5 percent in 2011, headline inflation jumped to 10.5 percent (y/y) in 2011 from 6.4 percent in 2010. Inflation moderated in the second half of 2012 in part because of an appreciating Turkish lira and monetary policy tightening but also due to a good harvest in 2012.^{FN1} Turkey's central bank cut its benchmark one-week repurchase rate by 25 basis points to 5.5% on December 18th in the context of moderating inflation to support weakening growth. Inflation rate fell to 6.4% (y/y) in November, but remains above the central bank targeted 5% inflation rate and is projected to remain above the targeted level due to higher administered prices.

Belarus has seen a major buildup in inflation momentum over the past year, due, among other things, to a relaxation in monetary policy, exchange rate devaluation, and higher food prices.

Inflation in Latin America and the Caribbean also accelerated in the second half of 2012

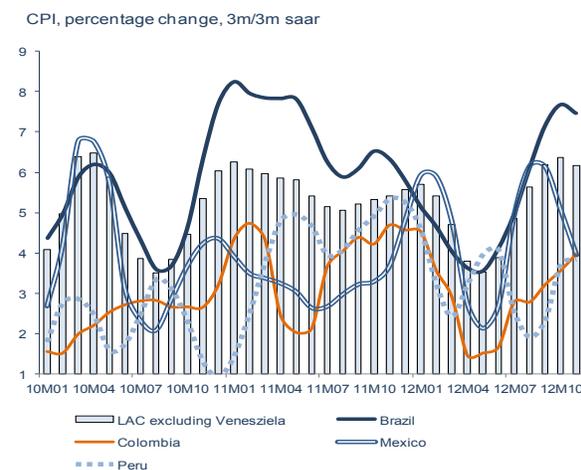
Inflation in Latin America and the Caribbean slowed to a 4.5 percent annualized pace in the second quarter of 2012 (down from a 7.2 percent pace in 2011), reflecting the weakening of global

activity, lower commodity prices, and the lagged impact of a previously tight monetary policy in the region. After the monetary policy tightening cycle that started in mid-2010, most inflation-targeting central banks paused in mid-2011, or have made very minor adjustments, with the exception of Brazil, which has lowered policy rates aggressively (commutative 525 basis point cut) between September 2011 and December 2012 to support weakening economic activity (figure INF.11).

The summer of 2012 marked a reengagement of inflationary pressure in several Latin American countries, however, following on the modest revival of global demand due to global policy easing but also reflecting higher prices of imported grain from the United States as a result of a drought in much of the country. Latin American countries registered some of the sharpest increases in real domestic maize prices in the world, which fed through to cause a temporary acceleration of headline inflation in the third quarter of 2012.

Headline inflation in Uruguay, for instance, accelerated to 8.6 percent (y/y) in September, well above the central bank's 4-6 percent targeted range, prompting the central bank to increase the policy rate to 9 percent and the government to implement a set of administrative and fiscal measures to contain the impact of the

Figure INF.11 Inflation momentum accelerated in LAC as economies reached their potential output levels



Source: World Bank and Datastream.

price hike. The government sought an agreement with supermarkets to reduce the prices of 200 staple items by 10 percent and considered lowering tariffs and taxes on basic foodstuffs.

Peru managed to achieve strong growth and low inflation (2.7 percent y/y in November, below the central bank target of 3 percent). Chile and Colombia, as well, have been successful in maintaining relatively low inflation during the recent volatile economic cycle due to effective counter-cyclical policies.

Inflation in Venezuela has declined significantly, from 25 percent at the start of 2011 to 13 percent as of June 2012 (3m/3m saar), after policy tightening, although headline inflation remains high.

In Brazil, the largest economy in LAC, growth slowed markedly in the third quarter of 2012, despite considerable policy easing implemented throughout 2012, while inflation accelerated, reflecting a temporary food price hikes due but also indicating that the economy is operating at its maximum potential and is facing supply-side bottlenecks, which are contributing to growing price bubbles. Headline inflation was 5.8 percent in December 2012—well above the 4.5 mid-pint annual inflation target (4.5% +/-2).

Inflation also picked up in Mexico in late 2012, reflecting an increase in food prices. Headline inflation, however, declined to 3.6 percent year-over-year in December 2012—below the country’s quite conservative 4 percent annual inflation target.

Inflation trends in developing MENA countries are diverse

Among Middle East and North African countries, Iran and Syria continue to experience double-digit inflation. In both countries, price pressure are to a large extent due to the impact of international sanctions. US and UK sanctions on Iran’s financial assets and transactions were on Iran tightened in 2012. Syrians experienced an acute rise in food prices through the course of 2012 (and, in some cases, a shortage of staples such as bread), while the flood of Syrians fleeing

the country to escape the conflict is now having spillover effects across the border in Lebanon, which is now posting steep increases in rental housing prices.

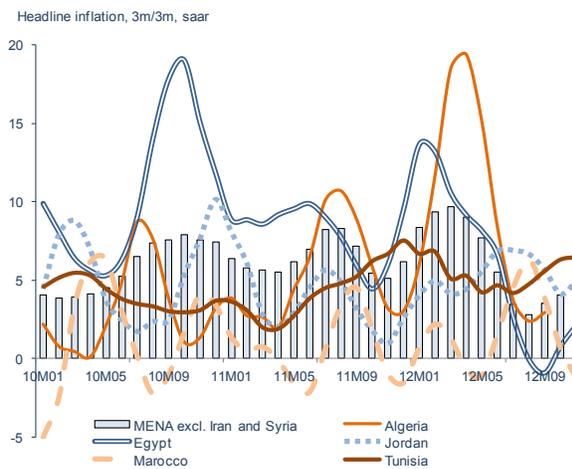
Food subsidies and administered prices suppress price pressures in Algeria and Morocco (figure INF.12). In Egypt, fuel and food subsidies, together with weak growth and subdued domestic demand, led to an easing of inflation momentum during summer 2012: headline inflation dropped to 6.2 percent on a year-on-year basis in September, the lowest in more than two years. Inflation has picked up in more recent months, however, reflecting reduction in subsidies and quotas for certain fuels. Tunisia raised fuel prices in September but prices are still below cost recovery levels.

Further reduction in subsidies and adjustment of prices to cost recovery levels will raise inflation temporarily, but their medium-term impact will be positive through private investment and increased domestic supplies, which in turn would result in weakening of price pressures.

In South Asia, supply-side bottlenecks keep inflation high, despite recent moderation in inflation momentum

Headline inflation among South Asian countries remained high in 2012. Price pressures stem

Figure INF.12 Falloff in inflation in MENA excluding Iran and Syria



Source: World Bank and Datastream.

from increasing demand for food (most notably in India), which in turn reflects rapidly raising household incomes and tight supplies, and from supply bottlenecks for non-food items. In addition to increasing at a rapid pace, food prices in South Asian countries are quite volatile, partly the result of structural constraints in the production, storage, and distribution of food.

Headline inflation exceeds 7 percent in Pakistan and Bangladesh, and remains close to 10 percent in India, Nepal and Sri Lanka— significantly higher than the average for developing countries. In Nepal, the continuing political crisis and infrastructure constraints mean that domestic supplies are not keeping pace with robust demand, resulting in persistent inflationary pressures; the currency peg of the Nepali rupee to Indian rupee has further boosted inflation during periods of depreciation of the Indian rupee. In Sri Lanka, a depreciation of the currency and agricultural drought caused inflation to surge to 10 percent in July. Although inflation has since eased, it remained close to 9 percent in October, prompting the central bank to cut the policy rate in December.

In several cases, partial pass through to domestic retail prices of international crude oil prices, which rose in the latter half of 2012 following a decline earlier in the year, together with several

governments' attempts to rein in fiscal subsidies, are exacerbating inflationary pressures.

In the third quarter of 2012, weakening of activity, the opening up of output gaps, and some degree of moderation in food inflation caused a slowdown in inflation momentum across South Asia, although individual country experiences have been diverse (figure INF.13). Headline inflation in the region remains in the 9-10 percent range, and wholesale price inflation in the range of 7-8 percent.

Moderating inflation allowed Pakistan's central bank to reduce its key policy rate by a cumulative 250 basis points between August and December 2012. Persistently high inflation expectations in India have prevented monetary policy easing. The country's benchmark policy rate was stable at 8 percent for most of 2012, but the central bank has used other instruments, including cuts to commercial banks' reserve requirements, to improve liquidity and ease monetary conditions. Similarly, despite a sharp slowdown in growth, Sri Lanka's central bank kept its benchmark policy rate at 7.75 percent from the second quarter of 2012 through the end of the year.

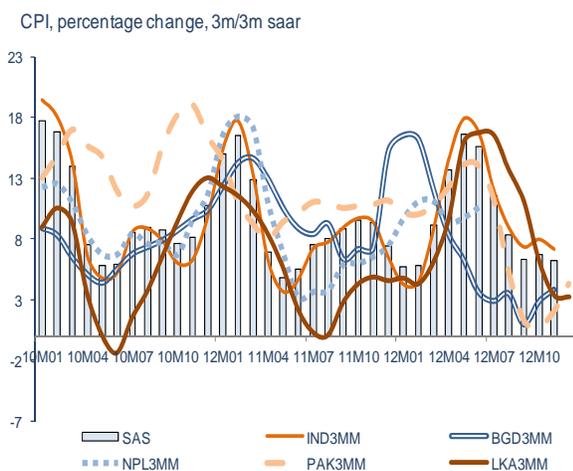
Sub-Saharan Africa has experienced a steep decline in inflation

Despite being extremely vulnerable to weather conditions and related supply disruptions, inflation moderated significantly across much of Sub-Saharan Africa in 2012.

In South Africa, the largest economy in the region, the steady decline in inflation through much of 2012 reflects weak demand and slow growth, which outweighed the upward inflationary pressure of wage hikes in the mining and transport sectors and a weakening rand. Looking ahead, higher wages and rand weakness are expected to contribute to a pickup in inflation during 2013.^{FN2} The turnaround can already be seen in the data for late 2012.

In East Africa, the high food and fuel prices that drove inflationary pressures in 2011 subsided in

Figure INF.13 Inflation momentum moderated in SAS



Source: World Bank and Datastream.

2012 (figure INF.14). Declining inflation allowed policy makers in Kenya and Uganda to support growth through monetary easing throughout 2012, with interest rates dropping from 18 percent to 11 percent in Kenya and from 23 percent to 12.5 percent in Uganda between November 2011 and December 2012.^{FN3} Inflation in Kenya, which hit 19.7 percent in 2011, was down to 4 percent in October 2012 (food inflation was only 3.4 percent) (figure INF.15). Similarly, quarterly inflation in Uganda, which had reached more than 40 percent in late 2011, turned negative in the third quarter of 2012.

In Tanzania, inflation decelerated from the 19.8 percent y/y registered in December 2011 (due to high local food prices related to a serious drought) to 13.5 y/y in September 2012, still short of the 10 percent inflation goal set by the central bank said for June 2012 and single digit by the end of the 2012/2013 fiscal year (June 2013). The impact on food prices of inconsistent rainfall in 2012 is main reason that inflation remains relatively elevated.

Rwanda continues to buck the regional trend, with inflation rising since June, largely due to increasing food prices (food costs represent 54 percent of Rwanda’s CPI basket). Urban inflation in Rwanda, however, dropped slightly in September, to 5.6 percent y/y, compared to

5.8 percent in August; rural inflation, which is more impacted by food prices, was 14 percent in September.

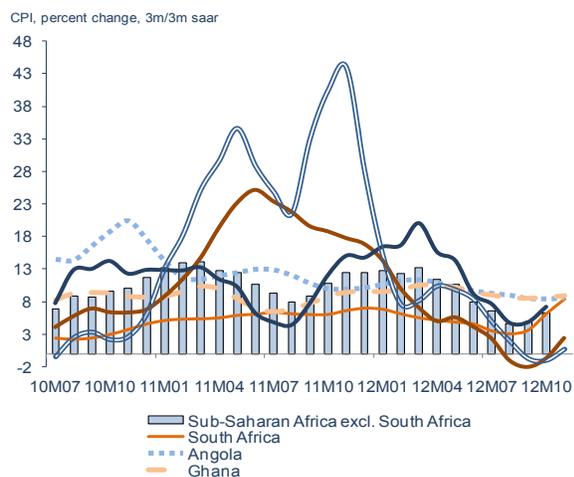
Among West African Economic and Monetary Union (WAEMU) countries (Benin, Burkina Faso, Cote d’Ivoire, Guinea Bissau, Mali, Niger, Senegal, and Togo), inflation pressures moderated on improving grain supplies during the last quarter of 2012 after experiencing a rise due to an increase in prices of fuel and cereals. The moderating prices allowed the Central Bank of West African States (BCEAO) to keep its benchmark marginal lending rate at 4 percent.

The impact of food prices on inflation is also evident among West African countries. Nigeria, for example, experienced a temporary price hike in October with inflation rising to 11.7 percent (y/y) reflecting food shortages due to the heavy floods.

Global inflation is projected to pick up somewhat from 2013 through 2015 as growth firms

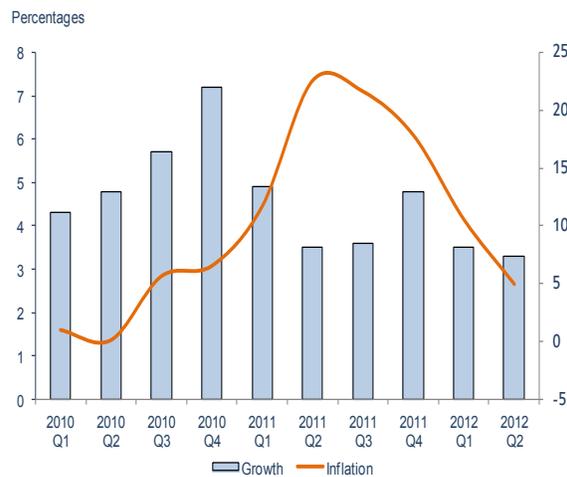
Global consumer price inflation is projected to pick up gradually as confidence and global demand strengthen. Weak growth will however keep inflation pressures subdued to around 3–4 percent globally and around 6.3 percent in developing countries—above 2012 levels but

Figure INF.14 Moderate inflation in Sub-Saharan Africa



Source: World Bank and Datastream.

Figure INF.15 Falloff in Kenya’s inflation



Source: World Bank and Datastream.

below inflation observed in 2011. Inflation in high income countries is projected to gradually increase to around 2.5-3 percent by the end of the first quarter of 2013 and remain around that level throughout 2013. In developing economies, price pressures are expected to build in some countries with the rebound in economic activity and more dynamism in the private sector.

Overall, consumer prices in these economies are projected to accelerate to around 6.3 percent in 2013 but still below their 2011 level.

The inflation outlook is however quite uncertain and is subject to both upside and downside risks—with the considerable consequences for low income countries, which are sensitive to price fluctuations due high reliance on primary commodities, narrow range of policy instruments and weak fiscal and monetary buffers.

On the upside, supply side bottlenecks may push inflation up as global demand revives. In addition, inflation may accelerate as the increased grain prices pass through into local food prices – especially in the countries with the large share of wheat and maize consumption in their food price basket. Implementation of fiscal measures, including increase in utility prices and tariffs to cost-recovery levels to reduce quasi-fiscal deficits, and increase in taxes, which have been delayed due to economic uncertainty may become additional source of inflation. The upside risks to supply side shocks also include weather related price hikes to food supplies and risks to price stability related to supply disruptions in case of the escalating tensions in the Middle East.

The positive effect of continuous policy easing by the G3 (US, EU, and Japan) as well as major developing countries and the positive effect of those policies on inflation expectations may be considered as an upside risks to inflation forecast. However, chances that those policies would lead to a surge in inflation in the near term are low in the present weak growth environment and inflation expectations remain anchored around the current target inflation rates.

On the downside, slower growth and excess capacity in some countries will help moderate core inflation. Stable or declining commodity prices will reinforce this outcome. Deepening of economic turmoil in Euro Area and slower US growth in case the looming “fiscal cliff” of spending cuts and tax hikes is not addressed and undermines the US and global growth, depressed economic activity and causes disinflation. Were external conditions to deteriorate, some developing countries have room to support growth through policy easing, but others are constrained.

Notes

1. In Turkey, the key policy rate used under the inflation-targeting framework is the one week repo auction rate. Turkey also uses an interest rate corridor and required reserve ratios as policy instruments.
2. In addition, South Africa plans to introduce a revised CPI basket in January 2013 to reflect changing household expenditure patterns. The new basket will assign a higher weight to services spending vis-à-vis goods.
3. As of July 2011, the Bank of Uganda has used a seven-day interbank interest rate as its main policy rate, shifting from supporting aggregate demand via money supply growth to targeting inflation and reducing bank credit growth.

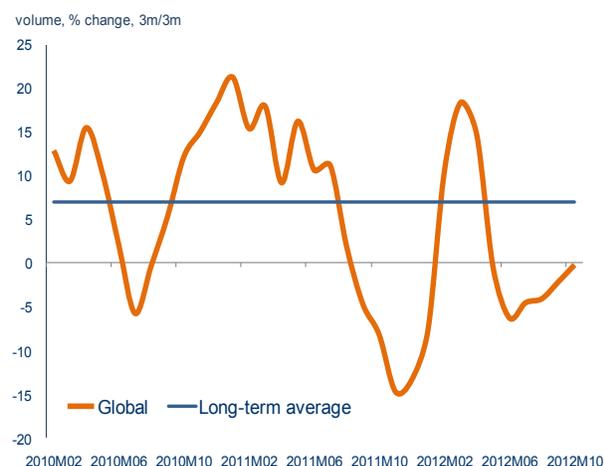
Global Trade Annex

Recent Developments

Consistent with the weakness in the global economy, global trade volume growth decelerated to about 3.8 percent in 2012, down from 6.1 percent in 2011 (figure Trade.1). This represents the weakest annual growth rate in global trade volumes since 2009 and falls well short of the historical average of 6.8 percent. Developments in global trade flows were driven mainly by ongoing weakness in high-income economies, particularly the European Union (the world’s largest trading bloc) as well as from a slowdown in some of the larger developing economies including, China, India and Brazil.

Global trade trends in 2012 were volatile on account of economic uncertainty during the year. After contracting at a seasonally adjusted annualized pace of 6.2 percent in Q2 2012 – precipitated by the then escalating financial market tensions related to the Euro Area crisis, and the resultant increase in precautionary savings as business and consumer sentiment weakened - the contraction in global trade volumes tapered-off somewhat in Q3 2012 and have shown signs of a pickup in Q4 2012.

Figure Trade.1 Global trade growth was subdued in 2012

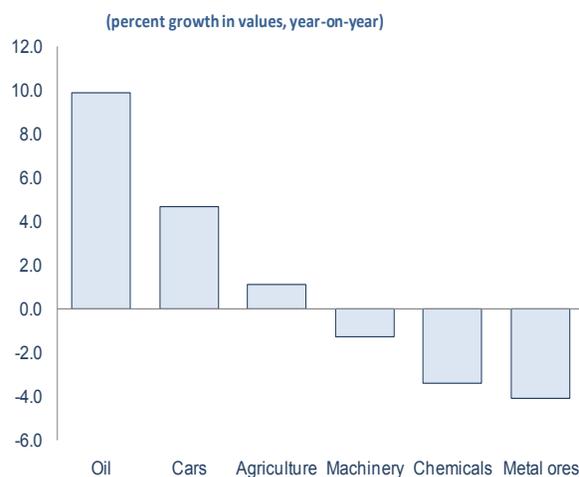


Source: World Bank.

Indeed, in the three months leading to October, global trade volumes began expanding once again at an annualized pace of 1.0 percent. Nonetheless much of the recent expansion in global trade has been as a result of the cyclical uptick in developing country import demand, as high-income country imports was still contracting in October, albeit marginally.

Reflecting subdued growth in the global economy, trade in industrial goods was weaker than that of agricultural goods. Latest available data on commodity composition of trade suggests that global imports of industrial inputs such as chemicals, metal and minerals and machinery were among the hardest hit, falling by 3.4 percent, 4.1 percent and 1.3 percent respectively in value terms over the first half of 2012 compared with the same period in 2011 (figure Trade.2). In part, this reflects weak durable goods sales, as firms and households postpone big-ticket purchases during periods of uncertainty and economic weakness. The income elasticity of agricultural goods meant that imports of agricultural goods fared better -- rising 1.1 percent (y/y) in value terms in the first half of 2012. Notwithstanding the slowdown in

Figure Trade.2 H1 2012 growth in imports of selected products



Source: World Bank.

the global economy, the trend increase in per capita oil consumption in developing countries coupled with the shift in Japan’s energy sources to crude and natural gas after the shut down of it’s nuclear power plants supported the increase in global imports of oil.

Import demand among high-income countries have differed, reflecting the relative strength of their respective domestic economies.

Among high-income countries, import volumes contracted for six consecutive months through October. With the Euro Area being at the epicenter of the crisis, and with banking sector deleveraging, fiscal consolidation and unemployment rising, the contraction in import demand was the most protracted. For each month between May and September, import demand in the Euro Area contracted at a double digits annualized pace (figure Trade.3). However, the supportive policy interventions by the European Central Bank which helped to reduce financial market tensions in the bloc has helped partially recover some business confidence and support to real side activity. Indeed, Euro Area import demand, though still contracting in October (-3.5%, 3m/3m saar), had improved from the depth of contraction in Q3 2012 (-13.5%, 3m/3m saar). In contrast to the Euro Area, and reflecting output expansion in the US economy (even if weak), import demand in the United States expanded through Q2 2012. Nonetheless, its

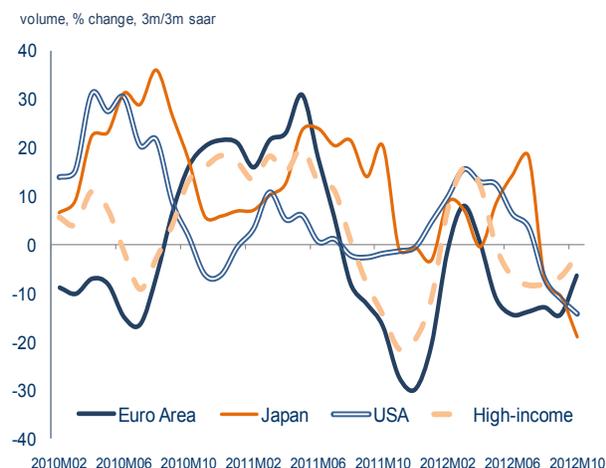
import demand contracted at a 11.2 percent annualized pace in Q3 2012. Import demand in Japan accelerated in the second quarter benefitting from government household incentives program but however weakened in the third quarter and fourth quarter, after the expiration of these incentive programs, as well as from weaker trade with China due to the Island dispute.

External demand has helped to mitigate weak domestic demand in several high-income countries, particularly in the Eurozone.

Reflecting the ongoing adjustment in the Euro Area (fiscal consolidation, banking sector deleveraging etc), domestic demand’s contribution to GDP growth has been negative (-1.8 percentage points), however, net exports contribution has been positive (1.6 percentage points), thereby helping to partially mitigate the recessionary domestic demand conditions in the Euro Area economy (figure Trade.4). In both the US and Japan, domestic demand was relatively stronger than in the Euro Area and while net exports contribution to growth in the US was neutral, in Japan it was negative due to the significant increase in it’s imports of crude oil and liquefied natural gas due to the shut down in it’s nuclear facilities.

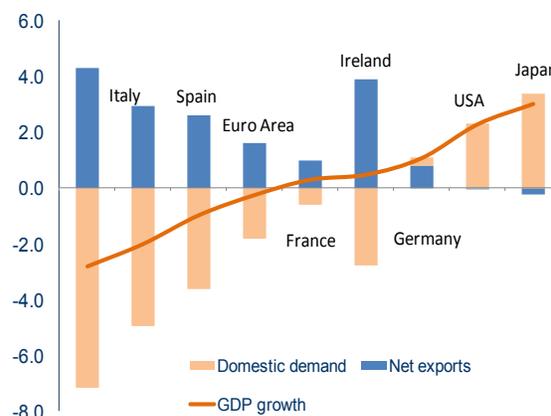
Much of the supportive external demand environment to GDP growth in high-income

Figure Trade.3 Though mostly weak, fortunes among high-income countries diverged through 2012



Source: World Bank.

Figure Trade.4 External demand helped to mitigate the recessionary conditions in several Euro Area economies



Source: Eurostat and World Bank.

Box Trade.1 The pace of market share gain by developing countries has increased in recent years.

Over the past two decades, the share of developing countries in global trade has doubled from some 15.9 percent to 31.5 percent, with an average annual increase in market share of some 0.8 percentage points. The great recession has only contributed to accelerating this trend as high-income countries continue to be weighed down by high-debt, fiscal consolidation, elevated unemployment levels and slow growth (even recession in some countries). With the economies of developing countries remaining fairly resilient since the great recession, this has allowed them to double their pace of increase in market share since 2008 to an average of 1.5 percentage points per annum – twice the increase in annual market share prior to the great recession.

countries came from developing country import demand. Even though global trade growth was weak in 2012, consistent with previous years, a significant share of the increase in high-income country exports was to developing countries. For instance, developing countries accounted for some 63 percent of the increase in both France and Germany’s extra-EU exports and 58 percent of the increase in US’s exports to the rest of the world.

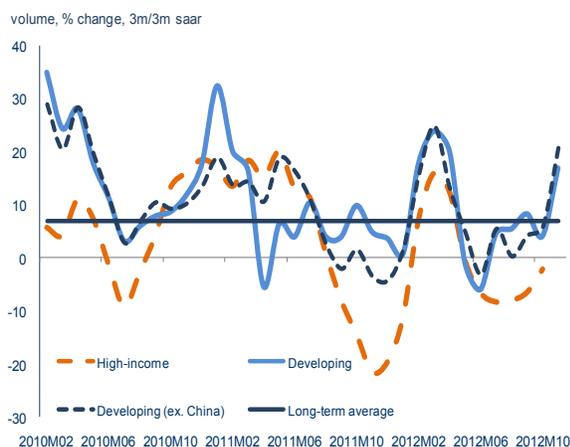
Developing country trade developments are heavily influenced by cyclical trends in high-income countries. With increased integration among themselves and also with high-income countries recent developments in developing countries confirm the synchronized nature of business cycles between developed and developing countries (figure Trade.5). The recent fall and pick-up in import demand among high-income countries was mirrored among developing countries. Developing country import demand contracted at a 5.7 percent

annualized pace in Q2 after an expansion of 23.8 percent in Q1. Nevertheless, reflecting stronger domestic demand in developing countries their imports recovered more quickly and by November 2012, import demand in developing countries was expanding at an annualized pace of 16.7 percent.

Not all the mid-year slowdown in developing countries can be attributed to spillovers from the Eurozone. In China, for instance earlier efforts by monetary authorities to engineer a soft landing (particularly in the property market) was at play in restraining domestic demand. And in India stalled reforms, an uncertain economic environment and a slowdown in foreign direct investment flows constrained domestic demand.

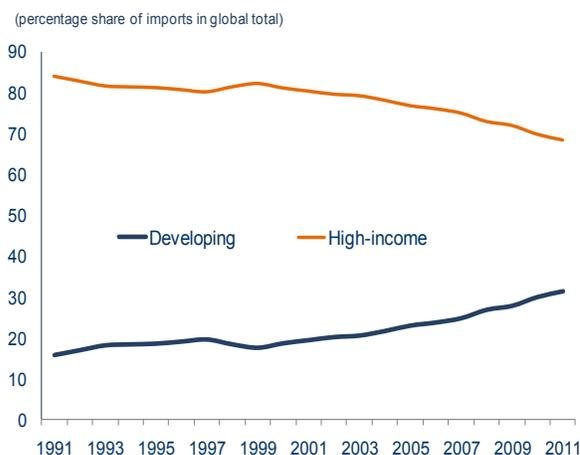
Notwithstanding the synchronized nature of high-income and developing country business cycles, the decoupling of high-income and developing-country trend growth rates points to an

Figure Trade.5 Cyclical trade trends between high-income and developing countries remain largely synchronized



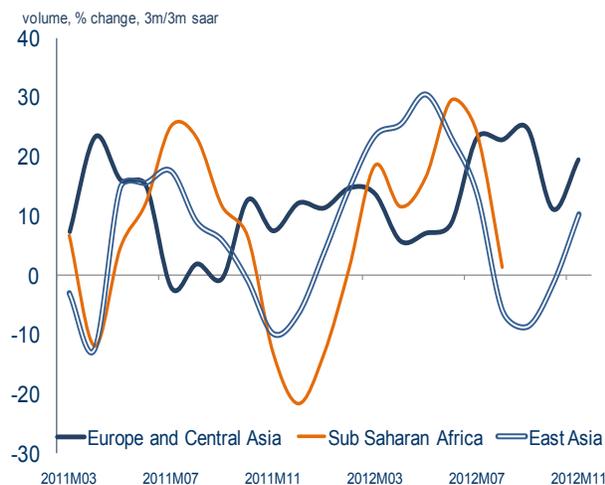
Source: World Bank.

Figure Trade.6 The share of developing countries in global trade is steadily growing in importance



Source: World Bank.

Figure Trade.7 Export volumes have rebounded in recent months in some developing regions



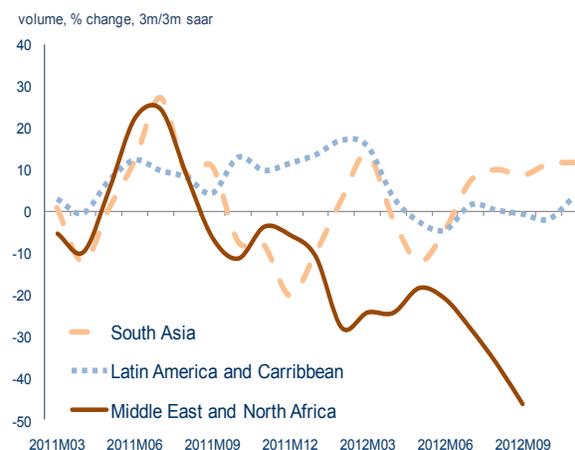
Source: World Bank.

increasing role for developing countries in global trade (figure Trade.6 and box Trade.1).

Developing country exports followed a similar pattern to imports, but with significant differences across countries and regions (figures Trade.7 and Trade.8). Consistent with the mid-year slump in global imports, developing country exports declined for three consecutive months through October, however, by November developing country exports had begun expanding once again. The recent up tick in developing country exports has been mostly supported by increased South-South trade as import demand from high-income countries was still contracting as of October, albeit at a weaker pace than in the third quarter.

Among developing regions, the worst hit by the Q2 slowdown included: East Asia and Pacific (excluding China) – whose export volumes of manufactured goods are particularly sensitive to global demand conditions; South Asia and Central and Eastern Europe both of which have strong ties to European demand; and Latin American and the Caribbean, though less dependent on Euro Area demand are sensitive to weakening Asian (particularly Chinese demand for their commodity exports). Notwithstanding the contraction in exports that each of these developing regions experienced in Q2 2012, they

Figure Trade.8 Developing country exports were impacted by both external and idiosyncratic domestic developments



Source: World Bank.

had all begun expanding once again by the third quarter.

Data for the Middle East and Africa lag behind. However, latest available data suggest that developments in the Middle East and North Africa have been influenced more by political developments than the external economic environment. Indeed, export volumes for the Middle East and North Africa region has contracted for twelve consecutive months, with volumes in the three months leading to August contracting at a peak 36.4 percent pace. In contrast, annualized growth rates in Sub Saharan Africa export volumes were at a double digit pace in both Q1 2012 (18.3%) and Q2 2012 (29.4%). However, in the three months leading to August, export volumes were expanding at a subdued pace of 2.5 percent, suggesting that the regions exports were hit by the mid-year weakness in global demand.

Medium term prospects for global trade

Global trade is projected to pick-up over the medium term but at relatively subdued rates. As described in the main text, global output is projected to remain weak but gradually firm during 2013 and through 2015, with US and Euro Area growth still hampered by fiscal

consolidation, banking-sector restructuring and high unemployment.

Growth in developing countries is also expected to firm but remain relatively weak. As a result, real trade growth is projected to only gradually return to pre-crisis growth rates of 5.7 percent in 2013, 6.7 percent in 2014, and 7.1 percent in 2015.

Developing countries trade shares and contribution to export and import growth will continue expand. Continued productivity differentials, policy reform and investments in human and physical infrastructure are projected to permit developing countries to continue growing their share of global trade.

Developing country imports are projected to expand at an annual average rate of 8.0 percent between 2013 and 2015, versus a moderate 5.9 percent for high-income countries (driven mainly by the United States).

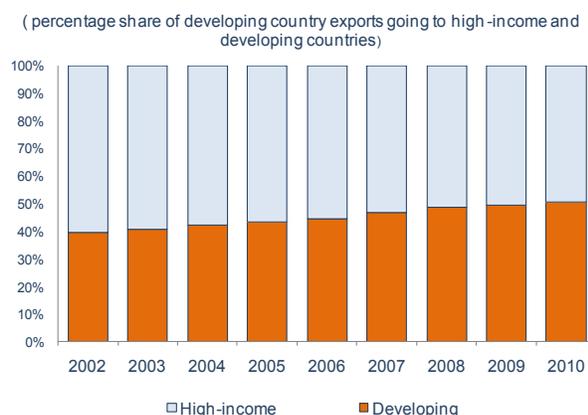
Overall, the share of developing countries in global trade is projected to reach 35 percent by 2015, with most of the pickup reflecting increasing South-South trade. As of 2002, South-South trade accounted for only 39.2 percent of total developing country exports, but by 2010 this share had topped 50 percent – meaning that for developing countries, other developing

countries are now more important trading partners than high-income countries. Developing countries are also increasingly important for high-income countries as well. Since 2000, North-North trade has been expanded on average by only 7.3 percent over the past decade, whereas high-income-country exports to developing economies has increased at an annual average pace of 11.8 over the past decade (figures Trade.9 and Trade.10).

The rise in Chinese wages presents an opportunity for other developing countries to enter light manufacturing sector. Not only will their share of trade increase but also the composition of trade among developing countries. Indeed, with the cost of labor continuing to rise in China and assuming a continued appreciation of the renminbi, other developing countries may be able to enter into some of the labor-intensive manufacturing sectors that China has dominated in recent decades (World Bank 2012).

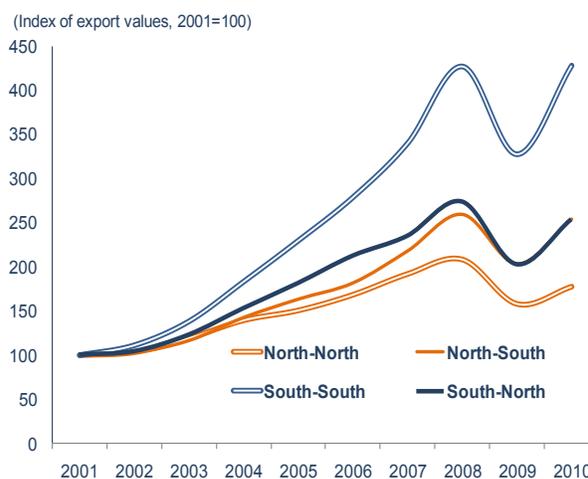
The quadrupling of Vietnamese exports over the past decade in part reflects its increasing competitiveness vis-à-vis China in light manufacturing – although to take advantage of their full potential, countries in Sub-Saharan Africa will have to address some of the binding constraints related to infrastructure, access to finance and human capital.

Figure Trade.9 The dynamic growth of South-South trade has accounted for the increasing share of developing country exports going to other developing countries



Source: ITC and Comtrade database.

Figure Trade.10 South-South trade has been the most dynamic segment of global trade over the past decade



Source: World Bank.

Risks

Significantly weaker global growth. The challenges faced by high-income countries continues to be the main sources of risk for trade going forward. Euro Area tensions, the fiscal cliff in the United States and a sharp decline in Chinese growth are among the risks that could derail trade in the months and years to come. Simulations presented in the main text suggest that a harder landing in China could reduce global trade growth by 0.63 percentage points from our baseline forecasts of 5.7 percent in 2013.

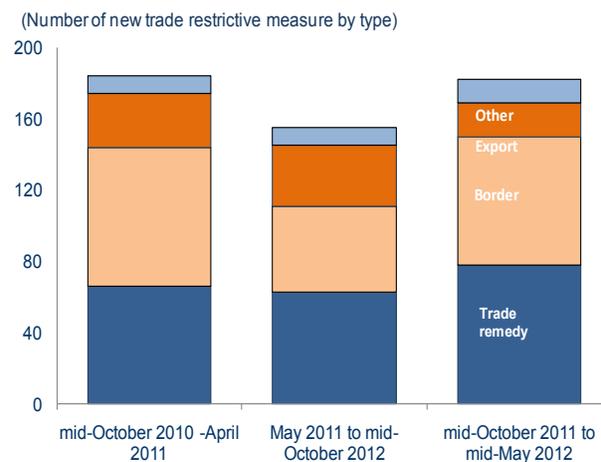
The current weakness in Japan also represents a risk for trade (Japan is the world's fourth largest importer).

Should the situation in either Europe or the United States degrade sharply, the solvency of private-sector banks could be affected – potentially forcing them to tighten up trade finance – with serious consequences for trade. Even in the absence of a global crisis, new regulations introduced under Basle III, due to come into force in 2016, could significantly raise the cost of trade finance, potentially increasing its cost and accessibility to developing-country firms.

A drying up of bank-led trade finance could be particularly damaging for smaller firms, who may not have access to alternative financing methods such as bonds available to larger firms.

A rise in protectionism. With unemployment remaining at elevated levels, weak global demand and little progress in multilateral trade talks, the incidence of new restrictive trade measures has held steady. The World Trade Organization reports that in the seven months leading to mid-May 2012, an additional 182 new trade restricting or potentially distorting measures were introduced (figure Trade.11). Compared to the same period a year ago, where 184 new measures were introduced which affected 0.5 percent of global trade, the recent measures affects some 0.9 percent of global trade. Further, only 18 percent of measures

Figure Trade.11 Trade restrictive measures continue to rise



Source: World Bank, World Trade Organization.

introduced since October 2008 by G-20 countries have been removed, with current measures estimated to affect some 3 percent of global trade (\$450 billion). Of particular concern is that, unlike previous restrictive trade measures that were seen as combatting the temporary effects of the global crisis, recent trade measures are embedded in national industrial plans, hence appear to be of a longer term nature.

References

- World Bank (2012). Light Manufacturing in Africa.
- World Trade Organization (2012). Report to the TPRB from the Director General on Trade-Related Developments. WT/TPR/OV/W/6.

Exchange Rates

High income exchange rates have been volatile

High income exchange rates, especially cross rates between the US dollar, Euro, and yen, have been volatile in recent months, reflecting alternate bouts of optimism and pessimism among investors regarding the prospects for resolution of the Euro Area debt crisis, fiscal and monetary policy actions in Euro Area, United States and Japan, and uncertainty regarding the pace and sustainability of economic recovery in high income countries. Indications by the European Central Bank on July 26 that it would take action to reduce financial market tensions, and expectations that the ECB's Outright Monetary Transactions (OMT) bond purchase program subsequently announced on September 6 would help reduce downside risks to growth, contributed to the strong 8.6 percent appreciation of the euro against the US dollar between July 26 and December 31 2012 (figure ExR.1). The third round of US quantitative easing (QE3) announced on September 11 resulted in an immediate weakening of the US dollar against both high income and developing countries' currencies. Subsequent events relating to the

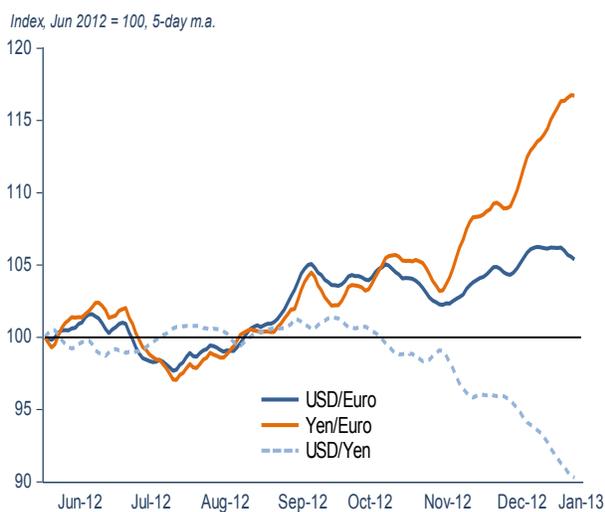
decision and timing of Spain's request for a bailout and the economic weakness in the Euro Area temporarily tempered appreciation of the euro. The euro appreciated strongly again in late November and early December after Greece exit fears receded following a debt deal in November to cut the interest rate on official loans to Greece, extend the maturity of loans from the European Financial Stability Facility (EFSF) from 15 to 30 years, and grant a 10-year interest repayment deferral on those loans. Meanwhile, in the United States, a temporary resolution was reached on the so-called "fiscal cliff" of automatic tax increases and spending cuts in early January. But the protracted fiscal policy impasse and uncertainty regarding the upcoming US debt ceiling negotiations have weighed on US economic activity, and in turn the dollar. Worsening growth outturns in Japan (partly due to an island-related dispute with China that caused a steep decline in exports) and aggressive monetary policy easing also contributed to weakening the yen against both the US dollar (-8.5%) and the euro (-13.1%) between September 1 and December 31 2012.

Movements among high income currencies have influenced developing countries' bilateral exchange rates

This ebb and flow of the high income exchange rates has been transmitted to varying extents to bilateral exchange rates of developing countries' currencies relative to the three major international reserve currencies, the US dollar, the euro and the yen. In the second half of 2012, bilateral exchange rates of several large developing countries experienced appreciation pressures relative to the US dollar, but depreciated relative to the euro, reflecting in part the movements in the dollar-euro rate discussed above (figure ExR.2).

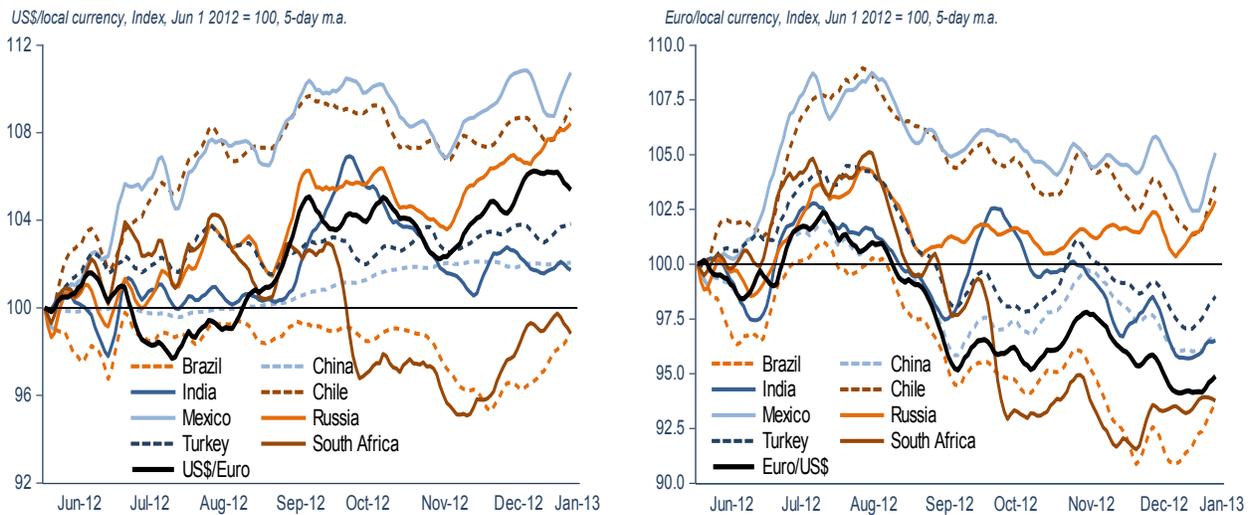
Notwithstanding the fluctuations in bilateral exchange rates of developing countries' currencies, their trade weighted nominal

Figure ExR.1 High income exchange rates



Source: World Bank.

Figure ExR.2 Developing countries' bilateral exchange rates relative to US dollar and euro

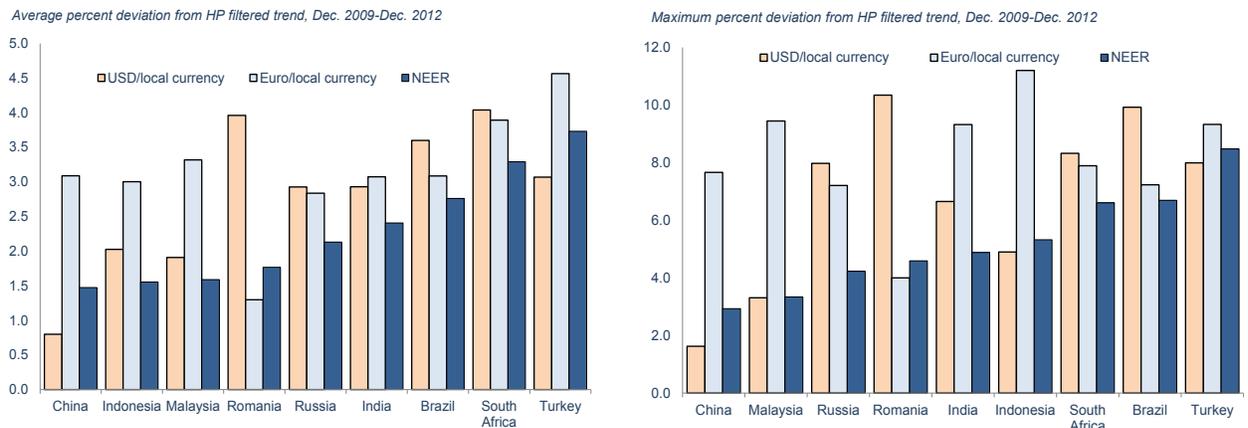


Source: IMF International Financial Statistics, JP Morgan, and World Bank.

effective exchange rates (NEERs) have been considerably less volatile (figure ExR.3). On average, bilateral exchange rates relative to the US dollar of the developing countries in figure ExR.3 were 22 percent more volatile than the NEERs during the three-year period from December 2009 to December 2012; and bilateral exchange rates relative to the euro were 36 percent more volatile than NEERs. Exchange rates that are more closely linked to the US dollar (e.g., the Chinese renminbi) exhibit considerable variation relative to the euro; while currencies of countries with tighter trade linkage

to the Eurozone (e.g., Romanian leu) exhibit more variation relative to the US dollar. But in general, the diversification of trade destinations of developing countries implies that bilateral movements relative to the high income currencies often offset each other in the trade-weighted basket of currencies relevant for developing countries. This suggests that a focus on any specific bilateral exchange rate could be misleading when considering trends in exchange rates for developing countries, and it may be more appropriate to consider effective (trade weighted) nominal or real exchange rates.

Figure ExR.3 Bilateral exchange rates of developing countries tend to be more volatile than trade-weighted nominal effective exchange rates (Average and maximum deviation from trend)



Note: NEER volatility is calculated as the average percent absolute deviation of monthly REER from a Hodrick-Prescott filtered trend ($\lambda=5000$) over 2000-2012.
Source: IMF International Financial Statistics, JP Morgan and World Bank.

Unconventional monetary policies in high income countries and gains in international commodity prices have caused concerns of currency appreciation and possible loss of competitiveness

The monetary authorities in the US and Euro Area have committed to an extended period of unconventional monetary policies, in the context of the third round of the US Federal Reserve's quantitative easing (QE3) program and the ECB's OMT bond purchases programs for Euro Area countries that seek financial assistance. Japan's central bank has also maintained a supportive monetary policy stance as growth faltered. The prospect of an extended period of accommodative monetary policies in high income countries has raised concerns among policy makers in some developing countries that it could cause large "hot money" inflows into government and corporate bonds, and equity markets, of developing countries (see Finance Annex of the *Global Economic Prospects* January 2013 report), which in turn, could result in currency appreciation and loss of export competitiveness (Frankel 2011, Ostry, Ghosh, and Korinek 2012).

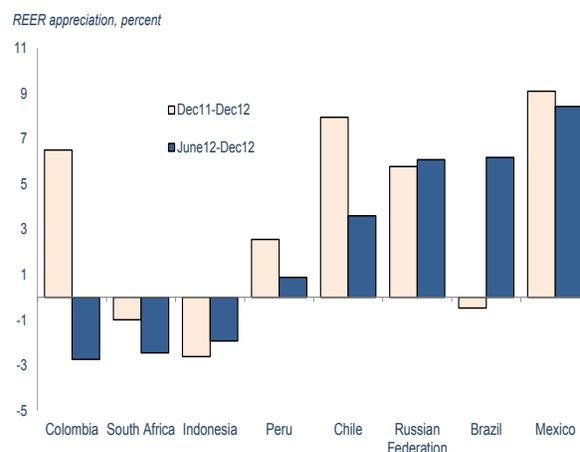
For commodity exporting countries, it can be difficult to distinguish between currency pressures related to high commodity prices and related foreign direct investment on the one hand, and more volatile hot money capital flows on the other. In such countries, high-income monetary easing-related capital inflows could plausibly exacerbate commodity price-driven swings in real effective exchange rates (REERs). For example, the 28 percent real effective appreciation of the Brazilian *real* since January 2009 seems to be principally a reflection of high commodity prices, strong commodity exports, and commodity-related foreign direct investment flows. While hot money flows may contribute to short-term volatility, the longer-term appreciation of the *real* does not seem to reflect these more volatile forms of capital flows (box ExR.1).

For some time now, Brazil has actively managed its bilateral exchange rate in an effort to prevent

loss of competitiveness of its manufacturing sector. Peru has also taken some steps, raising reserve requirements on local and foreign currency bank deposits and selectively intervening in currency markets, citing high international liquidity and exceptionally low international interest rates as reasons.^{FN1} It is worth noting, however, that capital controls and sustained interventions to prevent currency appreciation could involve significant risks for the economy over the medium term (see box ExR.1 and the *Global Economic Prospects* June 2012 report).

Mexico has also experienced heavy inflows into government bond markets in parallel with US monetary easing and relatively strong growth. However the peso has been allowed to float, contributing to a 8.4 percent appreciation in real terms since June (figure ExR.4). The South African rand has been a notable exception to the commodity- and capital flows-driven rally in exchange rates, with the trade-weighted real exchange rate declining 2.5 percent between June and December 2012 as protracted mining sector tensions, labor unrest, and domestic economic weakness (compounded by a sovereign rating cut by Moody's in late September) caused a loss of investors' confidence.^{FN2} This has resulted in a strong historical link to fundamentals, in particular to the terms of trade (see Exchange Rates Annex of

Figure ExR.4 Trade-weighted real exchange rates of commodities exporters in 2012



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

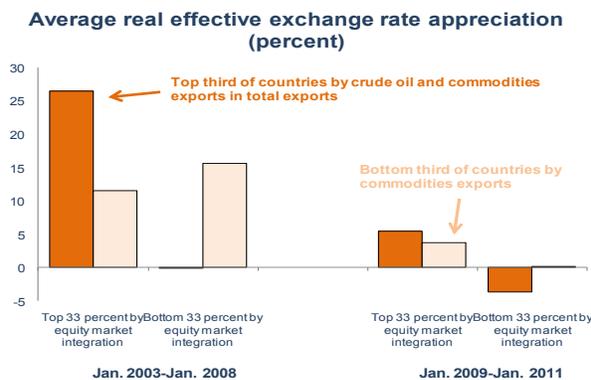
Box ExR.1 The influence of commodity prices and capital markets on developing country exchange rates

The experience during two earlier periods of sustained increase in international commodity prices and private capital flows is illustrative. Between 2003 and mid-2008 prior to the Lehman crisis, prices of industrial commodities rose more than 164 percent in real terms and crude oil prices rose 230 percent, implying annual increases of 21 percent and 26 percent. A second price rally occurred following the financial crisis with prices recovering close to the pre-crisis peaks in just over two years, helped by fiscal stimulus measures and sustained monetary easing in high income countries, and a quick rebound in developing countries’ growth compared to a much weaker growth in high income countries. The period of near-zero interest rates and quantitative easing in the US, UK, Japan and other high income countries caused capital flows to developing countries to surge again. The influx of commodity-seeking inflows as well as private capital flow (attracted by faster productivity growth), together resulted in a significant appreciation of developing countries’ currencies.

The extent of appreciation of developing countries currencies, however, varied along two dimensions—the importance of primary and industrial commodities in overall imports, and the extent of financial market openness. We measure the latter as the share of foreign portfolio equity inflows as a share domestic product (GDP), which signals the extent of integration into global financial markets. As box figure ExR 1.1 shows, developing countries that are in the top third along both dimensions (e.g., Brazil, South Africa) experienced the steepest appreciation, especially compared to other developing countries that are relatively well-integrated into financial markets but not significant commodity exporters (e.g. India, Turkey, Thailand). By contrast, the real exchange rates of other commodity exporters that are in the bottom third in terms of our measure of financial market integration (e.g. Gabon, Cameroon, Iran) were on average flat during the first period and lost value in the second period.

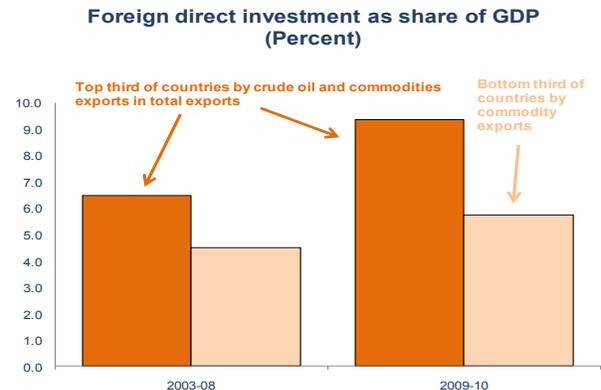
This suggests that commodity prices and capital flows can interact in complex ways to influence currencies of developing countries. A commodity price boom can attract not only foreign direct investment into resource intensive sectors raising overall levels of FDI (box figure ExR 1.2), but in countries with relatively higher levels of financial openness, it can also cause short-term speculative inflows into non-tradable sectors, for example, real estate, that benefit from the increased demand caused by commodity revenues, in the process further appreciating the currency. Eventually, when international prices retreat or investor risk aversion rises, the process is reversed, as sudden capital outflows depreciate the exchange rate, in the process raising the local currency burden of foreign currency-denominated liabilities (Ostry et al. 2010). Such a commodity price boom-fueled real exchange rate appreciation, especially in countries with relatively higher levels of financial market integration, can exacerbate risks to firm and sovereign balance sheets (Korinek 2011). Although some financially-integrated commodity exporters have made efforts to mitigate these risks through controls on cross-border flows, such as Chile’s “Encaje” in the 1990s and Brazil’s more recent IOF tax on inflows, such controls may come at the cost of reduced allocations of portfolio capital that is often redirected towards countries with more open exchange rate regimes (Forbes et al. 2012), and over time, lower investment rates, productive capacity and welfare. When there is significant cross-border spillovers of a country’s capital control policies that can exacerbate existing distortions in others, multilateral coordination of such unilateral policies may be beneficial (Ostry, Ghosh, and Korinek 2012).

Box figure ExR 1.1 Currencies of commodities exporters that are also financially-integrated experienced the largest gains during periods of commodity price increases and capital flows



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

Box figure ExR 1.2 FDI is stronger in commodity exporting countries



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

the *Global Economic Prospects* June 2012 report), breaking down in the most recent period. Indonesia's real effective exchange rate declined by 2.6 percent in 2012, but was 19 percent higher compared to the level in January 2009.

Policymakers in developing countries face difficult policy choices when faced with a sustained surge of inward foreign exchange flows, whether these are private flows caused by monetary easing in high income countries, commodity revenues from persistently high international prices, or remittances sent by migrants living in other countries. Policy discussion in middle-income resource-rich countries that are relatively well-integrated with global financial markets such as Brazil, Chile and Russia have typically focused on concerns about capital-inflows induced appreciation and possible loss of manufacturing competitiveness. However, commodity price-driven currency appreciation is also an important issue for other developing countries that are experiencing natural resource discoveries or increased exploitation, for example, in CEMAC countries (including Equatorial Guinea, Cameroon, Gabon and Central African Republic); in Kazakhstan where managing oil revenues presents macroeconomic challenges; and in Iraq where oil production is rising rapidly after political transition.

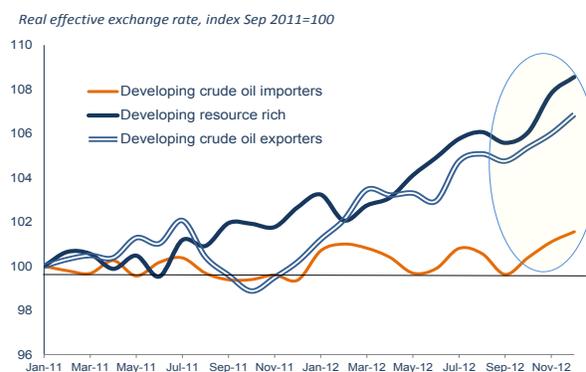
How then should policymakers on commodity revenue-dependent countries respond to these sustained inflows? To the extent that these inflows are used for longer-term productivity-enhancing investments, including in human capital and infrastructure, and used to diversify the economy towards non-commodity sectors such as manufacturing and services, there is less to fear in terms of loss of competitiveness. Some countries such as Norway and Chile have effectively managed commodity revenues and smoothed consumption and investment through cycles using "stabilization funds". Other countries, including African commodity exporters that are less advanced in managing their commodity revenues, have experienced large swings in public spending and higher costs in non-commodity sectors. In such cases,

innovative solutions may be needed to manage the consequences for growth and manufacturing competitiveness (Frankel 2011, Devarajan and Singh 2012).

Currencies of net crude oil importers among developing countries remain under pressure

With a weakening of the global economy and steep slowdown in exports of developing countries during the course of 2012 (see Trade Annex of the *Global Economic Prospects* January 2013 report), some developing countries had to draw down international reserves to support their currencies. Currencies of net oil importers which have faced high international prices of (and often relatively inelastic domestic demand for) crude oil imports faced little appreciation pressure, with their average trade-weighted real exchange rate broadly flat between January 2011 and December 2012. In contrast, crude oil exporters and resource rich developing countries experienced appreciation of 6.9 percent and 8.6 percent, respectively, during this period (figure ExR.5). While a depreciation of the nominal (and in turn, real) exchange rate can help to improve competitiveness and may be desirable in certain circumstances, a combination of a flat or declining real exchange rate and falling reserves suggests that a currency may be under pressure.

Figure ExR.5 Currencies of resource rich and crude oil exporters have experienced greater appreciation pressures compared to other developing countries



Note: GDP weighted averages of trade weighted real effective exchange rates of relevant sub-groups.
Sources: IMF International Financial Statistics, JP Morgan and World Bank.

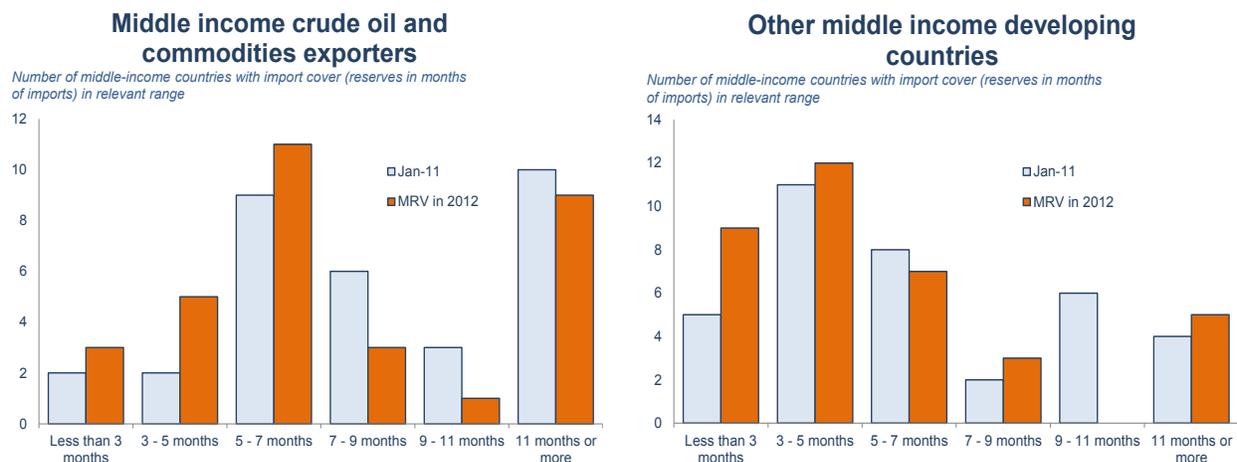
An indicator of vulnerability of the external position, and consequently of pressures on the exchange rate, is the “import cover”, the number of months of prospective imports that can be financed with available international reserves. The proportion of crude oil and industrial commodities exporters where international reserves were less than the critical three months of imports rose from 6.3 percent to 9.4 percent between January 2011 and September 2012 (or most recent available date); and the share of countries with less than five months of import cover rose from 12.5 percent to 25 percent (figure ExR.6). But in the group of non-oil non-commodities dependent countries, the share of countries with less than three months of import cover rose from 14 percent to 25 percent in the same period, and those with less than five months of import cover rose from 44.4 percent of the total to 58.3 percent. In some countries, the erosion of import cover has been alarming. For instance, Egypt’s international reserves fell from the equivalent of over 7 months of merchandise imports in January 2011 to about 3 months by November 2012.

Among countries that are relatively better integrated with global financial markets, reserve accumulation as an insurance against capital account shocks may be more important than insuring against current account shocks, than for countries that have relatively closed capital

accounts (Ghosh, Ostry and Tsangaridis 2012). The former set of countries may need to maintain adequate reserves to cover all short term liabilities, including the maturing portion of long term debt, in addition to covering several months of imports in order to avoid balance of payments shocks. A large stock of reserves may also plausibly deter currency manipulators who seek to profit from greater exchange rate volatility (Basu 2012).

Despite worsening terms of trade, currencies of some net oil importing countries have appreciated in trade weighted real terms due to country specific factors. For example, Turkey’s real effective exchange rate appreciated in 2012, initially helped by monetary support for the currency to cope with inflation and overheating, and later supported by an improving trade and current account position, as weakening of exports to Europe was offset by robust gains in exports to the Middle East (figure ExR.7). In contrast, the real exchange rate of India, another net crude oil importer, depreciated by nearly 11 percent between July 2011 and September 2012 on deteriorating external balances and weakening growth outturns. However, significant reform efforts in September led to a revival of investors’ interest, a surge in portfolio inflows, and a nominal appreciation of more than 5 percent during that month alone.

Figure ExR.6 Import cover declined in middle-income crude oil and commodities exporters, but to a larger extent in other countries



Note: Import cover is defined as international reserves as a share of the average monthly imports in the last six months. Sources: IMF International Financial Statistics and World Bank.

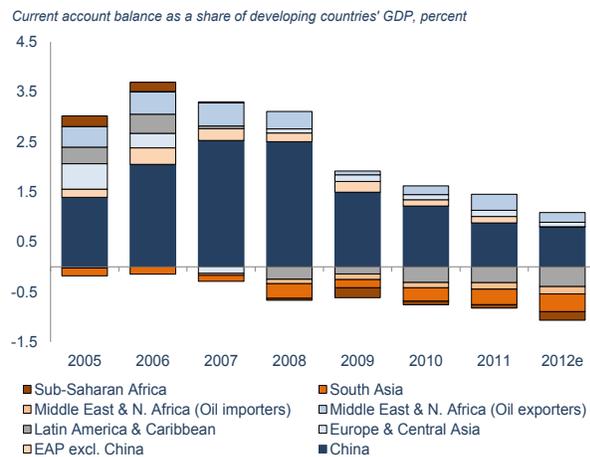
Figure ExR.7 Real effective exchange rates of net oil importers India and Turkey followed divergent paths even with worsening terms of trade in both



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

External vulnerabilities vary across developing regions and among country groups. Net oil importers across developing regions have faced high or widening current account deficits (figure ExR.8) and depreciation pressures. In contrast, developing crude oil exporters in the Middle East, and some East Asian countries such as China, have current account surpluses (albeit falling in recent years in the case of China) and large reserve buffers to draw on, and are therefore easily able to manage pressures on their exchange rates that may result from an adverse external environment.

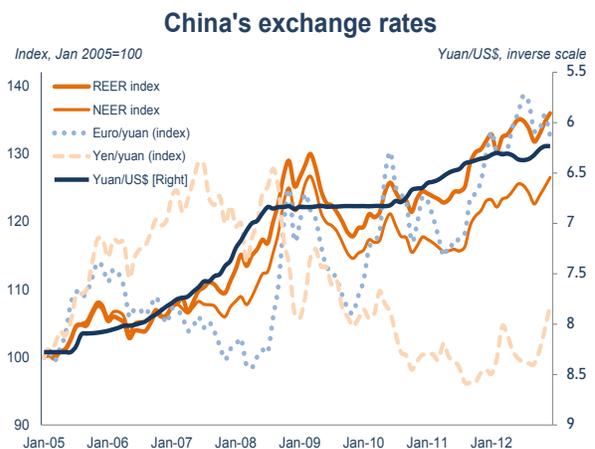
Figure ExR.8 Current account surpluses have fallen in East Asia, but deficits in several other developing regions have widened



Source: World Bank.

China's closely managed bilateral exchange rate relative to the US dollar appreciated to 6.25 renminbi/US dollar in October 2012, the highest level in over a decade, from 8.28 renminbi/US\$ in January 2005, representing a 32 percent appreciation with respect to the US dollar and a 35 percent appreciation relative to the euro (figure ExR.9). The renminbi's appreciation and fall in China's current account surplus is one of the elements of rebalancing the economy towards domestic demand and further internationalization of the currency, as evidenced by progressively larger volumes of trade

Figure ExR.9 The Chinese renminbi appreciated relative to the US dollar and euro between 2005 and 2012



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

transactions denominated in renminbis. However, the renminbi experienced significant depreciation relative to the Japanese yen during the latter part of this period until mid-2011, implying a 8 percent appreciation over the eight year period. Partly due to its tightly managed link to the US dollar, the renminbi experienced significantly greater volatility with respect to the euro and yen, broadly reflecting the movements among high income currencies discussed earlier. Given China's status as the world's largest exporter of goods, its exchange rate policy has significant spillover impacts on trade competitor countries. A recent study finds that exports of competitor countries to third markets tend to rise as the renminbi appreciates, with a 10 percent appreciation of the renminbi raising a developing country's exports at the product-level on average by about 1.5-2 percent (Mattoo, Mishra, and Subramanian 2012).

Looking forward

Developing countries' bilateral exchange rates with respect to the international reserve currencies are likely to continue to be volatile, as high income cross-exchange rates (US dollar, euro, yen) bounce around with the ebb and flow of global financial market conditions and with policy and real side developments (including the possibility of a protracted fiscal impasse in the United States or a resumption of Euro Area debt turmoil). While there is considerable uncertainty regarding price forecasts, given prospects that commodity prices are likely to remain high as global growth continues to firm, currencies of commodities exporters could continue to face upward pressure – especially those that are also significant recipients of private capital.

Finally, the vulnerabilities in some developing countries, especially net importers of crude oil, are likely to ease as their exports rise with a gradual strengthening of global trade, but their weaker international reserve position renders these currencies especially vulnerable to sudden withdrawal of private capital flows if investor sentiment shifts. Net oil importing developing countries that manage to attract high-income monetary easing-related capital flows could

temporarily find it easier to finance their current account deficits, implying easing of balance of payments pressures. But that could also result in heightened balance sheet risks in future, in particular if the share of short-term debt-creating portfolio inflows in overall inflows rises. Currencies of several net oil importing countries with low or eroded reserve buffers, such as Egypt, Pakistan, and India, remain vulnerable, especially when compared to oil exporters and East Asian countries that have significantly larger reserve buffers or current account surpluses.

Notes

1. Among the less-integrated commodity exporters, Zambia's currency benefited from strong copper export revenues and investor interest in its debut \$750 billion sovereign bond in September. The Nigerian naira benefited from high international oil prices in 2012, and more recently, from Nigeria's inclusion in JP Morgan's Emerging Markets Bond index (EMBI) in August. However, currency markets in these countries are relatively thin. In this note, we focus on the internationally traded currencies of typically middle income countries.
2. South Africa's inclusion in the Citi world government bond index (WGBI) was expected to attract substantial inflows, but coincided with a period of mining tensions.

References

- Basu, K. 2012. "The Art of Currency Manipulation: How Some Profiteer by Deliberately Distorting Exchange Rates." Manuscript, Ministry of Finance, Govt. of India, and Cornell University.

- Cashin, P., L. Cespedes, and R. Sahay. 2004. "Commodity Currencies and the Real Exchange Rate," *Journal of Development Economics*, Vol. 75(1), pp. 239-268, October.
- Devarajan, S., and Raju Jan Singh. 2012. "Government Failure and Poverty Reduction in CEMAC". Presentation at the World Bank
- Forbes, K., M. Fratzscher, T. Kostka, and R. Straub. 2012. "Bubble thy neighbor: portfolio effects and externalities from capital controls."
- Frankel, J. 2011. "How Can Commodity Exporters Make Fiscal and Monetary Policy Less Procyclical?" in *Beyond the Curse: Policies to Harness the Power of Natural Resources*, eds.: R. Arezki, T. Gylfason, and A. Sy, International Monetary Fund.
- Frankel, J. 2012. "The Natural Resource Curse: A Survey of Diagnoses and Some Prescriptions." In *Commodity Price Volatility and Inclusive Growth in Low Income Countries*, eds. R. Arezki, C. Pattillo, M. Quintyn, and M. Zhu, International Monetary Fund.
- Ghosh, A, J. Ostry, and C. Tsangarides. 2012. "Shifting Motives: Explaining the Buildup in Official Reserves in Emerging Markets since the 1980s" IMF Working Paper 12/34. January.
- Korinek, A. 2011. "The New Economics of Prudential Capital Controls." *IMF Economic Review* 59 (3), pp. 523-561
- Mattoo, A., P. Mishra, and A. Subramanian. 2012. "Spillover Effects of Exchange Rates: A Study of the Renminbi." IMF Working Paper 12/88. March.
- Ostry, J., A. Ghosh, K. Habermeier, M. Chamon, M. Qureshi, and D. Reinhart. 2010. "Capital Inflows: The Role of Controls," IMF Staff Position Note 10/04. February.
- Ostry, J., A. Ghosh, and A. Korinek. 2012. "Multilateral Aspects of Managing the Capital Account," IMF Staff Discussion Note 12/10. September.

Prospects for commodity markets

Overview

Following sharp declines during 2012Q2, commodity prices rebounded with most of the indices ending 2012 at levels close to where they began (figure Comm.1). For the year as a whole, crude oil prices averaged US\$ 105/bbl, just US\$ 1 above the 2011 level. Food prices increased marginally as well, though during 2012Q3 grains reached record highs (figure Comm.2). Metal prices declined more than 15 percent, ending the year at levels close to mid-2010 lows. Raw materials and beverages prices declined sharply as well—almost 20 percent each. Fertilizer and precious metal prices changed little.

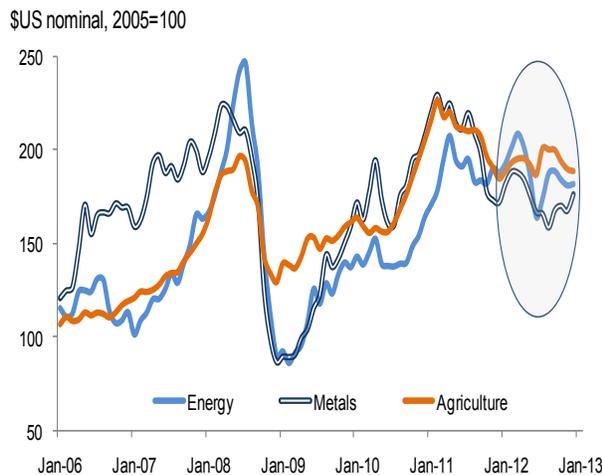
The price declines of most commodities earlier in the year reflected intensification of the European debt crisis along with slower growth prospects in emerging economies, especially China. In the summer, however, food prices rose sharply as hot weather and dry conditions in the US, Eastern Europe, and Central Asia reduced the maize and wheat outlook. Towards the end of 2012Q3 prices of most industrial commodities firmed following the ECB bond purchase program and later the announcement of QE3 by the US Federal Reserve. In addition to weakness

in the global environment, oil prices have responded to geopolitical concerns, including EU’s embargo on Iranian oil and on-going violence in the Middle East.

Under our baseline scenario, which assumes further easing of financial tensions in Europe, most prices are expected to decline in 2013. Oil is expected to average 102/bbl in 2013, just 3 percent lower than the 2012 average (table Comm.1). Agricultural prices are set to decline more than 3 percent (food, beverages, and raw materials down by 3.2, 4.7 and 2.2 percent, respectively). Metal prices are expected to gain marginally but still average 14 percent lower than 2011. Fertilizer prices are expected to decline 2.9 percent, while precious metal prices will increase a little less than 2 percent.

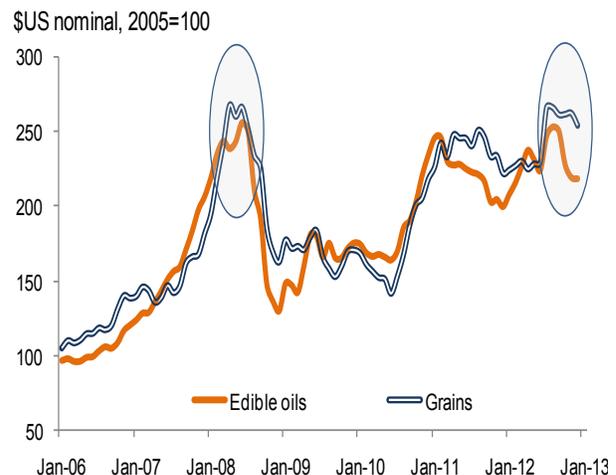
There are a number of risks to this forecast. On oil, global supply risks remain from the on-going political unrest in the Middle East. A major supply cutoff could limit supplies and result in prices spiking well above US\$ 150/bbl. Such outcome would depend on numerous factors, including the severity, duration, policy actions on emergency reserves, demand curtailment, and OPEC’s response. Downside price risks, on the

Figure Comm.1 Commodity price indices



Source: World Bank

Figure Comm.2 Food price indices



Source: World Bank.

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

	ACTUAL					FORECAST		CHANGE (%)		
	2008	2009	2010	2011	2012	2013	2014	2011/12	2012/13	2013/14
Energy	183	115	145	188	187	183	183	-0.4	-2.6	0.1
Non-Energy	182	142	174	210	190	186	180	-9.5	-2.0	-3.2
Metals	180	120	180	205	174	176	176	-15.3	1.3	-0.1
Agriculture	171	149	170	209	194	188	180	-7.2	-3.2	-4.4
<i>Food</i>	186	156	170	210	212	205	192	0.7	-3.2	-6.4
Grains	223	169	172	239	244	239	225	2.4	-2.1	-6.0
Fats and oils	209	165	184	223	230	220	206	3.3	-4.2	-6.5
Other food	124	131	148	168	158	153	143	-5.9	-3.1	-6.6
<i>Beverages</i>	152	157	182	208	166	158	155	-20.2	-4.7	-2.0
<i>Raw Materials</i>	143	129	166	207	165	162	162	-20.0	-2.2	0.4
Fertilizers	399	204	187	267	259	245	232	-2.9	-5.6	-5.3
Precious metals	158	175	272	372	378	378	353	1.7	0.0	-6.7
Memorandum items										
Crude oil (\$/bbl)	97	62	79	104	105	102	102	1.0	-2.9	0.2
Gold (\$/toz)	872	973	1,225	1,569	1,670	1,600	1,550	6.4	-4.2	-3.1

Source: World Bank.

other hand, include weaker oil demand due to slower economic growth, especially by emerging economies. Nevertheless, the key element for price stability will be how well OPEC (and more importantly Saudi Arabia) can address changing demand conditions. Historically, OPEC has been able to respond quickly to defend a price floor by cutting production sharply, but has been unwilling to respond as quickly to set a price ceiling. On the other hand, there is some room on spare capacity and stocks. OPEC's spare capacity averaged 3.9 mb/d during 2012Q3, 14 percent higher than 2012Q2 but remarkably similar to the past decade's historical average (it had reached a low of 2.3 mb/d during the first half of 2008, when oil prices exceeded US\$ 140/bbl.) Moreover, OECD oil inventories have recovered remarkably—up 17 percent from 2012Q2 to 2012Q3. On the demand side, while the oil intensity of GDP in middle income countries has been rising, it has not reached levels that could derail economic growth. Price risks on metals depend on the prospects for the Chinese economy; should it deteriorate, metal prices could decline substantially as China accounts for almost half of global metal consumption.

On agriculture (and most importantly food), a key upside risk is weather. Any adverse weather event is likely to induce sharp increases in maize

prices, in view of historically low stock levels. The wheat market (which currently is better supplied than maize) may come under pressure as well. In contrast, there are limited upside price risks for rice and oilseeds since the respective markets are well-supplied. Trade policy risks appear to be low as well. Despite the sharp increases in grain prices during the summer of 2012, countries did not engage in export restrictions—some press reports to the contrary turned out to be unsubstantiated. Finally, growth in the production of biofuels has slowed as policy makers are increasingly realizing that the environmental and energy security benefits from biofuels are not as large as originally thought.

Crude Oil

Despite large fluctuations, oil prices (World Bank average) ended the year at US\$ 101/bbl, close to where they began (figure Comm.3). The decline earlier in 2012 (23 percent down between March and June 2012), reflected weak demand due to slower growth outlook and heightened concerns about the European debt crisis. However, supply concerns, mostly of geopolitical nature, weighed in later prompting a firming of prices.

Although Brent prices (the international marker) topped \$113/bbl in September, West Texas

Intermediate (the US mid-continent price) has remained almost \$20/bbl below due to the build-up of regional stocks (figure Comm.4). A decline in the Brent-WTI spread in late 2011/early 2012, which reflected a euro zone-induced decline in Brent, turned out to be temporary and by August 2012 the spread exceeded 20 percent once more.

Crude flows from Canada through the Keystone pipeline that commenced in 2011, as well as rapidly rising shale-liquids production in the US, especially in the states of Texas and North Dakota, have contributed to the build-up of US stocks—at a time when U.S. oil consumption is dropping. Currently, there is limited capacity to transport surplus oil to the U.S. Gulf coast, apart from some utilization of rail, truck and barges. Although the WTI discount is expected to persist until 2015, when the new pipelines to the U.S. Gulf are expected to become operational, some easing may take place earlier depending on the speed at which the reversal of existing pipelines will materialize.

World oil demand increased only modestly (less than 0.8 percent or 0.67 mb/d) in 2012 (figure Comm.5). OECD consumption is down almost 5 mb/d, or 10 percent from its 2005 peak. Japan is the only OECD country that increased crude oil demand by 1 mb/d. Most of the increase was destined for power generation, following the closing of nuclear capacity after the Tohoku accident. Non-OECD demand is positive and robust—currently non-OECD countries account for almost half of global crude oil consumption and more than all of the increase in global demand.

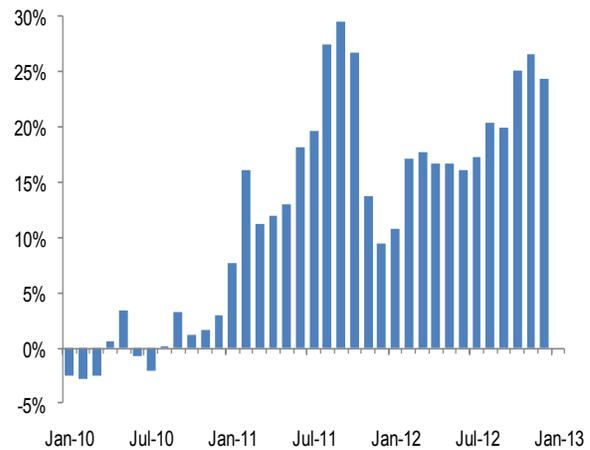
On the global supply side, the decline in non-OPEC output growth in 2011 appears to have reversed. In 2012, non-OPEC producers added over 1 mb/d to global supplies, mainly reflecting earlier large-scale investments. The technology in the exploitation of the natural gas in the U.S.—which combines horizontal drilling and hydraulic fracturing—is spilling into the petroleum industry and is currently applied to the oil-bearing shale plays of the Bakken formation in North Dakota and Eagle Ford

Figure Comm.3 Oil prices and OECD oil stocks



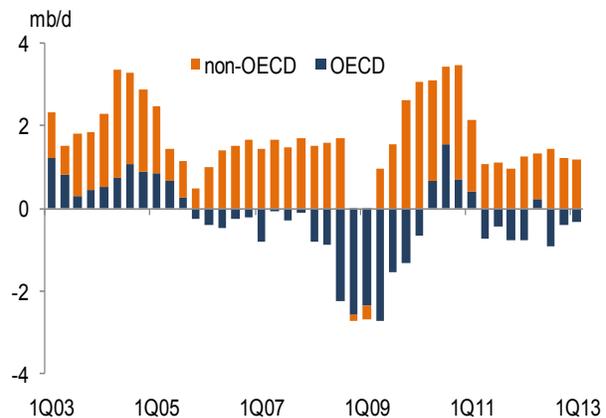
Source: IEA, World Bank.

Figure Comm.4 WTI/Brent price differential



Source: World Bank.

Figure Comm.5 World oil demand growth



Source: IEA, World Bank.

formation in Texas. Oil production from these two areas has risen very rapidly over the past few years. For example, Texas and North Dakota added 1 mb/d of crude oil in just 16 months (from April 2011 to August 2012, figure Comm.6). Although shale-liquids (also referred to as tight oil) production has great potential to be applied elsewhere in the U.S. and worldwide, there are some public concerns about effects of the potential ecological impacts of fracturing and water use.

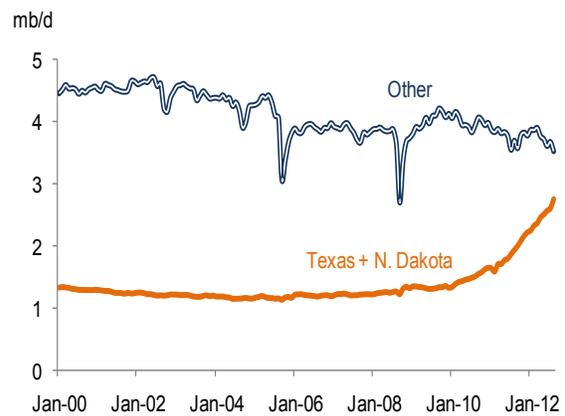
Production among OPEC countries has risen 1.8 mb/d since the end of 2010 (prior to disruptions in Libya) with Saudi Arabia accounting for 1.5 mb/d of the net gain. In the meantime, Libya's oil production has recovered to 1.3 mb/d, compared with 1.6 mb/d pre-crisis, although further gains may be difficult due to on-going internal disputes. Iraq's production reached a pre-war high in March 2012 of 2.84 mb/d, and exports are increasing from a new mooring system in the Gulf. On the other hand, Iran's exports have declined by 0.3 mb/d from pre-sanctions levels, and are set to tumble further unless alternative buyers (or buying arrangements) can be found. Iran's traditional crude buyers are struggling to arrange payment mechanisms, secure ships to lift oil, and to engage insurance companies to underwrite the trade. Numerous reports indicate that Iran is circumventing sanctions through bilateral in-kind trade arrangements.

The net growth in OPEC production has reduced its spare capacity to 3.5 mb/d (figure Comm.7), of which nearly two-thirds rests with Saudi Arabia. The Saudi Oil Minister has promised to keep the market well supplied, but also deems that \$100/bbl is a fair price.

Outlook

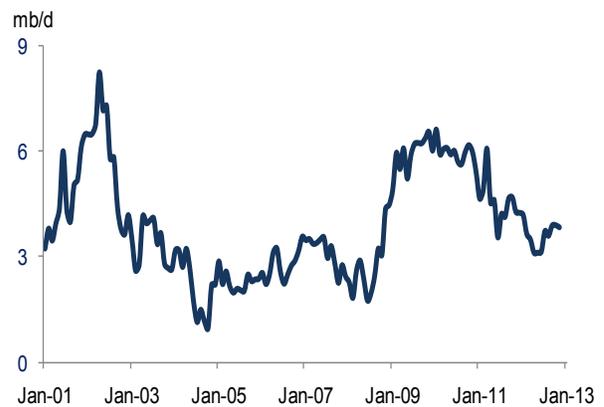
In the near term, oil prices are likely to be capped at around \$120/bbl because of price-induced demand restraint and publicly stated intentions of strategic reserve releases by the U.S., UK, and France. Upside risks stem from technical and geopolitical problems, particularly

Figure Comm.6 US crude oil production



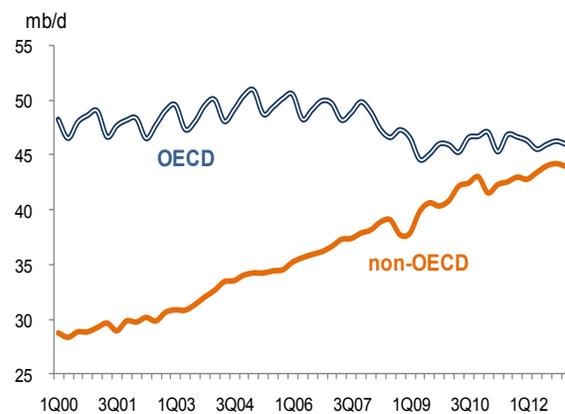
Source: EIA

Figure Comm.7 OPEC spare capacity



Source: IEA

Figure Comm.8 Crude oil consumption



Source: IEA.

in countries struggling with conflict and security, including Libya and Iraq.

In the medium term, world oil demand is expected to grow moderately, at 1.5% p.a., with all of the growth coming from non-OECD countries as it has done in the recent past (figure Comm.8). OECD oil consumption is expected to continue its weakness due to efficiency improvements in vehicle transport and a gradual switch to electric and natural gas transport (yet in the absence of innovations, the switch may be slow as discussed in box Comm.1). Moreover, environmental pressures to reduce emissions are expected dampen oil demand growth worldwide. Consumption growth in developing countries is expected to be strong in the near and medium terms, while it is expected to moderate in the longer term as their economies mature, subsidies are phased out, and other fuels penetrate their fuel mix, notably natural gas.

On the supply side, non-OPEC oil production is expected to continue its upward climb as high prices have attracted considerable investment associated with continued advances in upstream technology (figure Comm.9). High oil prices have reduced resource constraints, and new frontiers continue to be exploited, including deep water offshore and shale liquids discussed earlier. Production increases are expected from a number of areas, including Brazil, Canada, the

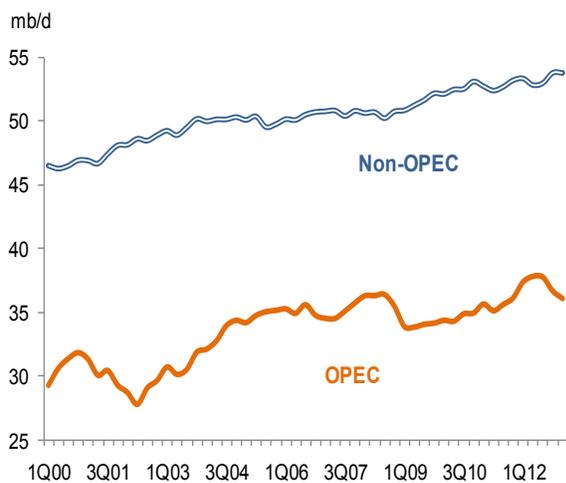
Caspian, West Africa, and the United States, likely to offset declines in mature areas such as the North Sea.

Nominal oil prices are expected to average \$102/bbl during 2013 and 2014 as supplies accommodate moderate demand growth. Over the longer term, oil prices are projected to fall in real terms, due to growing supply of conventional and (especially) unconventional oil, efficiency gains, and a substitution away from oil. The assumptions underpinning these projections reflect the upper end cost of developing additional oil capacity, notably from oil sands in Canada, currently assessed by the industry at \$80/bbl in constant 2012 dollars. It is expected that OPEC will continue to limit production to keep prices relatively high. However, the organization may be sensitive to letting prices rise too high, for fear of inducing technological changes that alter the long-term price of oil.

Metals

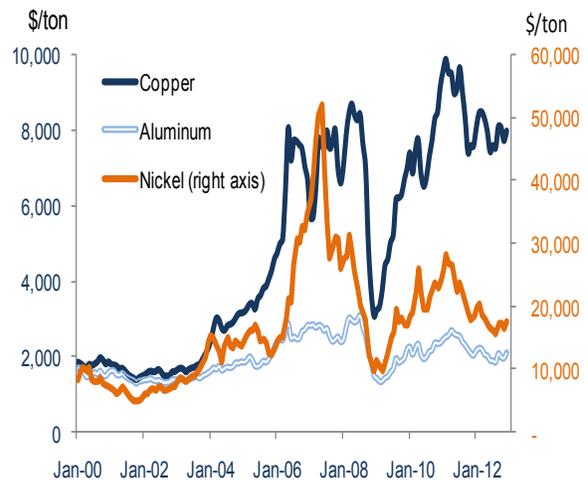
Most metal prices declined steadily during the first three quarters of 2012 (down 15 percent between February and September) on global growth concerns, weakening demand by China, high stocks for most metals, and emerging supply growth (figure Comm.10). Indeed, China’s import demand growth slowed in 2012,

Figure Comm.9 Crude oil production



Source: IEA.

Figure Comm.10 Metal prices



Source: World Bank

Box Comm.1 The “energy revolution”, innovation, and the nature of substitution

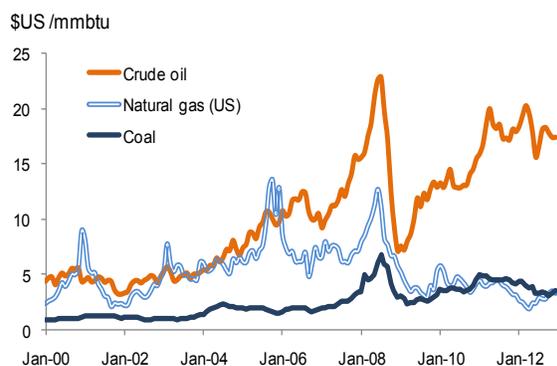
Large and sustained price changes alter relative input prices and induce innovation (Hicks 1932). The post-2004 crude oil price increases did just that in both natural gas and oil exploration and extraction through new technologies such as horizontal drilling and hydraulic fracturing. Because of these technologies, the US increased its natural gas production by almost 30 percent during 2005-12. Similarly, US crude oil production increased by 1.3 mb/d during the past 4 years. To put this additional oil supply into perspective, consider that global biofuel production in terms of crude oil energy equivalent was 1.2 mb/d in 2011.

The sharp increase in natural gas supplies, not only put downward pressure on prices but also induced substitution of coal by natural gas in various energy intensive industries, notably in electricity generation and petrochemicals. Natural gas, which traded just 7% below oil in 2000-04 in energy-equivalent terms, averaged 82% lower in 2011-12 and it has been traded close to parity with coal (figure Box Comm 1.1). On the other hand, growing US oil supplies, coupled with weak demand, caused WTI to be traded at 20% below Brent, the international marker (figure Box Comm 1.2). The discount is expected to persist until 2015 when new pipelines and reversal of existing pipelines will move oil supplies from the mid-continent US to the US Gulf.

Yet, the shift from crude oil to other types of energy, notably electricity and natural gas, with potential use by the transportation industry (which globally accounts for more than half of crude oil consumption) has been very slow. Such slow response reflects the different physical properties these types of energy, namely density (the amount of energy stored in a unit of mass) and scalability (how easily the energy conversion process can be scaled up). The energy densities of the fuels relevant to the transportation industry are 37 MJ/liter for crude oil, 1 MJ/kg for electricity, and 0.036 MJ/liter for natural gas (in its natural state); Compressed Natural Gas (GNG), used by bus fleets in large cities, is about 10 MJ/liter, while the density of Liquefied Natural Gas (LNG) is 24 MJ/liter. Energy density is measured in megajoules (MJ) per kilogram or liter. For comparison note that one MJ of energy can light one 100-Watt bulb for about 3 hours.

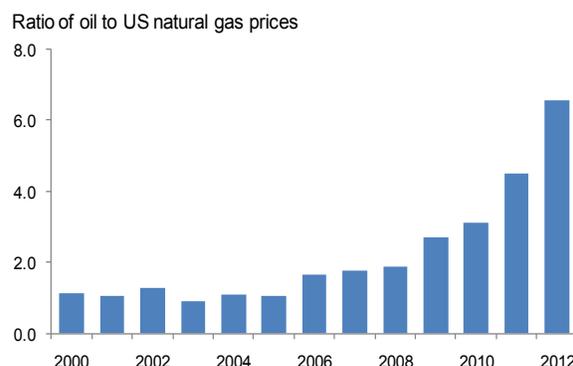
To gauge the importance of energy density associated with various fuels and technologies consider the following illustrative example. If a truck with a net weight capacity of 40,000 lbs were to be powered by Lithium-sulphur batteries (currently used by electric-powered vehicles) for a 500-mile range, the batteries would occupy almost 85 percent of the truck’s net capacity leaving only 6,000 lbs of commercial space. That is, an energy conversion process that works at a small scale (a passenger car) does not work at larger scales (a truck, an airplane, or an oceanliner). Similarly, to increase the energy density of natural gas, it must be liquefied, which involves cooling it to about -62 °C at a LNG terminal, transporting it in specially designed ships under near atmospheric pressure but under cooling, and then off loading at destination, gasified and re-injected into the natural gas pipe network. This is a technically demanding process adding considerable costs at delivery. Contrary to natural gas, crude oil products have convenient distribution networks and refueling stations that can be reached by cars virtually everywhere in the world. Thus, in order for the transport industry to substitute crude oil by natural gas at a scale large enough to reduce oil prices, innovations must take place such that the distribution and refueling costs of natural gas become comparable to those of crude oil, which explains why the transport industry is slow to utilize natural gas.

Box figure Comm 1.1 Energy prices



Source: World Bank.

Box figure Comm 1.2 Oil to natural gas price ratio



Source: World Bank.

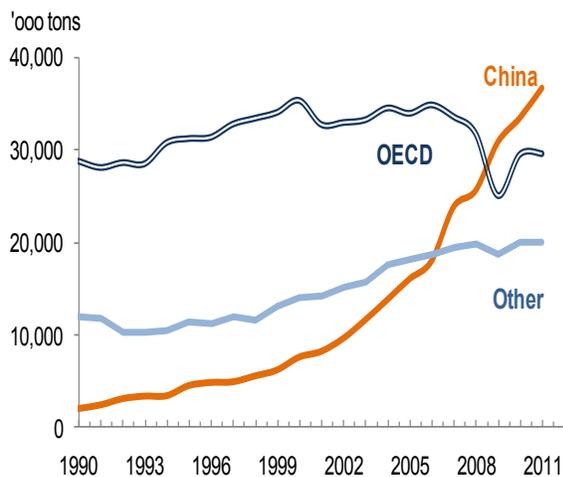
owing to destocking—China consumes almost 45 percent of world’s metal’s output (see figure Comm.11).

The extended period of high prices since mid-2000 has generated large investment in new capacity, and supply is rising more quickly than demand for some metals, including nickel and copper. During 2012Q4, however, most metal prices reversed their downward trend as the possibility of hard-landing in China became remote.

An interesting characteristic of the metals (and other industrial commodities) during the recent boom is that their prices have been highly volatile, even more volatile than food prices—historically, the reverse has been the case. In fact, non-food price volatility during the second half of the past decade has been the highest since 1970, not surprisingly since non-food commodities increased the most during the recent boom. However, price volatility for most commodities appears to have eased during the past two years, indicating that the high volatility during 2008-10 reflected the move from low to high prices and the financial crisis of 2008 (see discussion in box Comm.2).

Recent developments in metal markets

Figure Comm.11 Consumption of metals



Source: World Bureau of Metal Statistics

Aluminum prices fell below US\$ 2,000 per ton in the third quarter, near to their pre-2005 levels due to a persistent global surplus and high stocks. Prices nevertheless are now, at or below marginal production costs, for many producers with more limited downside risks—suggesting that prices are unlikely to fall much further. Furthermore, a significant amount of inventories are tied up in warehouse financing deals, and unavailable to the market. Aluminum consumption continues to benefit from substitution, mainly from away copper in wiring and cable sectors (copper prices are now more than four times higher than aluminum prices—they were similar prior to the 2005 boom). Substitution is expected to continue for as long as the aluminum to copper price ratio is at least 2:1. Global production capacity continues to outstrip consumption, the bulk of which comes from China and to a lesser extent from Middle East, Europe, and North America. The market surplus is expected to endure in the near term. Therefore, prices are likely to respond to higher production costs, of which energy accounts for 40 percent alone.

Copper prices fell sharply in 2012Q2 due to weakening import demand by China. High copper prices have led to significant substitution of copper use and have accelerated recycling rates of scrap reprocessing. These trends are expected to continue in the near term. Copper demand is expected to increase at a modest 2.5 percent per annum over the forecast period, and slow even further over the longer term as copper intensity in China—which has risen sharply—plateaus. Copper mine production, which was flat in 2011, has not kept pace with consumption due to various of reasons including, technical problems, labor disputes, declining grades, delays in start-up projects, and shortages of skilled labor and inputs. The tightness in copper production has been pronounced at the world’s two largest mines (Escondida in Chile and Grasberg in Indonesia). However, high copper prices have induced a wave of new mines that are expected to come on-stream, especially from some African countries, Peru, the US, and China.

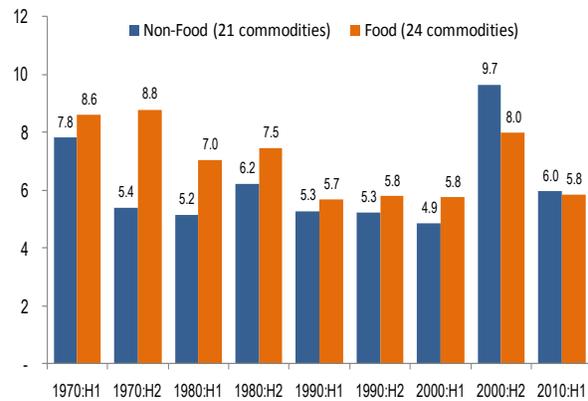
Box Comm.2 Commodity price movements: From levels to volatility and comovement

Applying a standard measure of volatility to 45 monthly prices during 1970-2012 shows that even though historically non-food prices have been less volatile than food prices, during 2005-09 non-food price volatility exceeded that of food prices by a wide margin (9.7 versus 8.0). Furthermore, while non-food price volatility reached record highs during 2005-09, food price volatility did not—in other words food price volatility during the recent boom has been high but not unprecedented. This result is remarkably similar to Gilbert and Morgan (2010, p. 3023) who concluded that food price variability during the post-2004 boom has been high but, with the exception of rice, not out of line with historical experience. And, there is some evidence that volatility has come down to historical norms during the past 3 years (figure Box Comm 2.1). Two factors may account for the high volatility during 2005-09: the move from a lower to higher price equilibrium and the 2008 financial crisis. The latter is supported by the fact that volatility increases sharply when August 2008 is included in a 2-year moving average while a similar decline becomes apparent when January 2011 is included in the average (figure Box Comm 2.2).

In addition to increased levels and volatility, commodity prices have been moving in a more synchronous manner. In fact, price comovement during the second half of the past decade has been the highest compared to the 43-year sample period (figure Box Comm 2.3). Moreover, while there is some evidence that comovement has moderated recently, it is still high by historical standards. The increase in comovement implies that common factors have been the dominant force behind post-2004 commodity price movements (box Comm.3 elaborates further on this point).

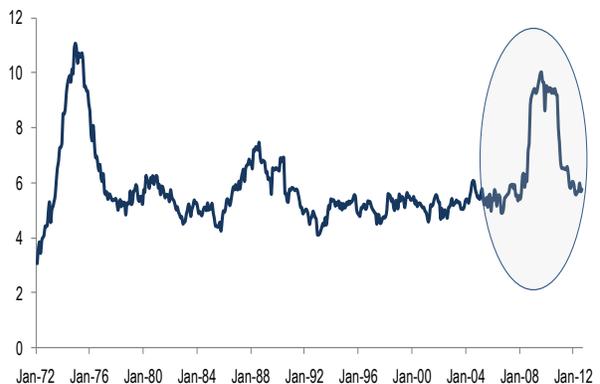
Price volatility is calculated as the median of $100 * STDEV[\log p(t) - \log p(t-1)]$, for 21 non-food and 24 food prices, where STDEV denotes standard deviation, $p(t)$ is the current, and $p(t-1)$ is the lagged price of each commodity (their logarithmic difference is the so-called returns). The measure is applied to 5-year periods, denoted as H1 and H2 for the first and second part of each decade, respectively (2010:H1 includes 36 observations because the sample ends in December 2012). Volatility is also presented as a 2-year trailing moving average. Apart from its simplicity, this measure of volatility is appropriate for non-stationary variables, which is typically the case with commodity prices. Comovement is measured as a 2-year trailing moving average of $ABS[n(up)-n(down)]/[n(up)+n(down)]$, where ABS is the absolute value operator and $n(up)$ and $n(down)$ denote the number of prices that went up and down during the month. The index can take values between zero (when half of the prices go up and half go down) and unity

Box figure Comm 2.1 Commodity price volatility: food and non-food (5 year averages)



Source: World Bank

Box figure Comm 2.2 Commodity price volatility: all commodities (2-year trailing moving average)



Source: World Bank

Box figure Comm 2.3 Commodity price comovement



Source: World Bank

(when all prices move in the same direction). While random chance is expected to generate half increases and half declines, because of common factors the index is likely to take values well above zero. Indeed during 1970-2012 the index averaged 0.27, implying that of the 44 commodities of the sample, on average, 16 prices went up (down) and 28 prices went down (up). Two key advantages of the index are that (i) it measures comovement across a large number of prices (difficult to be measured through parametric models) and (ii) it is not subjected to degrees of freedom limitations. However, these advantages come at the expense of measuring direction of changes only, not magnitude, thus underutilizing the informational content of prices. The index has been used in the financial literature (see, for example, Morck, Yeung, and Yu (2000) on the measurement of equity price comovement in emerging economies).

Nickel prices rose modestly in early 2012 but receded on sluggish market for stainless steel (the end use of more than two-thirds of nickel production) and rapid restart of nickel pig iron (NPI) production in China. The country accounts for 40 percent of global stainless steel production—up from 4 percent a decade ago. Stainless steel demand is expected to remain robust, growing by more than 6 percent annually, mainly driven by its high grade consumer applications, initially in high income countries and increasingly so by emerging economies. Yet, a wave of new nickel mine capacity is expected to keep nickel prices close to marginal production costs. Several new projects will soon ramp up production, including in Australia, Brazil, Madagascar, New Caledonia, and Papua New Guinea. Another major source of nickel supply is NPI in China which sources low-grade nickel ore from Indonesia and the Philippines. However, Indonesia has announced that it will develop its own NPI industry and has introduced export

quotas and may ban nickel ore exports by end-2013.

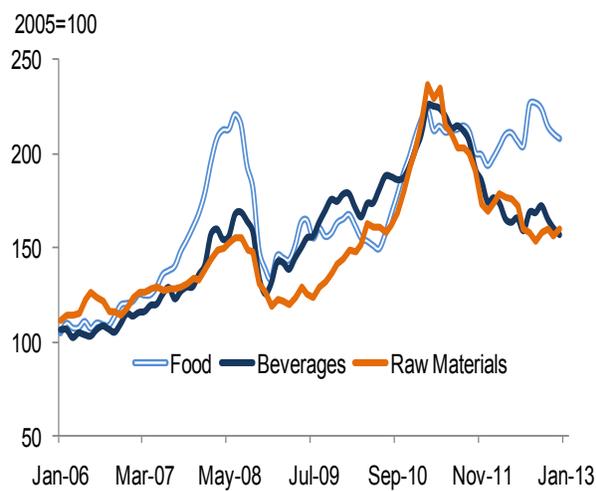
Outlook

Overall metal prices are expected to increase marginally in 2013. Aluminum prices are expected to increase almost 3 percent in 2013 and remain at that level for the two subsequent years due to rising power costs, and the fact that current prices have pushed some producers at or below production costs.

Nickel prices are expected to increase almost 3 percent in 2013, and following a slightly upward trend thereafter. Although there are no physical constraints in these metal markets, there are a number of factors that could push prices even higher over the forecast period, including declining ore grades, environmental issues, and rising energy costs.

On the contrary, copper prices are expected to decline 2 percent in 2013 and as much as 10 percent in 2014, mostly due to substitution pressures, and slowing demand.

Figure Comm.12 Agriculture price indices



Source: World Bank

Agriculture

Following a sharp decline from their 2011 peaks, agricultural prices diverged in the summer of 2012. Food prices firmed following a heat wave that affected the Midwestern US maize producing states while drought conditions in Eastern Europe and Central Asia reduced the outlook for wheat. On the other hand, oilseed and edible oil prices weakened towards the end of the year on better supply prospects from South America (soybeans) and East Asia (palm oil). Beverages and raw material prices continued their slide as well to end the year

about 30 percent lower than their 2011 peaks (figure Comm.12). For the year as a whole, the World Bank’s agricultural price index is down almost 7 percent.

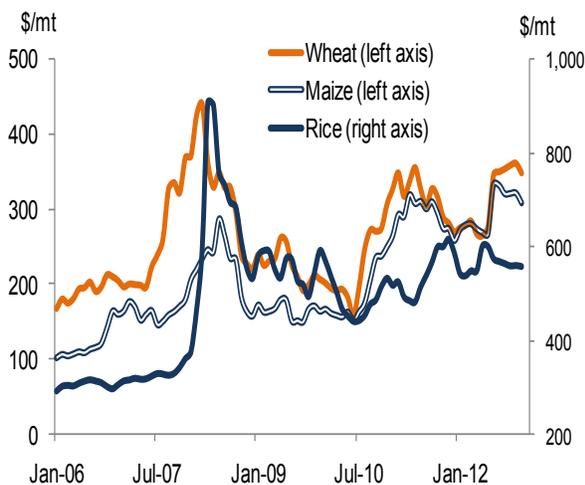
Recent developments in global agricultural markets

Grain prices were remarkably stable between the end 2011 and the summer of 2012, when initial assessments for the 2012/13 season indicated a good crop (figure Comm.13). As a consequence, prices of key grains fluctuated within a tight band during this period. The outlook changed dramatically in the summer when the heat wave in the US and drought conditions in Europe and Central Asia induced large declines in maize and wheat yields. In its July update, the US Department of Agriculture (USDA) reduced sharply the 2012/13 assessment for global maize production (from 950 to 905 million tons), causing end-of-season stocks to decline by 14 percent—associated with a stock-to-use ratio of less than 15 percent, the lowest since 1972/73. Lesser, but important downward assessment took place in the wheat market. Prices of both maize and wheat increased almost 40 percent within just a month. Since then, subsequent USDA assessments have retained the tight outlook for these two commodities.

During Aug-Dec 2012, maize and wheat prices averaged US\$ 313 and 353 per ton, associated with a 9 percent premium of wheat over maize—historically the premium has averaged 30%. Therefore, the summer drought not only reduced the maize stock-to-use ratio to historical lows, but brought the wheat-to-maize price premium to historical lows as well (figure Comm. 14).

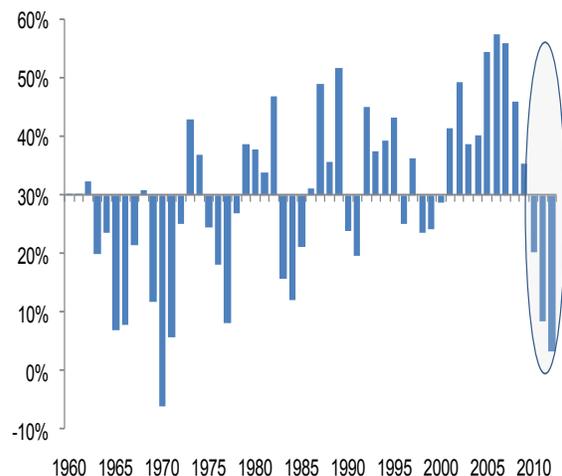
Contrary to maize and wheat the **rice** market is well-supplied. During the past 3 years rice prices have averaged \$520/ton (they have exceeded \$600/ton on only a few occasions). The rice price variability if the past year reflects, in part, purchases through the Thai Paddy Rice Program—Thailand is the world’s largest rice exporter, accounting for 25-30 percent of global exports, hence the large influence of its policy actions on world markets. Reports of some damage due to floods in Thailand earlier in the year caused some concern but turned out not to be important. According to the USDA’s January 2013 assessment, global rice production is expected to reach 466 million tons, 1 million ton above the 2011/12 record. The stock-to-use ratio is expected to reach 22 percent, marginally lower than 2011/12 but well within historical norms. Trade in rice has improved as well reaching a new record of 39.1 million tons in 2012, aided in part by a surge in Chinese imports (2.6 million tons in 2012, up from 0.5 million tons in 2011).

Figure Comm.13 Grain prices



Source: World Bank

Figure Comm.14 Wheat/maize price ratio

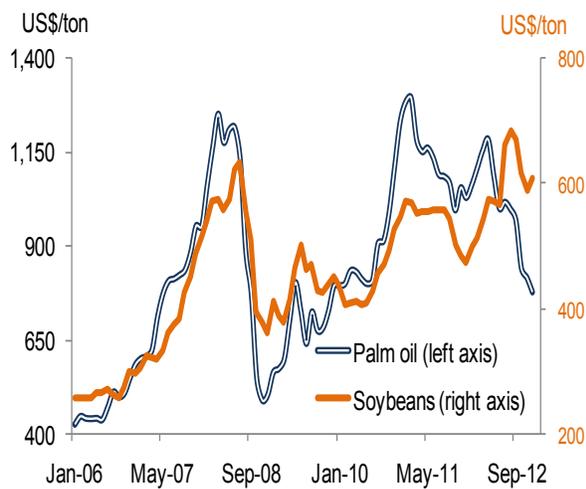


Source: World Bank.

After a 27 percent increase during the first eight months of 2012, *edible oil* prices reversed course with the World Bank edible oil price index dropping almost 12 percent from August to December. The decline reflects an improved outlook for the South American crop as well as a re-assessment of the US soybean crop whose yields turned out to be higher than originally expected. Palm oil supplies from Indonesia and Malaysia are improving as well (figure Comm.15).

Following the historic highs earlier in 2011, *beverage* prices have been declining consistently, ending the year 30 percent lower than their early 2011 highs. The strength in beverage prices reflected the surge in arabica prices (which averaged close to \$6.00/kg during 2011, the highest nominal level). However, news that Brazil's crop for the current season will be much higher than anticipated caused arabica prices to plummet 36 percent in 2012—Brazil is the world's largest arabica supplier. Robusta prices have been remarkably stable during the past year (around US\$ 2.30/kg), despite a record Vietnamese crop—Vietnam is the world's largest robusta supplier. Robusta prices did not decline because coffee roasters included more robusta in their blends due to high arabica prices. *Cocoa* prices, which reached record highs in 2011 as well, have weakened considerably in response to better crop outlook in Côte d'Ivoire

Figure Comm.15 Edible oil prices



Source: World Bank

coupled with demand weakening in Europe. *Tea* prices edged marginally percent down in 2012. Prices have surged during the last five years to record highs partly in response to repeated cycles of adverse weather conditions in the producing countries and strong demand by key tea consumers, including Russia, Pakistan, and various Middle East countries as well as domestic consumption in India.

Last season's tight *cotton* supplies caused prices to quadruple within less than a year exceeding US\$ 5/kg in March 2011. Yet, prices declined just as sharply to drop below US\$ 2.00/kg in May 2012. The improved supply outlook for the 2012/13 crop year induced further declines in prices which ended the year 18 percent lower than January 2012. The cotton market is well-supplied by historical standards; global production is expected reach 25.5 million tons while consumption will not exceed 23.5 million tons. An estimated two million tons will be added to stocks, pushing the stock-to-use ratio to 70 percent, the highest since the end of World War II. Approximately 9 million tons of cotton have gone to the state reserve of China during the past two seasons, explaining why price did not collapse (ICAC 2012). Nevertheless, from a longer term perspective, cotton prices increased the least during the recent commodity boom when compared to other crops, primarily because of the massive supply response by China and India caused by the adoption of biotechnology (Baffes 2011).

Natural Rubber prices have been declining steadily to average the year almost 30 percent lower than 2011. As was the case with cotton, natural rubber prices reached record highs in 2011 (they exceeded \$6.00/kg in February 2011, more than a 4-fold increase within just 2 years.) The recent decline reflects better supplies and fears of demand deterioration, especially by China—most natural rubber goes for tire production and China has been the fastest growing market. Crude oil prices play a key role as well, because synthetic rubber, a close substitute to natural rubber, is a crude oil by-product. Expectations for a boom in *timber* prices following the Tohoku accident were short

lived—it was expected to generate strong demand for timber products. Malaysian log prices are down 8 percent in 2012, effectively reaching pre-Tohoku levels as global demand for timber products has weakened considerably.

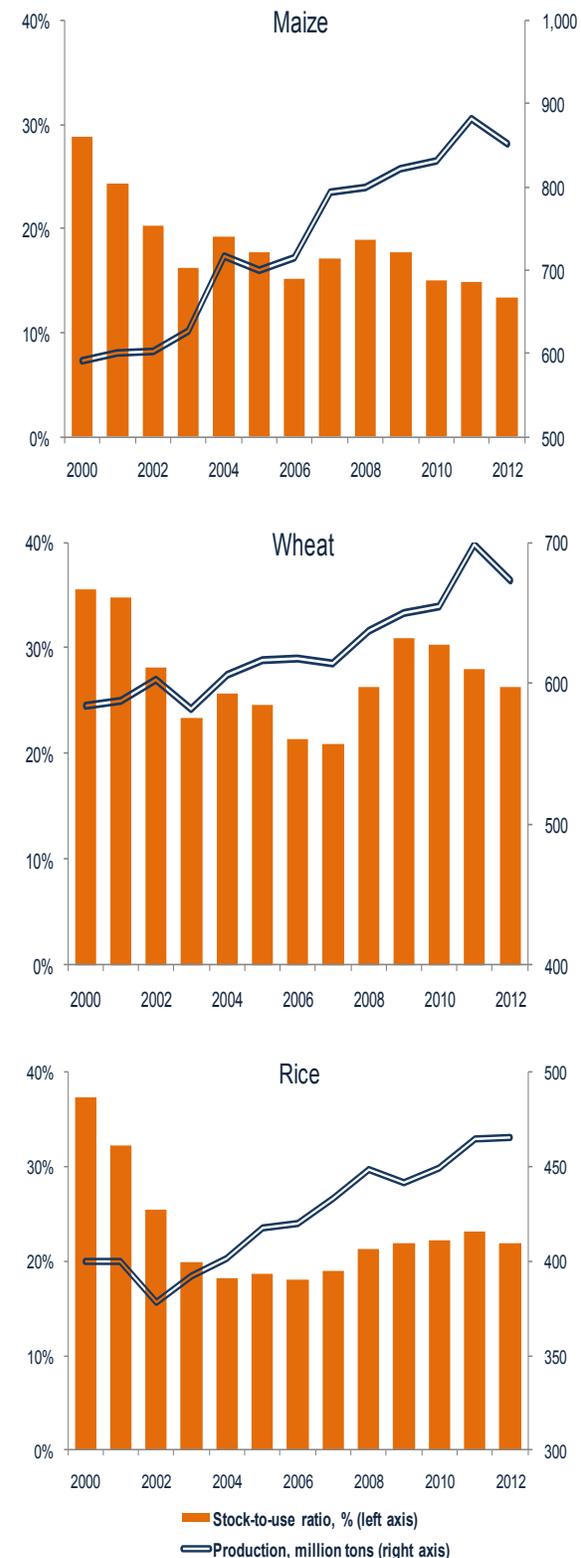
Global market outlook

Agricultural prices are projected to decline 3.2 percent in 2013. Specifically, wheat and maize prices are expected to average 2.2 and 2.8 percent lower than their 2012 levels. Rice prices are expected to decline about 4 percent to average \$540 per ton. Soybean and palm oil prices are expected to be 3.6 and 2.1 percent lower, respectively. Among beverage prices coffee may experience the largest decline (9.6 percent for robusta and 7.6 percent for arabica), while cocoa and tea will change only marginally. On raw materials, timber and natural rubber prices are expected to decline modestly (0.5 and 2.3 percent) while cotton prices will drop by 8.5 percent.

A number of assumptions underpin this outlook. First, it assumes that no adverse weather condition will affect the Southern Hemisphere’s crop while next season’s outlook will return to normal trends. In its January 2013 assessment, USDA estimated this season’s global grain supplies (production plus beginning stocks) at 2.47 billion tons, down 2.5 percent from 2011/12. If history is any guide, when markets experience negative supply shocks similar to the one experienced in the summer of 2012, production comes back to pre-crisis levels within the next season through resource shifting, as was the case for maize in 2004/05, wheat in 2002/03, and rice in 2001/02 (figure Comm.16). However, it takes between three seasons before stocks are fully replenished, in turn keeping prices of the respective commodity under pressure. As depicted in figure Comm.14, wheat is traded about 30 percent above maize in the long term, indicating that it may take up to 3 years before maize and wheat prices return to their long term equilibrium.

Second, it is assumed that in 2013 crude oil prices will ease marginally while fertilizer prices will decline by more than 6 percent (both

Figure Comm.16 Grain production and stocks



Source: US Department of Agriculture (January 2013 update).

Box Comm.3 Which drivers matter most in food price movements?

The post-2004 commodity price boom took place in a period when most countries sustained strong economic growth. Growth in low and middle income countries averaged 6.2% during 2005-12, one of the highest eight-year averages in recent history. Yet, economic growth was only one among numerous causes of the boom. Fiscal expansion in many countries along with low interest rates created an environment that favored high commodity prices. The depreciation of the US dollar strengthened demand from (and limited supply for) non-US\$ commodity consumers (and producers). Other factors include low past investment, especially in extractive commodities (in turn a response to a prolonged period of low prices); investment fund activity by financial institutions that chose to include commodities in their portfolios; and geopolitical concerns, especially in energy markets. In the case of agricultural commodities, prices were affected by higher energy costs, more frequent than usual adverse weather conditions, and the diversion of some food commodities to the production of biofuels. These conditions led to global stock-to-use ratios of some agricultural commodities down to levels not seen since the early 1970s. Lastly, policy responses including export bans and prohibitive taxes to offset the impact of high world prices contributed to creating the conditions for what has been often called a ‘perfect storm’ (Box Table Comm 3.1).

Which drivers matters most for food commodities? A reduced-form econometric model applied to five food commodities (wheat, maize, rice, soybeans, and palm oil) using 1960-2012 data shows that the most important variable is, by far, crude oil which explains almost two thirds of the post-2004 food price increases. The second important driver is stocks-to-use (S/U) ratio accounting for about 15%, followed by exchange rate, accounting for 10%. The remaining 15% reflects, among other drivers, policies. More detailed results can be found in Baffes and Dennis (2013)—Borensztein and Reinhart (2012) discuss the theoretical underpinnings of the model.

As an example consider wheat. Between 1997-2004 and 2005-12 (roughly considered as pre-and post boom periods), wheat prices increased by 81%; the S/U ratio declined by 17%, oil prices increased 228%, and the US\$ depreciated 12% against a broad index of currencies. The three significantly different from zero estimated elasticities were: -0.50 (S/U ratio), 0.28 (crude oil), and -0.86 (exchange rate). These elasticity estimates are consistent with the literature—see, for example, Bobenrieth et al (2012) for the S/U ratio, Gardner (1981) and Gilbert (1986) for exchange rates, and Baffes (2007) for oil prices. When these elasticities are applied to changes of the respective drivers, they give an 83% increase of the price of wheat during these two periods $[-0.50*(-17%) + 0.28*228% - 0.86*(-11.8\%)] = 8.7\% + 64.3\% + 10.2\% = 83.2\%$. These changes imply an 11% contribution by the S/U ratio, 77% contribution by oil and 12% by exchange rate movements. Using related methodology, von Witzke and Noleppa (2011) arrived at a remarkably similar conclusions. World Bank (2012) used similar methodology.

Box table Comm 3.1 Most of the post-2004 ‘perfect storm’ conditions are still in place

	1997-2004	2005-12	Change
Food price index (nominal, 2005 = 100)	89	154	73%
MACROECONOMIC DRIVERS			
GDP growth (middle income countries, % p.a.)	4.6	6.2	35%
Industrial production growth (middle income countries, % p.a.)	5.4	7.3	35%
Crude oil price (nominal, US\$/barrel)	25	79	216%
Exchange rate (US\$ against a broad index of currencies, 1997 = 100)	118	104	-12%
Interest rate (10-year US Treasury bill, %)	5.2	3.6	-31%
Funds invested in commodities (US\$ billion)	57	230	304%
SECTORAL DRIVERS			
Stocks (total of maize, wheat, and rice, months of consumption)	3.5	2.5	-29%
Biofuel production (tousand b/d of crude oil equivalent)	231	892	286%
Fertilizer price index (nominal, 2005 = 100)	69	207	200%
Growth in yields (average of wheat, maize, and rice, % p.a.)	1.4	0.5	-64%
Yields (average of wheat, maize, and rice, tons/hectare)	3.7	4.0	8%
Natural disasters (droughts, floods, and extreme temperatures)	174	207	19%
Policies (Producer NPC for OECD countries, %)	1.3	1.1	-15%

Source: Barclays Capital, Center for Research for the Epidemiology of Disasters, Federal Reserve Bank of St. Louis, Organization of Economic Cooperation and Development, US Department of Agriculture, US Treasury, World Bank, and author’s calculations.

Note: 2012 data for some variables are preliminary.

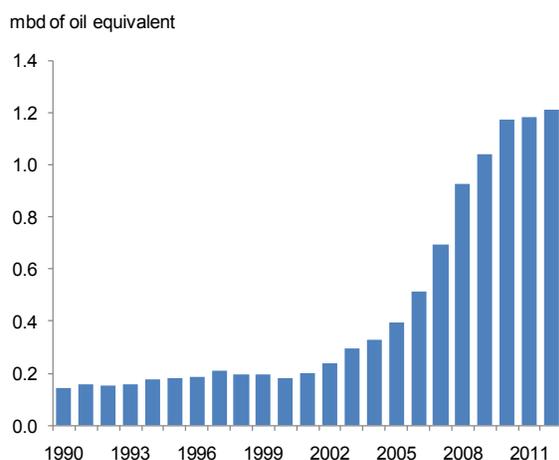
fertilizer and crude oil are key inputs to agriculture). However, because of the energy intensive nature of agriculture—estimated to be 4 to 5 times more energy intensive than manufacturing—an energy price spike is likely to be followed by food price increases. The price transmission elasticity from energy to agriculture ranges between 0.20 and 0.30 (depending on the commodity), implying that a 10 percent increase in energy prices will induce a 2-3 percent increase in food prices (see box Comm.3 for crude oil’s contribution to food price changes).

Third, based on recent experience there are no foreseeable policy responses that would upset food markets. Such risk however, depends crucially on the degree to which markets are well-supplied. If the assumed outlook materializes, policy actions are unlikely and, if they take place, they will be isolated with only limited impact. For example, when the market conditions for rice and cotton were tight (in 2008 and 2010, respectively), the export bans had a major impact on market prices. However, last year’s Thai rice program and the Indian export ban of March 2012 had very limited impact on prices because these markets were (and still are) well-supplied. News reports earlier in October that some Central Asia grain producing countries might introduce export bans did not materialize. For agricultural commodities, policy responses is, perhaps, the only risk that it covariant with

the risk of adequate supplies, which in turn depends on weather.

Lastly, despite the marginal increase in global biofuel production during 2011 and 2012, they will continue to play a key role in food markets. Currently biofuels account for 1.3/bbl of crude oil equivalent (figure Comm.17). The 2012 joint OECD-FAO Agricultural Outlook expects global biofuel production to expand at an annual rate of more than 5 percent through the next decade (from 140 billion liters in 2012 to 222 billion liters in 2021). Thus, at the beginning of the next decade between 3 and 4 percent of global area may be allocated to grains and oilseeds (evaluated at average world yields). However, policy makers are increasingly realizing that the environmental and energy security benefits of some biofuels may not outweigh their costs (in terms of higher food prices). Yet, the likely long term impact of biofuels on food prices is complex as it goes far beyond the land diversion and policy decisions. It will depend crucially on (i) whether current energy prices make biofuels profitable and (ii) whether technological developments on existing biofuel crops (maize, edible oils, and sugar cane) or new crops increase the energy content of these crops, thus making them more attractive sources of energy. Thus, high energy prices in combination with technological improvements may pose upside risks for food prices in the longer term.

Figure Comm.17 Biofuel production



Source: BP Statistical Review of World Energy and OECD

References

- Baffes John (2011). “Cotton Subsidies, the WTO, and the ‘Cotton Problem.’” *The World Economy*, vol. 34, pp. 1534-1556.
- Baffes John (2007). “Oil Spills on other Commodities.” *Resources Policy*, vol. 32, pp. 126-134.
- Baffes, John and Allen Dennis (2013). “Long Term Drivers of Food Prices.” *Mimeo*, World Bank, Washington, DC.
- Bobenrieth, Eugenio, Brian Wright, and Zi Zeng (2012). “Stocks-to-Use Ratios as Indicator of Vulnerability to Spikes in Global Cereal Markets.” Paper presented at the FAO, AMIS meeting, October 2012.
- Borensztein, Eduardo and Carmen M. Reinhart

- (1994). "The Macroeconomic Determinants of Commodity Prices." *IMF Staff Papers*, vol. 41, pp. 236-261.
- Gardner, Bruce (1981). "On the Power of Macroeconomic Linkages to Explain Events in U.S. Agriculture." *American Journal of Agricultural Economics*, vol. 63, pp. 871-878.
- Gilbert, Christopher L. (1989). "The Impact of Exchange Rates and Developing Country Debt on Commodity Prices." *Economic Journal*, vol. 99, pp. 773-783.
- Gilbert, Christopher L. and C. W. Morgan (2010). "Food Price Volatility." *Philosophical Transactions of the Royal Society [Biological Sciences]*, vol. 365, pp. 3023-2034.
- Hicks, John R. (1932). *The Theory of Wages*. Macmillan, London.
- ICAC, International Cotton Advisory Committee (2012). *Cotton: Review of the World Situation*, November-December. Washington DC: ICAC.
- IEA, International Energy Agency (2012). *World Energy Outlook 2012*. OECD/IEA, Paris, France.
- Morck, Randall, Bernard Yeung, and Wayne Yu (2000). "The Information Content of Stock Markets: Why Do Emerging Markets Have Synchronous Stock Price Movements?" *Journal of Financial Economics*, vol. 58, pp. 215-260.
- Von Witzke, Harald and Steffen Noleppa (2011). "Why Speculation is not the Prime Cause of High and Volatile International Agricultural Commodity Prices: An Economic Analysis of the 2007-08 Price Spike." HFFA Working Paper.
- World Bank (2012). *Responding to Higher and more Volatile Food Prices*. Report no. 68420-GLB. Washington, DC: World Bank.

East Asia and the Pacific Region

Overview: Growth in the East Asia and Pacific region declined to 7.5 percent in 2012 from 8.3 percent in 2011, largely on account of weak external demand and policy actions in China, aimed at containing inflationary pressures. China's economy slowed to an estimated 7.9 percent in 2012 from 9.3 percent in 2011, its weakest rate since 1999. Exports from the region contracted by 8 percent in the three months to September and caused industrial production growth to slow to 3-4 percent in Q2. Excluding China, growth in the region has been resilient to the global slowdown and accelerated to 5.6 percent 2012, up from 4.5 percent in 2011 thanks to strong domestic demand, which in major ASEAN economies (notably Indonesia, Malaysia and the Philippines) was effectively supported through countercyclical measures. This expansion also reflected the fact that the region grew from a low base, following last year's flooding that cut deeply into Thailand's output in particular. Industrial production growth picked up at 15 percent and export growth accelerated to 9 percent in the three months to November heralding economic recovery. Economic recovery is however fragile, with the net capital flows to the region, hit by Euro Area tensions at the middle of 2012, expected to pick up only gradually, from \$357.4 billion in 2012 to around \$547.8 billion by 2015.

Outlook: Continued strong domestic demand, improved global financial conditions and intensified trade flows will boost the output response in East Asia and the Pacific. China's growth will accelerate to 8.4 percent in 2013 before stabilizing at about 8 percent in 2014 and 2015 as economy re-orientes toward domestic demand and services. GDP growth in the region excluding China is projected to accelerate to 5.8 percent in 2013, and further to 5.9 percent in 2014 and 2015 reflecting robust growth in Indonesia (around 6.6 percent), Malaysia (around 5 percent), the Philippines (around 6 percent) and Thailand (around 4.5 percent). Vietnam, where growth recently slowed in

response to stabilization measures, will continue to benefit from firming up commodity prices, with growth projected to reach 6 percent by 2015. The region will also benefit from a potentially rapid economic transformation in Myanmar, where growth is projected to surpass 6 percent in 2013 and from the recent accession of Lao PDR to the WTO which completed the near-universal international trade integration of the EAP region.^{FN1}

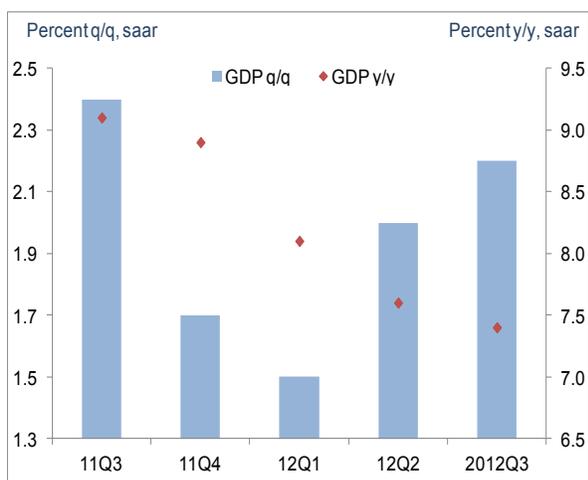
Risks and vulnerabilities: Openness and integration make East Asia and Pacific region vulnerable to sources of global instability. EAP region could see 1 percent cut in its GDP in 2013 if the risk of the Euro Area crisis unfolds. Failure to resolve the US debt and fiscal issues would cut regional GDP by 1.1 percent in 2013. The regional growth outlook is subject to growth slowdown in China, stemming from a risk of unwinding of China's high investment rates, particularly if this were to occur in a generally weak global growth context. A precipitous 5 percentage point decline in investment growth could see Chinese GDP decline by 1.4 percent and Chinese imports by 6 percent, shaving off 0.6 percent from the GDP of regional trading partners. The regional growth outlook is vulnerable to developments related to volatile capital inflows, related asset price bubbles, excessive credit growth and risk of sudden capital outflows. The economies in the region are also vulnerable to energy price spikes, in case of supply shortages related to a possible escalation of political tensions in the Middle East or elsewhere in the world. The EAP region will benefit from deepening capital markets and implementing flexible exchange rate policies to develop effective tools for managing volatile capital flows and demand. Building buffers to deal with future shocks remains a priority in Lao PDR, Vietnam and small Pacific islands where recent progress in global and regional integration benefitted growth, but also made these economies more vulnerable to the global and regional business cycles.

Recent developments

GDP growth in the **East Asia and Pacific** region weakened in 2012, reaching 7.5 percent, versus 8.3 percent in 2011. The slowdown in 2012 followed an earlier decline in growth from 2010, and was largely due to conditions in China, the region’s largest economy. The Chinese economy grew at an estimated 7.9 percent in 2012, its weakest annual rate since 1999, reflecting domestic policy tightening aimed at cooling an overheated housing sector. The slowdown in growth among East Asian and Pacific economies in 2012 was also related to the weakening of external demand following the escalation of tensions in the Euro Area during 2012Q2. Notwithstanding China’s historically low full-year GDP growth number for 2012 (figure EAP.1), growth picked up after the first quarter of 2012, expanding at a 9.1 percent annualized pace in the third quarter. Growth is going to moderate in the medium term however. The GDP growth goals for 2014-2-15 have been revised downward reflecting the government’s desire to reorient the economy towards domestic sources of demand and services.

Excluding the impact of China, GDP growth in the East Asia and the Pacific region was resilient in 2012, with annual growth accelerating to 5.6 percent (up from 4.5 percent in 2011), partly because of stimulus measures implemented in

Figure EAP.1 China’s annual GDP growth slows but quarter/quarter growth accelerates



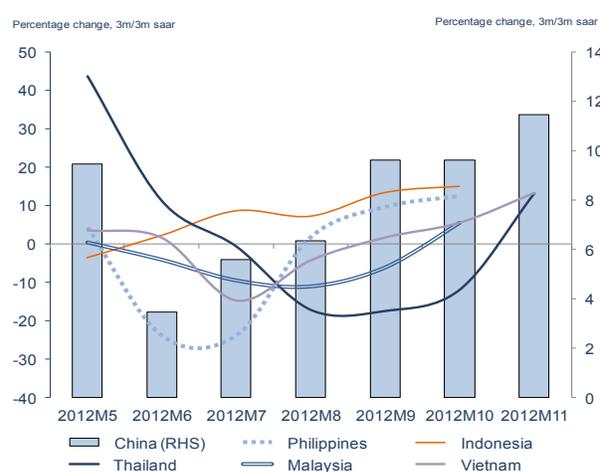
Source: World Bank.

ASEAN countries but also because of a rebound of economic activity in Thailand after last year’s floods cut into regional output in 2011.

The slowdown in growth of global trade from 6.2 percent in 2011 to an estimated 3.5 percent in 2012 had a considerable effect on trade intensive East Asia and the Pacific region. Trade flows slowed over the course of 2012 due to weakening external demand in East Asia’s largest export markets, the Euro Area and the United States. Regional exports, which had been growing at double-digit rates at the beginning of the year, slowed markedly and even contracted during Q3. This weakness, coupled with domestic policy tightening, caused regional industrial production to also decline sharply (figure EAP.2). China’s industrial output, which had been growing at a more than 11 percent annualized pace at the beginning of the year, slowed to a 3.5 percent pace in June, with industrial activity in the other developing countries in the region, notably Malaysia, Philippines and Thailand, experiencing a short-period of a mid-year contraction.

More recently, there are signs of recovery, with both third quarter industrial production and export data strengthening. Economic revival in the region has been driven by robust domestic demand in China, Indonesia, Malaysia, Philippines and Thailand and a surge in exports

Figure EAP.2 Plunge of industrial output growth in EAP in Q2 followed by recovery in Q3

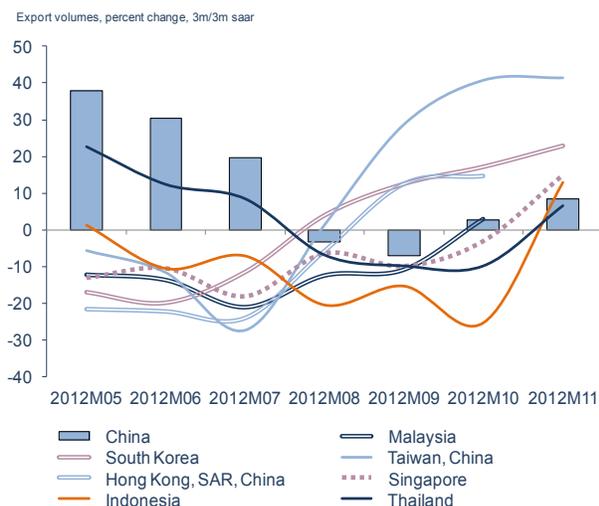


Source: World Bank.

toward the newly industrialized economies (NIE) of the region whose exports to the rest of the world have also experienced a rebound in the last quarter of 2012. Japan’s continued robust demand for imports, stemming from reconstruction efforts following the devastating earthquake in March 2011, also provided additional boost for exports among other countries in East Asia Pacific, particularly the Philippines. Chinese exports increased at a 8.6 percent annualized pace during the three months ending November, and its imports grew at a 12.5 percent clip (figure EAP.3).

Reflecting these developments industrial activity in the region has accelerated to 15 percent annualized pace through November, led by China and reflected among ASEAN economies, whose production is tightly linked to activity in China and the NIEs through multi-country production networks across the region. The revival of exports and industrial activity among the developing EAP economies took longer to engage than China and NIEs, in part because demand for key ASEAN-produced manufactured export products, including traditional electronics, lagged behind the revival of global demand for mobile devices produced in China and NIEs. Nevertheless, industrial activity in these countries expanded at a firm pace in the third quarter, growing at a 5 percent or higher pace in Indonesia, Malaysia, Philippines and Vietnam.

Figure EAP.3 Export rebound in EAP in Q4



Source: World Bank.

Production and exports in Thailand grew very rapidly at the beginning of 2012 from a flood affected low base with a pace of growth slowing down later in the year as production has recovered to the levels observed before flood related devastation. Indicators of consumer and business sentiment across the region, such as purchasing manager indexes (PMIs), are low but improving.

In Lao PDR, investments in mining and hydropower projects supported GDP growth of more than 8 percent in 2012. Growth in other transition economies of the region, including Cambodia and Vietnam slowed somewhat on weak external demand and in the case of Vietnam reflecting earlier policy tightening measures. Weaker growth in China disproportionately affected Mongolia through a steep decline in demand for the country’s mineral resources. As a result growth slowed from 17.5 percent in 2011 to a still very robust 11.8 percent in 2012 and there was a significant deterioration in the current account. Growth outcomes in the Pacific sub-region were mixed, with individual countries’ dependency on different external sources of growth (commodities (petroleum, gold and copper), tourism and remittances) explaining much of the variation in outturns. High commodity prices and investments into mining and infrastructure helped to sustain growth in PNG and Timor-Leste. Growth continues to be weak in Fiji and declined in crisis hit Solomon Islands particularly vulnerable to external shocks due to frequent natural disasters.

Weak global demand, rebalancing in China and increased domestic demand in Indonesia contributed to further reduction of regional current account surpluses in 2012. Reserve positions, however, remain strong across the region, serving as the buffers against the heavy external headwinds. The aggregate current account surplus of East Asian and Pacific countries declined by an estimated \$267 billion between 2008 and 2012. Almost all of the decline reflects a \$220 billion decline in China, where the current account fell from \$420 billion (9.3 percent GDP) in 2008 to below \$200 billion

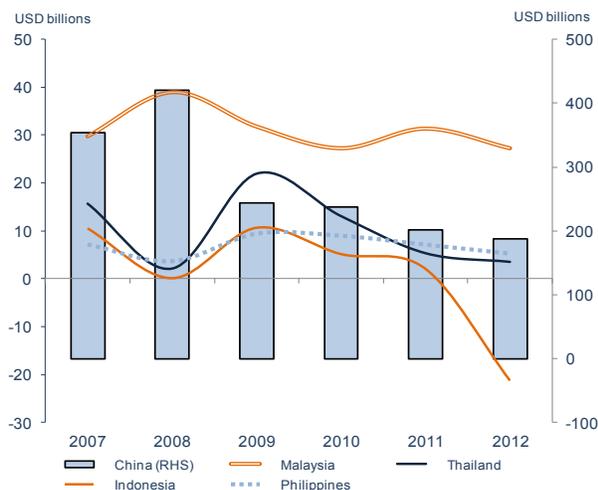
(2.3 percent of GDP) in 2012 (figure EAP.4). Net exports from China have declined because of a weak external demand, but also reorientation of growth toward import-intensive investments and the gradual appreciation of the renminbi. In Indonesia, the current account deteriorated partly because of robust growth in domestic demand and related strong import growth financed by FDI and other private inflows. Indonesia posted a record trade deficit of \$1.54 billion in October on weak external demand for the country’s commodity exports (coal, tin and palm oil) and strong growth of fuel imports supported by price subsidies. Declining mineral exports to China saw Mongolia’s current account deficit widening to over 18 percent of GDP in 2012, with the deficit being financed by strong FDI inflows and foreign credit attracted by the country’s rich mining sector.

Trade in services, including revenue from tourism and remittances, remains an important source of foreign exchange for small economies in the region. East Asia is a major global tourist destination among developing countries, having welcomed about 204 million visitors in calendar year 2011 (about one fifth of all international tourists), according to the United Nations World Tourism Organization (UNWTO). Tourist arrivals expanded quickly during the first nine months of 2012 in all three sub-regions of East

Asian Pacific: 7.8 percent in North-East Asia, 8.6 percent South-East Asia, and 5.4 percent in Oceania. China, Philippines and Vietnam continued to be among top ten recipients of remittances globally in 2012, receiving \$66 billion, \$24 billion, and \$9 billion, respectively, but among East Asia and the Pacific countries, remittances as a share of GDP is highest in Samoa and Tonga (20 percent), Philippines (10 percent), Vietnam (7 percent) and Fiji (6 percent). Remittances to East Asia and the Pacific increased an estimated 6.9 percent in 2012, reaching \$114 billion—well off the 12.3 percent increase recorded in 2011.^{FN2} The growth of remittances has been mixed across East Asia and the Pacific countries and depends to a large degree on the economic performance of the main remitter countries. Remittances to Samoa, for example, which receives inflows predominantly from New Zealand and Australia, registered double digit growth in 2012, while those to Tonga, which receives about half of its remittances from the United States, declined by more than 20 percent. Remittances to Philippines were much less volatile, growing at 5 percent in 2012, reflecting the diversified base of the remittances (see Remittances brief for more detailed discussion).

Economic policies. The majority of East Asian economies tightened their monetary policy in the early part of 2011 to slow down credit expansion and contain price pressures steaming from the overheating generated by the earlier easing cycle. Those measures had effect with a lag. In China, for example, where policy makers implemented the policy tightening to stem overheating in the housing market, tightening contributed to a sharp deceleration in real credit growth to an 11.6 percent annualized rate during the three months ending July from a peak of 25.3 percent in February. Weakening of global demand in mid 2012 exacerbated the easing of growth among East Asia and the Pacific economies for the year as a whole. Specifically, the decline in global trade volumes from 6.2 percent growth in 2011 to an estimated 3.5 percent in 2012 had considerable impact on trade intensive East Asia and the Pacific region. On the balance, economic growth slowed across the

Figure EAP.4 Compression of current accounts as economies rebalance



Source: World Bank.

region in the last quarter of 2012 and prompted the governments to react by stimulating demand through a combination of fiscal and monetary measures in the second half of 2012.

The majority of the countries engaged in expansionary fiscal policies, with fiscal deficits widening across the region (figure EAP.5). Monetary policy has been eased, with the multiple rounds of interest rate cuts in Indonesia, Thailand and Philippines. China returned to a monetary easing and stimulus mode in the second quarter of 2012, implementing the interest rates cuts, lowering reserve requirement ratios, and implementing a series of open market operations to inject liquidity and thus stimulate domestic credit (figure EAP.6).

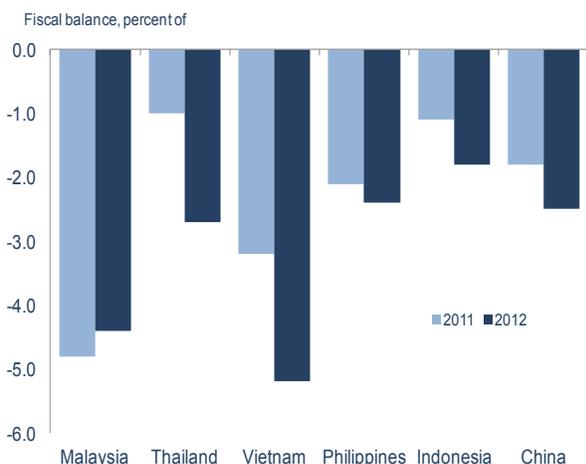
Fiscal policy was also relaxed in China in 2012 but much less so than during the previous round of stimulus measures. Implementing demand stimulating policy measures in China, Indonesia, Philippines and Thailand was possible due to comfortable fiscal positions, solid levels of foreign reserves, sustainable debt levels and stable prices across the region, allowing monetary policy easing without undermining price stability objectives. In addition, the economic structure of East Asia and the Pacific economies, with a dynamic private sector and efficient and deep financial intermediation, made

monetary policies effective in generating a supply response to monetary easing.

Monetary policy easing across the region also helped in providing temporary liquidity support to the private sector as international banking flows declined in early 2012 further due to re-emergence of the Euro Area crisis, deleveraging among troubled European banks and international portfolio flight toward safe havens from EMs. However, growth and price volatility and uncertainty had a negative impact on investment decisions exacerbating uncertainties related to the global economic slowdown and reflected in the performance of asset prices (see more detailed discussion below).

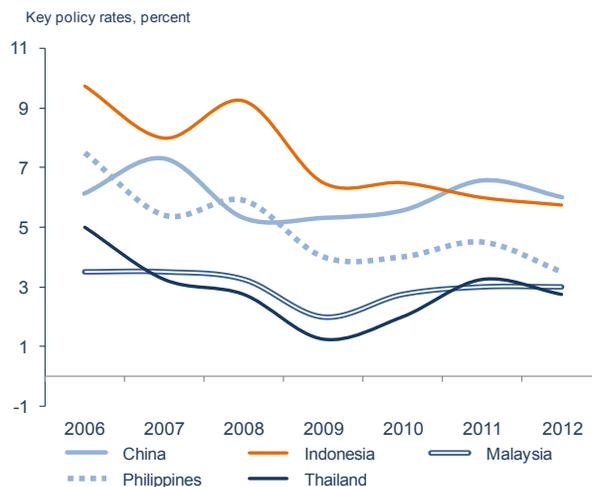
Inflation. Generally, East Asia and the Pacific has experienced a sharp fall in inflation rates due to slower demand, declining commodity prices and administrative measures to cool housing prices in China. Quarterly inflation in the region declined from a 6.0 percent annualized pace in the second quarter of 2011 to 2.4 percent during the three months ending October 2012 (saar). The pace of decline in inflation was fastest in China and Vietnam, but inflation in the other countries in the region has eased as well, allowing policy rate cuts across the region including most recent policy easing in Thailand and Philippines. Several ASEAN countries have

Figure EAP.5 Fiscal policies were relaxed across the region to support domestic demand



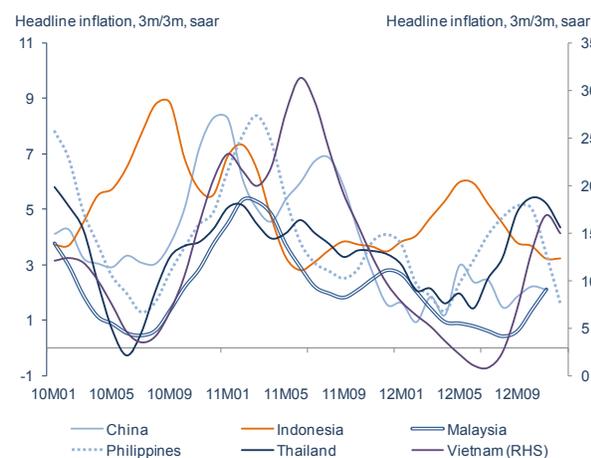
Source: World Bank.

Figure EAP.6 EAP Monetary policies have been accommodative across the region



Source: World Bank and Central Bank rates.

Figure EAP.7 Inflation moderated in EAP region led by China, but inflation momentum accelerated in Thailand and Vietnam



Source: World Bank.

experienced a temporary acceleration in inflation during the course of the year, mainly due to seasonal factors, including Indonesia in Q2, the Philippines in Q3, and Thailand and Vietnam most recently partly reflecting the rapid growth of domestic demand (figure EAP.7 and Inflation Annex). On the whole, EAP region saw a decline in the headline inflation rates in 2012, with the sharpest declines observed in China, Malaysia and Vietnam followed by the Philippines and Indonesia.

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

	2008	2009	2010	2011	2012e	2013f	2014f	2015f
Capital inflows	206.8	255.9	516.9	450.2	357.4	421.8	493.1	547.8
Private inflows, net	207.2	252.0	513.9	448.7	357.2	421.9	494.4	549.7
<i>Equity Inflows, net</i>	203.6	184.7	329.8	283.3	260.2	302.8	361.5	375.4
Net FDI inflows	211.2	154.5	290.0	274.9	251.7	284.8	332.0	339.2
Net portfolio equity inflows	-7.6	30.2	39.8	8.4	8.5	18.0	29.5	36.2
<i>Private creditors, net</i>	3.6	67.3	184.0	165.4	97.0	119.1	132.9	174.3
Bonds	1.2	8.4	20.8	18.9	19.6	21.4	22.3	19.3
Banks	17.9	-6.1	13.2	1.8	-4.3	6.7	8.3	11.3
Short-term debt flows	-13.3	65.0	148.9	144.9	85.1	90.7	102.1	143.2
Other private	-2.3	0.03	1.1	-0.2	-3.4	0.3	0.2	0.5
Official inflows, net	-0.4	3.9	3.0	1.4	0.2	-0.1	-1.3	-1.9
World Bank	1.2	2.2	2.7	0.9	0.3			
IMF	-0.05	0.1	-0.02	-0.03	-0.2			
Other official	-1.5	1.6	0.3	0.6	0.1			

Source: World Bank.

Note: e = estimate, f = forecast

Financial markets and capital flows

Capital flows toward the developing world (including East Asia and the Pacific (table EAP.1) declined sharply in the second quarter of 2012 as tensions over European debt sustainability escalated, but these tensions eased and flows regained strength in the third quarter, following action taken by the European Central Bank and the U.S. Federal Reserve (see main text and detailed discussion in Finance Annex). Despite the recovery in capital inflows to East Asia and the Pacific countries during the third quarter of 2012, overall net capital flows to the region for 2012 as a whole are estimated to have fallen by \$93 billion, mainly due to reduced short-term debt inflows reflecting the slow-down in trade (a large share of short-term debt flows are trade-finance related). Equity inflows, which represent about 70 percent of total net capital inflows to the region, are also estimated to have declined — mainly on account of China, where they are estimated to have fallen by about \$30 billion in 2012.

Despite the decline, China continues to attract substantial equity inflows, although the structure of these inflows is changing. Rising wages and production costs are reducing investment into primary manufacturing, while investment in the

services sector is gradually rising. Capital inflows are also experiencing a geographical shift, as global South-South flows are rising, with China playing a key role in outward FDI from the developing world as firms relocate labor-intensive and low-end production to neighboring countries. Indonesia, Philippines and Vietnam saw an increase in net equity inflows in 2012, including through equity investment from China. Bond issuance in the region, stepped up insignificantly to an estimated \$19.6 billion in 2012, up 3.7 percent from what was a robust pace of issuance (\$18.9 billion) in 2011. Net official inflows approached nil as repayments almost equaled new borrowing.

Asian equities have outperformed the major global and regional stocks markets and have surged further in December reflecting an improving global and regional economic outlook. The MSCI index of Asia-Pacific shares excluding Japan delivered double-digit returns expanding by almost 20 percent in 2012, reflecting investors' confidence in Asian economies despite the present global turbulence and experiencing a mid-year dip. Equity market performance at the country level showed considerable divergence, however, with Southeast Asian equities (those in Indonesia, Malaysia, Thailand and Philippines) outperforming North Asian equities – namely, those of China. The Shanghai Composite Index gained about 4 percent in 2012 reflecting the end-of-year recovery in December after falling below a symbolic 2,000 benchmark level on November 27. Relatively poor performance of North Asian equities in 2012 reflected concerns about China's medium-term growth outlook related to mid-year slowdown, uncertainty on corporate profitability, as well as economic reform directions related to the once-per-decade government transition that China completed in November 2012. In contrast, equity markets in Thailand and the Philippines delivered over 30 percent gains in 2012 on resilient domestic-demand-driven growth. Net capital flows to East Asia and the Pacific are expected to recover only gradually, growing from \$357.4 billion in 2012 (3.5 percent of regional GDP) to around \$547.8 billion (4.2 percent of regional GDP) by 2015—

only just surpassing the previous post-crisis peak of \$517 billion in 2010. The recovery of external flows should also be reflected in a gradual increase in asset prices throughout the region.

Medium-term outlook

Improved global financial conditions, a gradual pickup of growth in high-income countries and a return to more normal global trade growth are expected to support a gradual strengthening of output in East Asia and the Pacific between 2013 and 2015. Accommodative monetary policy and low inflation in ASEAN-4 (Indonesia, Malaysia, Thailand, Philippines) are also expected to contribute, while ample fiscal space in most countries in the region means that they will not have to contend with fiscal consolidation pressures. However, some fiscal tightening is envisaged in Malaysia as well as Indonesia, where plans to reduce fuel subsidies were delayed in 2012. In Cambodia and Vietnam, efforts to reduce high level of debt among state-owned enterprises may serve as a drag on growth. The East Asia and the Pacific region, especially China and ASEAN economies, enter 2013 with a strong carryover of growth from 2012, in contrast to the situation in high-income countries and many developing economies.

Overall, growth in developing East Asia and the Pacific is projected to accelerate to 7.9 percent in 2013. The figure reflects a firming of growth in China, to 8.4 percent. In the years thereafter, China's growth is expected to gradually ease, to 8 and 7.9 percent in 2014 and 2015, respectively, reflecting the ongoing re-orientation of output toward domestic demand and services. Growth will continue to rely heavily on consumer spending by the growing incomes and growing credit of the expanding middle-class. In the baseline of the January 2013 Global Economic Prospects (see the main text), the share of investment in China's overall GDP is projected to continue on a path of slow decline — implying significantly weaker investment growth and a gradual easing in potential output growth as the pace of capital accumulation and labor force growth slow.

The slower growth projected for China and the rebalancing of demand toward consumption and services will have important implications for other countries in the region. Countries whose economies that are heavily integrated with China's global production chains may need to similarly reorient their economies toward domestic demand, but also redirect their export sectors toward accommodating Chinese domestic demand. Despite the changing external environment, growth in other major East Asia and the Pacific economies is projected to pick up modestly in the coming years. Reflecting the expected recovery in the global trade flows, demand for the exports of East Asia and Pacific will strengthen, and with it the pace of industrial and export activity — although growth rates are expected to remain below the extraordinarily high rates of the recent past.

For the major ASEAN countries, growth is projected to increase to 5.8 percent in 2013 as these countries benefit from the revival of world trade (table EAP.2). Growth in this country group is expected to increase to 5.9 percent in 2015, as Indonesia continues to grow rapidly (at around 6.6 percent) and growth remains robust

in Malaysia (around 5 percent), Thailand (4.5 percent) and the Philippines as well (around 6 percent). Vietnam, as an oil exporter, continues to benefit from high oil prices. Among low-income countries in East Asia and the Pacific, Lao PDR is projected to sustain 7.5 percent growth, bolstered by continued strong investment in hydropower and mining. The country's recent WTO accession should provide additional boost to the economy as it expands its market share in global markets. Growth prospects in Cambodia (around 7 percent) are based on achieving the dividends from focus on higher rice production, inflows of FDI into the growing garment industry and a growing tourism industry. Mongolia and Myanmar also have the potential to deliver strong growth over the projection period due to rapid political transformation—but this potential may not be realized if the pace of reform weakens (table EAP.3).

Papua New Guinea, Fiji and the small Pacific islands are also expected to benefit from the revival in global trade and tourism, which is projected to increase by about 6 percent per year (globally) over the projection period. Moreover,

Table EAP.2 East Asia and Pacific forecast summary

	Est. Forecast						
	00-09 ^a	2010	2011	2012	2013	2014	2015
GDP at market prices ^b	8.1	9.7	8.3	7.5	7.9	7.6	7.5
	<i>(Sub-region totals-- countries with full NIA + BOP data) ^c</i>						
GDP at market prices ^c	8.1	9.7	8.3	7.5	7.9	7.6	7.5
GDP per capita (units in US\$)	7.3	8.9	7.6	6.8	7.2	7.0	6.9
PPP GDP	8.0	9.7	8.3	7.5	7.8	7.6	7.5
Private consumption	6.0	7.2	8.2	8.1	8.0	7.9	7.6
Public consumption	7.6	7.9	9.5	8.5	8.5	8.7	7.7
Fixed investment	10.6	13.8	9.5	9.0	6.5	6.8	5.7
Exports, GNFS ^d	10.3	23.0	8.2	4.3	10.4	9.9	9.9
Imports, GNFS ^d	9.6	19.5	6.2	5.9	10.3	10.8	9.3
Net exports, contribution to growth	0.8	2.5	1.3	-0.2	0.8	0.4	1.0
Current account bal/GDP (%)	4.7	3.7	2.6	1.9	1.9	1.5	1.5
GDP deflator (median, LCU)	5.3	6.8	5.6	6.5	4.6	4.2	3.9
Fiscal balance/GDP (%)	-1.8	-2.5	-1.7	-2.1	-1.7	-1.5	-1.3
Memo items: GDP							
East Asia excluding China	4.3	6.9	4.5	5.6	5.8	5.9	5.9
China	9.4	10.4	9.3	7.9	8.4	8.0	7.9
Indonesia	4.6	6.2	6.5	6.1	6.3	6.6	6.6
Thailand	3.5	7.8	0.1	4.7	5.0	4.5	4.5

a. Growth rates over intervals are compound weighted averages; average growth contributions, ratios and deflators are calculated as simple averages of the annual weighted averages for the region.

b. GDP at market prices and expenditure components are measured in constant 2005 U.S. dollars.

c. Sub-region aggregate excludes Fiji, Myanmar and Timor-Leste, for which data limitations prevent the forecasting of GDP components or Balance of Payments details.

d. Exports and imports of goods and non-factor services (GNFS).

Source: World Bank.

Table EAP.3 East Asia & the Pacific country forecasts

	00-09 ^a	2010	2011	Est. 2012	Forecast 2013	2014	2015
Cambodia							
GDP at market prices (% annual growth) ^b	7.4	6.0	7.1	6.6	6.7	7.0	7.0
Current account bal/GDP (%)	-5.3	-10.4	-8.7	-10.0	-8.7	-7.0	-6.7
China							
GDP at market prices (% annual growth) ^b	9.4	10.4	9.3	7.9	8.4	8.0	7.9
Current account bal/GDP (%)	5.0	4.0	2.8	2.3	2.3	2.0	2.0
Fiji							
GDP at market prices (% annual growth) ^b	1.3	0.1	1.9	2.1	2.2	2.3	2.3
Current account bal/GDP (%)	-7.7	-7.7	-9.9	-9.8	-10.0	-10.0	-9.0
Indonesia							
GDP at market prices (% annual growth) ^b	4.6	6.2	6.5	6.1	6.3	6.6	6.6
Current account bal/GDP (%)	2.5	0.7	0.2	-2.3	-1.6	-1.7	-1.7
Lao PDR							
GDP at market prices (% annual growth) ^b	6.2	8.5	8.0	8.2	7.5	7.5	7.5
Current account bal/GDP (%)	-2.4	-6.2	-11.4	-16.3	-18.1	-19.0	-18.0
Malaysia							
GDP at market prices (% annual growth) ^b	3.9	7.2	5.1	5.1	5.0	5.1	5.3
Current account bal/GDP (%)	12.9	11.1	11.0	7.7	5.8	3.7	2.9
Mongolia							
GDP at market prices (% annual growth) ^b	5.8	6.4	17.5	11.8	16.2	12.2	8.0
Current account bal/GDP (%)	-6.8	-14.3	-15.1	-18.0	-1.5	3.0	4.3
Myanmar							
GDP at market prices (% annual growth) ^b	9.7	5.3	5.5	6.3	6.5	6.6	6.7
Current account bal/GDP (%)	-0.7	-1.3	-2.6	-4.1	-4.2	-4.8	-5.1
Papua New Guinea^c							
GDP at market prices (% annual growth) ^b	3.0	7.6	9.0	8.0	4.0	7.5	4.6
Current account bal/GDP (%)	2.3	-25.6	-35.0	-30.0	-20.0	-13.0	-8.4
Philippines							
GDP at market prices (% annual growth) ^b	4.0	7.6	3.9	6.0	6.2	6.4	6.3
Current account bal/GDP (%)	1.5	4.5	3.1	3.2	2.9	2.7	2.5
Solomon Islands							
GDP at market prices (% annual growth) ^b	2.4	7.8	10.5	5.3	4.0	3.3	3.3
Current account bal/GDP (%)	-20.7	-30.8	-6.0	-5.8	-10.9	-9.0	-8.7
Thailand							
GDP at market prices (% annual growth) ^b	3.5	7.8	0.1	4.7	5.0	4.5	4.5
Current account bal/GDP (%)	3.3	4.1	1.5	0.2	-0.3	-0.4	-0.7
Timor-Leste							
GDP at market prices (% annual growth) ^b	3.3	9.5	10.6	10.0	10.0	10.0	9.0
Current account bal/GDP (%)	18.4	48.1	55.0	43.5	36.2	25.0	24.0
Vietnam							
GDP at market prices (% annual growth) ^b	6.6	6.8	5.9	5.2	5.5	5.7	6.0
Current account bal/GDP (%)	-7.4	-4.1	0.2	2.7	1.3	0.9	0.7

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.

Samoa; Tuvalu; Kiribati; Democratic People's Republic of Korea; Marshall Islands; Micronesia, Federated States; N. Mariana Islands; Palau; and Tonga are not forecast owing to data limitations.

a. GDP growth rates over intervals are compound average; current account balance shares are simple averages over the period.

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

c. The start of production at Papua-New-Guinea-Liquefied Natural Gas (PNG-LNG) is expected to boost PNG's GDP growth to 20 percent and shift the current account to a 9 percent surplus in 2015.

Source: World Bank.

in line with projected improvements to economic conditions in migrant receiving countries, remittances to the region are projected to increase by 8.3 and 9.9 percent in 2013 and 2014, respectively, with particular benefit to Vietnam and Philippines, as well as a number of Pacific islands, including Samoa and Tonga.

Risks and vulnerabilities

Prospects for East Asia and the Pacific region, like those in the rest of the world, remains vulnerable to volatility that could emerge from

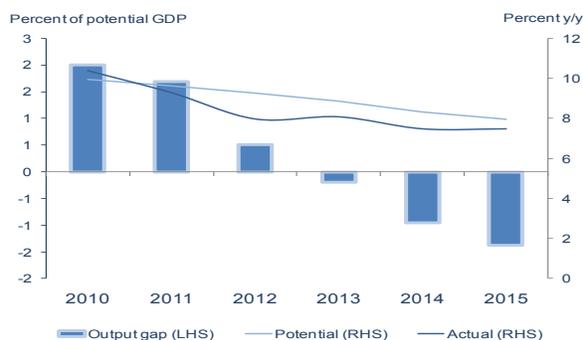
the high-income countries due to several factors, in particular a continuation (or deepening) of the crisis in the Euro Area and the fiscal impasse in the United States. In addition, while the immediate concerns of a hard landing in China have passed, the regional growth outlook is subject to a growth slowdown in China stemming from a risk of unwinding of China's high investment rates—particularly if this is to occur in a disorderly fashion in a generally weak global growth context. Although global financial conditions have improved significantly since July 2012, the economic outlook of the Euro

Box EAP.1 Investment and growth in China

China’s growth model of the past 30 years has been very successful. Relying on a combination of high investment rates, rapid capital stock accumulation, and strong productivity growth (due in part to the movement of the rural population to higher productivity manufacturing jobs), China has recorded an average of 10 percent annual growth since the initiation of structural reforms in 1978. During most of this high-growth period, investment (and savings) were at a relatively high 30-35 percent of GDP. In the 2000s, investment rates jumped to 40 percent of GDP (partly in reaction to the low cost of international capital at the time), and then to 45 percent of GDP as part of China’s fiscal and monetary stimulus plan introduced in response to the global financial crisis in 2008. Such high investment to GDP ratios are unprecedented. Neither Japan nor Korea – two countries that have also enjoyed lengthy periods of rapid growth – ever saw investment rates exceed 40 percent. As China’s investment rate increased, the contribution of investment to growth rose to about 50 percent of 10 percent annual growth in the 2000s. China’s capital/output ratio, which in an economy on a stable growth path will be broadly stable, increased by almost 25 percent over the past 15 years and is still rising rapidly.

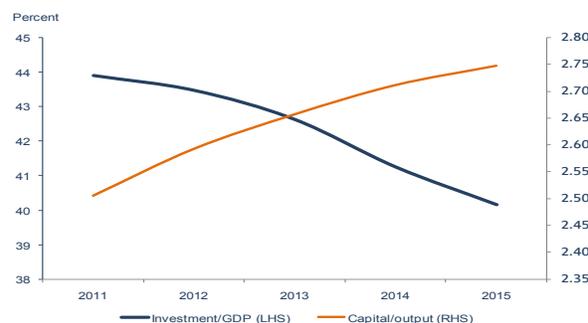
China’s authorities have identified the need for a more balanced pattern of investment, that implies not just a lower investment rate, but also a shift toward investments and expenditures in the service sector and in intangible assets like human capital, as a major medium-term challenge for the country, including in the recently released China 2030 study (World Bank, 2012). Doing so will be challenging, as investment will have to grow slower than GDP for a sustained period of time. Slower investment growth will imply a gradual slowing of Chinese potential output growth, but only gradually as it will be affected by the level of the investment rate and not the rate of growth of investment. As a result, if China is to avoid opening up a large output gap, either investment rates will have to decline slowly (thus allowing demand growth to keep pace with potential) or consumption growth will have to expand very rapidly. Both processes will be challenging, even in an economy like China’s where the state plays a strong and effective role in shaping the trajectory of growth.

Box figure EAP 1.1 China growth slowdown is likely to result in a recessionary gap...



Source: World Bank.

Box figure EAP 1.2 China capital output ratio continues to increase despite declining share of investment in the output...



Source: World Bank.

Area remains uncertain and continued improvement is contingent on continued progress implementing the structural and fiscal reform agendas that have so-far just begun. Failure to pursue these reforms or a significant growth disappointment could prompt markets to lose confidence once again, potentially pushing the currency area into a serious crisis. Unfolding this risk could cut EAP regional GDP by 1 percent in 2013 (see discussion in main text). The US fiscal paralysis also pose a major risk to the EAP regional growth outlook. Failure to

address fiscal problems in the US would result into a sharp 2.3 percentage point cut in the US growth in 2013 relative to the baseline. Given the importance of the US economy globally, this would also trigger a weaker global confidence. Should this risk materialize, EAP region will see a 1.1 percent cut in its GDP in 2013 relative to baseline—slightly higher than the impact associated with the Euro Zone related crisis. Among the EAP developing economies China, Thailand and Indonesia are projected to be most affected by a growth slowdown in high income

countries (about 1-1.2 percent cut in GDP in both 2013 and 2014 relative to the baseline) followed by Vietnam and Malaysia (about 0.8-0.7 percent cut in the GDP relative to the baseline) due to reduced import demand in high-income countries, much tighter international capital conditions and increased pre-cautionary savings within the region.

The process of bringing China's high investment rate down to more sustainable levels, while likely to proceed smoothly, does carry with it the risk of a more abrupt contraction, particularly if this were to occur in a generally weak global growth context. Such an outcome could arise if consumer demand does not offset slower investment growth, or profits from past investment are not forthcoming, resulting in a spike in unpaid loans and a rapid tightening of credit conditions. Such developments could in turn put pressure on loan repayments, new investment, employment and incomes (see box and discussion in main text). A precipitous 5 percentage point decline in investment growth could see Chinese GDP decline by 1.4 percent, and Chinese imports by 6 percent. Impacts on regional trading partners would see their GDP decline by around 0.6 percent. Simulations suggest Vietnam's export volumes and GDP could decline by 2.2 percent and 0.7 percent respectively, in Thailand export volumes and GDP may fall relative to baseline by 1.7 percent and 0.7 percent respectively and Malaysia's exports will contract by 1.8 percent, although the impact on GDP is projected to be smaller than in other countries of the region at estimated 0.4 percent of GDP. Commodity exporting countries would be hardest hit due to the additional burden implied by lower commodity prices, with metal prices projected to fall by 4.3 percent in 2013 and by another 3 percent in 2014.

The regional growth outlook is vulnerable to developments related to volatile capital inflows and related asset price bubbles, excessive credit growth and risk of future sudden capital outflows. EAP region will benefit from a continued effort to deepen structural reforms to keep its global competitive edge in the Medium-Term perspective. This would also include

deepening capital markets and implementing flexible exchange rate policies to develop effective tools for managing volatile capital flows and demand.

East Asia and the Pacific countries are also vulnerable to commodity price increases, perhaps due to supply shortages following an escalation of geo-political situation in the Middle East. Should oil prices rise by \$50 dollars per barrel for a sustained period, growth among oil importers could decline by 1.7 percentage points, inflationary pressures would rise and regional trade balances would significantly deteriorate (see Main text). Building buffers to deal with future shocks remains a priority in Lao PDR, Vietnam and small Pacific islands where recent progress in global and regional integration benefitted growth, but also made these economies more vulnerable to the global and regional business cycles.

Notes:

- 1 With Laos joining the WTO, all East Asia and the Pacific countries with the exception of North Korea will be members of the institution.
- 2 Remittances are measured as a sum of three components in the IMF's BOP Statistics: compensation of employees, workers' remittances and migrants' transfers. The compensation of employees refers to "the income of border, seasonal, and other short term workers who are employed in an economy where they are not residents and of residents employed by nonresident entities". The workers' remittances are current transfers by migrants". Migrant transfers are "net worth of migrants' assets that are transferred from one country to another at the time of their migration". For the Philippines, the estimate differs from US\$ 21 billion projected based on the Central Bank's definition of remittances. Share of remittances in GDP is based on the last three year average reported in the World Development Indicators database (WDI).

Europe and Central Asia Region

Overview: Growth in developing **Europe and Central Asia** region (box ECA.1) decelerated considerably in 2012 after a relatively strong 2011. All economies in the region had to deal with challenging external conditions, including the Euro Area recession and debt problems, volatile global financial markets and a slowing global economy. The Western Balkan countries, with their strong economic and banking linkages with high-income Europe, suffered the most from declining export demand, reduced capital and remittance flows, and banking-sector deleveraging. Banking systems in several countries are under considerable pressure due to a sharp slowdown in economic activity, weak credit demand, and tight foreign funding conditions. Non-performing loans (NPLs) rose especially in Bosnia and Herzegovina (12.7 percent), Moldova (15.3 percent) and Romania (17.3 percent). NPL rates are likely to have climbed in Ukraine, while remaining a high level of 37 percent in Kazakhstan.

External factors have improved since September. Export values grew by a 21 percent annualized pace in the three months ending in November supported by the robust import demand from non-European markets. Improved financial conditions have helped the region's access to international bond markets with increased number of issuances by Russia and Turkey as well as less frequent issuers such as Bulgaria, Romania, Lithuania, Serbia and Ukraine. The region's industrial production growth has also picked up since November.

GDP growth in the region is estimated to have fallen to 3.0 percent in 2012, from 5.5 percent in 2011. And, despite high oil prices, growth in Russia, the region's largest economy, declined to

an estimated 3.5 percent in 2012 (4.3 percent in 2011), due to drought, rising inflation and weak global sentiment. Several countries in the region (Albania, Bulgaria, Macedonia and Romania) grew by less than one percent in 2012, while Turkey had a soft landing, after two years of unsustainably high growth, at 2.9 percent in 2012 (8.6 percent in 2011).

Outlook: GDP growth in the region is projected to rebound only slightly to 3.6 percent in 2013, under the baseline assumptions that there will be no major loss of confidence in the global financial markets; and that there will not be a major setback in the resolution of Euro Area crisis and US fiscal problems. The rebound in 2013 is projected to be limited as most of the factors that constrained the growth in 2012 are likely to remain present albeit less forcefully. Prospects for the region critically depend on tackling large current account and fiscal deficits, high unemployment and inflation, lack of competitiveness and other structural constraints to the economies. Regional GDP is projected to firm to 4.0 percent in 2014 and 4.3 percent in 2015.

Risks and vulnerabilities: The region's economic outlook remains subject to serious global and regional risks.

Euro Area Crisis. Given Europe and Central Asia region's close financial and trade ties with high-income Europe, it would be directly impacted by both a major deterioration of the debt crisis or slow-growth/stagnation in the Euro Area.

China. An abrupt unwinding of China's high investment rates, particularly if this were to occur in a generally weak global growth context, will have significant global consequences, especially for commodity exporters.

Banking Sector. The high levels of NPLs in the region's banking system may further constrain the already slowing credit growth. Nevertheless, there is some level of resilience in most banks in the region with their capital adequacy ratios in excess of 10 percent by the end of 2011.

Box ECA. 1 Country coverage

For the purpose of this note, the Europe and Central Asia region includes 21 low- and middle-income countries with income of less than \$12,276 GNI per capita in 2010. These countries are listed in the table ECA.3 at the end of this note. This classification excludes Croatia, the Czech Republic, Estonia, Hungary, Poland, Slovakia, and Slovenia. The list of countries for the region may differ from those contained in other World Bank documents.

Recent developments

Growth slowed down during the first half of 2012 as the region faced several headwinds...

Economic growth decelerated considerably in Europe and Central Asia during the first half of 2012 as various factors hindered economic activity in the region (box ECA.1). All economies had to deal with challenging external conditions, including the recession and debt problems in Euro-zone, volatile global financial markets and slowing global economy. Western Balkan countries that have strong economic and banking linkages with high-income Europe suffered most from: declining export demand, reduced capital and remittances flows (including FDI); and banking-sector deleveraging (which together with domestic policy tightening in some cases contributed to a sharp decline in regional credit growth).

The global economic slowdown reduced export demand for commodities such as steel, which affected Ukraine's economy adversely. And despite a 4.6 percent increase in gold prices this year, a geological shift at the country's main gold mine, and to a lesser extent strikes, led to a sharp contraction in production growth in Kyrgyz Republic.

Domestic consumption, which has been the main driver of growth in the region during the financial crisis was increasingly held back by tighter credit conditions, fiscal tightening, and high unemployment. A particularly sharp adjustment in domestic demand in Turkey was mainly the result of monetary tightening from October 2011 through July 2012 that led to a sharp contraction in bank lending.

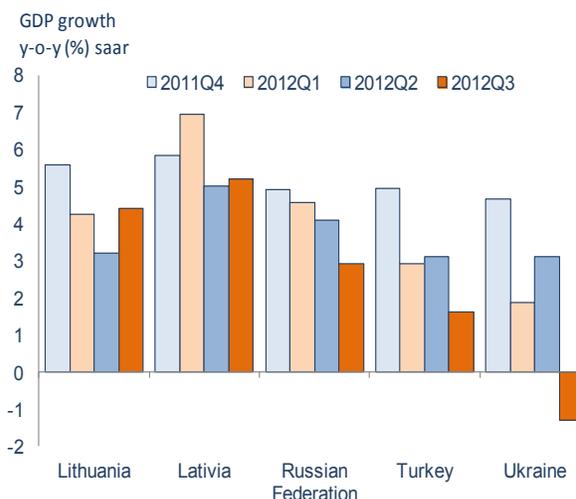
In addition, unusually bad weather cut into agricultural activity, after a relatively strong 2011 in countries such as Romania and Serbia. Also, political uncertainty ahead of elections in Russia, Serbia and Ukraine, and escalated political problems in Romania also impeded growth by slowing progress in necessary reforms, prompting capital outflows, and limiting external capital inflows.

The overall impact of these developments was to cause growth to slow down during the first half of 2012 in almost all economies in the region (figure ECA.1). The contraction was particularly sharp in Serbia and Macedonia FYR with negative growth rates during the first half of the year. Growth also eased markedly in Lithuania, Turkey and Ukraine. Although third quarter GDP data is available for only a few countries, where it exists it suggests that that growth remained weak in the third quarter. Real GDP contracted in Ukraine (-1.3 percent saar year over year) and Romania (-0.5 percent) and growth weakened in Russia (2.9 percent) and Turkey (1.6 percent), while there was a slight improvement in Latvia (5.2 percent) and Lithuania (4.4 percent).

High frequency data indicate that economic performance was mixed across countries during the later months of the year

Industrial production in the Europe and Central Asia region rebounded sharply growing at a 6.4 percent annualized rate (3m/3m saar) in the three-months ending in November (figure ECA.2). The rebound was mainly supported by the strong performance in few economies: Turkey (30.5 percent due to strong exports and extra working days in November), Lithuania (26.3 percent as it is still rebounding from prolonged closure of the main oil refinery), and Kazakhstan (mainly due

Figure ECA.1 Growth has been slowing down...



Source: World Bank.

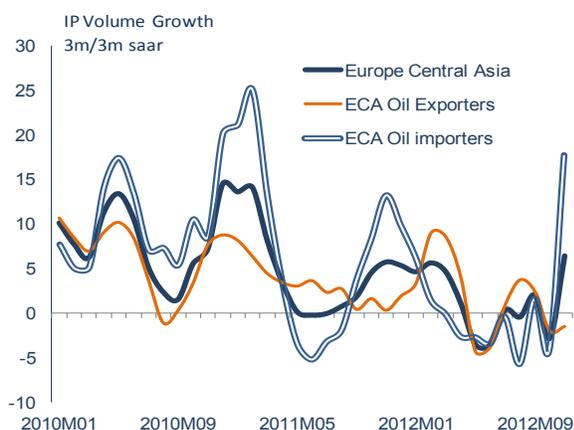
to base effects). Industrial production growth remained weak for the rest of the region contracting sharply in Bulgaria (13.1 percent), Ukraine (by 8.6 percent), Latvia (3.7 percent), and more modestly in Russia (2 percent), Serbia (1.2 percent) and Romania (1 percent) in the three-months ending in November. In addition to industrial production, the impact of the summer drought is expected to have cut into GDP growth in the third quarter in affected countries, including Russia, Romania, Serbia, and Bosnia and Herzegovina.

Business surveys for December suggest that favorable operating conditions of the Turkish manufacturing sector will continue as its PMI index remained above the benchmark 50 for December. While seasonally adjusted PMI index for Russia's services sector also remained above the benchmark in December, its PMI for the manufacturing sector went back to 50 indicating a possible slow-down in the sector in early 2013.

External factors have improved since September with global trade picking up....

As discussed in detail in the main text and the finance annex, global financial market tensions eased in late July, as confidence was slowly restored in the Euro Area. The real side impact of the improvements in financial conditions and capital flows was modest in high-income countries – although it is more visible in the data

Figure ECA.2 Mixed IP performance in the second of 2012



Source: World Bank.

for developing countries in general. There has been only a modest pickup in global trade in Q3 2012, with developing country imports volumes expanding once again, although for high-income country imports were still contracting.

For the region, the improvement in trade is more marked. Regional merchandise export value rebounded growing at a 21 percent annualized pace during the three months ending in November 2012 (figure ECA.3). The rebound came despite the recession and weak import demand in high-income Europe—the region's main export destination (high-income European import value growth was negative through the third quarter and only grew at a 1.7 percent annualized pace in November). The exports were driven by the strong performance of large middle income countries such as Russia (24.1 percent saar during the three months through November 2012) and Turkey (15.5 percent). The robust export performance of the region partly reflects base effects and partly the increasing importance of non-European economies including other developing countries as destinations supported by Russia's accession to the WTO. Turkey's remarkable export performance during most of this year for example was supported by its successful market diversification strategies, depreciation in real effective exchange rate and strong gold exports to Middle Eastern economies including Iran and the United Arab Emirates. Similarly, Latvia has been able to offset the weak state of demand in high-income Europe by increasing exports to Russia and other CIS economies. Turkey continues to be a major destination for exports from the South Caucasus region as is China for countries in Central Asia.

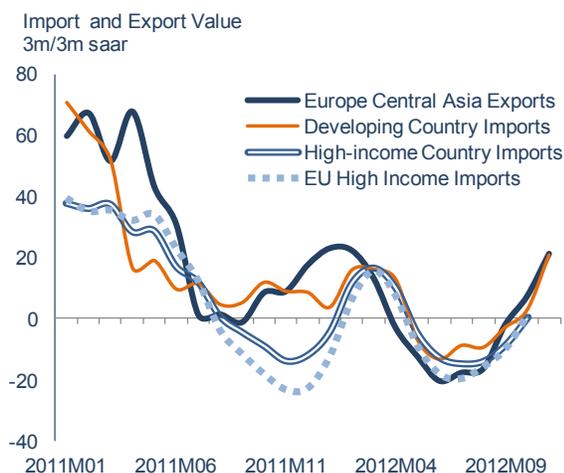
Export demand in the region is likely to remain firm in coming months driven by non-European markets especially from other developing countries. Also, import demand from European markets has been strengthening in recent months. Prospects for Turkey's export growth remain uncertain, however.^{FN1} While it will benefit from the pick-up in global trade, the prospects for its gold exports remain uncertain in coming months.

..but the improved financial market conditions has only helped the region’s access to bond markets while other capital flows remained weak

Following the decisive actions taken by the European Central Bank, and liquidity injections by G3 countries, the cost of insuring against a sovereign default of European and Central Asian countries has narrowed by between 100 bps and 250 bps since June. Bond yields also declined by similar amounts. Taking advantage of lower borrowing costs, firms in Russia issued international bonds totaling \$39.3 billion, while Turkey issued \$19.3 billion. Infrequent sovereign issuers also took advantage, with Bulgaria issuing \$1.2 billion in bonds since July. Other issuers included: Ukraine (\$5.4 billion), Romania (\$5.2 billion), Lithuania (\$2.2 billion) and Serbia (\$1.8 billion) (figure ECA.4). Overall, despite the mid-year weakness, international bond issuance by firms and sovereigns in Europe and Central Asia surged in 2012 at \$85 billion, its highest value in three years. With the large equity issuances by two Russian companies and a Turkish bank since September, equity flows in the region increased by 12 percent reaching 13.6 billion in 2012. In contrast, bank lending to the region fell by 8 percent in 2012. Excluding Russia, the fall was even larger at 14 percent.

Syndicated bank lending has been under pressure

Figure ECA.3 Export value growth has rebounded mostly driven by developing country demand



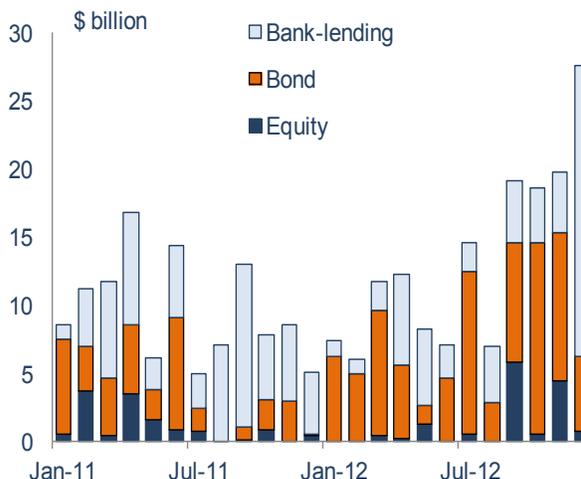
Source: World Bank.

since mid-2011 due to deleveraging by Euro Area banks. Most of the decline in 2012 involved refinancing and general corporate purposes loans. After the intense period during the second half of 2011, the pace of deleveraging in high-income Europe appears to have eased in 2012 (see Main text and the Finance annex). Nevertheless, bank-lending has declined substantially. According to Bank of International Settlement data, European banks’ foreign claims—including all the cross-border and local lending by subsidiaries—fell by \$51 billion between June 2011 and June 2012. Countries subject to the largest reductions included Romania (\$18 billion, 9 percent of GDP), Serbia (\$5.4 billion, 12.8 percent of GDP) and Bulgaria (4.6 billion, 8.8 percent of GDP). The impact of deleveraging by the European banks was compensated for fully in Russia, Uzbekistan, and partially in Turkey by non-European banks. The decline in cross-border bank loans is likely to impact activity most in those countries that have limited access to alternative financing sources like bond-financing. Intense deleveraging has already coincided with negative domestic growth in many countries in the region (see the discussion later).

FDI inflows to Europe and Central Asia have declined sharply...

Foreign direct investment (FDI) inflows account

Figure ECA.4 Gross capital flows have rebounded



Source: World Bank.

for more than 20 percent of gross fixed investment during 2009 and 2011 in Georgia (36.8 percent), Kazakhstan (32.6 percent) and Albania (31.8 percent). For the region as a whole, FDI fell by 25 percent (year-over-year) during the first half of 2012. While FDI declined in other regions too, the decline in Europe & Central Asia was much sharper—due to a severe contraction in investment outflows from high-income European economies. In addition, unlike most other developing regions, reinvested earnings were limited due to weak profitability and intercompany loans slowed down sharply. The largest decline was in Serbia (80 percent) followed by countries such as Georgia, Latvia and Lithuania with declines around 20 percent. With the exception of Russia, the flows increased only slightly in the second half in most countries. While improved financial conditions since July encouraged several countries to accelerate privatization efforts, some postponements and less successful sales of stakes in state owned assets suggest that investors still have limited appetite for these assets.

Net private capital inflows to the Europe and Central Asia region are estimated to have declined to \$175.9 billion (4.4 percent of the region's GDP) in 2012 from \$194.6 billion (5.7

percent) in 2011 (table ECA.1). While these levels are well off the unsustainably high 14 percent of GDP levels observed in the boom years, they are nevertheless on par with other developing regions where private capital flows account for 4 to 6 percent of their GDP. Going forward, assuming there is no major set-back in the resolution of Euro-area crisis or in financial markets confidence, net private capital inflows to the region are expected to start rising in 2013 and gradually strengthen along with global growth to reach \$226 billion in 2015—around 4.8 percent of the region's GDP. By 2015, all flows are expected to increase, with bond issuance expected to level off slightly as bank lending picks up the pace, with the latter supported by increased South-South flows.

Developing Europe has suffered from a sharp decline in remittances, while Central Asian economies benefited from the increased flows from Russia...

Remittances are an important source of both foreign currency and domestic incomes for several countries in the developing Europe and Central Asia region. They represent more than 20 percent of GDP in Kyrgyz Republic and Moldova and about 45 percent in Tajikistan. Remittance flows to the region are projected to

Table ECA.1 Net capital and workers' remittances flows to Europe and Central Asia (\$ billions)

	2010	2011	2012e	2013f	2014f	2015f
Capital Inflows (official+private)	180.9	200.1	174.2	209.7	224.2	224.9
Private inflows, net	157.3	194.6	175.9	211.0	226.4	226.1
Equity inflows, net	87.2	108.6	103.1	137.4	149.8	142.6
Net FDI inflows	88.0	118.7	99.5	131.2	138.7	129.1
Net portfolio equity inflows	-0.8	-10.1	3.6	6.2	11.1	13.5
Private creditors, net	70.1	86.0	72.8	73.6	76.6	83.5
Bonds	21.3	13.6	22.5	27.3	21.4	19.3
Banks	-5.8	33.2	23.4	15.4	16.3	18.5
Short-term debt flows	45.9	24.5	16.5	23.5	29.7	40.0
Other private	8.8	14.7	10.4	7.4	9.2	5.7
Official inflows, net	23.5	5.5	-1.7	-1.3	-2.2	-1.2
World Bank	3.5	2.4	-0.1			
IMF	9.4	-1.0	-5.0			
Other official	10.7	4.1	3.4			
<i>Memo item:</i>						
Workers' remittances	37	41	41	45	51	58
Central and Eastern Europe & Turkey	18	18				
Commonwealth of Independent States	19	23				

Note: e = estimate, f = forecast

Source: World Bank.

remain at their 2011 level of \$41 billion but with major differences across countries (table ECA.1). On-going economic problems in high income European countries have led to a jump in unemployment rates skewed against migrant workers, with migrant unemployment rising faster than native-born unemployment in France, Greece, Italy and Spain causing some migrants from European Union with free mobility such as Romania return home. Overall, remittance inflows have declined significantly in Serbia, Albania, and Romania. In contrast, remittances flows from Russia, which account for 30 percent of the inflows to the region, benefited from high oil prices. As a result, total inflows to Armenia, Georgia, Kyrgyz Republic, Moldova and Tajikistan are estimated to have grown in 2012. Flows are expected to reach \$58 billion by 2015 (see Migration and Development Brief 19).

Domestic demand growth has remained under pressure with tighter credit conditions, rising inflation, fiscal adjustments, and high unemployment which are likely to linger through next year...

Credit growth in the region has declined sharply over the last year especially in countries with strong European bank presence. Real domestic credit growth has been negative for Latvia and Lithuania since early 2009—not shown in the figure, and has also sharply declined in countries such as Albania, Bulgaria, Macedonia FYR, Romania and Turkey in recent months (figure ECA.5). With the exception of Turkey where the slowdown in credit growth was mainly due to domestic monetary policy tightening, the declining credit growth reflects partly supply-side constraints related with foreign funding. While the demand for credit also fell as the economic activity in the region slowed down during the same time, the recent CESEE Deleveraging Monitor by the Vienna Initiative assesses that the tightening of supply conditions have contributed decelerating credit extension in the region.^{FN2}

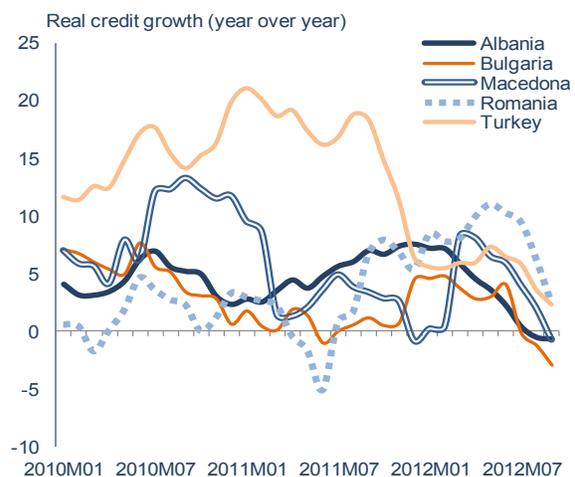
Foreign funding—particularly cross-border lending from the parent banks to their subsidiaries operating in the region—played an

important role in supporting the robust credit growth before the crisis. Several countries in the region had loan-to-deposit ratios exceeding 100 percent by large margins. Reflecting the intense deleveraging by the parent banks in recent years, however foreign funding has become limited and costly. In an effort to reduce to the dependence on cross-border lending, domestic banks hiked deposit rates in order to attract more domestic savings. The process has helped to reduce the dependence on foreign funding in countries such as Bulgaria and Romania where loan to deposits ratios declined. While this will be beneficial in the long-term and reduce external vulnerabilities in the region over the longer run, over the short-run it has also increased lending costs—contributing to tighter credit conditions.

Even if the acute intense phase of deleveraging has passed now, tight supply conditions are expected to remain in the medium-term with strict regulatory changes ahead for the global banking system (see Finance Annex box FIN.2). When the demand for credit pick up in tandem with the economic activity, this might create bottlenecks for countries with little room to improve their local funding sources.

After easing slightly in the first half of the year, inflation in the region has gained momentum in recent months (figure ECA.6), reflecting increased food prices following weak crops in

Figure ECA.5 Sharp fall in real domestic credit growth

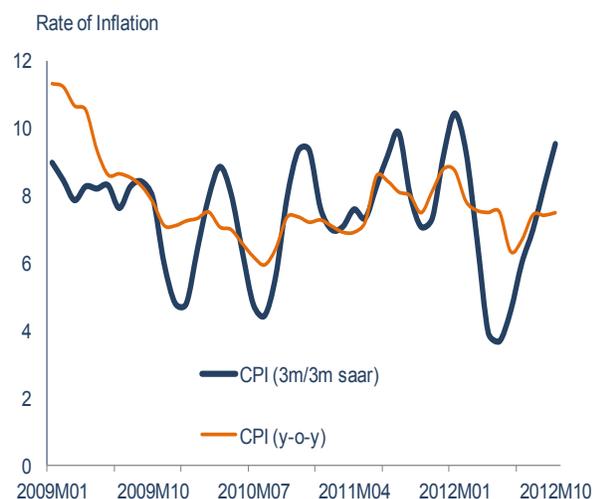


Source: IMF and World Bank

Russia, Ukraine and Kazakhstan, as well as supply constraints and increased taxes and administrative tariffs (Russia and Turkey). The uptick in inflation will likely weigh on consumption, particularly if food prices continue to rise, and will leave less room for monetary policy to support the growth if conditions deteriorate. Indeed, the central bank of Russia raised interest rates by 25bps in September on the expectation that inflation pressures will continue.

While the inflation in Turkey did not accelerate in the second half of the year, it remained high around 9 percent (year over year) up until September. Nevertheless, the central bank of Turkey responded to weak growth mid-year by increasing liquidity supply to banks in July, and cut its overnight lending rate for the first time in seven months in September. The bank cut its overnight lending rate which serves as the upper bound of its interest rate corridor by 150 basis points to 10 percent and took steps to keep loan growth in check to avoid overheating. Further easing came in October as the inflation has started to fall significantly. Turkey's inflation reached 6.4 percent (year over year) by November with the help of the fall in food prices. The move also seeks to reduce appreciation pressures as capital flows strengthened following quantitative easing steps in high-income countries and the upgrade of

Figure ECA.6 Inflation has gained momentum



Source: World Bank

Turkey's credit rating to investment grade.

On-going fiscal adjustment by most of the countries in the region has also been hampering the domestic demand growth. Developing countries that are part of the European Union (EU) have been lowering structural fiscal deficits to meet the 3 percent target required by the EU. The further adjustments are likely to occur in Ukraine and Romania, where government spending increased in the run up to elections. Russia too may adopt a tighter stance, as its surplus has been depleted following pre-election spending.

High rates of unemployment in the region are another factor weighing on domestic demand. While unemployment conditions in Turkey, Latvia, Lithuania and Russia have improved along with output, labor market conditions remain very weak elsewhere, including in Albania and Bulgaria and Serbia. Currently, unemployment is well over 20 percent of the labor force in Serbia, Kosovo, and Macedonia FYR.

Outlook

Growth in the region is expected to decline sharply to an estimated 3.0 percent in 2012 from 5.5 percent in 2011 (table ECA.2). Hit hard by the weakness in high-income Europe, the Central and Eastern Europe is projected to have slowed down markedly, whereas the adjustment for CIS countries is expected to have been less severe. Several countries (Albania, Bulgaria, Macedonia FYR and Romania) are forecasted to grow less than one percent, while Serbia entered to a recession in 2012 (table ECA.3).

GDP growth in the region is projected to rebound only slightly to 3.6 percent in 2013, under the baseline assumptions that there will be no major loss of confidence in the global financial markets; and that there will not be a major set-back in the resolution of Euro-area crisis and US fiscal challenges. The rebound in 2013 is projected to be limited as most of the factors that constrained the growth in 2012 are likely to remain present (albeit somewhat less

forcefully). Economic growth in high-income Europe is forecasted to rebound but still remain weak in 2013. Fiscal adjustments by regions' economies will continue and domestic credit growth will continue to be constrained on the supply-side. Region's growth is expected to gradually rise to 4.3 percent by 2015.

Prospects for the region critically depend on the progress in addressing external (large current account deficits) and domestic (large fiscal deficit, unemployment, and inflation) imbalances; lack of competitiveness; and structural constraints in their economies. Key structural factors include strengthening policy reform effort to reduce public debt, advancing structural fiscal reforms, improving labor market flexibility, improving business environment and financial market efficiency. Some of the countries have already progressed considerably in reducing their fiscal deficit such as Romania and Latvia where it is projected to fall below 3 percent required by EU.

External support from international financial

Table ECA.2 Europe and Central Asia forecast summary

	(annual percent change unless indicated otherwise)			Est.		Forecast	
	00-09 ^a	2010	2011	2012	2013	2014	2015
GDP at market prices ^b	4.2	5.3	5.5	3.0	3.6	4.0	4.3
	<i>(Sub-region totals-- countries with full NIA + BOP data)^c</i>						
GDP at market prices ^c	4.2	5.4	5.6	3.0	3.6	4.0	4.2
GDP per capita (units in US\$)	4.0	4.9	5.1	2.6	3.2	3.6	3.9
PPP GDP	4.3	5.1	5.3	3.0	3.6	4.0	4.2
Private consumption	5.9	5.1	6.6	3.4	4.2	4.5	4.8
Public consumption	2.5	-0.2	2.2	2.9	2.7	3.2	3.0
Fixed investment	6.6	11.7	7.2	0.0	4.5	5.0	5.6
Exports, GNFS ^d	5.2	7.5	6.4	5.3	4.2	5.4	6.0
Imports, GNFS ^d	7.1	17.3	11.4	3.4	5.2	6.0	6.7
Net exports, contribution to growth	-0.3	-2.7	-1.6	0.6	-0.4	-0.3	-0.3
Current account bal/GDP (%)	2.3	0.7	0.8	0.6	0.0	-0.4	-0.7
GDP deflator (median, LCU)	9.3	9.2	8.6	2.2	6.0	5.6	5.4
Fiscal balance/GDP (%)	-0.6	-3.5	0.3	-0.2	-1.0	-1.1	-1.2
Memo items: GDP							
Transition countries ^e	4.7	3.9	4.4	3.1	3.5	3.8	3.9
Central and Eastern Europe ^f	4.1	-0.4	3.1	1.4	1.8	2.5	3.3
Commonwealth of Independent States ^g	4.8	4.7	4.6	3.4	3.7	4.1	4.0
Russia	4.4	4.3	4.3	3.5	3.6	3.9	3.8
Turkey	3.0	9.2	8.5	2.9	4.0	4.5	5.0
Romania	4.2	-1.6	2.5	0.6	1.6	2.2	3.0

a. Growth rates over intervals are compound weighted averages; average growth contributions, ratios and deflators are calculated as simple averages of the annual weighted averages for the region.

b. GDP at market prices and expenditure components are measured in constant 2005 U.S. dollars.

c. Sub-region aggregate excludes Bosnia and Herzegovina, Kosovo, Montenegro, Serbia, Tajikistan and Turkmenistan. Data limitations prevent the forecasting of GDP components or Balance of Payments details for these countries.

d. Exports and imports of goods and non-factor services (GNFS).

e. Transition countries: CEE and CIS (f + g below).

f. Central and Eastern Europe: Albania, Bosnia and Herzegovina, Bulgaria, Georgia, Kosovo, Lithuania, Macedonia, FYR, Montenegro, Romania, Serbia.

g. Commonwealth of Independent States: Armenia, Azerbaijan, Belarus, Kazakhstan, Kyrgyz Republic, Moldova, Russian Federation, Tajikistan, Turkmenistan, Ukraine, Uzbekistan.

Source: World Bank.

institutions has been crucial for many countries in the region to create financial buffers and to be a catalyst in addressing their macroeconomic imbalances. Some countries including Bosnia and Herzegovina, Georgia and Romania (with precautionary IMF supported program and lending from the World Bank) have benefited from the financial support from the IMF and other IFIs to cope with the deterioration of external conditions. On the other hand, the IMF supported programs were put on-hold during pre-election period in Serbia and Ukraine but discussions are expected to resume in coming months. Both of these economies have large external financing needs (current account and external debt amortization) and reducing borrowing costs is crucial going forward. Already in recession, Serbian economy also suffers from a large fiscal deficit, very high unemployment rate (more than 20 percent) and rising inflation.

After two years of unsustainably strong growth, Turkey has had a soft-lending with growth slowing to a projected 2.9 percent in 2012 from

8.6 percent in 2011 (table ECA.3). Most of the deceleration came from easing domestic demand and investment following monetary policy tightening that led to sharp adjustment in credit growth. The sharp adjustment has not generated any major disturbance in the economy as the country continues to benefit from its ongoing access to international capital markets (bond flows in particular). Economic rebalancing has started already with easing current account deficit from 10 percent in 2011 to a projected 6.8 percent in 2012. While capital flows to Turkey are expected to be robust next year, current account deficit remains high and makes the country vulnerable to sudden changes in investor sentiment. In addition, while the adjustment has also come through declining imports, the resilience of its exports has been mainly due to its unprecedented exports of gold to Iran (directly or via the United Arab Emirates) in return for its energy imports. The impact of gold exports on the current account is unsustainable however since the draw down on Turkish gold stocks (Turkey is not an important producer of gold) will likely require an increase in imports going forward to bring stocks back up to normal level.

Economic growth in Russia—the largest economy in the region—is expected to decline to 3.5 percent in 2012 from 4.3 percent in 2011 due to unfavorable base effects, a drought in agriculture, rising inflation, and weak global sentiment. Despite the projected high oil price, growth is expected to pick up only modestly to 3.8 percent by 2015 reflecting monetary tightening, a tight labor market, and capacity constraints. The government will find it difficult to step up public investment in view of the large non-oil budget deficit. Similarly, economic growth in Kazakhstan is projected to slowdown in 2012 due to capacity constraints and the drought affecting the wheat production and expected to pick up only by 2014 after a new oilfield becomes operational.

For the commodity exporters, the key challenge continues to be high dependence on extractive industries. Most of them are bumping against capacity constraints, and while current

exploration and investments should result in increased production over the forecast period, both the pace of income (commodity prices are projected to decline in real terms) and output growth is likely to be significantly slower than in the recent past. While the extractive sectors will remain important sources of income, policy must focus on establishing the conditions under which other sectors of the economy can prosper and expand. Here there are no easy answers, but improving the predictability and enforcement of laws, reducing administrative burdens and hurdles and investing in both infrastructure and human capital are important components of any lasting effort to diversify and reducing dependence on commodity-related earnings.

Risks and vulnerabilities

The region's economic outlook is still subject to serious downside global and regional risks. On the external front:

- Given the region's close financial and trade ties with high-income Europe, it would be directly impacted by a major deterioration of the Euro-area debt crisis (by as much as 1.3 percent of regional GDP, see discussion in main text), but even a slow-growth or stagnation scenario would impinge on the recovery in Europe and Central Asia.
- The US fiscal policy paralysis is another imminent risk. Here the direct linkages are less strong (an estimated 0.9 percent of GDP), with regional oil and metal exporters hit harder due to weaker commodity prices. However, should the situation there go very wrong knock on effects in the Euro Area (and developing Europe) could be serious.
- Finally, while a progressive decline in China's unusually high investment rate is expected over the medium- to long-term, there would be significant domestic and global consequences if this position were to unwind abruptly. Impacts for developing commodity exporters would be especially harsh if commodity prices fall sharply.

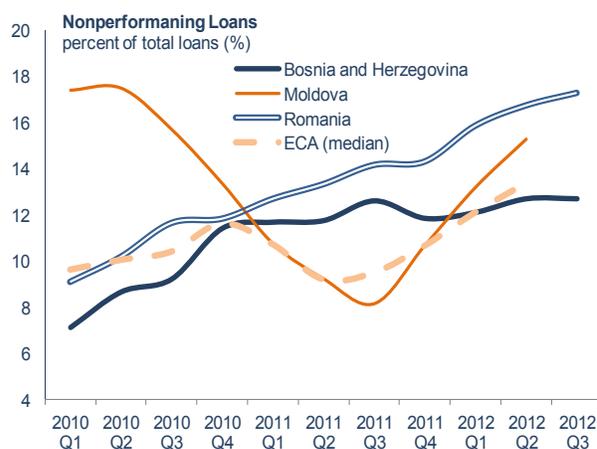
A sharp drop in confidence can lead to a sudden

reversal of global financial conditions and affect significantly the countries with high external financing needs (current account deficits and amortization of external debt) in 2012. Even if the risks related with then Euro-area and US cliff are not fully actualized, these countries are still in a vulnerable position as these uncertainties are likely to generate volatility in the financial markets on the way. Some of the vulnerabilities have decreased. According to the recent data by Bank of International Settlements, all countries in the region—with the exception of Bulgaria and Ukraine—have reduced short-term debt since 2011 lowering their external financing needs for 2013.

The internationally-traded food prices surged in the summer of 2012 as a result of adverse weather shocks. So far, the current food price shock is less severe than in 2007-08, mainly because fewer crops have been involved. Moreover, this time around it has not been aggravated by a significant and simultaneously higher oil price. The pass-through from world to local prices during the most recent period continued to be low. A spike in local food prices will affect poor population with a higher share of food in household budgets. Nevertheless the higher volatility of commodity prices will require a concerted policy response that should combine continued strengthening of the capacity of social safety nets to respond to crises, and agricultural programs aimed at enabling the supply response.

Aside from these global risks for the region's economy, banking systems in several countries are under considerable pressure (figure ECA.7). The sharp slowdown in economic activity, weak credit demand and tight foreign funding conditions have increased pressures on profits. Non-performing loans (NPL) in some countries rose especially in Bulgaria (17 percent), Bosnia and Herzegovina (12.7 percent), Moldova (15.3 percent) and Romania (17.3 percent). After sharp economic slowdown, the NPL rates are likely to have climbed in countries such as Ukraine, while remaining at already very high level at 37 percent in Kazakhstan. The high levels of NPL in region's banking system may further constrain

Figure ECA.7 The share of nonperforming loans in total loans rose markedly



Note: Methodology may vary by country.

Source: IMF Financial Soundness Indicators and World Bank.

credit growth going forward, which has already slowed down considerably. Nevertheless, there is some level of resilience in most banks in the region with their capital adequacy ratios in excess of 10 percent by the end of 2011.

Notes:

1. Turkish gold exports totaled \$14.3 billion by October from \$2.7 billion during January to October in 2011. The Turkish government stated on November 23rd that Iran was using the earnings from energy sales to Turkey, which are deposited in Turkish banks, to buy gold. The gold is subsequently transferred to Iran. Iran provides 18 percent of Turkey's natural gas and 51 percent of its oil.
2. http://ec.europa.eu/economy_finance/articles/governance/pdf/2012-11-12-deleveraging-monitor_en.pdf

Table ECA.3 Europe and Central Asia country forecasts

	00-09 ^a	2010	2011	Est. 2012	Forecast		
					2013	2014	2015
Albania							
GDP at market prices (% annual growth) ^b	4.9	3.5	3.0	0.8	1.6	2.0	3.0
Current account bal/GDP (%)	-8.6	-11.4	-12.6	-11.8	-9.7	-7.9	-6.0
Armenia							
GDP at market prices (% annual growth) ^b	7.7	2.2	4.7	6.8	4.3	4.4	4.4
Current account bal/GDP (%)	-7.4	-14.6	-10.8	-10.6	-9.3	-9.1	-9.1
Azerbaijan							
GDP at market prices (% annual growth) ^b	14.4	5.1	0.1	2.0	4.2	3.7	3.6
Current account bal/GDP (%)	2.9	28.2	26.6	15.5	12.4	11.4	9.9
Belarus							
GDP at market prices (% annual growth) ^b	6.6	7.7	5.3	2.8	4.0	4.0	4.5
Current account bal/GDP (%)	-4.6	-15.0	-10.5	-1.5	-3.0	-3.5	-4.4
Bulgaria							
GDP at market prices (% annual growth) ^b	4.0	0.4	1.7	0.8	1.8	2.4	3.0
Current account bal/GDP (%)	-11.3	-1.5	0.3	-1.5	-2.9	-3.2	-3.4
Georgia							
GDP at market prices (% annual growth) ^b	5.6	6.3	7.1	4.9	5.1	5.4	5.6
Current account bal/GDP (%)	-12.6	-11.4	-12.5	-10.8	-11.9	-11.3	-10.3
Kazakhstan							
GDP at market prices (% annual growth) ^b	7.5	7.3	7.5	5.0	5.5	5.7	6.0
Current account bal/GDP (%)	-2.0	1.6	7.6	4.3	3.9	3.3	3.0
Kosovo							
GDP at market prices (% annual growth) ^b	5.8	3.9	5.0	3.6	3.3	4.0	4.0
Current account bal/GDP (%)	-18.2	-25.9	-26.2	-23.6	-21.6	-18.0	-16.0
Kyrgyz Republic							
GDP at market prices (% annual growth) ^b	4.1	-0.5	5.7	1.0	8.5	7.5	3.5
Current account bal/GDP (%)	-6.0	-6.4	-6.3	-9.1	-6.4	-4.6	-3.3
Latvia							
GDP at market prices (% annual growth) ^b	3.7	-0.3	5.5	5.3	3.0	3.4	3.6
Current account bal/GDP (%)	-10.2	3.0	-1.2	-2.1	-2.9	-3.6	-3.7
Lithuania							
GDP at market prices (% annual growth) ^b	4.2	1.3	5.9	3.3	2.5	3.5	4.3
Current account bal/GDP (%)	-7.1	1.5	-1.7	-3.0	-3.4	-3.3	-3.1
Moldova							
GDP at market prices (% annual growth) ^b	4.4	7.1	6.4	0.0	3.1	4.0	5.0
Current account bal/GDP (%)	-8.4	-9.8	-12.6	-10.8	-8.9	-8.8	-8.4
Macedonia, FYR							
GDP at market prices (% annual growth) ^b	2.3	2.9	2.8	0.0	1.0	2.5	3.5
Current account bal/GDP (%)	-6.1	-2.8	-2.6	-3.5	-4.3	-4.5	-5.2
Montenegro							
GDP at market prices (2005 US\$) ^b	-	2.5	3.2	0.2	0.8	1.5	2.0
Current account bal/GDP (%)	-11.4	-22.9	-17.7	-17.8	-18.5	-17.8	-17.0
Romania							
GDP at market prices (% annual growth) ^b	4.2	-1.6	2.5	0.6	1.6	2.2	3.0
Current account bal/GDP (%)	-7.5	-4.4	-4.9	-3.6	-4.3	-3.9	-3.7
Russian Federation							
GDP at market prices (% annual growth) ^b	4.4	4.3	4.3	3.5	3.6	3.9	3.8
Current account bal/GDP (%)	9.3	4.8	5.5	4.2	3.3	2.6	1.8
Serbia							
GDP at market prices (% annual growth) ^b	3.6	1.0	1.6	-2.0	2.0	3.1	3.6
Current account bal/GDP (%)	-9.5	-6.8	-8.9	-11.3	-9.9	-9.2	-8.8
Tajikistan							
GDP at market prices (% annual growth) ^b	7.7	6.5	7.4	7.5	7.0	6.0	6.0
Current account bal/GDP (%)	-4.8	-0.2	0.6	-0.4	-2.5	-1.4	-1.5
Turkey							
GDP at market prices (% annual growth) ^b	3.0	9.2	8.5	2.9	4.0	4.5	5.0
Current account bal/GDP (%)	-3.3	-6.4	-10.0	-6.8	-7.0	-6.8	-6.5
Ukraine							
GDP at market prices (% annual growth) ^b	3.9	4.1	5.2	0.5	2.2	3.2	3.5
Current account bal/GDP (%)	2.2	-2.5	-6.2	-7.8	-6.6	-5.6	-4.7
Uzbekistan							
GDP at market prices (% annual growth) ^b	6.1	8.5	8.3	8.2	7.5	7.0	6.8
Current account bal/GDP (%)	5.2	4.9	4.8	4.5	4.5	4.0	3.8

Source: World Bank.

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

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

a. GDP growth rates over intervals are compound average; current account balance shares are simple averages over the period.

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

Latin America & the Caribbean Region

Overview: Economic growth in Latin America and the Caribbean region slowed sharply in 2012, making the region the second slowest performer, after developing Europe and Central Asia, amongst all developing regions of the world. A weak external environment and a contraction in domestic demand were largely responsible for a tepid regional GDP growth estimated at 3 percent in 2012 (4.3 percent in 2011). Growth in Brazil, the region's largest economy, decelerated markedly to an estimated 0.9 percent in 2012, from an already-modest 2.7 percent in 2011, while Argentina's economic growth contracted to 2 percent, from 8.9 percent the previous year. The slowdown was modest in Central America and the Caribbean, while growth in Mexico, the region's second largest economy, remained robust expanding by an estimated 4 percent in 2012 despite its strong links to the fledgling US economy. Elsewhere in the region, growth was relatively buoyant, albeit weaker than 2011. Chile posted a brisk performance with growth estimated at 5.8 percent in 2012, as did Panama (10 percent), and Peru (6.3 percent).

Economic activity in the region provided a mixed picture in 2012. Industrial production slowed, though not uniformly, in the first half of the year but rebounded in 3Q 2012 with signs of weakness reappearing in 4Q again. Growth of remittances decelerated due to weak labor market conditions in the main migrant destinations of the US and Europe, while the region received the largest share of gross capital flows (international bond issuance, cross-border syndicated bank loans, and equity placements) to developing countries, accounting for 33 percent of the \$412 billion global gross capital flows in the first 10 months of 2012.

Outlook: Regional growth is expected to accelerate to 3.5 percent in 2013 and average about 3.9 percent over the 2014-2015 period, mainly due to a more accommodative policy environment in some of the larger economies in the region, supported by stronger external

demand and robust domestic demand. Growth in Brazil is forecast to accelerate to 3.4 percent in 2013, boosted by accommodative monetary and fiscal policies whose full effects are yet to be felt. Growth in Mexico is forecast to slow to 3.3 percent in 2013, in part, due to slower US growth. Energy exporters Bolivia, Venezuela and Ecuador will see growth slow, as will Central America. The Caribbean will strengthen slightly mostly on account of the Dominican Republic.

Risks and vulnerabilities: The region remains vulnerable to an uncertain external environment, an increased exposure to East Asia, and to country-specific factors.

Euro Area and the US fiscal paralysis. Should either of these scenarios materialize, the ensuing weak global demand and demand for commodities would negatively impact commodity prices, incomes, fiscal balances and GDP growth in the region, in particular for commodity exporting countries. Countries with fewer macroeconomic buffers could be particularly vulnerable in case of a significant weakening in global demand.

Looking East. As the region, notably South America, is becoming increasingly reliant on exports to East Asia, particularly China, the risk of a stronger-than-expected deceleration in China is a downside risk for commodity exporting countries in particular.

Policy Errors. Domestic imbalances and/or policy errors could also be detrimental to growth in selected economies in the region. In the Caribbean countries, with weak financial systems, a sharp slowdown in growth would result in a marked deterioration in credit quality that could further impair growth.

Hot Money. In the short-run, a possible return of hot money may complicate policy-making in financially integrated economies in the region, resulting in currency appreciations. Over the medium term, however, expectations of costlier capital could limit investment and growth.

Recent economic developments

Economic growth decelerated in Latin America and the Caribbean during 2012, although performance was mixed across economies in the region

Growth in Latin America and the Caribbean (LAC) slowed from 4.3 percent in 2011 to an estimated 3 percent in 2012, largely due to a weaker global environment, but also to a marked slowdown in domestic demand in some of the larger economies in the region (e.g. Brazil) and country-specific factors (e.g. Argentina) (table LAC.1). Growth decelerated to a 1.9 percent seasonally adjusted annualized rate (saar) in the third quarter of 2012, from close to 3.2 percent in the first quarter of the year and around 4 percent in the first half of 2011. Apart from Europe and Central Asia, where growth slowed by 2.6 percentage points in 2012 versus 2011, Latin America and the Caribbean experienced the sharpest growth deceleration (1.3 percentage points) among developing regions in 2012.

Slowdown during the latter half of 2012 was particularly sharp in Brazil, where annual GDP growth is estimated to have fallen to 0.9 percent, compared to the 2.9 percent expected as of mid-

year. The slowdown was much more moderate in the Central American sub-region, where growth expanded by 0.1 percent in 2012, and in the Caribbean economies, where growth decelerated by 1.4 percentage points. On the other hand, despite its strong links to the relatively weak US economy, growth in Mexico (the second-largest economy in LAC), held up well, expanding by an estimated 4 percent in 2012.

Elsewhere in the region, growth remained relatively buoyant, with the economies of Colombia, Chile, Panama, and Peru continuing to expand briskly, albeit at a slightly lower rate than in 2011. Paraguay stood out as a poor performer in 2012, contracting by an estimated 1 percent (following 4 percent growth in 2011) on account of a severe drought as well as weaker growth in major trading partners such as Argentina and Brazil. In Colombia, tourist arrivals performed well despite subdued global growth in the first half of 2012; tourist arrivals in the Caribbean and Central America were up in 2012 as well, by 5.2 and 6.8 percent, respectively.

Industrial production exhibited similar patterns as regional GDP growth in the first and second

Table LAC.1 Latin America and the Caribbean summary forecast

(annual percent change unless indicated otherwise)	Est. Forecast						
	00-09 ^a	2010	2011	2012	2013	2014	2015
GDP at market prices ^b	2.6	6.0	4.3	3.0	3.5	3.9	3.9
	<i>(Sub-region totals-- countries with full NIA + BOP data) ^c</i>						
GDP at market prices ^c	2.6	6.1	4.4	3.0	3.6	3.9	3.9
GDP per capita	1.4	4.9	3.2	1.8	2.4	2.8	2.8
PPP GDP	2.7	6.1	4.5	2.9	3.6	4.0	3.9
Private consumption	2.9	6.0	5.2	3.0	3.5	3.8	3.9
Public consumption	2.6	4.1	2.7	2.5	2.5	2.5	2.5
Fixed investment	3.6	10.9	7.8	4.2	5.3	6.0	6.1
Exports, GNFS ^d	2.8	11.6	5.9	3.8	5.4	6.3	6.7
Imports, GNFS ^d	3.7	22.4	9.8	4.7	5.6	6.2	7.0
Net exports, contribution to growth	-0.2	-2.7	-1.3	-0.4	-0.3	-0.3	-0.4
Current account bal/GDP (%)	-0.3	-1.2	-1.3	-1.7	-1.5	-1.6	-1.6
GDP deflator (median, LCU)	6.3	5.1	7.0	5.5	5.8	5.4	5.8
Fiscal balance/GDP (%)	-2.4	-3.0	-2.2	-2.8	-2.6	-2.4	-2.4
Memo items: GDP							
LAC excluding Argentina	2.5	5.8	4.0	3.1	3.6	3.9	3.9
Central America ^e	1.5	5.4	4.0	4.1	3.4	3.7	3.7
Caribbean ^f	3.4	4.7	3.8	2.4	3.8	3.9	4.2
Brazil	2.9	7.5	2.7	0.9	3.4	4.1	4.0
Mexico	1.2	5.6	3.9	4.0	3.3	3.6	3.6
Argentina	3.4	9.2	8.9	2.0	3.4	4.1	4.0

a. Growth rates over intervals are compound weighted averages; average growth contributions, ratios and deflators are calculated as simple averages of the annual weighted averages for the region.

b. GDP at market prices and expenditure components are measured in constant 2005 U.S. dollars.

c. Sub-region aggregate excludes Cuba and Grenada, for which data limitations prevent the forecasting of GDP components or Balance of Payments details.

d. Exports and imports of goods and non-factor services (GNFS).

e. Central America: Costa Rica, Guatemala, Honduras, Mexico, Nicaragua, Panama, El Salvador.

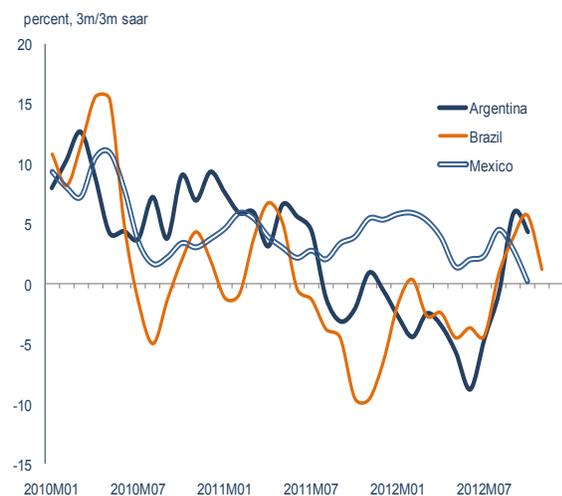
f. Caribbean: Antigua and Barbuda, Belize, Dominica, Dominican Republic, Haiti, Jamaica, St. Lucia, St. Vincent and the Grenadines, and Suriname.

Source: World Bank.

quarters of 2012, slowing to 1.9 and -1.1 percent (saar), respectively. In contrast to regional GDP growth, which was weak in the third quarter, industrial production in LAC economies rebounded, reaching 3.4 percent in the third quarter. However, this rebound in industrial production has not been uniform across the region and the signs of a new slowdown towards the end of 2012 are evident. For example, Mexican industrial production growth held up well during most of 2012 and has only started to slow recently. Argentina and Brazil, on the other hand, experienced strong industrial production growth in the third quarter, after registering weak performance in the first half of the year, but have started slowing down again in the fourth quarter (figure LAC.1). In Central American countries, industrial production trends have been similar to those observed in Argentina and Brazil – i.e., it troughed at around -1.5 percent in May, and have accelerated to around 4.9 percent by September and have slowed down recently to 3.4 percent in November.

The industrial production growth patterns are also reflected in export volumes with Argentinean and Brazilian exports volumes on the rise in recent months after bottoming out in June, whereas Mexican export volumes appears to have peaked in July and has been declining in recent months. In Central American countries export volumes have been under significant

Figure LAC.1 Industrial production



Source: World Bank.

pressure since peaking at 23.7 percent in February and have declined at a 13.2 percent annualized pace in November. Overall, regional import growth (+9.5 percent annualized in November) has recovered from five months of decline – supportive of a modest improvement in domestic demand. But exports remains weak, with export volumes growing at only 3.8 percent annualized pace in November, largely on account of weak import demand from the US and the Euro Area.

The pace of growth of remittance flows in nominal US dollar terms to the Latin America and the Caribbean region decelerated to estimated 2.9 percent in 2012 from 7.3 percent in 2011, as weak labor markets and subdued income growth in the main migrant destinations in North America and Europe affected the ability of migrants to send money home. Notwithstanding a gradual recovery in the US labor market and an upturn in the housing sector in the second half of the year, flows to the largest regional remittance recipient Mexico remained broadly stable, declining by estimated 0.3 percent to \$23.5 billion in 2012, compared with a 6.8 percent increase the previous year. Several remittance-dependent economies, and in particular in countries with large migrant population to the U.S. such as Honduras and Jamaica (where these flows are 16.7 percent and 14.1 percent of GDP, respectively), have seen a steep deceleration in estimated growth of nominal remittance inflows to 1.7 and 2.3 percent, respectively in 2012. The sharp economic downturn and high unemployment in Spain and other European remittance sources has weighted negatively on the overall remittance volumes in Latin America as well.

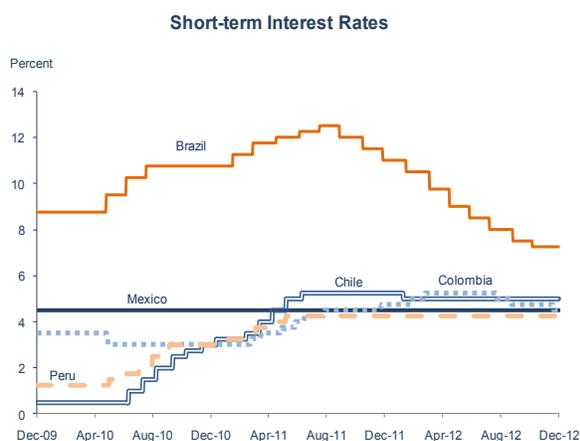
Inflation in the Latin America and the Caribbean region dropped to 4.8 percent annualized pace in the second quarter of 2012 (down from a 7.1 percent pace in 2011) reflecting the weakening of global activity and the lagged impact of relatively tight monetary policy stance (earlier on) in the region. After the monetary policy tightening cycle that started in mid-2010 most inflation-targeting central banks paused in mid-2011, or have made very minor adjustments,

except of Brazil which has lowered policy rates aggressively (commutative 525 basis point cut) to support the weakening economic activity (figure LAC.2).

Inflation started picking up again during the third quarter in reaction to the considerable global policy easing, while higher food and oil prices also contributed to price pressures during a temporary US drought related grain price uptick. Latin America registered some of the sharpest increases in real domestic maize prices affecting food price inflation and contributing to a temporary acceleration of the headline inflation in the third quarter of 2012 to 7 percent. The headline inflation in Uruguay accelerated to 7.5 percent (y/y) in December well above the central bank's 4-6 percent targeted range prompting the central bank to increase the policy rates to 9.25 percent and the government to implement a set of administrative and fiscal measures (e.g. seek an agreement with the country's supermarkets to reduce the price of 200 basic staples by 10 percent and to consider lowering tariffs and taxes on basic foodstuff) to contain the price hike.

Peru managed to achieve strong growth and low inflation (2.7 percent y/y in December - within the Central Bank's target band of 1-3 percent). Chile and Columbia have been successful in maintaining relatively low inflation during the recent volatile economic cycle due to effective

Figure LAC.2 Monetary policy has been on hold in several countries



Sources: World Bank, Bloomberg, and Datastream.

counter-cyclical policies. Moderate price pressures allowed Columbia to cut the policy rates in November and late December to provide additional stimulus to the economy. Inflation remains high in Venezuela and Argentina reflecting expansionary policies.

Capital flows return were buoyant in the second half of 2012

Overall capital flows to the region have remained strong helped by intensifying search for higher yields, renewed prospects of appreciation of select local currencies, and still favorable commodity prices. Net private capital inflows rose slightly to an estimated \$321 billion in 2012 (or 6.1 percent of GDP), up 7.2 percent from 2011, with net bond financing climbing 11.7 percent to \$95 billion (or 1.8 percent of GDP) (table LAC.2). There was a slight increase in FDI inflows as they reached about \$167 billion, 5.7 percent above the \$158 billion registered in 2011. FDI continues to be the most significant source of financing for the current account in many countries, with Brazil remaining the favored destination of FDI investors in the region—and is the second only to China among developing countries. Short-term debt flows showed some signs of rebound, posting positive net flows of \$4.3 billion, but they remain well below a peak of \$43.8 billion in 2010. Net portfolio equity inflows rose to \$12.2 billion in 2012, after dropping sharply to \$7.4 billion in 2011, while net bank lending declining slightly to \$41 billion.

Latin America received the largest share of gross capital flows (international bond issuance, cross-border syndicated bank loans, and equity placements) to developing countries this year, accounting for 33 percent of the \$412 billion registered in the first ten months of 2012. The robust flows underlined a record pace of bond issuance by region's borrowers, which rose to \$91 billion, up about 22 percent year-on-year basis. In fact, Latin American borrowers have dominated the developing-country corporate bond market, constituting nearly half of the total market volume (\$158 billion), as they have taken full advantage of the low funding costs and

Table LAC.2 Net capital flows to Latin America and the Caribbean region (\$ billions)

	2008	2009	2010	2011	2012e	2013f	2014f	2015f
Capital Inflows	186.0	179.6	328.5	303.9	322.4	326.2	327.1	342.3
<u>Private inflows, net</u>	179.3	161.6	306.1	299.1	320.5	327.1	327.8	344.7
Equity Inflows, net	127.5	126.5	166.6	165.6	179.5	198.0	200.8	214.5
<i>Net FDI inflows</i>	137.2	84.9	125.3	158.3	167.3	182.4	176.3	184.2
Net portfolio equity inflows	-9.7	41.6	41.3	7.4	12.2	15.6	24.5	30.3
Private creditors, Net	51.8	35.1	139.5	133.4	141.0	129.1	127.0	130.2
<i>Bonds</i>	8.9	45.9	72.9	85.2	95.1	72.2	57.7	60.2
Banks	40.8	-1.7	21.7	51.7	41.4	42.7	45.2	51.4
Short-term debt flows	2.6	-8.6	43.8	-3.0	4.3	12.7	23.4	16.5
Other private	-0.5	-0.5	1.1	-0.4	0.2	1.5	0.7	2.1
Official inflows, net	6.7	18.0	22.5	4.8	1.9	-0.9	-0.7	-2.4
World Bank	2.4	6.6	8.3	-2.9	0.4			
IMF	0.0	0.4	1.3	0.2	0.1			
Other official	4.3	11.0	12.9	7.5	1.4			

Note: e = estimate, f = forecast

/a Combination of errors and omissions, unidentified capital inflows to and outflows from developing countries.

Source: World Bank.

unprecedented investor demand. In terms of sectoral distribution, banks and oil & gas are especially over-represented with a combined share of about 60 percent. For example, Brazilian oil company Petrobras has raised more than \$10 billion through two bond offerings in February and September. In contrast, bank lending and equity issuance fell sharply this year as companies continued to move away from the higher borrowing costs in the bank markets (and turned to the bond market instead), and region's stocks markets remained fragile following global equity-market sell-offs in 2011.

Economic outlook

Growth is accelerating starting with the final quarter of 2012

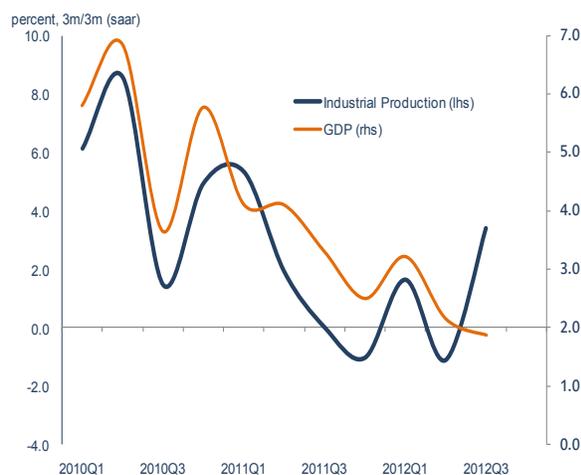
Overall growth in the region is expected to accelerate to 3.5 percent in 2013 and average about 3.9 percent over the 2014-15 period.

Already there are indications that growth has bottomed-out in the second/third quarter of the year. Historically there has been a strong correlation between industrial production and GDP growth rates (figure LAC.3). With industrial production growth increasing from -1.3 percent in the second quarter to 3.4 percent in the third quarter – the highest industrial

production growth rate in 6 quarters – a (modest) rebound in GDP growth is expected.

Furthermore, a more accommodative environment in some of the larger economies in the region in conjunction with stronger external demand should lift growth in 2013, while sound macroeconomic policies, robust domestic demand and stronger external demand should support growth over the medium term. Particularly in Brazil, the benefits of lower interest rates are expected to start kicking-in during the course of the year, which should underpin stronger domestic demand growth.

However, this will to some extent be countered by the reshaping of demand in China away from investments and exports towards domestic consumption and manufacturing, and will affect commodity exporters in the region that rely on Chinese demand as the main growth engine. Most commodity prices are expected to decline marginally in 2013, due to weaker demand, and in some cases improved efficiency, lower intensity of use and substitution. On an annual basis, oil prices are an exception, as it is expected to remain relatively stable at high levels. Non-oil commodity prices are forecast to decline, while manufacturing prices are expected to recover somewhat after declining in 2012. This means that, on one hand, the terms of trade

Figure LAC.3 GDP growth to follow revival in industrial production

Source: World Bank.

for non-oil commodity exporters will deteriorate while, on other hand, the terms of trade will improve for their non-commodity sectors as their currencies depreciate. Marginal improvements in terms of trade for oil exporters and manufacturing exporters could be expected as well (see Commodity Annex).

Growth in Brazil is forecast to accelerate to 3.4 percent in 2013, boosted by stimulative monetary and fiscal policies whose full effects have not yet been felt (table LAC.3). Growth will also benefit from 2012-second half carryover effects. The slowdown of credit growth is expected to subtract from growth however, as will a slightly less favorable terms of trade.

Lower interest rates should reduce interest payments releasing resources for countercyclical measures over the medium term. Efforts by the government to improve the efficiency of the economy by reducing Custo Brazil (high input costs and tax burden, heavy bureaucracy and inadequate infrastructure) should support potential GDP over the medium term notwithstanding a deceleration in labor force growth.

The end of tax exemptions and the lagged pass-through of past depreciations will put upward

pressure on core inflation in 2013 in Brazil. But this should be countered by cuts in electricity tariffs (while also helping support to the manufacturing sector as tariffs will be cut 28 percent for industrial users). Also, the somewhat below potential growth will also help curtail inflationary pressures.

Growth in Mexico is also forecast to slow to from an estimated 4 percent in 2012 to 3.3 percent in 2013, primarily due to negative 2012 base effects (i.e., exceptionally strong growth in the first part of 2012), but also as the economy is impacted by still sluggish US growth. On the other hand, the approval of labor reforms is expected to support growth by lowering the cost of hiring and firing, encouraging job creation including temporary and part-time jobs that could lead to an increase in participation rate. The ministry of Labor estimates 400,000 jobs would be created yearly as a result of labor market reform. Growth in other countries with strong macroeconomic frameworks and competitive economies is expected to exceed the regional average, with Colombia and Chile growing in around 4 percent or more, with domestic demand showing strong dynamism, in particular private investment.

Growth performance among other commodity exporters will be mixed. In Argentina expectations of a record harvest next season and high international prices for its soft commodities exports, along with a recovery in Brazil's domestic demand are expected to support growth of 3.4 percent in 2013, while continued weakness in consumer and business sentiment and policy uncertainties will constrain growth. Over the medium term Argentina's economic performance is likely to be affected by interventionist policies, weaker business environment and consumer sentiment, as well as growing imbalances. Changes to the Central Bank Charter in March 2012 increased the limit on Central Bank credits to fiscal authorities, in effect increasing the ability of the Central Bank to monetize government's deficits. The deterioration in fiscal balances and external accounts is limiting Argentina's ability (policy room) to respond to global or domestic shocks in

a countercyclical manner. Difficulties in financing government deficits at both federal and state level are expected to lead to a tightening of fiscal spending in coming years, especially if prices of soft commodities decline. Paraguay's economy is expected to recover from the 2012 recession, as agricultural output improves sharply and as Brazilian demand recovers. GDP is expected to continue to slow in energy exporters such as Bolivia, Venezuela, and Ecuador as government spending growth eases. In Peru, growth will remain relatively steady at around 6 percent over the forecast period.

The expansion in Central America is expected to slow somewhat due to relatively weak performance in the U.S., notwithstanding a more expansionary fiscal stance in some of the economies. An incipient modest recovery in the U.S. housing sector will provide some support to remittances although sluggish improvement in labor markets and lower net migration to the U.S. will keep remittances growth subdued. Private consumption will also be affected by higher food and energy prices. Panama is forecast to remain the fastest growing economy in Latin America, expanding 7.5 percent in 2013, with growth driven by the expansion of the Panama Canal and several other large investment projects, including the Panama City project.

Growth in the Caribbean is expected to strengthen slightly to 3.8 percent in 2013, mostly on account of improving performance in the Dominican Republic. Growth in other countries in the sub-region will continue to be constrained by high debt levels, and relatively weak remittances and tourism revenues, despite a pick-up in tourist arrivals. Large debt and current account deficits will continue to constrain growth in the sub-region.

Current account balances are expected to deteriorate in the region overall as terms of trade deteriorate for some of the larger economies in the region, while stronger domestic demand and a loss of competitiveness fuel imports.

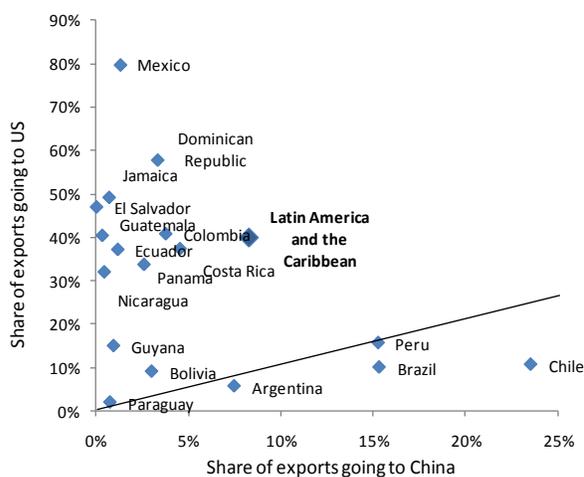
Risks and vulnerabilities

The region remains vulnerable to an uncertain external environment, an increased exposure to East Asia, and to country-specific factors.

A main risk to the global economy is still posed by the possibility of a marked deterioration in conditions in Euro area, although this scenario is less likely than only a few months ago. In such a scenario, global demand and demand for commodities would be significantly weaker than in the baseline, negatively affecting commodity prices, incomes, fiscal balances and GDP in particular in commodity exporting countries. If it unfolds this risk could cut Latin America and the Caribbean regional growth by 1.2 percent in 2013 and 0.8 percent in 2014 (see discussion in main text).

The US fiscal policy paralysis is another imminent risk for countries in this region. Failure to address fiscal problems in the US would result into a sharp 1.8 cut in the US growth in 2013 relative to the baseline through a considerable fiscal drag on the US economy. Direct impact of such scenario is as strong (an estimated reduction of 1.2 percent of GDP in 2013 and 0.4 percent in 2013), with regional oil and metal exporters hit harder due to weaker commodity prices as well as economies dependent remittances from the US.

Figure LAC.4 Region's trade exposure to the US and China (average 2009-2011)



Source: UN Comtrade and World Bank.

As the region, particularly South America, has become increasingly reliant on exports to East Asia, prospects in that region and China in particular are increasingly important (figure LAC.4). The risk of a stronger-than-expected deceleration in China is another downside risk for commodity exporting countries in particular.

Domestic imbalances and/or policy errors could also be detrimental to growth in selected economies in the region. In the Caribbean countries with weak financial systems a sharp slowdown in growth would result in a marked

deterioration in credit quality that could further impair growth.

A possible return of hot money to the region may complicate the fine-tuning of policy in financially integrated economies in the region, resulting in currency appreciation. Over the medium term expectations of costlier capital could limit investment and growth (Global Economic Prospects 2010).

Table LAC.3 Latin America and the Caribbean country forecasts

	00-09 ^a	2010	2011	Est. Forecast			
				2012	2013	2014	2015
Argentina							
GDP at market prices (% annual growth) ^b	3.4	9.2	8.9	2.0	3.4	4.1	4.0
Current account bal/GDP (%)	2.7	0.8	0.0	1.1	0.3	-0.1	-0.5
Antigua and Barbuda							
GDP at market prices (% annual growth) ^b	3.4	-8.9	-5.5	1.0	1.5	3.2	3.4
Current account bal/GDP (%)	-15.4	-12.8	-10.7	-11.4	-12.2	-14.6	-16.2
Belize							
GDP at market prices (% annual growth) ^b	3.6	2.9	2.0	4.0	2.8	2.6	2.9
Current account bal/GDP (%)	-12.9	-2.9	-2.5	-2.3	-2.4	-2.6	-2.8
Bolivia							
GDP at market prices (% annual growth) ^b	3.4	4.1	5.2	4.7	4.4	4.1	3.9
Current account bal/GDP (%)	3.7	4.9	2.7	4.3	3.7	3.2	2.4
Brazil							
GDP at market prices (% annual growth) ^b	2.9	7.5	2.7	0.9	3.4	4.1	4.0
Current account bal/GDP (%)	-0.7	-2.2	-2.1	-2.5	-2.6	-2.8	-3.1
Chile							
GDP at market prices (% annual growth) ^b	3.3	6.1	6.0	5.8	5.1	4.5	4.7
Current account bal/GDP (%)	0.7	1.5	-1.3	-2.9	-2.8	-2.8	-2.7
Colombia							
GDP at market prices (% annual growth) ^b	3.7	4.0	5.9	3.5	3.8	4.1	4.2
Current account bal/GDP (%)	-1.4	-3.1	-2.9	-4.2	-4.4	-4.1	-3.0
Costa Rica							
GDP at market prices (% annual growth) ^b	3.8	4.7	4.2	4.6	4.0	4.3	4.4
Current account bal/GDP (%)	-5.0	-3.5	-5.3	-5.5	-5.3	-5.2	-5.4
Dominica							
GDP at market prices (% annual growth) ^b	2.4	0.1	0.9	0.4	1.2	1.5	1.7
Current account bal/GDP (%)	-18.2	-20.8	-16.0	-13.3	-13.7	-13.8	-14.1
Dominican Republic							
GDP at market prices (% annual growth) ^b	4.5	7.8	4.5	3.0	4.3	4.5	4.8
Current account bal/GDP (%)	-2.6	-8.6	-8.1	-7.2	-6.5	-5.9	-5.9
Ecuador							
GDP at market prices (% annual growth) ^b	4.2	3.3	8.0	4.5	3.9	3.3	3.3
Current account bal/GDP (%)	1.0	-2.4	-0.3	-0.4	2.6	-0.6	-2.9
El Salvador							
GDP at market prices (% annual growth) ^b	1.7	1.4	1.5	1.8	2.3	2.9	2.8
Current account bal/GDP (%)	-3.8	-3.1	-5.4	-5.0	-4.4	-3.7	-3.4
Guatemala							
GDP at market prices (% annual growth) ^b	3.0	2.8	3.9	3.3	3.5	3.4	3.6
Current account bal/GDP (%)	-4.8	-1.5	-3.2	-3.5	-3.6	-3.8	-3.8
Guyana							
GDP at market prices (% annual growth) ^b	2.1	3.6	5.2	4.2	4.8	4.6	4.5
Current account bal/GDP (%)	-9.0	-7.2	-8.6	-14.0	-15.8	-17.1	-18.2
Honduras							
GDP at market prices (% annual growth) ^b	3.8	2.8	3.4	3.3	3.7	3.9	3.7
Current account bal/GDP (%)	-6.4	-6.2	-8.7	-9.4	-9.3	-8.9	-8.5
Haiti							
GDP at market prices (% annual growth) ^b	0.6	-5.4	5.6	2.2	6.0	4.2	4.2
Current account bal/GDP (%)	-20.7	-2.5	-4.6	-4.2	-5.2	-5.0	-4.7

	00-09 ^a	2010	2011	Est. Forecast			
				2012	2013	2014	2015
Jamaica							
GDP at market prices (% annual growth) ^b	1.0	-1.5	1.3	-0.3	1.0	1.6	1.6
Current account bal/GDP (%)	-10.3	-6.9	-14.1	-12.0	-11.6	-12.1	-10.2
Mexico							
GDP at market prices (% annual growth) ^b	1.2	5.6	3.9	4.0	3.3	3.6	3.6
Current account bal/GDP (%)	-1.5	-0.4	-1.0	-1.3	-1.0	-0.6	-0.6
Nicaragua							
GDP at market prices (% annual growth) ^b	2.8	3.1	5.1	4.0	4.2	4.4	4.6
Current account bal/GDP (%)	-17.5	-10.5	-14.2	-17.6	-15.7	-13.7	-11.8
Panama							
GDP at market prices (% annual growth) ^b	5.6	7.5	10.6	10.0	7.5	7.0	6.5
Current account bal/GDP (%)	-4.8	-10.8	-11.3	-9.8	-10.6	-10.7	-10.5
Peru							
GDP at market prices (% annual growth) ^b	4.8	8.8	6.9	6.3	5.8	6.0	6.0
Current account bal/GDP (%)	-0.7	-2.5	-1.9	-3.9	-4.1	-3.8	-4.0
Paraguay							
GDP at market prices (% annual growth) ^b	2.5	15.0	4.0	-1.0	8.5	4.6	4.7
Current account bal/GDP (%)	0.2	-3.6	-1.2	-2.5	-1.3	-1.6	-1.4
St. Lucia							
GDP at market prices (% annual growth) ^b	2.1	3.4	1.2	0.7	1.2	1.7	2.0
Current account bal/GDP (%)	-19.6	-13.7	-23.2	-24.1	-20.8	-19.2	-18.7
St. Vincent and the Grenadines							
GDP at market prices (% annual growth) ^b	2.8	-1.8	0.0	1.2	1.5	2.5	3.0
Current account bal/GDP (%)	-18.9	-31.6	-30.1	-27.2	-25.9	-23.8	-20.5
Suriname							
GDP at market prices (% annual growth) ^b	4.2	4.1	4.7	4.0	4.5	4.5	5.0
Current account bal/GDP (%)	9.9	6.4	5.5	-0.1	-2.1	-4.1	-1.3
Uruguay							
GDP at market prices (% annual growth) ^b	2.1	8.9	5.7	4.0	4.0	4.0	4.0
Current account bal/GDP (%)	-1.3	-1.9	-2.8	-4.5	-4.7	-2.7	-2.6
Venezuela, RB							
GDP at market prices (% annual growth) ^b	3.3	-1.5	4.2	5.2	1.8	2.0	2.0
Current account bal/GDP (%)	10.0	3.1	8.7	5.3	6.4	6.1	6.0

World Bank forecasts are frequently updated based on new information and changing (global) circumstances.

Consequently, projections presented here may differ from those contained in other Bank documents, even if basic assessments of countries' prospects do not significantly differ at any given moment in time.

Cuba, Grenada, St. Kitts and Nevis, are not forecast owing to data limitations.

a. GDP growth rates over intervals are compound average; current account balance shares are simple averages over the period.

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

Source: World Bank.

Middle East and North Africa Region¹

Overview: Political uncertainty continued to weigh on economic activity in many countries in the **Middle East and North Africa** region during 2012. Nonetheless, growth in 2012 recovered to above 2010 levels, with aggregate GDP estimated to have grown by 3.8 percent in 2012, compared with a 2.4 percent contraction in 2011. The rebound was largely driven by a recovery in oil exporter Libya, where GDP grew an estimated 108 percent, and continued robust expansion in Iraq (11 percent growth). However, GDP in Syria, in the throes of internal conflict, is estimated to have contracted by a fifth, but there is significant uncertainty about these estimates. Algeria's economy grew an estimated 3 percent, while Iran experienced a modest recession. Growth among oil importers remained sluggish at an estimated 2.5 percent in 2012 due to the impact of the Euro Area debt crisis on regional exports, together with domestic problems, including a poor harvest in Morocco (3.0 percent growth in 2012), fiscal difficulties in Jordan (3.0 percent growth in 2012), and continuing uncertainty and weak reserves position in Egypt (2.6 percent growth projected for the 2012-13 fiscal year). Tunisia's GDP rose an estimated 2.4 percent in 2012, but in Lebanon, spillover effects from the conflict in Syria caused growth to decelerate to an estimated 1.7 percent in 2012.

Production in crude oil exporters continued to expand in 2012. But among oil importers, industrial production and manufactured exports remained weak amid domestic tensions and the Euro Area debt crisis. Inflation rose sharply in Iran and Syria. In other countries, despite international food price increases during 2012, inflation rates remained subdued, in part owing to subsidy regimes. Private capital flows to the region continued to decline in 2012, falling by an estimated 16 percent, to \$12.5 billion. FDI flows to the region also fell, by a more modest 7 percent. Good news came in the form of tourist arrivals, with Egypt, Jordan and Tunisia posting stronger gains in attracting tourists, but tourism to the region was still below 2010 levels.

Outlook: Regional GDP growth is projected to slow to 3.4 percent in 2013 as growth in Libya returns to a more sustainable pace; and then to rise to 3.9 percent in 2014 and 4.3 percent in 2015. In Egypt, GDP growth is projected to rise to 3.8 percent in the 2013-14 fiscal year and to 4.7 percent in 2014-15. GDP in Jordan and Morocco is projected to expand 3.3 and 4.4 percent in 2013, firming to 4.5 and 5.1 percent by 2015. Iraq's economy will remain buoyant with growth projected at 13.5 percent in 2013 before moderating to 8.5 percent in 2015; Libya's growth is forecast to moderate to 7.6 percent in 2013, easing to 5.1 percent in 2015; while Algeria's growth is projected to firm to 4.3 percent by 2015. Iran's growth is forecast at 0.6 percent in 2013, rising to a modest 2.8 percent in 2015, while growth in Lebanon is forecast at 2.8 percent in 2013, firming to 4.0 percent in 2015.

Risks and vulnerabilities:

Political uncertainty. Protracted political uncertainties and domestic unrest pose a key risk to the region's growth outlook. The ongoing conflict in Syria is a notable source of instability in the region: economic spillovers from Syria to Lebanon, Jordan, and other countries may intensify if the political crisis in Syria worsens.

Euro Area or US debt turmoil. A resumption of Euro Area tensions would particularly affect the region's oil importers, due to Europe's importance as a trade partner and source of investment, tourism, and remittances. A flare up of debt tensions in the United States would also harm this region through trade ties and from negative effects on global economic growth.

Fiscal challenges. Despite recent efforts and plans in several countries to improve fiscal sustainability by undertaking significant subsidy reforms, further reforms could prove challenging in the face of popular resistance.

¹ Due to data limitations, Djibouti and West Bank and Gaza which are part of the MENA region are not included in these regional forecasts. The MENA region classification excludes the six countries of the Gulf Cooperation Council.

Recent economic developments

Gross domestic product (GDP) in the developing **Middle East and North Africa (MENA)** region contracted in 2011 due to disruptions to economic activity following the “Arab Spring” popular movements in early 2011.^{FN1} But in 2012, regional GDP recovered to about 1 percent higher than its level in 2010, as an estimated 3.8 percent growth in 2012 reversed the 2.4 percent decline recorded in 2011. The regional upturn in 2012 was mainly due to a partial recovery of Libya’s GDP following a steep contraction the previous year. But in many countries across the region, continuing domestic tensions and political uncertainty held back investment and weighed on economic activity during 2012. External headwinds from a slowing global economy and economic contraction in the Euro Area, the developing MENA region’s largest trade partner, also contributed to weak non-oil exports. Within the overall context of relatively sluggish growth across the region in 2012 (barring a few notable exceptions), economic performance across developing crude oil exporters and oil importers exhibited substantial variation.

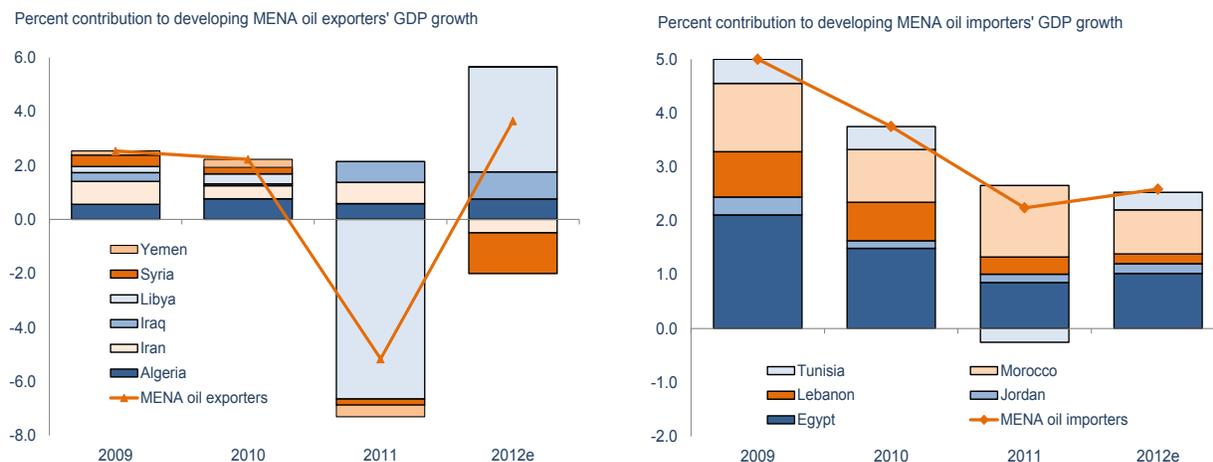
Output in developing MENA oil exporters recovered close to the level of 2010

A sharp recovery of Libya’s output resulted in

developing MENA oil exporters’ GDP growing by an estimated 4.6 percent in 2012 (figure MNA.1, left panel and table MNA.2). However, because of the contraction in 2011, GDP for oil exporters is still about 1 percent lower than its 2010 level. Libya’s output contraction in 2011 was especially deep, with crude oil production dropping precipitously from 1.7 million barrels per day (mb/d) in early 2011 to less than 10,000 b/d in August 2011; but by November 2012, crude oil production had risen to 1.5 mb/d, according to data compiled by the Organization of Petroleum Exporting Countries (OPEC). Iraq’s GDP expanded an estimated 11 percent in 2012, similar to the pace in 2011, led by rapidly rising crude oil production and investment in capacity expansion. Algeria’s GDP growth accelerated modestly to an estimated 3 percent in 2012, from 2.5 percent in 2011, with demand supported in part by oil revenues and government expenditure, although crude oil production remained broadly stable during the year.

In several other developing oil exporters, however, GDP declined or remained flat during 2012. The escalation of internal conflict in Syria resulted in GDP falling by about a fifth, according to preliminary estimates, but lack of reliable aggregate or sector-level data implies that GDP estimates for Syria are subject to significant uncertainty. Iran’s GDP contracted

Figure MNA.1 Among MENA developing oil exporters, a sharp recovery of Libya’s GDP in 2012 offset weaker outturns in Syria and Iran, while oil importers experienced a modest growth pick-up in 2012



Source: World Bank.
 Note: 2012 GDP data are estimates.

modestly by an estimated 1 percent in 2012 as tightening of international sanctions—including a ban by the EU on oil purchases in mid-2012 and the freezing of Iran’s financial assets and transactions by the US and UK earlier—cut into crude oil production, exacerbating existing macroeconomic imbalances including already high inflation.^{FN2} By November, Iran’s crude oil production had fallen to 2.7 mb/d, one quarter less than the 3.6 mb/d average in 2011, according to OPEC data. Yemen’s GDP remained flat in 2012, as production continued to be disrupted by domestic tensions.

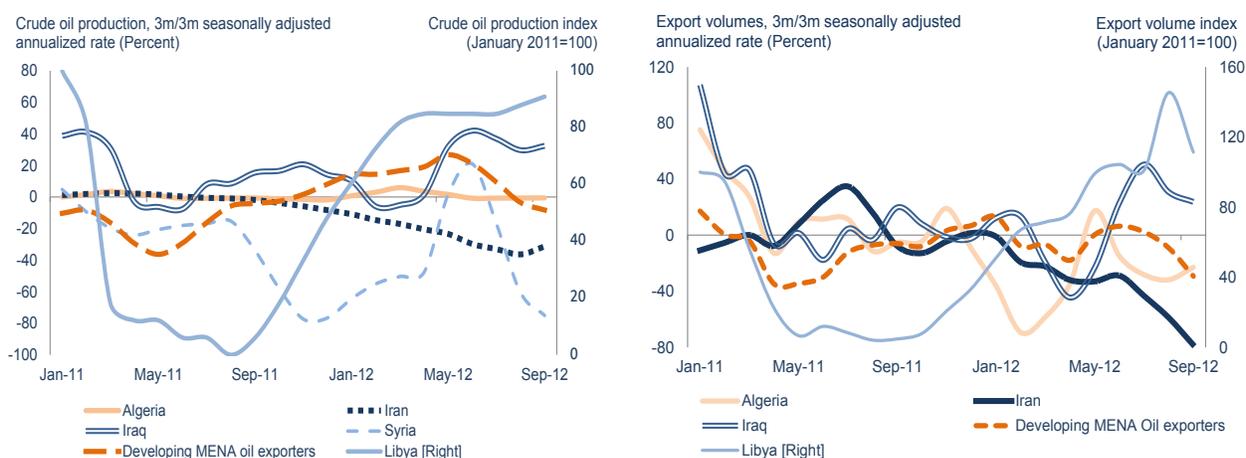
Growth of crude oil production in developing MENA oil exporters slowed in the third quarter of 2012 (figure MNA.2, first panel). In line with weaker production growth, developing MENA oil producers also recorded weaker export volume growth in the third quarter, as strengthening exports in Libya and Iraq were offset by a decline in Iran, and, to a smaller extent, in Algeria (figure MNA.2, second panel). While the drop in Iran’s exports can be attributed to tighter sanctions, a smaller annualized decline in Algeria’s export growth appears to be partly related to rising domestic demand for gasoline, caused by a rise in vehicle ownership. In Yemen, a fragile security situation and attacks on oil and gas pipelines during 2012 caused considerable volatility in exports.

Oil importers’ economic performance remained sluggish in 2012 mainly due to domestic uncertainty

GDP growth in developing MENA oil importers remained sluggish in 2012, broadly unchanged at an estimated 2.5 percent in 2012 compared with 2.4 percent in 2011 (figure MNA.1, right panel, and table MNA.2), as these countries continued to grapple with domestic tensions amid an adverse external environment. While domestic difficulties played a more significant role in the relatively weak economic performance of oil importers, external headwinds from the debt crisis in the Euro Area (the region’s largest trade partner) contributed to subdued exports and investment inflows.

In Egypt, which has the largest economy among oil importers, GDP growth picked up modestly to 2.2 percent in the fiscal year ending in June 2012 from 1.8 percent in the previous fiscal year. But continuing domestic uncertainty and unrest into the final months of 2012 resulted in a weak calendar year performance. Tunisia returned to growth in 2012 after experiencing an output contraction in 2011. But Morocco’s growth moderated to an estimated 3 percent in 2012, from 5 percent the previous year, partly because of a weaker than expected agricultural harvest. Despite problems with a gas pipeline that also contributed to fiscal difficulties in 2012, GDP

Figure MNA.2 Crude oil production and export volume growth in developing MENA oil exporters weakened during the third quarter of 2012



Source: US Energy Information Administration for monthly crude oil production data (accessed via Thomson Reuters), Haver Analytics and World Bank

growth in Jordan accelerated modestly to an estimated 3 percent in 2012, up from 2.6 percent in 2011. Lebanese GDP growth weakened to an estimated 1.7 percent in 2012, as economic spillovers from Syria’s conflict intensified during the course of the year.

Reflecting country-specific drags on growth in oil importers, and to an extent, the impact of the European debt crisis on demand for the region’s exports, industrial production for the group of oil importers declined at a 9.8 percent annualized pace in the three months to September 2012 (figure MNA.3, first panel). Despite the sequential decline in production, oil importers’ industrial output was 4.5 percent higher in the first three quarters of 2012 compared with the same period of 2011, and close to the level in the like period of 2010. Industrial output in Egypt continued to decline in the second half of 2012 on an annualized basis, by 17.9 percent in the three months to October compared to the previous quarter. But industrial production in Jordan and Morocco started to pick up in the third quarter, by an annualized 3 percent in both countries. In Tunisia, with a reduction of domestic tensions, industrial output growth accelerated to an annualized 14.1 percent pace in the third quarter compared with the second quarter, but industrial output was only 1.6 percent higher in the first three quarters of 2012 than the same period in 2011.

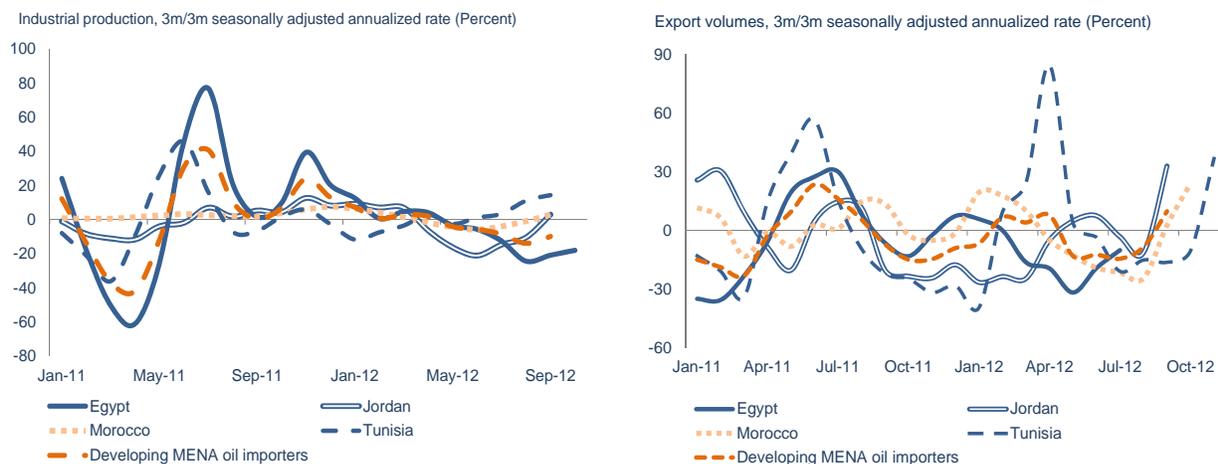
The extended downturn in Europe adversely affected the export performance of the developing MENA region, but exports appear to be picking up in some countries (figure MNA.3, second panel). Merchandise export volumes of oil importing MENA countries fell at a 14 percent annualized pace in the three months to July 2012 during resurgence of Euro Area debt tensions, but rose 9.9 percent in the third quarter. Egypt experienced an export volume decline of 10 percent (annualized) in the three months to July; but in Jordan, Morocco, and Tunisia, export volume growth picked up strongly between September and November.

Inflation experiences in the developing MENA countries are diverse

Inflation experiences in developing MENA countries have been relatively diverse, reflecting several factors: supply disruptions from ongoing domestic unrest or conflict, a relatively high dependence on imports of food (and among oil importers, of crude oil), subsidy regimes for fuel and food, and weak purchasing power due to erosion of incomes in countries experiencing economic instability.

Iran and Syria experienced steep increases in annual inflation though the course of 2012 (figure MNA.4, first panel). In Iran, officially reported inflation rose to 37 percent in December

Figure MNA.3 In developing MENA oil importers, industrial production has remained sluggish, but exports are picking up



Source: World Bank.

2012 (27.4 percent for the 12-month period), as international sanctions exacerbated the effect of earlier subsidy reforms on domestic prices. Sanctions also caused the black market value of the Iranian rial to decline precipitously, from 12,500 per U.S. dollar at the beginning of 2012 to around 35,000 in October. Inflation rose sharply in conflict-affected Syria, from 15.4 percent in January to nearly 50 percent by September 2012. Syria’s conflict had spillover effects on inflation in Lebanon, in part from a increase in rental prices for residential properties from Syrians fleeing the conflict.

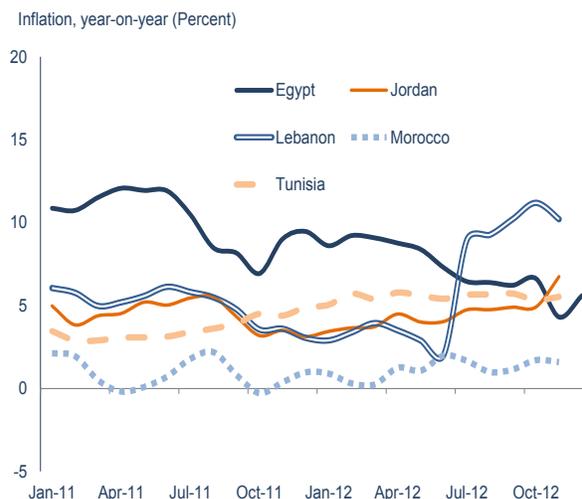
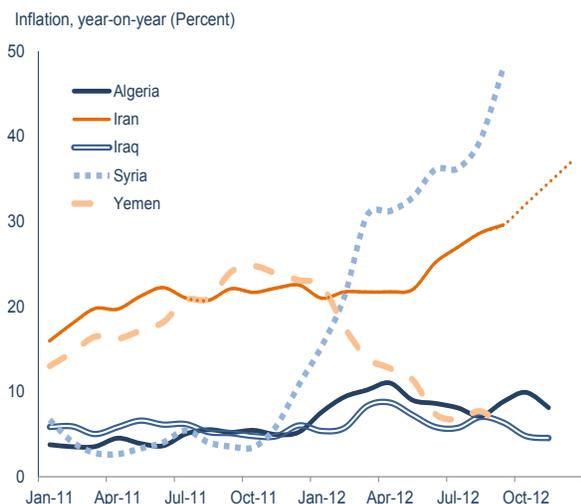
Notwithstanding an increase in international food prices during the summer of 2012 (caused by drought in the US and heat wave in Russia), and the MENA region’s relatively higher dependence on food imports (figure MNA.5), year-on-year inflation rates in other developing MENA countries did not rise in a significant manner, in part owing to subsidy regimes and administered prices. A forthcoming World Bank study estimates that even with the high import dependence in the developing MENA region, the pass through of international prices to domestic prices in MENA countries is, on average, similar to that in other regions. Inflation momentum and annual inflation have been relatively subdued in Iraq. In Algeria, inflation rose in the months to October mainly because of food price increases, but moderated in November. In Egypt, fuel and

food subsidies, together with weak growth and subdued domestic demand, caused inflation to fall to 4.3 percent in November, but inflation rose again to 5.6 percent in December (figure MNA.4, second panel). In Morocco, a poor agricultural harvest and a rise in food grain imports have added mostly to the subsidy burden, rather than being manifested in higher inflation, with annual inflation at only 1.6 percent in November. Similarly, a disruption to Jordan’s natural gas supplies from Egypt and a substitution to costlier imported fuels caused Jordan’s subsidy burden, rather than domestic prices, to rise—although inflation increased to 6.7 percent in November from under 5 percent in previous months, in part due to a rise in fuel price undertaken as part of fiscal reforms.

Governments in developing MENA countries are attempting to rein in fuel subsidies to improve fiscal sustainability

The high burden of fuel subsidies in the developing MENA countries (figure MNA.6) and their adverse implications for public finances have resulted in several governments in the region, particularly among crude oil importers, undertaking significant subsidy reforms to improve fiscal sustainability. Jordan and Tunisia raised fuel prices in the second half of 2012 in an effort to bring down their fuel subsidy burden and reduce fiscal deficits. Such

Figure MNA.4 Annual inflation has spiked in a few developing MENA countries



Source: World Bank.

reforms may cause a one-time increase in prices and possibly temporarily raise inflation, but their positive impact on fiscal positions would result in reduced crowding out of private investment, which in turn would ease supply constraints and weaken price pressures over time. Given the importance of fuel subsidies in the overall subsidy burden in developing MENA countries, reducing fiscal deficits will require a forceful attack on fuel subsidies and greater transparency in pricing. However, reducing fiscal pressures without causing social turmoil could prove challenging, and will require efforts to communicate the longer term benefits of subsidy reforms and better targeting of subsidies to reach the most vulnerable.

External balances in some developing MENA oil importers have deteriorated

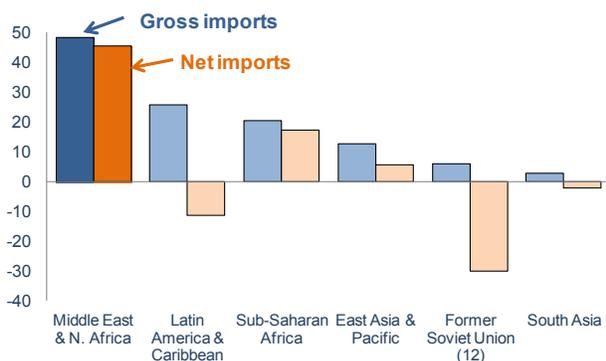
Several oil importing developing MENA countries experienced deteriorating current account positions due to elevated international prices of crude oil and food imports, together with weakening European demand for their exports. As a result of balance of payments pressures, Egypt drew down its international reserves substantially during the course of 2011 and 2012, such that by November of 2012,

reserves represented only three months of imports (figure MNA.7). Financial assistance from Gulf Cooperation Council (GCC) countries and other donors have allowed reserve levels to rise in more recent months, but reserves fell by about half a billion dollars in November. Moreover, the final approval of a \$4.8 billion IMF program has been delayed until January 2013 or later. If approved, IMF assistance would unlock substantial additional aid flows from other multilateral and bilateral donors and improve Egypt’s reserve position significantly in 2013, while reforms undertaken as part of the program would contribute towards enhancing fiscal and external sustainability. However, domestic tensions could pose implementation difficulties, deter private investment, and dampen growth in the near term. In Jordan, Morocco, and Tunisia, current account deficits have widened, mostly as a result of weak export performance together with a high burden of crude oil imports. In contrast, Libya’s current account position has improved, buoyed by recovery in crude oil production and continued elevated international prices, but current account positions have deteriorated in Syria and Iran.

Migrant remittances grew and tourism rose modestly in 2012

Figure MNA.5 Dependence on food imports is higher in MENA than in other developing regions

Foodgrain imports as share of domestic foodgrain consumption, (average of 2009/10, 2010/11 and 2011/12 crop years, Percent)

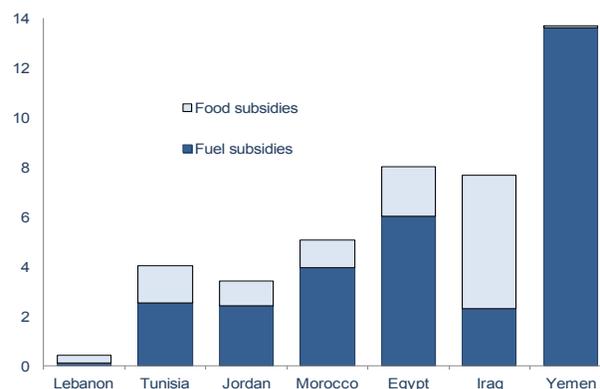


Source: World Bank based on US Department of Agriculture (accessed October 2012).

Note: US Department of Agriculture (USDA) sub-regions are aggregated into broader geographical categories but may not fully correspond with the World Bank’s regional classification. See www.usda.gov for details.

Figure MNA.6 Fuel subsidies comprise a large share of GDP in several MENA countries

Subsidies as percent of GDP



Source: “Inclusion, Dignity, and Resilience: The Way Forward for Social Safety Net Reform in the Middle East and North Africa Region”, J. Silva, V. Levin, and M. Morgandi, World Bank June 2012.

Note: Data are for different years: Lebanon (2008), Tunisia (2011), Jordan (2011), Morocco (2008/9), Egypt (2009), Iraq (2009), Yemen (2008).

Figure MNA.7 Egypt's international reserves have stabilized at a low level

Source: World Bank

Migrant remittances to the region rose as migrants sent money to help their families and friends in need during this period of domestic turbulence. Remittance flows to the developing MENA region rose 8.4 percent in 2012, accelerating from a 6.3 percent increase in 2011, according to World Bank estimates. This rise was led by strong increase in flows to Egypt, where inflows rose 26 percent in 2012, to \$18 billion. The experience for other countries was uneven, however. Remittance inflows to Jordan, for example, rose by 2.2 percent, while inflows to Tunisia rose 9.8 percent, and those to Morocco fell 3.3 percent.

The year 2012 also saw a return of tourists to the MENA region, although tourism has yet to recover to 2010's level. According World Tourism Organization statistics, tourism arrivals in the Middle East and North Africa region fell 7.5 percent in 2011. But arrivals in 2012 rose 3.5 percent in the first half of the year compared to the like period in the previous year.^{FN3} Tourist arrivals in the Middle East rose by less than 1 percent in the first half of 2012, as several countries continue to face domestic tensions. In North Africa, however, tourist arrivals rebounded at a faster 10.5 percent pace in the first half of 2012, led by strong gains in arrivals in Egypt, Tunisia and Jordan.

Financial flows to the developing MENA region slowed in 2012 and remain weak compared with 2010 levels

Private capital flows to developing MENA countries halved in 2011 due to domestic turmoil in several countries, with private debt and equity flows experiencing steep falls as portfolio investors retreated from the region. The decline continued into 2012, when private capital inflows are estimated to have fallen a further 16 percent, to \$12.5 billion, mainly due to continuing domestic uncertainties in several countries (table MNA.1). FDI flows to the region, however, fell a smaller 7 percent in 2012, as a decline in flows to Iran offset rising foreign investment in crude oil exploration and extraction in other oil exporters. In oil importing countries, in particular in Egypt and Lebanon, foreign investment inflows remained subdued. Some projects in the non-oil sector (for instance, the reopening of an Isuzu auto plant in Tunisia in 2012) suggest that foreign firms are anticipating expanded market opportunities, but many more investment projects remain on hold due to continuing political uncertainty and domestic unrest.

Outlook

GDP growth in the developing MENA region is forecast to slow from 3.8 percent in 2012 to 3.4 percent in 2013 (see table MNA.2 for regional forecasts and table MNA.3 for country-specific forecasts). Growth in oil producers is projected to return to a more sustainable pace in 2013 after a sharp recovery in 2012, in line with further increases in crude oil production in Iraq and in Libya, and to a smaller extent in Algeria, while output in Iran and Syria remains subdued. In oil importers, GDP growth is forecast to pick up modestly in 2013, as continuing domestic uncertainty in several countries, together with a projected near-stagnant output in the Euro Area in 2013 and weak demand for the MENA region's exports, hold back a more robust

Table MNA.1 Net capital flows to Middle East and North Africa (\$ billions)

	2008	2009	2010	2011	2012e	2013f	2014f	2015f
<u>Capital inflows</u>	23.7	30.9	31.4	15.8	13.1	19.0	24.4	32.4
Private inflows, net	25.4	28.4	30.2	14.8	12.5	17.3	22.0	29.5
<u>Equity Inflows, net</u>	30.0	27.5	24.2	15.2	13.3	16.0	19.2	24.9
Net FDI inflows	29.6	26.3	22.3	15.4	14.3	15.5	17.9	23.0
Net portfolio equity inflows	0.4	1.2	2.0	-0.2	-1.0	0.5	1.3	1.9
<u>Private creditors, net</u>	-4.6	0.9	5.9	-0.4	-0.8	1.3	2.8	4.6
Bonds	-0.8	0.1	3.2	-0.6	-1.1	-0.7	0.5	1.8
Banks	-0.6	-1.3	-0.9	-0.02	-2.0	-0.8	0.8	1.4
Short-term debt flows	-1.9	3.0	4.5	0.9	2.3	2.8	1.5	0.9
Other private	-1.3	-1.0	-0.8	-0.6	0.0	0.0	0.0	0.5
Official inflows, net	-1.7	2.4	1.3	0.9	0.6	1.7	2.4	2.9
World Bank	-0.3	0.9	0.8	0.9	-0.2			
IMF	-0.1	-0.1	0.0	-0.1	0.1			
Other official	-1.3	1.6	0.4	0.1	0.7			

Source: World Bank.

Note: e = estimate, f = forecast.

rebound in economic activity.

Regional GDP growth is forecast to rise gradually to about 4.3 percent by 2015 — assuming that the negative influences on growth of domestic uncertainty and unrest fade during the forecast period, and ongoing political transitions lead to more accountable and transparent institutions over time. As regional uncertainty ebbs and global growth accelerates in 2014 and 2015, rebuilding of infrastructure, private investment, industrial activity, and economic diversification can be expected to support growth in both developing oil exporters and oil importers in the MENA region. Forecasts for all MENA countries are subject to the baseline assumptions that the adverse effects of the Euro Area debt crisis on the MENA region's trade and investment flows start to wane over time, and that domestic tensions within the region do not flare up in a significant manner.

The outlook for developing oil importers is clouded by domestic uncertainty and weakness in Europe

GDP growth for the group of developing oil importers is forecast to pick up modestly to 3.5 percent in 2013. Economic conditions in this group are expected to improve marginally in 2013. But continuing uncertainty will hold back private investment and growth, while weak conditions in high-income Europe in 2013 imply subdued demand for the region's exports. In Egypt, GDP growth is projected to rise to a modest 2.6 percent pace in the 2012-13 fiscal year ending in June 2013, as policy uncertainties, a deteriorating reserve position, and domestic unrest negatively impact economic activity.

Jordan's GDP growth is forecast to rise modestly to 3.3 percent in 2013, as weak domestic and external demand acts as a drag on growth. Growth in Morocco is forecast to bounce back to 4.4 percent in 2013, buoyed by an expected return to normal agricultural harvests and strengthening domestic demand. Lebanon's GDP growth forecast for 2013, at 2.8 percent, is weaker than that of all other developing MENA oil importing countries, partly due to the negative

spillovers from unrest in neighboring Syria on tourism and other services exports. Nevertheless, Lebanon's growth is forecast to rise gradually over time, to around 4 percent by 2015. Even after a return to growth in 2012, Tunisia continues to face domestic tensions and structural challenges to generating sustained and inclusive growth over the medium term. Tunisia's GDP growth is forecast to rise modestly to 3.2 percent in 2013.

As domestic tensions are resolved over time, GDP growth among oil importers is forecast to rise to about 4.7 percent by 2015. In Egypt, the expected approval of a substantial IMF program in 2013, together with the

release of other multilateral and bilateral assistance contingent on the IMF program, would arrest the deterioration in external balances, while significant cuts to fuel subsidies and tax reforms, if implemented as planned, will bring the fiscal position to a sounder footing and free up resources for the private sector. Egypt's growth is expected to firm to 3.8 percent in the 2013-14 fiscal year, and rise to 4.7 percent by 2014-15. Steps towards sound macroeconomic policies in oil importers are also likely to result in a decline in investors' risk aversion and result in higher private investment inflows over the medium term (see below).

GDP in developing oil exporters is projected

Table MNA.2 Middle East and North Africa regional forecast summary

(annual percent change unless indicated otherwise)							
	00-09 ^a	2010	2011	Est. Forecast			
				2012	2013	2014	2015
GDP at market prices ^b	3.9	2.8	-2.4	3.8	3.4	3.9	4.3
	<i>(Sub-region totals-- countries with full NIA + BOP data) ^c</i>						
GDP at market prices ^c	4.3	2.8	1.5	0.2	2.4	3.3	4.0
GDP per capita (units in US\$)	2.8	1.2	0.0	-1.3	0.9	1.8	2.5
PPP GDP ^d	4.3	2.6	1.4	0.0	2.2	3.1	3.8
Private consumption	4.3	1.4	2.4	1.3	3.0	3.5	3.8
Public consumption	3.6	3.9	5.5	3.8	4.3	4.1	3.9
Fixed investment	6.4	0.6	3.4	1.1	3.8	4.8	5.6
Exports, GNFS ^e	4.2	2.2	0.0	-4.6	4.6	5.6	6.9
Imports, GNFS ^e	7.2	1.0	1.7	4.1	4.7	6.2	7.0
Net exports, contribution to growth	-0.6	0.4	-0.6	-3.0	-0.1	-0.3	-0.2
Current account bal/GDP (%)	5.3	1.3	3.7	1.0	0.6	0.4	0.3
GDP deflator (median, LCU)	5.9	8.4	10.5	7.5	6.2	5.4	5.1
Fiscal balance/GDP (%)	-1.0	-3.0	-0.8	-7.0	-4.9	-2.6	-1.7
Memo items: GDP							
MENA Geographic Region ^f	3.8	3.1	1.8	4.4	3.6	3.9	4.1
Selected GCC Countries ^g	3.6	3.5	6.3	5.1	3.8	3.9	3.8
Developing Oil Exporters	3.6	2.2	-5.2	4.6	3.3	3.7	4.1
Developing Oil Importers	4.5	3.7	2.4	2.5	3.5	4.4	4.7
Egypt	4.4	3.5	2.0	2.4	3.2	4.3	4.7
Fiscal Year Basis	4.3	5.1	1.8	2.2	2.6	3.8	4.7
Iran	4.6	1.0	1.7	-1.0	0.6	1.6	2.8
Algeria	3.4	3.3	2.5	3.0	3.4	3.8	4.3

a. Growth rates over intervals are compound weighted averages; average growth contributions, ratios and deflators are calculated as simple averages of the annual weighted averages for the region.

b. GDP at market prices and expenditure components are measured in constant 2005 U.S. dollars.

c. Sub-region aggregate excludes Iraq and Libya, for which data limitations prevent the forecasting of GDP components or Balance of Payments details.

d. GDP measured at PPP exchange rates.

e. Exports and imports of goods and non-factor services (GNFS).

f. Geographic region includes high-income countries: Bahrain, Kuwait, Oman, United Arab Emirates and Saudi Arabia.

g. Selected GCC Countries: Bahrain, Kuwait, United Arab Emirates, Oman and Saudi Arabia.

Source: World Bank

to rise at a slower but more sustainable pace in 2013-15

For the group of regional oil exporters, GDP growth is projected to slow to 3.3 percent in 2013, as the pace of increase in crude oil production in Libya slows and production in Iran and Syria remains subdued. After a dramatic expansion of Libya's GDP in 2012, supported by a recovery of crude oil production to close to the level of early 2011, economic output is expected to grow at a slower but still robust 7.6 percent pace in 2013. Continuing security uncertainties, however, pose risks to Libya's growth outlook. GDP growth in Iraq is forecast to accelerate to 13.5 percent in 2013, as further investments in developing additional capacity are made and crude oil production continues to rise. But infrastructure bottlenecks, disputes over revenue sharing arrangements with the Kurdish province and security concerns may pose obstacles to bringing new production capacity on stream. Over the medium term, Iraq's crude oil production is expected to rise from over 3 mb/d in late 2012 to more than 4 mb/d by 2015, and further to 6 mb/d by 2020, according to International Energy Agency (IEA) forecasts. Revenues are also likely to increase as oil prices are expected to continue to remain buoyant in US dollar terms over the forecast horizon in step with a gradual acceleration of global demand.

GDP in Iran, however, is projected to remain broadly flat in 2013, rising a modest 0.6 percent, as international sanctions dampen crude oil production and economic activity. Despite a slow pace of growth, space for policy stimulus is limited following a large currency depreciation in 2012 and high inflation. Iran's GDP growth is forecast to pick up to a modest 3 percent pace by 2015 as the impact of domestic and external factors that are acting as a drag on current

economic performance wane over time. After GDP declined in 2012, growth in Syria is also expected to remain subdued, as the civil conflict continues into 2013. In Yemen, crude oil and gas production has been constrained by an uncertain domestic security situation. Following a large GDP decline in 2011 and flat growth in 2012, Yemen's economy is projected to grow by about 4.0 percent in 2013—but GDP in 2013 would still be below its 2010 level. GDP growth in Algeria is projected to rise to 3.4 percent in 2013, and further strengthen to around 4.3 percent by 2015, as government plans to promote oil and gas extraction and non-oil economic activities bear fruit. As a result of the above country-specific factors, GDP growth among MENA oil producers is expected to rise gradually over the forecast horizon, reaching about 4.1 percent by 2015.

Private capital flows are expected to remain subdued in the near term as continuing uncertainty discourages foreign investors, but flows are projected to rise over time

Private capital flows to developing countries in the MENA region are projected to increase to about \$17 billion in 2013, from the low base of 2012 (table MNA.1). But flows would be significantly smaller than that received in 2009 and 2010, as continuing uncertainty and domestic tensions in several large oil importers and in some developing oil exporters discourages foreign investors. Over the medium term, private capital flows are forecast to rise to \$30 billion by 2015, close to their 2010 level, as international investors are attracted by opportunities in non-oil activities, especially in tourism and manufacturing, as well by continuing expansion of the oil and gas sectors. Private capital flows to Egypt are likely to remain weak in the near term given unresolved domestic tensions, although in the later years of the forecast

horizon, flows into non-oil economic activities should rebound as these tensions are gradually resolved. In other oil importers, including Jordan, Morocco and Tunisia, further improvement in the macroeconomic and policy environment over time will attract foreign investment. Spillovers effects from civil conflict in Syria could, however, result in temporarily weaker foreign investment inflows to Lebanon.

Foreign investment in developing MENA oil exporters is expected to rise over the forecast horizon, as producers continue to expand capacity, while foreign investment inflows into non-oil sectors of these countries will increase as they attempt to reduce dependence on oil revenues and diversify their industrial base. Iraq is expected to allow significant foreign investments to meet its ambitious crude oil production targets. Algeria, faced with a rising domestic

Table MNA.3 Middle East and North Africa country forecasts

	00-09 ^a	2010	2011	Est. Forecast			
				2012	2013	2014	2015
Algeria							
GDP at market prices (% annual growth) ^b	3.4	3.3	2.5	3.0	3.4	3.8	4.3
Current account bal/GDP (%)	22.3	7.3	10.3	7.0	4.7	4.1	3.8
Egypt, Arab Rep.							
GDP at market prices (% annual growth) ^b	4.4	3.5	2.0	2.4	3.2	4.3	4.7
Fiscal Year Basis	4.3	5.1	1.8	2.2	2.6	3.8	4.7
Current account bal/GDP (%)	1.1	-2.0	-2.3	-3.1	-3.6	-3.5	-3.2
Iran, Islamic Rep.							
GDP at market prices (% annual growth) ^b	4.6	1.0	1.7	-1.0	0.6	1.6	2.8
Current account bal/GDP (%)	6.6	6.7	12.0	8.3	7.6	6.3	5.4
Iraq							
GDP at market prices (% annual growth) ^b	-1.0	0.8	9.9	11.1	13.5	11.0	8.5
Current account bal/GDP (%)		-1.8	7.9	0.1	5.8	6.8	8.2
Jordan							
GDP at market prices (% annual growth) ^b	6.1	2.3	2.6	3.0	3.3	4.0	4.5
Current account bal/GDP (%)	-4.4	-7.1	-12.0	-14.7	-13.3	-12.7	-12.1
Lebanon							
GDP at market prices (% annual growth) ^b	4.4	7.0	3.0	1.7	2.8	3.8	4.0
Current account bal/GDP (%)	-16.8	-20.4	-21.4	-20.1	-19.4	-18.5	-17.9
Libya							
GDP at market prices (% annual growth) ^b	3.8	3.5	-61.1	108.0	7.6	5.8	5.1
Current account bal/GDP (%)		22.6	-11.8	16.9	8.5	7.8	7.3
Morocco							
GDP at market prices (% annual growth) ^b	4.6	3.7	5.0	3.0	4.4	4.8	5.1
Current account bal/GDP (%)	0.2	-4.6	-8.3	-9.0	-8.1	-7.4	-6.7
Syrian Arab Republic							
GDP at market prices (% annual growth) ^{b,c}	4.6	3.2	-3.0	-20.0	1.0	2.3	2.8
Current account bal/GDP (%)	2.7	-0.6	1.5	-7.1	-6.3	-5.4	-4.8
Tunisia							
GDP at market prices (% annual growth) ^b	4.1	3.0	-1.8	2.4	3.2	4.5	4.8
Current account bal/GDP (%)	-2.7	-4.8	-7.4	-9.0	-8.4	-8.1	-8.0
Yemen, Rep.							
GDP at market prices (% annual growth) ^b	3.5	7.7	-10.5	0.1	4.0	4.1	4.3
Current account bal/GDP (%)	1.2	-5.6	-5.0	-5.0	-6.3	-6.1	-5.6

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

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

a. GDP growth rates over intervals are compound average; current account balance shares are simple averages over the period.

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

c. The estimate for GDP decline in Syria in 2012 is subject to significant uncertainty.

Source: World Bank.

demand for energy, is expected to encourage greater foreign investment in exploration and refining in the oil and gas sectors, as well as continue efforts to attract investment in non-oil sectors as it attempts to further diversify its economy.

Risks and vulnerabilities

The growth outlook for the MENA region is vulnerable to a combination of domestic and global risks. A key domestic risk to the outlook is that of protracted political uncertainty and continuation of domestic tensions, which could have negative effects on economic performance. Other risks include the possibility of reforms aimed at improving fiscal sustainability, in particular those involving reduction of subsidies and fuel price increases, going off track or being reversed. In Egypt, a delay or halt in future aid disbursements could spiral into serious balance of payments difficulties given its already low level of reserves. In Iraq, a still-uncertain security situation poses downside risks. The ongoing conflict in Syria and the sanction-fueled downturn in Iran are notable sources of instability and weakness in the region.

As for external risks, a protracted fiscal impasse in the United States represents an immediate threat to global growth, and in turn, for the economic performance of developing MENA countries. The baseline assumes that a credible medium-term plan to restore fiscal sustainability in the US and authorize government borrowing is agreed to by the end of February 2013 (see the main text of the *Global Economic Prospects January 2013* report). An alternative scenario where only a short-term relief from the debt ceiling legislation is agreed upon and considerable uncertainty remains regarding future tax and fiscal policy, could shave off 2.3 percent from US GDP growth

relative to the baseline, and reduce global growth by 1.4 percent. The developing MENA region's growth would be 0.8 percent lower in 2013 compared with the baseline. A resumption of Euro Area debt tensions during the forecast horizon would also adversely affect MENA oil importers, since Europe is the largest trade partner and the most important source of investment and remittances for the developing MENA region.

Another external risk stems from the possibility of a sharp fall (or spike) in crude oil prices compared with that projected in the baseline. A sharp fall in international crude oil prices resulting from weaker than projected global economic growth, a protracted fiscal impasse in the US, or other unforeseen events, would benefit the fiscal and current account positions of oil importers, while hurting oil exporters, in particular those with relatively weak fiscal and reserve buffers. Conversely, a rise in crude oil prices, for instance resulting from intensification of geopolitical tensions along the Strait of Hormuz, would put pressure on the fiscal and external balances of MENA oil importers.

The risk of a further spike in international food prices in 2013, following sharp increases in 2012, also presents a significant source of external risk for this net food importing region (see figure MNA.5). The global stock-to-consumption ratio for maize, and to a lesser extent for wheat, are expected to remain very low for the 2012-13 crop year, according to the US Department of Agriculture forecasts. Such tight supplies suggest that international prices could rise sharply even in the event of a relatively small supply shock. The high import dependence of MENA countries and still-high subsidies—despite expectations that these will be gradually reduced as part of

ongoing economic reforms—imply that fiscal positions could deteriorate, and domestic prices surge (to the extent that these are market determined) in response to an upward shock to international food prices. Increasing domestic food supplies in the region and reducing dependence on imported food remains key to reducing the region's vulnerability over the longer term. In the short term, however, the fiscal impacts and the adverse implications for the poorest and most vulnerable could be mitigated through better targeting of subsidies.

Notes:

- 1 Crude oil exporting countries in the developing Middle East and North Africa (MENA) region for which GDP estimates and forecasts are available include Algeria, Iran, Iraq, Libya, Syria, and Yemen. Developing MENA oil importers include Egypt, Jordan, Lebanon, Morocco and Tunisia. The addition of Libya and Iraq to the MENA regional aggregate in this report has resulted in a significant adjustment in region's growth performance in recent, current and future years vis-à-vis the estimates published in the June 2012 Global Economic Prospects report.
- 2 As a result of falling Iranian oil production and rising Iraqi output, Iraq has become the second largest producer (behind Saudi Arabia) in the group of Organization of Petroleum Exporting Countries (OPEC).
- 3 The UN World Tourism Organization's country classification for the Middle East and North Africa sub-regions (see www.unwto.org) does not correspond with the World Bank's regional classification for developing countries (<http://data.worldbank.org/about/country-classifications/country-and-lending-groups>).

South Asia Region

Overview: Economic growth in **South Asia** weakened considerably in 2012 to an estimated 5.4 percent, from 7.4 percent the previous year. Delayed monsoon rains, electricity shortages, macroeconomic imbalances including large fiscal deficits and high inflation, and policy and security uncertainties contributed to subdued economic activity in the region, which also faced negative impacts from the Euro Area debt crisis and a weak global economy. In India, the region's largest economy, growth measured in factor cost terms is projected to decelerate to 5.4 percent in the 2012 fiscal year (ending in March 2013) from 6.5 percent in the 2011 fiscal year. Growth in Pakistan, the second largest economy in the region, remained broadly stable at a projected 3.8 percent in the 2012-13 fiscal year compared with 3.7 percent in 2011-12. Bangladesh's growth is projected to slow to 5.8 percent in 2012-13 (6.3 percent in 2011-12); and Nepal's growth to 3.8 percent in 2012-13 (4.6 percent in 2011-12). Sri Lanka's GDP growth slowed to an estimated 6.1 percent in 2012 (8.3 percent in 2011). In contrast, Afghanistan's economy grew robustly by about 11 percent mostly due to a good harvest.

Industrial production in South Asia was sluggish until the third quarter of 2012, due to domestic difficulties as well as weak external demand, but picked up in the fourth quarter. The debt crisis in the Euro Area, South Asia's largest export market, had severe knock on effects on the export performance of South Asian countries, but exports in some countries appear to be turning a corner. Agriculture, which accounts for half of South Asia's employment and just under a fifth of its GDP, was hit by weak monsoon rains. Remittances rose 12.5 percent to \$109 billion, buoyed by flows from Arabian Gulf countries that benefited from elevated oil prices. Net private capital flows to the region remained stable at \$72.6 billion in 2012 (\$72.5 billion in 2011), as an increase in portfolio equity inflows offset declines in bank lending and foreign direct investment (FDI). Portfolio equity inflows to India surged after a number of reforms were

announced in September-October 2012.

Outlook: Regional GDP growth is projected to rise to 5.7 percent in 2013, firming to 6.7 percent in 2015, supported by a gradual improvement in global demand for South Asia's exports, policy reforms in India, stronger investment activity, and a return to normal agricultural production. India's GDP growth is forecast to strengthen modestly to 6.4 percent in the 2013 fiscal year, rising to 7.3 percent in 2015. Pakistan's GDP growth is projected to strengthen to 4.0 and 4.2 percent in 2013-14 and 2014-15, respectively. Bangladesh's GDP growth is projected to pick up to 6.2 and 6.5 percent in 2013-14 and 2014-15, while Sri Lanka's growth is forecast to rise in 2013 to 6.8 percent, strengthening to 7.2 percent in 2015. Net private capital flows to the region are expected to rise by 20 percent to \$87 billion in 2013 and to \$117 billion by 2015.

Risks and vulnerabilities: Growth in the region remains vulnerable to an uncertain external environment and country-specific factors.

Euro Area or US debt turmoil. A resumption of financial market tensions in the Euro Area or protracted debt uncertainty in the United States would affect the South Asia region through both trade and financial channels. Moreover, greater volatility in international financial markets could make it difficult for India to finance its widening current account deficit.

Fiscal challenges. Although governments across the region have committed to tackling their large subsidy burdens and fiscal deficits, such efforts could get side-tracked by spending pressures, especially with elections scheduled in several countries in the next two years. In particular, if coupled with weak growth, continuing high budget deficits may have potentially adverse implications for sovereign creditworthiness.

Agriculture. Another poor harvest could have adverse implications for rural incomes and employment, food prices, inflation, the fiscal burden of subsidies, and overall growth.

Recent economic developments

South Asia's economic performance weakened in 2012 in the face of external and domestic headwinds. Regional gross domestic product (GDP) growth slowed to an estimated 5.4 percent in 2012 from 7.4 percent in 2011, as headwinds from the Euro Area debt crisis and weakening global growth exacerbated the impact of adverse domestic factors in South Asia.^{FN1} Delayed monsoon rains resulted in a subpar agricultural outcome, while electricity shortages, macroeconomic imbalances including large fiscal deficits and high inflation, and policy and security uncertainties contributed to weaker investment and subdued economic activity. A decline in regional export revenues during the second and third quarters of 2012 and elevated international prices of crude oil imports maintained pressures on current account positions of South Asian countries, partially alleviated by a steady increase in migrant remittances. And although inflation momentum eased across South Asia in the second half of 2012, headline annual inflation remains significantly higher than the average for other developing regions, reflecting structural capacity constraints and, to some extent, expansionary fiscal policies in recent years.

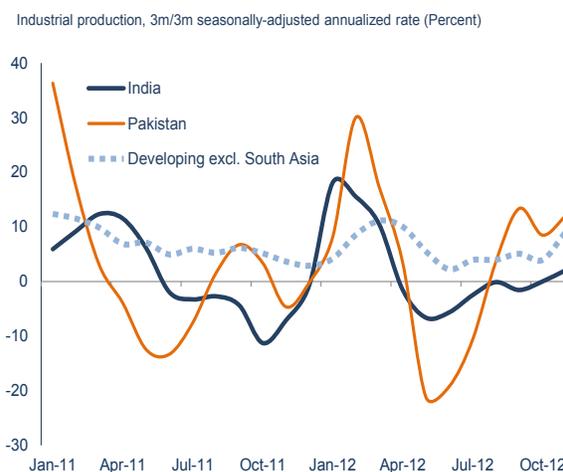
The already large fiscal deficits and persistently high inflation in South Asian countries have limited the scope for policy easing or demand stimulus measures to support growth. Given a projected weak global economy in 2013 and downside risks to the outlook, including the possibility of a protracted fiscal impasse in the United States or a resumption of Euro Area debt turmoil (see the main text of the *Global Economic Prospects January 2013* report), South Asian countries urgently need to strengthen their macroeconomic fundamentals and rebuild their policy buffers to withstand external shocks, as well as enhance their longer-term domestic growth drivers. These can be achieved, in particular, through sustained efforts at fiscal consolidation over the medium term, maintaining prudent macroeconomic policies, deepening structural reforms to ease capacity constraints, and improving the business

environment for the private sector.

Industrial production and exports have stabilized and are turning a corner towards growth

After a strong decline during the second quarter of 2012, industrial production in South Asia has stabilized and is picking up, with output rising at a 2.4 percent annualized pace in the three months to October. In India, industrial production surged 8.3 percent in October 2012 from a year earlier and then fell 0.1 percent in November, partly due to a difference in timing of the Diwali festival across the years. On a seasonally adjusted annualized basis, India's industrial output grew 2.1 percent in the three months to November compared with the previous quarter (figure SAR.1). Industrial activity has picked more decidedly in Pakistan, rising at a 12 percent annualized pace in the three months to November from the previous quarter, and was 6.5 percent higher in November than a year earlier. However, inadequate supply of electricity, and of gas for firms with captive power plants, continues to hobble Pakistan's industrial sector. In Sri Lanka, weak external demand and slowing economic growth weighed negatively on industrial production. But the pace of deterioration eased slightly in October, with production volume 7.1 percent lower than a year earlier compared with -8.0 percent in September.

Figure SAR.1 Industrial production is picking up in South Asia



Sources: Haver Analytics and World Bank.

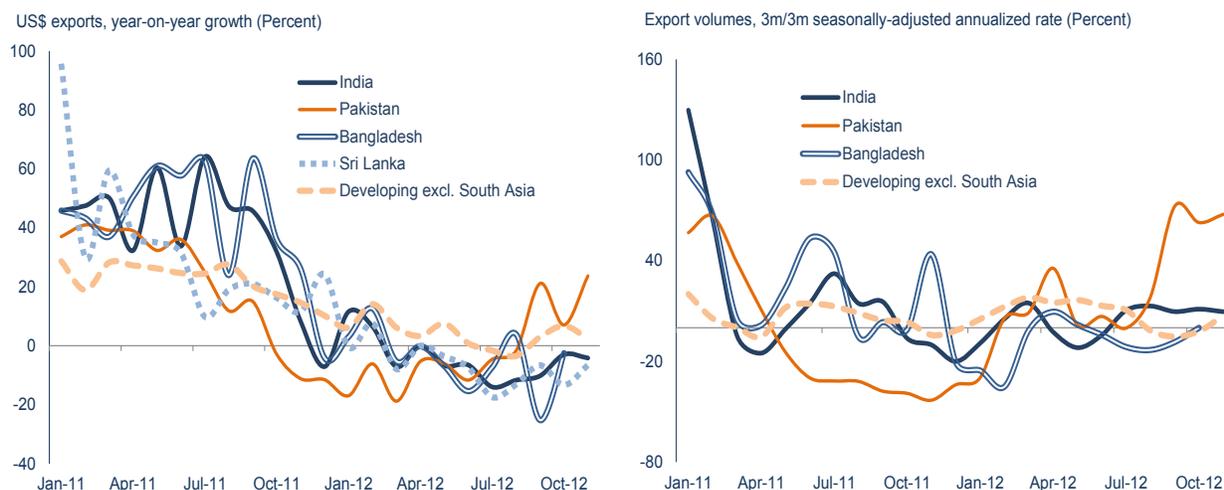
The debt crisis in the Euro Area, South Asia’s largest export market, had significant knock on effects on the export performance of South Asian countries. The slowing of South Asia’s exports during the summer of 2012 was particularly severe in US dollar terms, especially when contrasted with the double-digit rates of expansion in 2010 and in the first half of 2011 (figure SAR.2 first panel). But with an improvement in the pace of demand growth in the United States and China in the third quarter of 2012, and a slowing pace of deterioration in Euro Area output, South Asia’s export volumes appear to have turned a corner towards growth in the final months of 2012 (figure SAR.2 second panel). In India, the pace of decline in monthly export revenues slowed in October and November compared with the steep year-on-year declines experienced during the second and third quarters of 2012 after the Euro Area debt turmoil intensified in early May, and export volume growth has stabilized. Pakistan’s export growth picked up in the months leading to November, mostly reflecting an increase in exports of garments and processed cotton products. However, electricity shortages during the second half of December adversely affected textile production and may dampen export growth in subsequent months. After experiencing declines during the June-September period, Bangladesh’s export volume growth was flat in the three months to October compared with the previous

quarter, as a pick-up in US garment demand (fueled in part by an acceleration of US economic growth in the third quarter of 2012) offset to some extent weak European demand. Similarly in Sri Lanka, with a pick up in garment exports, the pace of year-on-year declines in overall exports slowed in recent months, but export revenues in US dollar terms were still 6.6 percent lower in November than a year earlier.

Inflation momentum has slowed across the region, but headline inflation remains persistently high

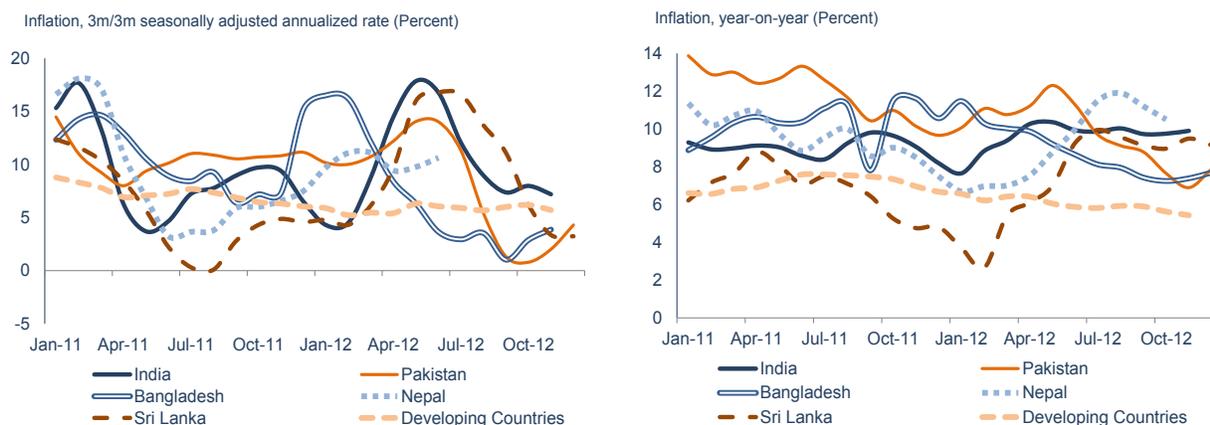
Reflecting the weakening of activity since the second quarter of 2012 and the opening up of output gaps, and a moderation in food inflation, inflation momentum slowed sharply in the South Asia countries in the second half of 2012. Regional inflation moderated to a 6.2 percent annualized pace in the three months to October (3m/3m saar), from 8.4 percent in August (figure SAR.3 first panel). An easing of food inflation as agricultural harvests came to the market helped to moderate overall consumer price inflation across the region, except in the case of India where food inflation remained sticky at a high level (figure SAR.4). However, annual (year-on-year) inflation picked up again in December in Pakistan, caused partly by an acceleration in the pace of food price increases. Inflation also picked in Bangladesh, but to a smaller extent,

Figure SAR.2 South Asia’s export revenue and volume growth slowed sharply in 2012, but are turning a corner



Sources: Haver Analytics and World Bank.

Figure SAR.3 Inflation momentum fell sharply but annual inflation remains high compared with the average for developing countries



Source: Haver Analytics and World Bank.

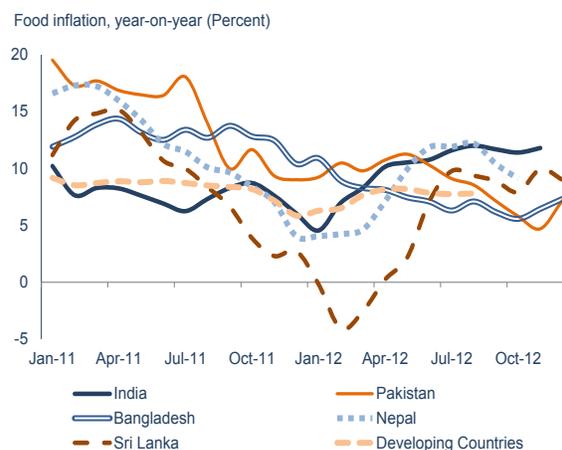
Note: Inflation for India based on the consumer price index for industrial workers (CPI-IW). For annual inflation in the second chart, the new All-India CPI inflation series is used from December 2011 onwards.

reflecting recent fuel price increases as well as higher food price inflation. Despite the moderation in regional inflation since the second quarter of 2012, annual consumer price inflation exceeds 7.5 percent in Pakistan and Bangladesh, and remains at around 9-10 percent in India, Nepal, and Sri Lanka—significantly higher than the average for developing countries (figure SAR.3 second panel).

The persistence of inflation in South Asia reflects structural capacity constraints in production (partly the result of a weak business environment – see Box 1), as well as entrenched inflationary expectations. Despite a deceleration in headline inflation in Pakistan since May, core inflation (i.e. excluding food and energy items) has continued to remain close to 10 percent. One-year ahead inflation expectations in India rose from 5.6 percent in the third quarter of 2006 to 9.2 percent in the last quarter of 2009, and reached 12.7 percent by the third quarter of 2012 (figure SAR.5). Moreover, food inflation in India has remained high on a year-on-year basis, as rising urban and rural incomes in recent years have resulted in increased demand for proteins, fruits and vegetables, while supply has not kept pace, in part due to structural bottlenecks in food production, storage, and logistics (figure SAR.4). In Nepal, the continuing political crisis and infrastructure constraints have resulted in

domestic supplies not keeping pace with robust demand that is partly fueled by remittances, resulting in persistent inflationary pressures; the currency peg of the Nepali rupee to the Indian rupee has further raised inflationary pressures during periods of depreciation of the Indian rupee. In Sri Lanka, a depreciation of the currency, drought, and earlier increases in administered fuel prices caused inflation to surge to 10 percent by July; inflation remained close to that level moderating slightly to 9.1 percent in December.

Figure SAR.4 Food inflation moderated in countries other than India, but has started to pick up in Bangladesh and Pakistan



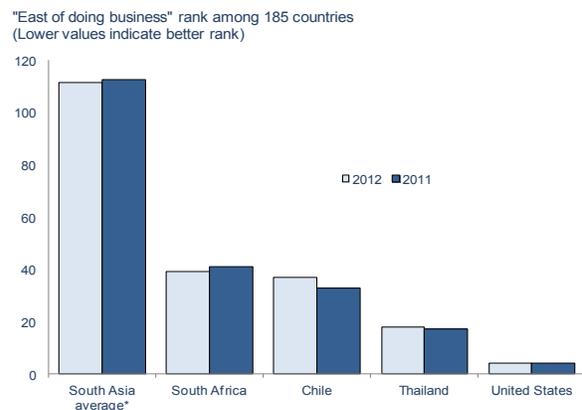
Source: Haver Analytics and World Bank

Box SAR.1 Doing Business in South Asia

South Asian countries score relatively low in terms of their position in the World Bank’s *Doing Business* index with an average rank of 111 among 185 countries in the latest round, which suggests that firms in the region face a difficult business environment. The sub-indices suggest that South Asian firms encounter serious obstacles in getting reliable access to electricity, in paying taxes, and in enforcing contracts. The finding on difficult access to electricity is consistent with the shortages and demand-supply gaps that have characterized this sector. The obstacles in paying taxes are also reflected in the relatively narrower tax bases and lower tax revenue-to-GDP ratios in South Asian countries compared with the average for other developing countries (see South Asia Annex of the *Global Economic Prospects* June 2012 report). South Asian countries, however, score better in terms of access to credit and protecting investors than their overall rank suggests, reflecting strength of domestic financial markets.

In terms of changes in ranks between the 2011 and 2012 rounds, Nepal, Pakistan, and Bangladesh fell by one, three and five notches, respectively, while India’s rank held steady. Sri Lanka’s rank improved from 96 to 81—making it one of the top ten countries in the world that have improved the most, in part due to improvements in the process of starting a business and getting access to credit.

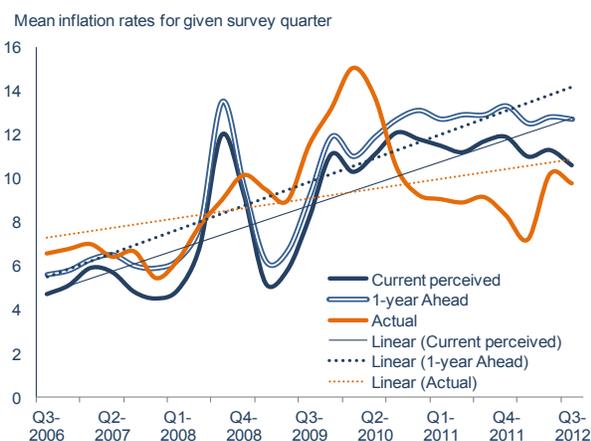
Box figure SAR.1 South Asia is a difficult place for doing business



Source: *Doing Business 2013* report, World Bank
 Note: South Asia average includes Bangladesh, India, Nepal, Pakistan and Sri Lanka. See www.doingbusiness.org for more details.

Persistent inflation and large fiscal deficits in South Asia (see below) have, in general, limited available space for monetary easing to support growth or to respond to external and domestic shocks. In India despite a deceleration in GDP growth to 5.3 percent in the third calendar quarter of 2012 from more than 8 percent in the

Figure SAR.5 Inflationary expectations in India have risen since 2006



Source: Reserve Bank of India and World Bank
 Note: Consumer price index inflation for industrial workers (CPI-IW)

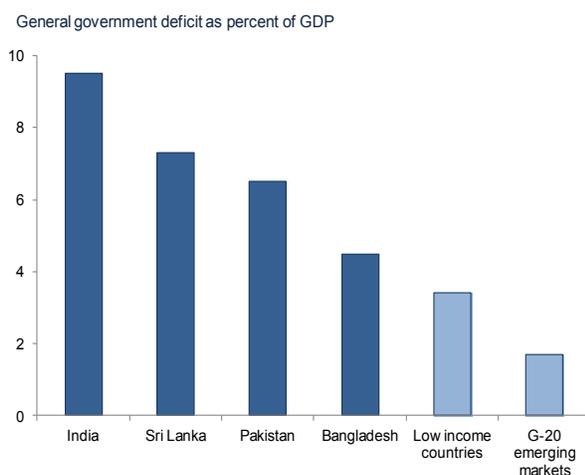
2009 and 2010 fiscal years, persistently high inflation has limited the scope for interest rate cuts, with the benchmark policy rate kept stable at 8 percent for most of 2012. India’s central bank, however, has used other instruments, including cuts to commercial banks’ cash reserve requirements to inject liquidity into the system. Similarly, despite a sharp slowdown in GDP growth in the second quarter of 2012, Sri Lanka’s central bank kept its benchmark policy rate at 7.75 percent for most of the year. But the bank cut its policy rate by 25 basis points in mid-December after growth slowed even further in the third quarter of 2012, expecting inflation to moderate in the first half of 2013 as a result of previously introduced policies to curb domestic demand. In contrast, a moderation in inflation allowed Pakistan’s central bank to reduce its key policy rate by a cumulative 250 basis points between August and December of 2012.

Fiscal deficits remain high indicating need for continued efforts at consolidation

Large fiscal deficits in South Asia compared

with other developing regions remain a source of concern, as government borrowing requirements may be crowding out private investment, while associated spending may be contributing to inflationary pressures. India's general government deficit is estimated at over 9 percent of GDP, significantly higher than the 1.7 percent average deficit for the emerging market economies belonging to the Group of 20, according to the IMF's *Fiscal Monitor* (figure SAR.6).^{FN2} A target of 5.3 percent of GDP has been set for the central government budget deficit for the 2012 fiscal year ending in March 2013, with plans to gradually reduce the deficit to 3 percent by the 2016 fiscal year. But the deficit could overshoot the target if growth remains weak, tax and non-tax revenues do not materialize to the extent expected, or if spending pressures remain strong. Despite efforts at consolidation, fiscal deficits are 6 percent or higher in Pakistan and Sri Lanka, and above 4 percent in Bangladesh. Subsidies, mainly for fuel and to a lesser extent for food, contribute to the overall deficits—subsidies account for over 2 percent of GDP in India and Pakistan, and over 3.5 percent of GDP in Bangladesh, according to recent World Bank and IMF estimates. Moreover, losses of public sector firms in the petroleum and electricity sectors have been substantial in South Asian countries, implying a

Figure SAR.6 Fiscal deficits are significantly higher in several South Asian country compared with the average for the G-20 emerging market countries



Source: IMF Fiscal Monitor October 2012, IMF Article IV consultations; and World Bank

“quasi-fiscal” burden for governments.

Governments across South Asia have taken steps to redress these subsidies, in particular by raising administered prices for fuel, and in some cases, of electricity. For instance, Sri Lanka raised administered fuel prices in early 2012 as a part of fiscal reforms, and again later in the year. Bangladesh has recently raised fuel prices to reduce the burden of subsidies. The Indian government raised regulated diesel prices by 14 percent in September 2012, but local prices are still well below international prices. Plans in India to move towards direct cash transfers in 2013 (based on the “Aadhar” national identity card) would eventually replace existing fuel subsidies and welfare payments, and is expected to result in lower leakages and improved targeting to the neediest. Reducing deficits in South Asian countries will require a more forceful attack on fuel subsidies, which even after successive measures to bring them under control still account for the bulk of the overall subsidy burden. Moving towards pricing mechanisms that better reflect the level and variability of input costs will help to improve the financial sustainability of public and private firms in this sector. Efforts to bring deficits under control will also need to involve efforts to broaden the tax base, which is extremely narrow in some countries, and to improve compliance—in particular, in Pakistan where a very small percentage of citizens pay income tax—as well as to simplify the tax code (see also South Asia Annex of the *Global Economic Prospects* June 2012 report). Bangladesh has undertaken significant tax policy and public financial management reforms in 2012 towards similar objectives.

Agriculture in South Asian countries was affected to varying extents by delayed monsoon rains

Agriculture, which accounts for half of South Asia's employment and just under a fifth of its GDP, was affected to varying extents by a delayed monsoon season (late arrival and late departure) in 2012, following good harvests in previous years. Although the share of agriculture

in South Asia's GDP has been declining steadily in recent decades, the weak monsoon rains in 2012 slowed regional agricultural activity and exacerbated the economic downturn. As a result, food grain production for the region is expected to decline modestly by about 1 percent in the 2012/13 crop year after two consecutive years of more than 5 percent increases, according to US Department of Agriculture (USDA) estimates (table SAR.1).^{FN3} In India, the delayed monsoon season resulted in "below normal" rather than "deficient" rains, according to India's Meteorological Department, thereby avoiding a serious adverse impact on food grain production. Accumulated food grain stocks from good harvests in previous years have helped to avert a threat to food security in India and enabled it to continue to export rice. In Pakistan, the late monsoon arrival during the secondary Kharif crop only marginally affected rice and cotton production. Despite limited water availability earlier in the year and floods later, rice output is expected to rise modestly, according to UN Food and Agriculture Organization (FAO) estimates.

In Bangladesh, the delayed monsoon rains affected the Aman rice crop in a few areas (the Aman crop accounts for more than a third of the country's rice production), but it does not appear to have had a major effect on the aggregate Aman harvest. Sri Lanka, however, experienced a drought in 2012 due to the delayed monsoons, which is estimated to have resulted in a more than 30 percent decline in the secondary Yala rice harvest in 2012 (following a good main Maha rice harvest earlier in the year) according to the FAO. In Nepal, the delayed monsoon rains and fertilizer shortages reduced rice production in parts of the country in 2012, following a good

harvest the previous crop year.

Stabilization of international crude oil prices in 2012 resulted in easing of terms of trade shocks

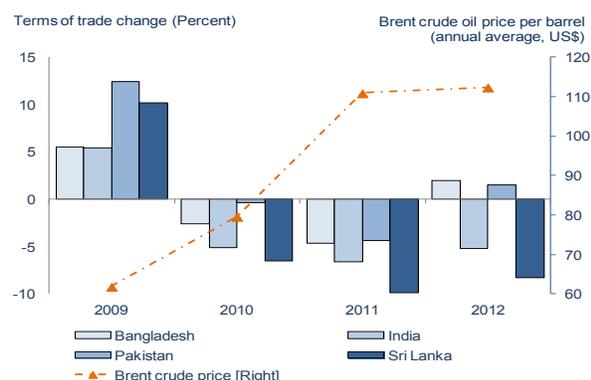
Rapid increases in international crude oil prices in 2010 and 2011 had contributed to deteriorating terms of trade for South Asian countries. Brent crude oil prices rose 29 percent in 2010, and by 39 percent in 2011, but prices stabilized in 2012 (figure SAR.7), resulting in an easing of the earlier terms of trade shocks. Current account positions in South Asia, however, continued to deteriorate as export revenue growth slowed rapidly, or even declined, due to the Euro Area debt crisis and a slowing global economy, but import growth slowed to a smaller extent. India's current account deficit rose sharply to 5.4 percent of GDP in the third calendar quarter of 2012 from 3.9 percent in the second quarter, as export earnings continued their decline while import costs remained relatively strong, in part reflecting robust domestic demand for gold and still elevated crude oil prices. Partly as a result of earlier crude oil price increases, Pakistan's current account deficit had widened to 2 percent of GDP in the 2011-12 fiscal year, but the release of coalition support funds and continued robust pace of increase in migrant remittances helped to reduce Pakistan's current account deficit to 0.4 percent of GDP in the first five months of the 2012-13 fiscal year (July-November period).

Migrant remittances have remained a stable resource flow for the South Asia region, but tourism to Sri Lanka slowed

Table SAR.1 South Asia's food grain balances (millions metric tons)

	2008/2009	2009/2010	2010/2011	2011/2012	2012/2013 (f)
Production	292.1	284.2	298.8	315.8	313.7
% change	1.2	-2.7	5.1	5.7	-0.7
Consumption	279.4	278.4	292.9	296.2	303.1
% change	-0.8	-0.3	5.2	1.1	2.3
Net exports	-2.1	1.0	2.3	13.7	13.7
Ending stock	41.0	45.8	49.4	55.2	52.1

Source: US Department of Agriculture (USDA) and World Bank.
Note: Crop marketing years vary across countries.

Figure SAR.7 Deterioration in South Asia's terms of trade eased in 2012 with stabilization of crude oil prices

Source: World Bank

Notes: Terms of trade based on changes in country-specific commodity-weighted export and import price indices.

Migrant remittance inflows to South Asia were buoyed by flows from the oil-rich Gulf Cooperation Council (GCC) countries that benefited from elevated crude oil prices in 2011 and 2012, compared with the levels in previous years. Remittances to South Asia are estimated to have totaled \$109 billion in 2012, an increase of 12.5 percent over 2011—the largest percentage increase among all developing regions (table SAR.2). South Asia's share in overall remittances received by developing countries rose from 17 percent in 2005 to 27 percent in 2012. In addition to the continued demand for migrant labor from the GCC countries, the increase in remittances to India was also partly a result of incentives created by the more than 12 percent depreciation of the Indian rupee against the US dollar in 2012, compared with the average rupee-dollar rate in 2011. Nepal likely experienced a similar effect

given the Nepali rupee's peg to the Indian rupee. The more-or-less steady increase in remittances to South Asian countries has supported current account positions, particularly when demand for exports weakened. And, migrant remittances represent an important source of incomes and domestic demand in Nepal (22% of GDP), Bangladesh (11%), Sri Lanka (7.9%), and Pakistan (5.7%).

Tourism, a significant source of revenue for Sri Lanka, boomed in the aftermath of the civil conflict, with tourist arrivals growing by 46 percent in 2010 and 31 percent in 2011. However, the pace of increase in tourism arrivals slowed to 11 percent by September 2012 (figure SAR.8), as arrivals from Western Europe (37 percent of the total) slowed and tourism from other South Asian countries (26 percent of the total) virtually stalled, mainly due to slowing economic growth in India. However, tourist arrivals from the United States and East Asian countries have picked up strongly in recent months, reflecting rising disposable incomes in the countries of origin. As a result, the year-on-year growth of tourist arrivals to Sri Lanka picked up again to 18 percent in November.

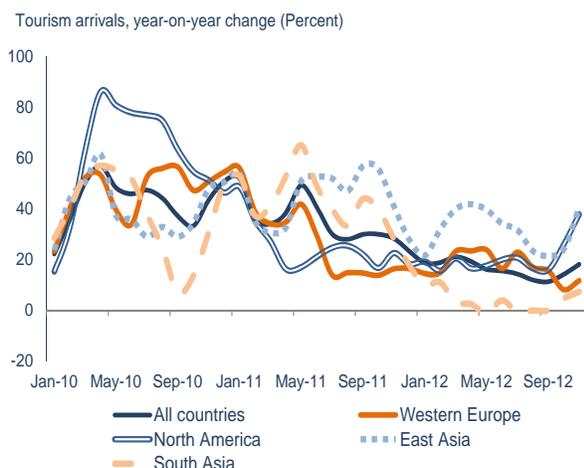
Capital flows to South Asia remained stable in 2012, due to strong equity flows to India

Private capital flows play a critical role for stability of the region's balance of payments position given the size of South Asia's (in particular India's) current account deficit. Net private capital flows to the region remained stable at \$72.6 billion in 2012 (\$72.5 billion in 2011), as an increase in portfolio equity inflows offset declines in bank lending and foreign direct

Table SAR.2 Migrant remittances inflows to South Asia grew robustly in 2012 (US\$ billions)

	2005	2006	2007	2008	2009	2010	2011	2012e
Bangladesh	4.3	5.4	6.6	8.9	10.5	10.9	12.1	13.7
India	22.1	28.3	37.2	50.0	49.5	54.0	63.0	69.8
Nepal	1.2	1.5	1.7	2.7	3.0	3.5	4.2	5.1
Pakistan	4.3	5.1	6.0	7.0	8.7	9.7	12.3	13.9
Sri Lanka	2.0	2.2	2.5	2.9	3.4	4.2	5.2	6.3
South Asia	34	43	54	72	75	82	97	109
<i>Share of South Asia in developing countries (%)</i>	<i>17.1</i>	<i>18.3</i>	<i>18.9</i>	<i>21.6</i>	<i>23.8</i>	<i>24.1</i>	<i>25.4</i>	<i>26.8</i>

Source: Migration and Development Brief 19, World Bank

Figure SAR.8 Tourism arrivals to Sri Lanka (especially from India) slowed in 2012

Sources: Haver Analytics and World Bank

investment (table SAR.3). FDI inflows to South Asia fell 17 percent in 2012, while international bank lending slumped a larger 34 percent amid European banking sector deleveraging. In contrast, net equity flows to South Asia rose to an estimated \$11.5 billion in 2012, reversing a net \$4.8 billion outflow in 2011. Despite weakening growth and a deteriorating current account position, equity inflows to India surged and the domestic equity market rebounded after a number of reforms were announced in September-October 2012 (figure SAR.9). FDI inflows to India also picked up strongly in the

third quarter, according to Reserve Bank of India data. FDI to Pakistan, however, has continued to decline over a longer period (since 2008) reflecting the uncertain security situation, weak growth prospects, and widespread electricity shortages, while portfolio equity flows remain subdued (figure SAR.10).

Outlook

South Asia's growth is projected to strengthen over the forecast horizon

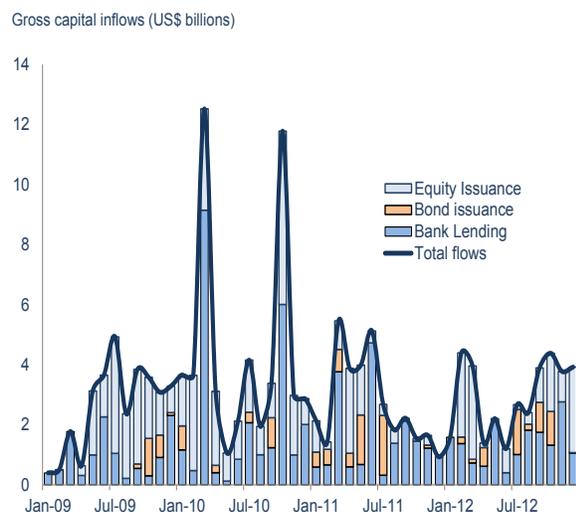
South Asia's GDP growth is projected to rise to 5.7 percent in the 2013 calendar year from 5.4 percent in 2012 (tables SAR.4 and SAR.5). The modest recovery in growth is in line with projections of a weak global economy and near-stagnant output in the Euro Area, South Asia's largest trade partner. Regional growth will be constrained by an uncertain external environment, amid risks of a protracted fiscal impasse in the United States and possible resurgence of Euro Area turmoil. Electricity shortages are expected to ease gradually over time as South Asian countries continue structural reforms to expand capacity and improve financial sustainability of this sector, but this constraint is likely to remain binding in the near term. Together with a gradual pick up in the global economy, South Asia's regional GDP growth is projected to accelerate to 6.4 percent

Table SAR.3 Net capital flows to South Asia (\$ billions)

	2008	2009	2010	2011	2012e	2013f	2014f	2015f
<u>Capital inflows</u>	64.7	89.8	100.4	78.3	75.2	89.1	105.9	117.9
Private inflows, net	55.9	78.9	90.7	72.5	72.6	87.3	104.7	117.3
<u>Equity Inflows, net</u>	35.0	63.4	60.3	30.9	41.1	53.3	63.5	76.4
Net FDI inflows	50.8	39.3	30.4	35.7	29.7	36.9	42.9	51.8
Net portfolio equity inflows	-15.8	24.1	29.9	-4.8	11.5	16.4	20.6	24.6
<u>Private creditors, net</u>	20.8	15.5	30.4	41.6	31.5	34.0	41.2	40.9
Bonds	1.7	1.9	10.1	0.7	0.2	0.9	1.5	2.9
Banks	11.2	10.9	8.6	18.4	12.1	15.4	16.5	19.6
Short-term debt flows	8.0	2.7	11.8	22.5	19.4	17.8	23.1	18.3
Other private	-0.05	-0.1	-0.05	-0.03	-0.2	-0.1	0.1	0.1
Official inflows, net	8.8	11.0	9.6	5.8	2.6	1.8	1.2	0.6
World Bank	1.4	2.4	3.3	2.0	0.9			
IMF	3.2	3.6	2.0	0.0	-0.2			
Other official	4.2	4.9	4.4	3.7	1.9			

Source: World Bank.

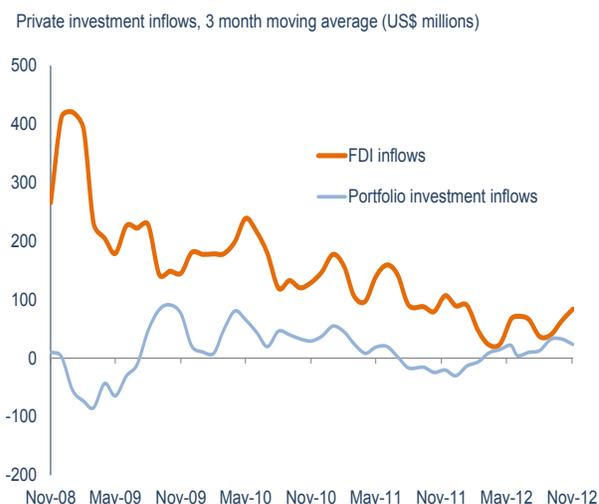
Note: e = estimate, f = forecast.

Figure SAR.9 Gross capital flows to South Asia

Source: Dealogic and World Bank

and 6.7 percent in 2014 and 2015, respectively, supported by a gradual improvement in global demand for South Asia's exports, continued policy reforms, stronger investment activity, and a return to normal agricultural production.

India's GDP growth measured in factor cost terms slipped to 5.3 percent in the third quarter of 2012, as a subpar agricultural outcome exacerbated relatively weak performance in manufacturing, mining and services. Growth in the 2012 fiscal year ending in March 2013 is forecast at 5.4 percent, the weakest in nearly a decade.^{FN4} India's GDP growth is projected to strengthen to 6.4 percent in the 2013 fiscal year, with a stronger rebound held back in part by difficult global economic conditions. A range of policy reforms were initiated in the second half of 2012, including liberalization of regulations for foreign direct investment in the retail, aviation and broadcasting sectors; an increase in administered diesel prices and rationing of subsidized liquefied petroleum gas (LPG) cylinders in an effort to curb fuel subsidies; passage of banking sector reforms in Parliament; the creation of a high-level cabinet committee to fast-track clearances for infrastructure projects; and a move towards direct cash transfers to reduce leakages and improve targeting of subsidies and welfare payments. As discussed, the spurt of reforms temporarily restored

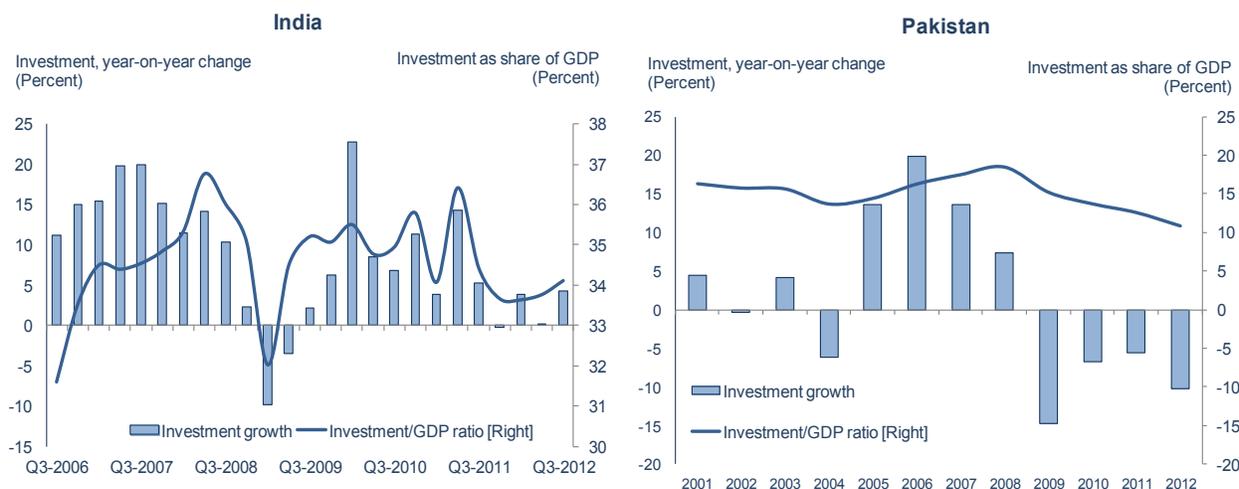
Figure SAR.10 Foreign investment in Pakistan

Source: Haver Analytics and World Bank

investor confidence and led to an increase in equity inflows. Several reforms still remain pending, however, including (among others) on land acquisition, insurance, pensions, mining, and direct taxes, that require parliamentary approval. Moreover, investment growth has been relatively weak in recent quarters (figure SAR.11 first panel), the fuel subsidy burden and fiscal deficit remain high, and the country needs to attract substantial foreign investment inflows to finance a larger current account deficit. Given a projected weak, albeit gradually strengthening, global economy and a potentially volatile external environment, it will be essential to maintain sound macroeconomic policies, sustain efforts at fiscal consolidation over the medium term, deepen structural reforms, and improve the investment climate for the private sector. Reflecting a projected gradual improvement in global demand and expectations of continued policy reforms, India's GDP growth in factor cost terms is forecast to rise to 7.1 percent in the 2014 fiscal year and to 7.3 percent by 2015. A return to normal agricultural production during 2013-15 and an expected revival of mining activity as hold-ups to production in key natural resource-rich states are gradually resolved should boost output in these sectors, providing a tailwind to growth over the forecast horizon.

Pakistan's GDP growth is projected to remain

Figure SAR.11 Weaker investment growth in India and Pakistan



Sources: Haver Analytics and World Bank.

broadly stable at 3.8 percent in the 2012-13 fiscal year compared with 3.7 percent growth recorded in 2011-12. Growth is projected to remain close to 4 percent during 2014 and 2015, a relatively sluggish pace compared to regional peers. A weak investment climate, infrastructure gaps, sovereign creditworthiness concerns, and large fiscal deficits continue to pose obstacles to a sustained improvement in investment activity and economic performance. Electricity and gas shortages for the industrial and agricultural sectors, macroeconomic challenges including fiscal deficits and high inflation, and security uncertainties, have hampered productive business activities. Mainly as a result of adverse domestic factors, investment as a share of GDP fell by nearly a third between the 2007-08 and 2011-12 fiscal years (figure SAR.11 second panel), contributing to Pakistan's current lackluster growth potential, especially compared with the more than 6 percent average annual GDP growth recorded between 2003 and 2007. This secular decline in investment, unless reversed through sustained improvements in macroeconomic performance and policy credibility as well as addressing infrastructure gaps, has negative implications for productive capacity and potential output growth during the forecast horizon. Concerted efforts to address electricity shortages, a major constraint to growth, would also help to raise the sustainable pace of growth.

Bangladesh's GDP growth is projected to decline to 5.8 percent in the 2012-13 fiscal year from 6.3 percent in 2011-12, in part due to a moderation in exports resulting from an adverse global environment. Although Bangladesh's export performance weakened in 2012, domestic demand was supported by steady inflows of migrant remittances and a relatively stable agricultural performance. External constraints have been exacerbated by supply side bottlenecks including inadequate infrastructure, and by political uncertainty. A further diversification of export markets and gains in market share will benefit Bangladesh, as growth is expected to pick up faster in North America and Asia compared with near-stagnant growth projected for the Euro Area in 2013. Infrastructure and energy constraints could, however, slow further gains in competitiveness. Bangladesh's GDP growth is forecast to rise to 6.2 percent in the 2013-14 fiscal year, as the global economy continues its slow path to a recovery, and pick up to 6.5 percent in 2014-15.

GDP growth in Sri Lanka slowed to an estimated 6.1 percent in 2012, in part from policy efforts designed to limit excessive credit growth and contain overheating, exacerbated by weakening demand for exports and a drought. Sri Lanka's imports also slowed due to weaker domestic demand, policy measures to curb imports, and currency depreciation. Electricity cuts resulting

from the effect of drought on hydropower generation capacity also adversely affected economic activity. Although policy reforms in Sri Lanka acted as a drag on growth in 2012, they are also likely to boost growth outturns during the forecast horizon. A pick up of tourism during the forecast horizon will also contribute to economic activity in the island. Sri Lanka's growth is forecast to rise to 6.8 percent in 2013 as external demand continues to improve gradually and agricultural production growth returns to normal rates. Growth is expected to increase further to 7.2 percent by 2015 (a weaker pace compared with the more than 8 percent growth in 2010 and 2011), as the earlier boom in investment and reconstruction following stabilization after political conflict tapers off, implying a more sustainable pace of growth in line with underlying macroeconomic fundamentals.

Nepal's economic performance has remained relatively sluggish, as the ongoing constitutional crisis, a weak investment climate, and infrastructure bottlenecks have eroded business confidence and adversely affected investment and industrial activity. Following a surge in growth to 4.6 percent in the 2011-12 fiscal year mainly from a robust agricultural harvest and services growth (in part supported by migrant remittances), GDP growth is projected to weaken to around 3.8 percent in the 2012-13 fiscal year, as agricultural output growth returns to its longer-term trend, while industrial performance continues to remain weak. GDP growth is then forecast rise to about 4.3 percent by the 2014-15 fiscal year as the political and economic situation start to normalize. Migrant remittances are expected to remain a relatively stable and significant source of financing and, together with tourism revenues, support consumption demand during this period of

Table SAR.4 South Asia regional forecasts

	Est. Forecast						
	00-09 ^a	2010	2011	2012	2013	2014	2015
(annual percent change unless indicated otherwise)							
GDP at market prices ^{b,f}	5.9	9.3	7.4	5.4	5.7	6.4	6.7
GDP per capita (units in US\$)	4.4	7.8	5.9	4.0	4.3	5.0	5.3
PPP GDP ^d	5.9	9.4	7.4	5.4	5.7	6.4	6.7
Private consumption	5.4	6.6	5.9	5.8	6.0	6.5	6.8
Public consumption	5.8	11.1	6.3	5.8	5.7	5.8	5.9
Fixed investment	8.8	12.3	5.8	5.2	6.2	7.2	7.5
Exports, GNFS ^e	11.3	16.9	16.5	4.4	6.1	8.3	8.9
Imports, GNFS ^e	9.6	14.8	21.1	7.7	6.6	8.0	8.6
Net exports, contribution to growth	-0.3	-0.6	-2.5	-1.5	-0.8	-0.7	-0.8
Current account bal/GDP (%)	-0.6	-2.7	-3.2	-3.8	-3.2	-2.6	-2.0
GDP deflator (median, LCU)	6.5	9.3	8.3	8.9	9.3	8.6	8.4
Fiscal balance/GDP (%)	-7.1	-8.7	-7.6	-9.0	-8.3	-7.7	-7.0
Memo items: GDP at market prices^f							
South Asia excluding India	4.6	5.1	5.1	4.8	4.9	5.3	5.5
India	6.6	9.6	6.9	5.1	6.1	6.8	7.0
at factor cost	-	8.4	6.5	5.4	6.4	7.1	7.3
Pakistan	4.2	3.1	3.0	3.7	3.8	4.0	4.2
Bangladesh	5.2	6.1	6.7	6.3	5.8	6.2	6.5

a. Growth rates over intervals are compound weighted averages; average growth contributions, ratios and deflators are calculated as simple averages of the annual weighted averages for the region.

b. GDP at market prices and expenditure components are 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.

uncertainty; as well as finance imports of petroleum products and cover the trade deficit with India. However, after a surge in remittance inflows during 2011-12, helped partly by the incentives created by a depreciation of the Nepali rupee in line with its peg to the Indian rupee, remittances are likely to grow at a more sustainable rate over the forecast period.

Afghanistan is in a state of transition which involves the handover of security responsibilities from international forces to the Afghan government. This process is characterized by

considerable political and security uncertainty. However, in 2012, Afghanistan's economy grew strongly as a result of an exceptionally good harvest. Real GDP growth is estimated at around 11 percent, a significant increase from 7.3 percent in 2011. The good harvest has also brought Afghanistan to near food self-sufficiency and slowed inflation to 4.6 percent in July 2012 on a year-on-year basis, although inflation edged up to 5.4 percent in September. The medium-term outlook for Afghanistan remains cautiously optimistic. At the Tokyo conference in July 2012, donors pledged

Table SAR.5 South Asia country forecasts

	00-09 ^a	2010	2011	Est. Forecast			
				2012	2013	2014	2015
Calendar year basis^b							
Bangladesh							
GDP at market prices (% annual growth) ^c	5.2	6.4	6.5	6.1	6.0	6.3	6.5
Current account bal/GDP (%)	0.6	1.8	0.2	0.8	0.8	1.0	0.9
India							
GDP at market prices (% annual growth) ^c	6.2	10.4	7.9	5.5	5.8	6.6	6.9
Current account bal/GDP (%)	-0.5	-3.2	-3.6	-4.5	-3.8	-3.0	-2.4
Nepal							
GDP at market prices (% annual growth) ^c	3.4	4.4	4.2	4.2	4.0	4.2	4.3
Current account bal/GDP (%)	-0.9	-2.6	0.2	0.7	0.7	0.8	1.0
Pakistan							
GDP at market prices (% annual growth) ^c	4.2	3.0	3.4	3.8	3.9	4.1	4.2
Current account bal/GDP (%)	-1.4	-0.7	-1.0	-1.0	-0.8	-0.7	-0.5
Sri Lanka							
GDP at market prices (% annual growth) ^c	4.4	8.0	8.3	6.1	6.8	7.1	7.2
Current account bal/GDP (%)	-3.7	-2.3	-7.9	-7.1	-5.8	-5.0	-4.3
Fiscal year basis^b							
Bangladesh							
GDP at market prices (% annual growth) ^c	5.2	6.1	6.7	6.3	5.8	6.2	6.5
India							
GDP at market prices (% annual growth) ^c	6.6	9.6	6.9	5.1	6.1	6.8	7.0
Memo: Real GDP at factor cost	-	8.4	6.5	5.4	6.4	7.1	7.3
Nepal							
GDP at market prices (% annual growth) ^c	3.4	4.8	3.9	4.6	3.8	4.1	4.3
Pakistan							
GDP at market prices (% annual growth) ^c	4.2	3.1	3.0	3.7	3.8	4.0	4.2

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

Afghanistan, Bhutan, Maldives are not forecast owing to data limitations.

a. GDP growth rates over intervals are compound average; current account balance shares are simple averages over the period.

b. National income and product account data refer to fiscal years (FY) for the South Asian countries with the exception of Sri Lanka, which reports in calendar year (CY). The fiscal year runs from July 1 through June 30 in Bangladesh and Pakistan, from July 16 through July 15 in Nepal, and April 1 through March 31 in India. Due to reporting practices, Bangladesh, Nepal, and Pakistan report FY2009/10 data in CY2010, while India reports FY2009/10 in CY2009. GDP figures are presented in calendar years (CY) based on quarterly history for India. For Bangladesh, Nepal and Pakistan, CY data is calculated taking the average growth over the two fiscal year periods to provide an approximation of CY activity.

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

Source: World Bank.

sufficient funds to fill Afghanistan's (civilian) financing gap (estimated at \$4 billion per year on average over the next years), and this should allow the government to sustain service delivery and development gains. Nevertheless, the transition process, which is associated with a decline in military and civilian aid, and the upcoming presidential elections could further increase uncertainty in the medium term and take a toll on investor confidence. Projections suggest that even with favorable assumptions, real GDP growth may fall from the average of 10 percent per year experienced over the past decade to 4-6 percent for 2013-2015.

Private capital flows are projected to rise reflecting a favorable medium-term growth outlook

Private capital flows to South Asia are expected to rise by 20 percent to \$87 billion in 2013, and to increase further to \$117 billion by 2015, as regional growth picks up over the course of 2013-15 (table SAR.3). Improved growth outturns, together with an extended period of low-interest rates in high income countries and abundant liquidity in global financial markets will buoy capital flows to South Asia during the forecast horizon. Foreign direct investment is expected to increase in 2013 to \$37 billion, while net portfolio equity flows are forecast to rise further to around \$16 billion. As issues relating to hold-ups in mining activity in India are resolved, investment flows are expected to recover in this sector as well. Even with a modest pick-up of growth in 2013, India's growth will remain relatively high by global standards, and thus the country is likely to remain an attractive destination for international investors looking to longer term returns.

Migrant remittances to South Asia are expected to increase by around 9-11 percent annually over 2013-15 to reach \$144 billion in 2015, according to forecasts by the World Bank's *Migration and Development Brief 19*. These resilient resource flows, notably from the oil-rich Gulf Cooperation Council (GCC) countries, are expected to continue to support domestic demand in the region, especially in Nepal and

Bangladesh, and to provide a relatively stable source of hard currency earning for South Asian countries, particularly for Pakistan where FDI flows have dried up in recent years.

Risks and vulnerabilities

The economic outlook for the South Asia region is subject to several risks. A key domestic risk is that of fiscal consolidation not proceeding as planned. Although governments across the region have committed to fiscal consolidation measures, with elections coming up in several South Asian countries within the next two years, the pressures for populist spending measures could increase and cutting subsidies may prove difficult. If in addition, growth outturns turn out weaker than anticipated or planned revenue-raising measures (e.g., disinvestment plans for public enterprises) do not materialize, it could lead to higher than planned budget deficits and rising government debt, with potentially adverse consequences for sovereign creditworthiness. Another domestic risk is that agricultural outturns are weaker than expected due to rainfall shortages or drought during the forecast horizon, which would have adverse implications for rural incomes and employment, food prices, inflation, the fiscal burden of subsidies, and overall growth.

In terms of external risks, a protracted fiscal impasse in the United States is an immediate risk to the global economy, and in turn for South Asia's economic outlook. The baseline assumes that a credible medium-term plan to restore fiscal sustainability in the US and authorize government borrowing is agreed to by the end of February 2013 (see the main text of the *Global Economic Prospects* January 2013 report). An alternative scenario where only a short-term relief from the debt ceiling legislation is agreed upon and considerable uncertainty remains regarding future tax and fiscal policy could shave off 2.3 percent from US GDP growth relative to the baseline, and reduce global growth by 1.4 percent in 2013. Such a scenario would reduce demand for South Asia's exports and cut into financial flows to the region. Overall, South Asia's growth would be 0.4 percent lower than

under the baseline. Another source of external risk for South Asia is the possibility of resurgence of Euro Area tensions during the forecast horizon. The Euro Area accounts for the largest share of South Asia's exports and a resumption of financial market tensions in the Euro Area would affect South Asia through trade and financial channels.

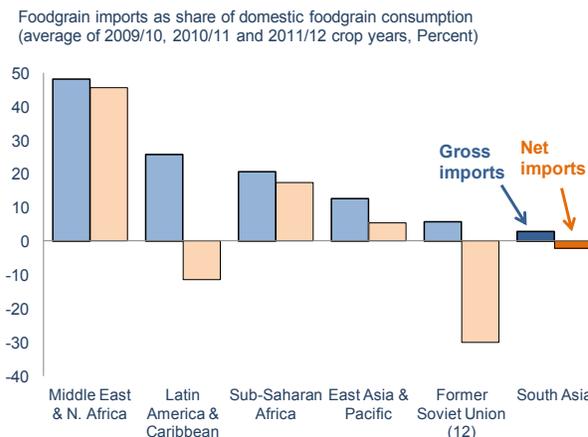
A fall in crude oil prices due to weaker than projected global growth—caused by either of the above two scenarios or other unforeseen events—would benefit current account positions of South Asian countries and reduce the fiscal burden of fuel subsidies. But lower crude oil prices would also cut into migrant remittances if economic activity in the migrant-destinations in the oil-exporting Arabian Gulf region were to slow and demand for migrant labor were to decline. Conversely, a spike in crude oil prices due to geopolitical tensions would worsen current account and fiscal positions in this net oil importing region.

A further increase in international food prices represents yet another source of external risk for South Asia. Drought in the US and heat conditions in Eastern Europe and Central Asian grain exporters cut into international grain supplies and caused international food prices to rise during the course of 2012, although international food prices moderated somewhat towards the end of the year. The overall dependence of the South Asia region on imported food grains is small compared with other regions (figure SAR.12). However, structural capacity constraints in food production, especially as consumption of proteins and edible oils continues to increase with rising incomes, are likely to imply tight domestic supplies (relative to demand) going forward, which can increase the vulnerability of the region to shocks to international food prices.

Policy reforms need to address fiscal and structural constraints

Domestic uncertainties, an adverse external environment, and a relatively poor business climate in the South Asia region have deterred

Figure SAR.12 South Asia is relatively less dependent on food grain imports than other regions



Source: US Department of Agriculture and World Bank
Note: US Department of Agriculture (USDA) sub-regions differ from the World Bank's regional classification. See www.usda.gov for details.

both domestic and foreign investors, resulting in weakening investment growth in recent years. Moreover, South Asia's high fiscal deficits have adverse economic consequences in terms of contributing to persistence of inflation and crowding out of productive business investment. Sustained efforts at fiscal consolidation are therefore necessary to free up resources for the private sector, reduce inflation, and generate policy space to respond to external and domestic shocks.

Policies also needed to address structural challenges to growth, including, among others, in electricity generation and agricultural production. Firms and consumers in South Asian countries have been faced with widespread power outages, as rising demand has outstripped capacity. Both electricity generation companies and firms with captive power plants face rationed supply of inputs, which have adversely affected industrial activity. Expanding capacity and ensuring financial sustainability of both public and private enterprises in the energy sector are critical for future growth outcomes. Similarly, agricultural supply has fallen short of demand as incomes have risen and food preferences have shifted, contributing to persistence of food inflation, and in turn overall inflation. Raising agricultural productivity and

output, as well as improving storage and transport infrastructure both to reduce spoilage and to enable improved access to foreign markets, are necessary steps towards easing shortages, improving food security, and reducing inflationary pressures.

half a percentage point from India's GDP growth in the 2012 fiscal year compared with a normal agricultural season.

Notes:

- 1 The South Asian countries included in the regional estimates and forecasts include Bangladesh, India, Nepal, Pakistan, and Sri Lanka. The text also discusses recent developments and economic prospects for Afghanistan. However, Afghanistan, Bhutan and Maldives were not included in the South Asia regional aggregates due to insufficient reliable historical data on national income accounts and balance of payments components.
- 2 The World Bank follows the IMF's methodology for the estimates of the general government deficit for India. IMF and Indian presentations differ, particularly regarding divestment and license auction proceeds, net versus gross recording of revenues in certain minor categories, and some public sector lending (IMF *Fiscal Monitor* October 2012).
- 3 USDA crop marketing years vary across countries in South Asia (and across rice and wheat harvests in India): the 2012/13 crop marketing year corresponds to April 2012-March 2013 for wheat and October 2012-September 2013 for rice in India; May 2012-April 2013 in Pakistan; July 2012-June 2013 in Bangladesh and Nepal; and October 2012-September 2013 for Sri Lanka. Therefore, changes in weather patterns during the course of 2012 influence harvests to a significantly greater extent in the current (2012-13) crop year than output in the previous (2011-12) crop year.
- 4 Preliminary estimates suggest that weak agricultural performance due to delayed monsoon rains may have subtracted almost

Sub-Saharan Africa Region

Overview: GDP growth in Sub-Saharan African remained robust at 4.6% in 2012, notwithstanding the slowdown in the global economy. Indeed, excluding the region's largest and most globally integrated economy, South Africa, GDP growth in the region was at strong 5.8% in 2012, with a third of countries in the region growing by at least 6%. Robust domestic demand, steady remittance flows, still high commodity prices, and increased export volumes (thanks to increased investment flows to the natural resource sector in recent years) were supportive of the region's growth in 2012. Nonetheless, besides the drag from a weaker global economy, domestic factors, including earlier monetary policy tightening (Kenya and Uganda), protracted labor disputes (South Africa), and political unrests (Mali and Guinea Bissau) weakened growth in a number of countries in the region.

Economic activity was similarly diverse in the region. Reflecting still high commodity prices and relatively robust growth prospects in the region, net private capital flows to the region increased by 3.3 percent to a record high \$54.5 billion in 2012. Much of the increase in net capital flows came in the form of increased foreign direct investment flows to the region, which increased to \$37.7 billion in 2012 from \$35.7 billion in 2011, notwithstanding the 6.6 percent decline in foreign direct investment flows to developing countries in 2012. Exports grew strongly in the first half of the year; however, a sharp deceleration of industrial commodities and oil exports occurred in the third quarter. Tourism, an important driver of growth in the region, remained robust, with strong tourist arrivals in many of the popular destinations, including South Africa, Mauritius, Sierra Leone, Madagascar and Cape Verde.

Outlook: Medium-term growth prospects remain strong and should be supported by a pick-up in the global economy, still high commodity prices, and increased investment. Since 2000, investment in the region has increased steadily

from 15.9 percent of GDP to over 22 percent of GDP in 2012. This is expected to continue, particularly so as an increasing number of the region's economies are able to tap into international capital markets to help address binding infrastructural constraints (in 2012 Zambia issued its debut international bond, a \$750 million Euro bond, which was oversubscribed by 15 times). Further, the ongoing increase in export volumes from several countries that have discovered mineral deposits in recent years (Ghana, Kenya, Mozambique, Niger, Sierra Leone, Tanzania, and Uganda) should boost growth prospects. Overall, the region is projected to grow at its pre-crisis average rate of 5 percent over the 2013-15 period (4.9 percent in 2013, gradually strengthening to 5.2 percent in 2015). Excluding, South Africa, the region's growth will average 6% over the 2013-15 period.

Risks and vulnerabilities: Risks to the outlook remain tilted to the downside, as weaker growth in China, ongoing fiscal consolidation in the Euro Area and the United States could potentially derail the region's growth prospects. Further, a number of domestic concerns could be a drag on growth in the region.

Euro Area debt crisis. Although the worst appears to be over, should a credit crunch hit some of the larger troubled Euro Area economies, GDP growth in the region could decline by one percentage point.

Weak US economy. Fiscal policy paralysis in the US could curtail growth in the region by at least 0.9 percentage points in the 2013.

China investment. With Chinese demand accounting for some 50 percent of many industrial metals exported from Africa, a disorderly unwinding of China's high investment rate could lead to deteriorating current account and fiscal balances, and cut into the region's growth prospects.

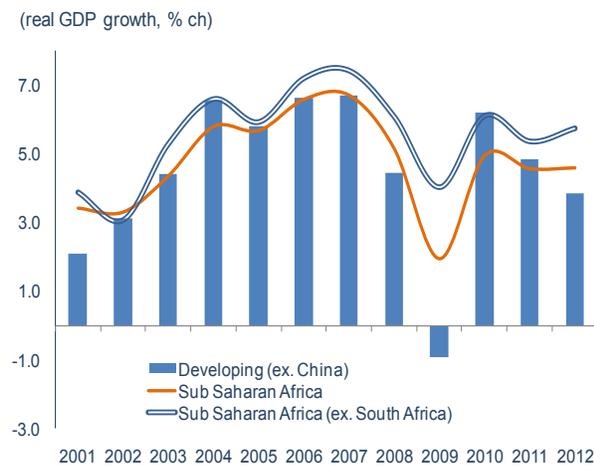
Domestic factors. Political instability, protracted industrial disputes and adverse weather conditions could also undermine growth in a few countries in the region.

Introduction

Despite the global economic slowdown in 2012, growth in Sub-Saharan Africa has remained robust, supported by resilient domestic demand and still relatively high commodity prices. In 2012 the region’s growth is estimated at 4.6 percent (figure SSA.1). About a third of countries in the region grew by at least 6% (figure SSA.2). Excluding South Africa, the region’s largest economy, the remaining economies grew at a robust 5.8 percent – higher than the developing country average of 5.1 percent. Medium-term growth prospects remain strong and should be supported by a pick-up in the global economy, still high commodity prices, and investment in the productive capacity of the region’s economies. The ongoing increase in export volumes from several countries in the region (Mozambique, Niger, Sierra Leone, etc.) that have discovered mineral deposits in recent years should boost growth prospects.

Overall, the region is projected to grow at its pre-crisis average rate of 5.0 percent over the 2013-15 period: 4.9 percent in 2013, and gradually strengthening to 5.2 percent by 2015. Risks to the outlook remain tilted to the downside, as the global economy remains fragile, and weaker growth in China, ongoing fiscal consolidation in the Euro Area and the United States could potentially derail the

Figure SSA.1 Sub-Saharan Africa continues robust growth



Source: World Bank

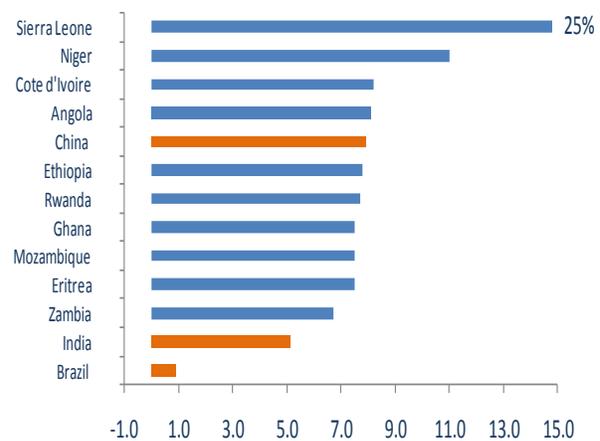
region’s growth prospects. Besides external risks, domestic concerns such as political instability, protracted industrial disputes and adverse weather conditions could undermine growth in a few countries in the region.

Recent developments

Capital flows to Sub Saharan Africa held up in 2012, despite slowdown in global economy. Uncertainty in financial markets, banking sector deleveraging in the Euro Area and a subdued global economy weakened capital flows to developing countries by an estimated 8.6 percent in 2012. Reflecting still high commodity prices and relatively robust growth prospects in the region, net private capital flows to the region increased by 3.3 percent to a record high \$54.5 billion in 2012 (table SSA.1). Much of the increase in net capital flows came in the form of increased foreign direct investment, however, the de-escalation of market tensions following policy interventions by European authorities and ultra-loose monetary policy in other high-income countries also supported an increase in bond flows to the region with the bulk of the increase coming from two new international sovereign bond issuers – Angola and Zambia.

Aggregate foreign direct investment inflows increased by 5.5 percent in 2012, although for developing countries as an aggregate it fell by

Figure SSA.2 Fastest growing Sub-Saharan Africa economies in 2012



Source: World Bank

6.6 percent. Foreign direct investment flows to the region increased to \$37.7 billion in 2012 from \$35.7 billion in 2011 (figure SSA.3). The resilience of foreign direct investment flows in the region in 2012 reflects, inter alia, the longer time horizon of investment decisions in the extractive industries sector (which in value terms accounts for the bulk of investment to the region), and is therefore less sensitive to short-term shifts in market sentiment. Investment incentives remain elevated due to still high level of commodity prices in 2012 (even if lower than 2011), the wealth of natural resources across the region, and the relatively high rates of returns on investment in sub-Saharan Africa.^{FN1} In 2012, several mines were expanded or new ones built across countries in the region, prospecting yielded major gas discoveries along the east coast of Africa, new commercially viable oil wells were drilled in West Africa and East Africa and a number of countries across West, Central and Southern Africa found new mineral deposits.^{FN2}

While the extractive industry sector dominates in terms of the value of overall foreign direct investment flows, the relative importance of the primary sector in greenfield investments is declining (although project numbers are stable), reflecting increasing investments in the services

sector, notably among infrastructure related projects in construction, transportation, electricity, telecommunication and water.^{FN3} This should help alleviate some of the binding constraints to growth that many countries in the region face. In addition, some of the larger economies with a growing middle-class such as Nigeria, South Africa, Angola, Kenya, and Ghana, are increasingly attracting investment flows to their rapidly expanding consumer sector (e.g. retail, consumer banking etc).

Consumer spending most likely held up in 2012. Consumer spending accounting for over 60 percent of GDP in the region and is, therefore, an important determinant of overall growth. Consumer demand has grown relatively rapidly in recent years, supported by solid real incomes growth. Indeed, over the past decade real per capita incomes rose by an average of 2.3 percent annually. As a result, as of 2012 some 21 Sub-Saharan African countries (almost half) are classified as middle-income economies compared to only nine a decade ago.

Unfortunately comprehensive data on retail spending, consumer demand and sentiment is unavailable in most countries in the region. Where data do exist, they suggest that consumer demand was robust in 2012. In South Africa,

Table SSA.1 Net capital flows to Sub-Saharan Africa (\$ billions)

	2008	2009	2010	2011	2012e	2013f	2014f	2015f
<u>Capital Inflows</u>	43.4	47.0	61.1	64.2	65.0	68.3	76.2	86.1
Private inflows, net	38.4	37.1	47.8	52.7	54.5	58.8	68.9	81.0
<u>Equity Inflows, net</u>	33.4	43.2	42.7	44.1	47.4	53.7	61.3	69.0
Net FDI inflows	39.1	32.5	26.7	35.7	37.7	42.4	48.7	55.6
Net portfolio equity inflows	-5.7	10.7	16.0	8.4	9.7	11.3	12.6	13.4
<u>Private creditors, Net</u>	5.0	-6.2	5.1	8.6	7.1	5.1	7.6	12.0
Bonds	-1.6	2.0	1.4	6.0	7.0	5.0	5.0	7.0
Banks	2.3	0.5	0.5	3.1	0.9	1.2	1.8	2.9
Short-term debt flows	4.4	-9.5	2.8	-0.5	-0.9	-1.2	0.6	1.2
Other private	-0.1	0.8	0.5	-0.05	0.1	0.1	0.2	0.9
Official inflows, net	5.0	9.9	13.3	11.4	10.5	9.5	7.3	5.1
World Bank	1.9	3.1	4.0	3.2	3.3			
IMF	0.7	2.2	1.2	1.4	1.3			
Other official	2.4	4.6	8.2	6.8	5.9			

Note: e = estimate, f = forecast

e = estimate, f = forecast

/a Combination of errors and omissions, unidentified capital inflows to and outflows from developing countries.

Source: World Bank

record low interest rates and solid wage hikes contributed to a 4.9 percent (y/y) increase in retail sales volumes during the first eight months of 2012. Similarly, in the region’s second largest economy, Nigeria, wholesale and retail sales volume were up 8.5 percent for the first half of 2012.

For countries where high-frequency retail sales data does not exist, data on specific products can be used to gauge the strength of consumer spending. In Kenya, a 14 percent decline in motor vehicle registration in the first eight months of 2012 suggests that consumer spending on durables was weak. However, passenger car imports for the broader region suggest some strength, with car imports up 6.1 percent (y/y, values) for H1 2012 compared with a 1.2 percent rise globally (figure SSA.4).

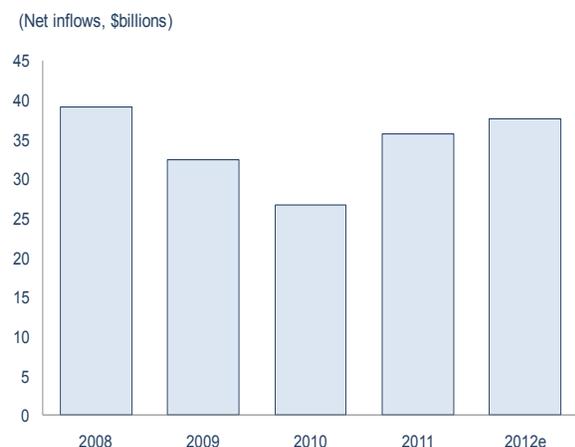
Stronger consumer spending was supported by improved access to credit (e.g. South Africa, Angola, Ghana, Mozambique, and Zambia), declining inflation rates and lower interest rates, a rebound in agricultural sector incomes thanks to more favorable weather conditions (Niger, Guinea and Mauritania all experienced better rains compared with the 2010/2011 crop year), and the steadiness of remittance flows (estimated at \$31bn in 2012 and 2011). In contrast, higher interest rates earlier in the year for Uganda and Kenya and political unrest in Guinea Bissau

contributed to the decline in passenger car imports there.

Overall, although data are sparse available indicators suggest that consumer strength held up in most countries, except where monetary stance was tight, political instability disrupted economic activity and adverse weather cut into agricultural sector incomes.

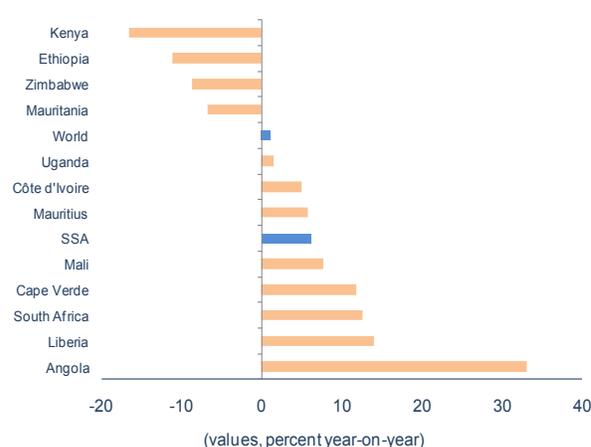
With a few notable exceptions, central banks in the region reacted to weakening inflation pressures and slower growth by easing monetary policy. Inflation rates declined in the region, from a GDP-weighted average of 9.5 percent in January to 7.7 percent in September. This in addition to the weak global environment sparked many central banks in the region to cut policy rates, supporting credit flow to the real economy (particularly business spending as firms account for a higher share of private credit demand in most Sub Saharan African countries). Interest rate cuts outnumbered hikes by 3:1 in in 2012 (figure SSA.5). Kenya and Uganda were among the most aggressive to cut policy rates. However credit growth in these two economies remained constrained for the greater part of 2012 – partly because of lags in the transmission of monetary policy and because interest rates though declining remained high (between 11-23 percentage points). Interest rates were however hiked in economies where inflation was creeping

Figure SSA.3 Foreign direct investment flows to Sub Saharan Africa held-up in 2012, despite weaker global economic environment



Source: World Bank.

Figure SSA.4 Growth in passenger car imports in selected Sub-Saharan Africa economies (1st half 2012)



Sources: UNITC , Comtrade and World Bank.

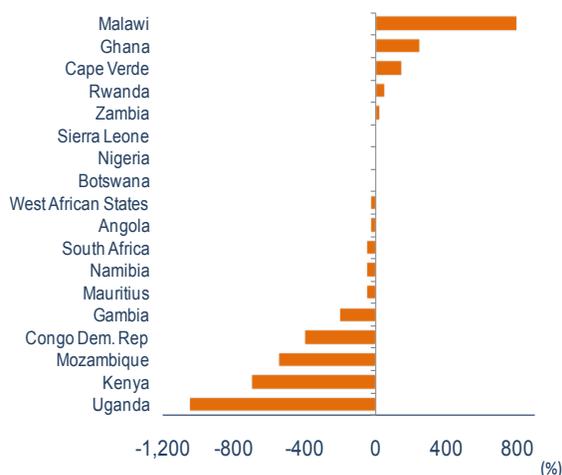
up (Ghana) and or faced some current account challenges (Cape-Verde).

Fiscal balances deteriorated in 2012. Although very difficult to evaluate with precision, World Bank estimates of the level of potential output in Sub-Saharan economies suggests that demand levels in more than half were close to or above potential in 2012 – despite the slowing of growth (figure SSA.6). In other countries, estimated output gaps (the difference between demand levels and actual output) are relatively small – exceeding 2 percent in only 9 countries in the region (figure).

Overall real government spending is projected to grow about 0.6 percentage points higher than GDP in 2012 and the region’s general government balance is projected to deteriorate in 2012. Debt-to-GDP ratios in the region are relatively low in historical comparisons or as compared with high-income countries, nonetheless they have increased from 28.9 percent in 2008 to 33.1 percent in 2012.

While government spending has been appropriately prioritizing infrastructure projects that are likely to contribute to the countries future growth potential, care must be exercised to ensure the long-term sustainability of spending programs. In particular, in so far as high commodity prices have boosted

Figure SSA.5 Year-to-date changes to policy rates in Sub-Saharan Africa countries



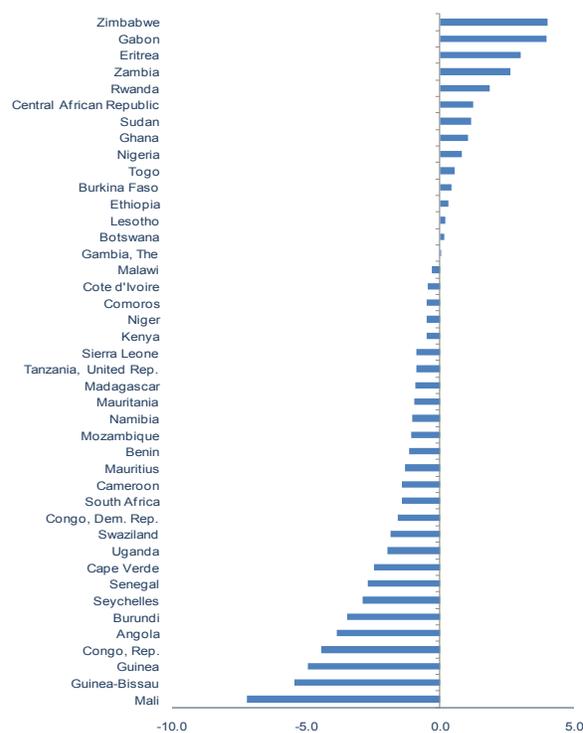
Source: World Bank and Central Bank news info

government revenues in many Sub-Saharan African countries, spending needs to be sufficiently flexible as to be able to absorb what could be a significant revenue loss if commodity prices were to fall. World Bank simulations suggest a 20 percent fall in industrial commodity prices would lead to a further 1.6 percentage point decline in government balances over a three year period.

That said, markets appear to be confident in the ability of countries and of firms operating in the region to repay loans. Increasingly, countries in the region are issuing longer-term bonds (both domestic and foreign) and attracting financing from larger developing countries, notably China. And this borrowing is helping to bridge what the World Bank estimates to be a \$31 billion annual infrastructure financing deficit. For the more fragile economies in the region, public capital investments rely heavily on official development assistance (ODA)

While only a few countries are active in international bond markets, more are gaining

Figure SSA.6 Estimated output GAP for 2012



Source: World Bank.

access. For example Zambia issued a maiden 10-year \$750 million Euro bond at a 5,625 percent yield - - lower than yields in some high-spread Euro Area economies at the time - that was oversubscribed. As such it joined Ghana, Senegal, Nigeria, Namibia -- all of which accessed global bond markets for the first time in recent years. Further, the inclusion of South Africa to the Citi World Government Bond Index (WGBI) and Nigeria to the JP Morgan Emerging Market Global Bond Index is supporting an increase in foreign investor participation in their domestic bond markets.

Export growth in Sub Saharan Africa was relatively robust in 2012. Export volumes in the region increased by 4.5 percent between January and July 2012, versus a global average of 3.6 percent during that period. Excluding South Africa, the region's largest economy, exports from the rest of the region were up 6.0 percent (figure SSA.7). The good performance was supported by earlier investments in the export sector, and a diversification of trading partners (particularly to Asia). The region's oil exporters increased their exports by some 5 percent (mostly due to increased output from Angola, as output in Nigeria declined slightly). Metal and other industrial raw material producers (excluding South Africa), several of whom have benefited from the coming onstream of new mineral exports (Sierra Leone, Mozambique, Niger etc.) increased their export volumes by 13.9 percent (y/y) during the first seven months of 2012. Export volume growth was strongest for the predominantly agricultural exporters (17.1 percent, y/y), in part due to weaker base effects but also due to the lower cyclical sensitivity of agricultural commodities.

Overall, however, regional exports were sensitive to the slowdown of the global economy in the second quarter of 2012. As with other developing economies, following a strong rebound in the first half of the year, exports slowed in the third quarter. The sharpest deceleration occurred among the industrial commodity exporters, whose exports had been growing at a 52.1 percent annualized pace in the three months ending in June, but who saw export

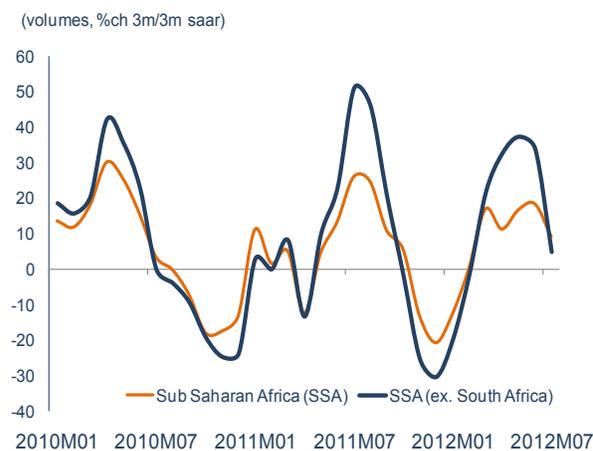
volumes decline at a 2.1 percent pace in July (42.1 and 5.9 percent for oil exporters).

Reflecting the preponderance of commodities in their export baskets and the decline in commodity prices, the deceleration in exports values was even steeper. Indeed, excluding South Africa export values contracted at a -30.5 percent pace (3m/3m) in July; with sharpest declines occurring among oil (-39.4 percent) and industrial raw material exporters (-10.3 percent) reflecting the greater sensitivity of their export prices to global demand changes compared to agricultural commodities.

While the global cycle was an important factor here, local disruptions to production from labor unrest (South Africa) and military confrontations (Guinea Bissau) were also at play.

Trends in services trade, particularly tourism, are increasingly becoming an important driver of growth in several Sub Saharan African countries (including traditional destinations such as Cape-Verde, Kenya, Mauritius, Seychelles and newer destinations such as Rwanda. Data from the UN World Tourism Organization shows that the growth in tourist arrivals to the region picked up by some 5.7 percent in the first half of 2012, compared with a global average of 4.9 percent during the same period (figure SSA.8). Sub Saharan African countries that recorded strong

Figure SSA.7 Growth in Sub-Saharan Africa exports were impacted by developments in the global economy



Source: World Bank and Datastream.

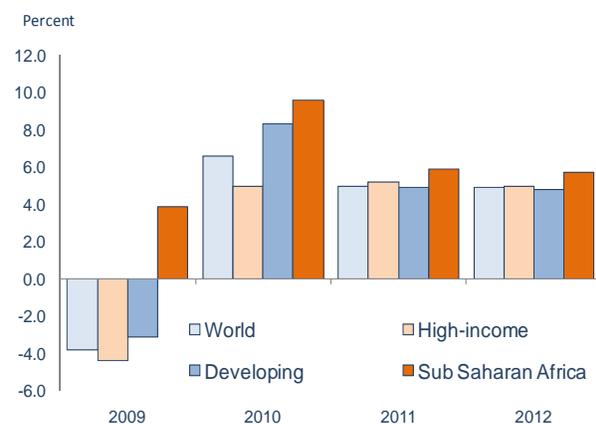
growth in tourist arrivals included South Africa (11 percent), Sierra Leone (17 percent), Madagascar (13 percent) and Cape Verde where tourist arrivals jumped 15 percent, supported in part by a diversion of tourists from troubled North African countries.

The growth of tourist arrivals to destinations in the region notwithstanding the economic weakness in Europe is encouraging and reflects a diversification of source countries. For instance, in Mauritius, arrivals from Europe (largest source market) fell by 7.7 percent for the January – September period, but arrivals from China rose 38.3 percent, and those from Russia by 91.2 percent. Further arrivals were up from elsewhere in Africa (13.2 percent), Australia (13.5 percent), Canada (18 percent) and South America (55.3 percent). Other countries have fared much less well, for instance the cancellation of major charter flights to Mombasa following terrorism and piracy concerns there contributed to the 2 percent (y/y) fall in tourist arrivals to Kenya between January and August 2012. Similarly the conflict in Mali led to a sharp decline in tourist arrivals there.

Medium-term outlook

Medium term GDP growth prospects for Sub Saharan Africa remain strong with the same driving forces that have underpinned the region's

Figure SSA.8 Growth in tourist arrivals in Sub-Saharan Africa has been above average in recent years, albeit from a low base



Sources: UN World Tourism Organization

robust performance in recent years expected to be sustained over the projection horizon (table SSA.2). On aggregate the region's GDP growth is expected to average 5 percent over 2013-2015 (4.9, 5.1, and 5.2 percent for 2013, 2014 and 2015 respectively). Excluding, the region's largest economy, South Africa, GDP growth for the rest of the region is expected to pick-up to about 6.1 percent in 2013 and maintain that growth through 2015 (6.0 percent and 6.1 percent in 2014 and 2015 respectively).

Increased investment will be a major driving force of growth over the medium term. Increased investment is to be a main driving force in the region. Since 2000, investment in Sub-Saharan Africa has steadily increased from 15.9 percent of GDP to over 22 percent of GDP in 2012. In addition to growing foreign sources of investment finance, domestic investment is also expected to benefit from the ongoing financial sector deepening in the region, albeit from a very weak base. Over the past decade, bank deposits as a share of GDP have increased by some eight percentage points, supporting a ten percentage point increase in the private sector credit to GDP ratio during this period (figure SSA.9). With the lag in monetary policy transmission, the widespread cuts in policy rates in 2012, is expected to provide some stimulus to economic activity through 2014.

Foreign direct investment to the region is expected to remain strong over the medium term. The World Bank projects FDI to the region to increase to new record levels each year reaching \$55.6 billion in 2015. FDI inflows to the extractive industries sector and to the agriculture sector (to a lesser extent) should be supported by persistently high (if somewhat softening) commodity prices over the next 2-3 years (see commodity annex). Strong exploration efforts in East Africa during recent years have led to the striking of several oil and gas wells and further exploration and discoveries are expected over the forecast horizon. In Southern Africa, Mozambique expects to attract some \$50bn in foreign investment over the next decade thanks to its huge coal deposits and offshore gas discoveries. Similar investments in the minerals

sector in West Africa (Ghana, Liberia, Sierra Leone, Guinea, Niger etc.) are also expected.

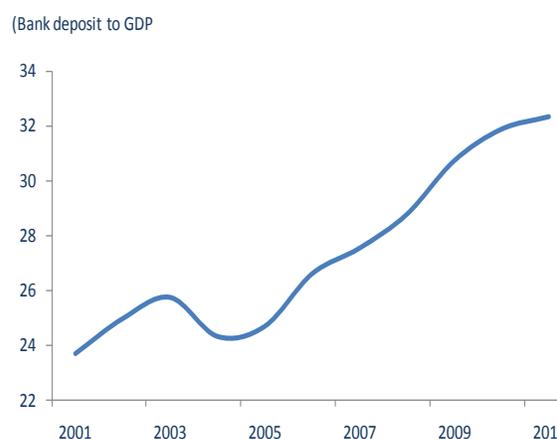
Sixty percent of firms not currently present in the region, indicated in a recent survey their intention to expand into the region over the next 3-5 years (EIU, 2012). For instance, the Carlyle group and two other partners recently announced plans to invest some \$210 million in a Tanzanian agribusiness entity (the private-equity group's first foray into Sub-Saharan Africa).

Continued investment in infrastructure will be critical to maintaining and strengthening growth over the medium term— potentially boosting growth rates in the region by 2 percentage points. Indeed, infrastructural shortcomings may be depressing firm-level productivity by as much as 40 percent in some countries in the region (Escribano, Guasch, and Pena, 2008).

As discussed above, countries will need to continue giving priority to such investments, while at the same time taking care to safeguard fiscal flexibility should commodity prices and

government revenues decline. If appears likely, official development assistance continues to come under budgetary pressure in high-income countries, poor and more fragile economies that depend on aid for infrastructure spending may find themselves falling behind. Other countries

Figure SSA.9 Financial deepening across Sub-Saharan Africa, 2001-2011



Source: World Bank, Datastream.

Table SSA.2 Sub-Saharan Africa forecast summary

(annual percent change unless indicated otherwise)

	00-09 ^a	2010	2011	Est. Forecast			2015
				2012	2013	2014	
GDP at market prices ^b	4.3	5.0	4.5	4.6	4.9	5.1	5.2
	<i>(Sub-region totals— countries with full NIA + BOP data)^c</i>						
GDP at market prices ^c	4.3	4.9	4.5	4.6	4.9	5.1	5.2
GDP per capita (units in US\$)	2.0	2.4	2.0	2.1	2.4	2.5	2.7
PPP GDP ^c	4.5	5.2	4.7	4.6	5.4	5.4	5.5
Private consumption	4.7	5.6	5.5	5.2	4.8	4.4	4.4
Public consumption	5.6	13.6	3.3	5.3	4.9	4.1	2.8
Fixed investment	8.9	-0.1	14.7	3.2	8.6	6.4	6.3
Exports, GNFS ^d	4.5	6.4	2.9	4.5	6.4	8.1	9.0
Imports, GNFS ^d	5.3	2.5	11.2	6.6	6.9	7.3	7.1
Net exports, contribution to growth	-0.3	1.3	-2.9	-0.9	-0.4	0.0	0.4
Current account bal/GDP (%)	0.1	-1.2	-1.2	-2.9	-3.1	-3.3	-3.0
GDP deflator (median, LCU)	6.7	6.1	8.0	4.1	6.7	5.9	6.0
Fiscal balance/GDP (%)	-0.4	-3.9	-1.0	-2.8	-2.4	-2.1	-1.7
Memo items: GDP							
SSA excluding South Africa	4.9	6.2	5.3	5.8	6.1	6.0	6.1
Oil exporters ^e	5.5	6.1	4.9	6.0	6.2	6.0	6.2
CFA countries ^f	3.8	4.5	2.7	5.2	5.2	4.7	4.3
South Africa	3.2	2.9	3.1	2.4	2.7	3.2	3.3
Nigeria	5.6	7.8	6.7	6.5	6.6	6.4	6.3
Angola	10.7	3.4	3.4	8.1	7.2	7.5	7.8

a. Growth rates over intervals are compound weighted averages; average growth contributions, ratios and deflators are calculated as simple averages of the annual weighted averages for the region.

b. GDP at market prices and expenditure components are measured in constant 2005 U.S. dollars.

c. Sub-region aggregate excludes Liberia, Chad, Somalia and São Tomé and Príncipe. Data limitations prevent the forecasting of GDP components or Balance of Payments details for these countries.

d. Exports and imports of goods and non-factor services (GNFS).

e. Oil Exporters: Angola, Cote d'Ivoire, Cameroon, Congo, Rep., Gabon, Nigeria, Sudan, Chad, Congo, Dem. Rep.

f. CFA Countries: Benin, Burkina Faso, Central African Republic, Cote d'Ivoire, Cameroon, Congo, Rep., Gabon, Equatorial Guinea, Mali, Niger, Senegal, Chad, Togo.

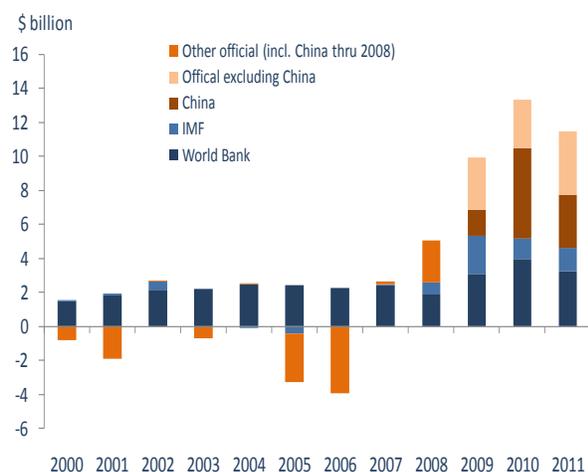
Source: World Bank.

in the region are likely to tap into international capital markets to support their infrastructural programs, including perhaps first-time entries by countries like Rwanda, Uganda, Kenya, and Mozambique. Bilateral funding sources, particularly from other developing countries will also be critical for some countries. Indeed, the Forum on China-Africa Cooperation (FOCAC) recently announced that China will provide \$20bn of credit lines to African countries to assist in developing infrastructure, agriculture, manufacturing and small and medium-sized enterprises (figure SSA.10).

The modest pick-up in the global economy projected in 2013 and beyond should provide some support to Sub-Saharan African export growth. Sub-Saharan Africa exports are projected to continue increasing rapidly over the forecast horizon, partly due to an expected strengthening of global demand, but mainly reflecting further increases in the region’s share of global markets – itself partly a reflection of productivity growth, but also the coming on stream of new mineral exports in several countries (e.g. Burkina Faso, Mozambique, Niger, Cameroon, Gabon, Sierra Leone etc.). A stronger global economy should also see a further strengthening of the region’s tourism sector.

The increased demand for capital goods to meet

Figure SSA.10 Net official flows to Sub-Saharan Africa



Source: World Bank.

infrastructure and other investment needs, growing demand for oil among oil importers, and rising per capita incomes, should boost demand for consumer durables and other imports. As a result, the regional current account deficit is projected to about 2.8 percent of regional GDP in 2014 from 2.4 percent in 2012 before improving to 2.5 percent in 2015, and net exports are expected to be a modest drag (figure SSA.11). However, for some of the less diversified oil exporters (Angola, Congo), net exports will be positive.

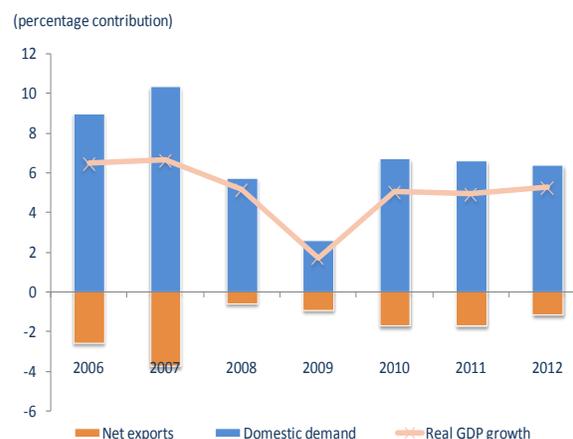
These expected medium term positive developments will however not be universal across the region. Indeed, labor market challenges (South Africa) and political instability (Mali) is expected to cut into economic activity in some countries in the region over the forecast horizon.

Risks

Notwithstanding the robust growth expected for the region over the forecast horizon, the risks remain tilted on the downside.

Fragile global recovery. While the tepid recovery of global economic activity is our baseline scenario, the many tension points in the global economy could result in a much weaker global outcome. Financial markets tensions in

Figure SSA.11 Domestic demand remains a robust pillar of growth in Sub-Saharan Africa

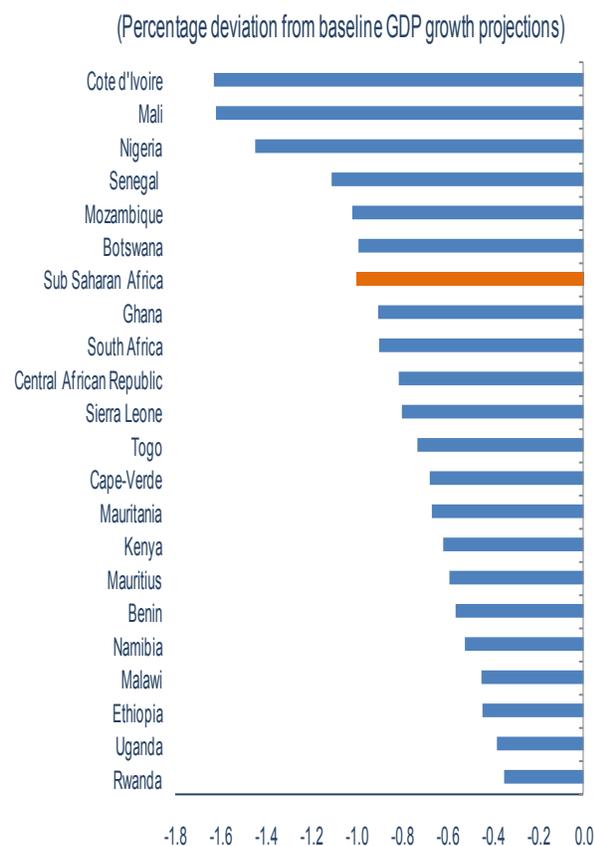


Source: World Bank.

the Euro Area have eased since 2012Q2 and the likelihood of a serious deterioration in conditions decreased, nonetheless conditions still remain fragile and sentiment is vulnerable to bad news. Should they deteriorate markedly, with a credit freeze to some of the larger high-spread troubled Euro Area economies, global economy activity could return to recession-like conditions and GDP in Sub-Saharan Africa could fall by up to 1.0 percentage points relative to the baseline forecasts, although results will differ by country (figure SSA.12).

The fiscal consolidation in the United States is already sapping growth there. In our baseline, a credible medium-term plan to restore fiscal sustainability is assumed to be arrived at by February 2013—implying a 1.6 percent of fiscal compression. However, were this not to occur

Figure SSA.12 Potential GDP impacts on selected Sub Saharan African economies from an escalation in Euro Area Crisis



Source: World Bank.

and a deeper fiscal contraction to take place, this would serve as a larger drag to US growth. In an alternate scenario we assume no such agreement is arrived at and that authorities agree on a partial deal that provides for \$110bn additional fiscal contraction but only short-term relief from debt ceiling legislation, creating further uncertainty on future tax and fiscal policy. Should that arise, the trade channel alone could cause Sub Saharan African GDP to decline by 0.9 percentage points relative to baseline. Further, current account and fiscal balances could deteriorate by 1.3 and 0.8 percentage points from their baseline projections. However, given the importance of the US economy in global markets, the indirect impacts through weaker confidence and the potential rattling of global financial and commodity markets would likely have a stronger impact on the region.

A third tension point surrounds the possibility of a disorderly unwinding of China's unusually high investment rate. With Chinese demand accounting for some 50 percent of many industrial metals exported from Africa, a sharper than envisaged down turn there could lead to a slump in commodity prices which would impact the non-diversified metal and mineral exporters in the region (e.g. Zambia, Botswana, Namibia, Democratic Republic of Congo) as well as oil exporters in the region that trade predominantly with China (e.g. Angola, Sudan etc.). Indeed, an abrupt slowing in Chinese investment would slow the regions GDP by 0.3 percent, with current account and fiscal balances deteriorating by 0.6 and 0.3 percentage points of GDP respectively.

Indeed, the above discussed tension points in the global economy are not necessarily mutually exclusive as one event could trigger another event. Hence in this environment of increased fragility in the global economy, developing countries, including in Sub Saharan African countries will benefit from building the relevant short-term policy buffers and undertaking policies that will support the competitiveness of their economies in the long-run (including physical and human capital development, access to finance, and removing cumbersome regulatory

requirements that impede investment activity). However, compared to the pre-crisis period policy buffers for most economies in the region remain weaker. For instance, while in 2007 fiscal balances were in a surplus of some 0.4 percent of GDP, in 2012 fiscal balances have deteriorated to above 2 percent of GDP for the region. And though in 2012, headline inflation has come down for the region, it still remains high in a number of countries, hence limiting options for monetary policy stimulus in these economies. Hence, were there to be another significant down turn in the global economy, unlike the recent episode where the fiscal policy space existed to embark on countercyclical policy, the capacity to do so now remains more limited, unless buffers are quickly rebuilt. The importance of having adequate buffers is observed in a simulation carried out of an arbitrary high-income country shock - equivalent to a 5% decline in GDP. The results of the simulation show that while GDP growth for Sub Saharan African countries with adequate policy buffers suffer a 0.3 percentage point decline in GDP, their counterparts without the policy buffers, and thus unable to engage in countercyclical fiscal policies, suffer a more marked decline of 0.8 percentage point reduction in their GDP growth relative to the baseline.

Domestic risks. Besides these external risks, downturns from domestic challenges are equally important. Disruptions to productive activity from unrest (political, civil and labor) are important potential downside risks, as investment, trade and tourism activity, all important growth drivers, are likely to suffer. Indeed, in 2012, labor unrest in South Africa, terrorists activity in parts of Nigeria, coup d'etats in both Mali and Guinea Bissau, and political stalemate in Guinea and Madagascar curtailed economic activity to varying degrees in these economies. Though most economies in the region remain stable, simmering concerns, particularly in the fragile economies continue to pose an important downside risk to economic activity there over the medium term.

With the agricultural sector being the largest employer for almost all economies in the region,

and with much of activity in the sector being of a subsistence nature and dependent on good rain fall patterns, adverse weather conditions remain an important risk factor. Rain patterns in the latter half of 2012 in the Sahel region of West Africa and in East Africa suggest normal first harvests for 2013, however the situation thereafter remains unknown.

Notes:

1. The United Nations World Investment Report, 2012 reports that data on the profitability of United States FDI (FDI income as a share of FDI stock) show a 20 per cent return in Africa in 2010, compared with 14 per cent in Latin America and the Caribbean and 15 per cent in Asia (UNCTAD, 2012).
2. Until these recent findings East Africa was considered to be less endowed compared to the rest of the region
3. World Investment Report, 2012.

References:

- Economist Intelligence Unit, 2012. Africa cities rising. EIU, London.
- Escribano, Alvaro, J.Luis Guasch, Jorge Pena (2008). Impact of Infrastructure Constraints on Firm Productivity in Africa. Working Paper 9, Africa Infrastructure Sector Diagnostic, World Bank, Washington, DC.

Table SSA.3 Sub-Saharan Africa country forecasts

	00-09 ^a	2010	2011	Est. Forecast			
				2012	2013	2014	2015
Angola							
GDP at market prices (% annual growth) ^b	10.7	3.4	3.4	8.1	7.2	7.5	7.8
Current account bal/GDP (%)	4.9	9.1	13.0	8.5	5.9	4.7	4.8
Benin							
GDP at market prices (% annual growth) ^b	3.7	3.0	3.1	3.5	3.8	4.5	5.0
Current account bal/GDP (%)	-8.4	-9.4	-9.8	-9.8	-9.0	-7.6	-6.4
Botswana							
GDP at market prices (% annual growth) ^b	3.4	7.0	8.1	5.8	5.1	4.9	4.8
Current account bal/GDP (%)	8.3	0.5	8.7	8.9	8.7	8.9	8.6
Burkina Faso							
GDP at market prices (% annual growth) ^b	5.2	7.9	4.2	6.4	6.7	7.0	6.3
Current account bal/GDP (%)	-13.1	-7.0	-0.7	-8.9	-8.3	-7.7	-7.1
Burundi							
GDP at market prices (% annual growth) ^b	2.9	3.8	4.2	4.1	4.3	4.6	4.9
Current account bal/GDP (%)	-17.8	-15.9	-16.0	-18.2	-17.4	-16.6	-15.8
Cape Verde							
GDP at market prices (% annual growth) ^b	5.5	5.2	5.0	4.8	4.9	5.0	5.1
Current account bal/GDP (%)	-11.3	-12.8	-11.1	-9.9	-8.3	-6.4	-6.4
Cameroon							
GDP at market prices (% annual growth) ^b	3.0	3.2	3.8	4.6	4.8	5.0	5.1
Current account bal/GDP (%)	-2.4	-3.8	-6.6	-5.8	-4.3	-4.1	-3.7
Central African Republic							
GDP at market prices (% annual growth) ^b	0.6	3.3	3.1	3.8	4.0	4.1	4.2
Current account bal/GDP (%)	-8.5	-12.6	-7.2	-6.1	-5.4	-5.1	-4.9
Comoros							
GDP at market prices (% annual growth) ^b	1.8	2.1	2.2	2.5	3.5	4.0	4.0
Current account bal/GDP (%)	-12.2	-28.2	-9.6	-7.0	-6.1	-6.9	-7.6
Congo, Dem. Rep.							
GDP at market prices (% annual growth) ^b	4.2	7.2	6.9	6.6	8.2	6.4	7.5
Current account bal/GDP (%)	0.6	-16.6	-11.5	-12.7	-14.6	-15.1	-12.2
Congo, Rep.							
GDP at market prices (% annual growth) ^b	3.8	8.8	3.4	4.7	5.6	5.4	4.7
Current account bal/GDP (%)	-2.0	-21.4	5.4	0.5	2.6	1.4	0.5
Cote d'Ivoire							
GDP at market prices (% annual growth) ^b	0.8	2.4	-4.7	8.2	7.0	6.0	5.5
Current account bal/GDP (%)	1.9	2.0	0.3	-3.7	-3.9	-4.5	-4.7
Equatorial Guinea							
GDP at market prices (% annual growth) ^b	17.0	-0.8	7.8	5.7	6.1	1.4	-1.3
Current account bal/GDP (%)	15.4	-32.3	-7.9	-14.1	-10.0	-11.8	-12.3
Eritrea							
GDP at market prices (% annual growth) ^b	1.8	2.2	8.7	7.5	6.0	3.5	3.0
Current account bal/GDP (%)	-21.5	-5.6	-0.9	-0.8	1.3	2.7	4.1
Ethiopia							
GDP at market prices (% annual growth) ^b	7.4	9.9	7.3	7.8	7.5	7.2	7.5
Current account bal/GDP (%)	-5.7	-1.4	-2.5	-6.3	-6.3	-6.7	-6.7
Gabon							
GDP at market prices (% annual growth) ^b	1.6	6.6	5.7	4.7	3.5	3.3	3.5
Current account bal/GDP (%)	14.9	7.2	23.8	22.0	16.5	12.2	7.3
Gambia, The							
GDP at market prices (% annual growth) ^b	3.8	6.1	-4.3	3.9	10.7	5.5	5.8
Current account bal/GDP (%)	-3.5	2.0	-16.8	-17.9	-17.1	-15.0	-13.2

	00-09 ^a	2010	2011	Est. 2012	Forecast 2013	2014	2015
Ghana							
GDP at market prices (% annual growth) ^b	5.0	8.0	14.4	7.5	7.8	7.4	7.5
Current account bal/GDP (%)	-6.5	-7.5	-9.9	-11.8	-9.7	-9.7	-8.1
Guinea							
GDP at market prices (% annual growth) ^b	2.6	1.9	3.9	4.8	5.0	6.0	6.5
Current account bal/GDP (%)	-7.1	-7.0	-23.8	-39.6	-46.7	-52.5	-53.9
Guinea-Bissau							
GDP at market prices (% annual growth) ^b	0.9	3.5	5.3	-2.8	3.0	4.6	5.1
Current account bal/GDP (%)	-14.9	-23.8	-7.2	-6.5	-6.5	-6.7	-6.6
Kenya							
GDP at market prices (% annual growth) ^b	3.6	5.6	4.5	4.3	4.9	5.1	4.8
Current account bal/GDP (%)	-2.4	-7.4	-9.3	-8.9	-8.7	-8.2	-7.7
Lesotho							
GDP at market prices (% annual growth) ^b	3.2	5.6	5.8	4.3	5.2	5.3	5.0
Current account bal/GDP (%)	2.9	-20.2	-21.4	-23.6	-13.4	-9.2	-6.9
Madagascar							
GDP at market prices (% annual growth) ^b	2.5	1.6	1.0	2.2	4.5	4.8	5.4
Current account bal/GDP (%)	-12.3	-15.0	-7.6	-8.1	-7.9	-8.2	-7.6
Malawi							
GDP at market prices (% annual growth) ^b	4.0	6.5	4.3	4.1	5.4	5.6	6.0
Current account bal/GDP (%)	-10.9	-17.9	-12.2	-12.7	-12.9	-12.6	-12.0
Mali							
GDP at market prices (% annual growth) ^b	5.1	5.8	2.7	-1.5	3.5	5.9	6.0
Current account bal/GDP (%)	-8.1	-12.6	-4.9	-5.1	-4.8	-7.6	-7.2
Mauritania							
GDP at market prices (% annual growth) ^b	4.5	5.2	3.9	4.8	5.2	4.9	4.9
Current account bal/GDP (%)	-11.2	-2.9	2.9	-18.4	-15.4	-15.3	-13.2
Mauritius							
GDP at market prices (% annual growth) ^b	3.4	4.1	3.8	3.3	3.6	4.0	4.4
Current account bal/GDP (%)	-2.7	-10.4	-12.6	-10.8	-9.7	-8.8	-7.8
Mozambique							
GDP at market prices (% annual growth) ^b	7.1	6.8	7.3	7.5	8.0	8.2	8.0
Current account bal/GDP (%)	-14.0	-18.1	-25.7	-27.7	-27.0	-41.7	-41.6
Namibia							
GDP at market prices (% annual growth) ^b	4.0	6.6	3.8	4.2	4.3	4.4	5.0
Current account bal/GDP (%)	3.5	-2.1	-0.9	-0.3	-0.9	-1.3	-1.7
Niger							
GDP at market prices (% annual growth) ^b	3.7	8.0	2.3	12.0	6.8	6.1	5.0
Current account bal/GDP (%)	-9.7	-32.5	-21.6	-22.6	-18.9	-18.6	-19.1
Nigeria							
GDP at market prices (% annual growth) ^b	5.6	7.8	6.7	6.5	6.6	6.4	6.3
Current account bal/GDP (%)	14.4	6.8	3.6	3.5	2.0	1.2	0.4
Rwanda							
GDP at market prices (% annual growth) ^b	6.8	7.2	8.6	7.7	7.5	7.3	7.2
Current account bal/GDP (%)	-6.2	-7.7	-7.3	-9.9	-9.7	-9.8	-9.6
Senegal							
GDP at market prices (% annual growth) ^b	3.6	4.1	2.6	3.7	4.8	4.8	5.0
Current account bal/GDP (%)	-8.0	-4.7	-6.9	-8.6	-8.2	-7.8	-7.5

	00-09 ^a	2010	2011	Est. Forecast			
				2012	2013	2014	2015
Seychelles							
GDP at market prices (% annual growth) ^b	1.5	6.7	5.0	3.3	4.2	3.9	3.7
Current account bal/GDP (%)	-14.1	-19.7	-21.0	-19.5	-19.1	-15.4	-12.1
Sierra Leone							
GDP at market prices (% annual growth) ^b	9.0	4.9	6.0	25.0	11.1	7.6	7.6
Current account bal/GDP (%)	-14.1	-34.2	-55.4	-15.6	-8.8	-7.5	-6.3
South Africa							
GDP at market prices (% annual growth) ^b	3.2	2.9	3.1	2.4	2.7	3.2	3.3
Current account bal/GDP (%)	-3.0	-2.8	-3.4	-6.9	-6.4	-6.3	-5.9
Sudan							
GDP at market prices (% annual growth) ^b	5.9	4.5	5.0	3.0	3.2	3.3	5.0
Current account bal/GDP (%)	-6.3	-0.5	2.9	3.5	3.0	2.6	2.2
Swaziland							
GDP at market prices (% annual growth) ^b	2.1	2.0	1.3	-2.0	1.0	1.9	1.9
Current account bal/GDP (%)	-2.6	-10.4	-14.5	-14.2	-12.2	-14.1	-15.7
Tanzania							
GDP at market prices (% annual growth) ^b	6.2	7.0	6.3	6.5	6.8	7.0	7.0
Current account bal/GDP (%)	-9.2	-11.9	-12.9	-16.2	-14.3	-12.8	-11.9
Togo							
GDP at market prices (% annual growth) ^b	1.7	3.7	3.9	4.0	4.4	4.6	4.6
Current account bal/GDP (%)	-9.2	-6.3	-6.5	-8.9	-8.7	-8.8	-9.3
Uganda							
GDP at market prices (% annual growth) ^b	6.8	5.9	6.7	3.4	6.2	6.9	7.3
Current account bal/GDP (%)	-5.2	-10.8	-13.3	-11.5	-11.3	-11.4	-10.7
Zambia							
GDP at market prices (% annual growth) ^b	4.8	7.6	6.6	6.7	7.1	7.8	6.0
Current account bal/GDP (%)	-10.9	5.7	-1.2	-3.9	-2.4	-2.6	-1.8
Zimbabwe							
GDP at market prices (% annual growth) ^b	-5.9	9.0	9.3	5.0	6.0	5.5	5.0
Current account bal/GDP (%)	-11.4	-13.4	-20.7	-19.5	-20.3	-22.5	-24.0

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

Liberia, Somalia, Sao Tome and Principe are not forecast owing to data limitations.

a. GDP growth rates over intervals are compound average; current account balance shares are simple averages over the period.

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

Source: World Bank.

www.worldbank.org/globaloutlook



THE WORLD BANK