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The Outlook for Developing Economies

Summary of the medium-term outlook

Growth in the developing countries came in at 7.3 percent in 2006, the fourth year that their economies expanded by more than 5.5 percent. Very fast-growing countries, such as China (10.7 percent) and India (9.2 percent), contributed strongly to this overall result. But even excluding these countries, low- and middle-income countries grew 5.9 percent and gross domestic product (GDP) in every developing region expanded by more than 5 percent. This robust developing-country demand was reflected in stronger high-income country export growth, which was the main factor behind the acceleration of GDP in those countries to 3.1 percent. Overall, global output increased by 4 percent (5.3 percent using purchasing power parity [PPP] weights).

Despite these strong figures, 2006 was likely a cyclical peak, as both GDP and industrial production began slowing in mid-2006 and into 2007. This moderation of growth among developing countries is welcome, however, because it should help reduce the chance that the current growth boom could be followed by a bust.

The past few years of very strong growth have generated a number of tensions in the global economy, including increased commodity and asset prices (notably those of oil, metals, and housing) and a buildup of inflationary pressures.

The moderation of growth reflects the influence of a number of economic adjustment mechanisms that are in part a self-correcting reaction to these tensions.

Rising interest rates and tighter fiscal policy form a central part of the re-equilibrating process. Both policy action and market-induced revaluations of long-term risk have caused short-term interest rates to rise. Among developing countries, monetary tightening is most advanced in East Asia, where it has both slowed growth and contained inflationary pressures in a number of countries. In other developing economies, interest rates have risen and fiscal policy has been less procyclical than in the past, but the overall stance of macroeconomic policy in many of these countries is still relatively accommodating—leaving open the possibility of a much bumpier return to potential growth rates than is laid out in the baseline projection.

Growth in many developing countries continues to exceed potential. Partly as a consequence, there are clear signs of overheating in several middle-income countries, and inflation, which had been easing in 2005, stabilized or picked up over the past 12 months in four of six developing regions. Among high-income countries, slower growth (especially in the United States) and lower oil prices have brought down headline inflation. But core inflation is high in the United States and rising in Europe, causing monetary authorities to remain cautious.

Another factor contributing to a slowing in growth is the apparent stabilization of capital flows to developing countries. While inflows remain high, they have stabilized as a share of GDP and are no longer making a significant contribution to growth. Partly as a result, most developing countries have stopped accumulating reserves at rapid rates—although China and Russia constitute important exceptions in this regard.

Commodity prices also show signs of having reached cyclical peaks. Oil prices have eased from high points in mid-2006, as have the prices of copper and zinc, two of the metals whose prices have risen most rapidly. As growth eases, commodity prices are projected to decline further, which should support real incomes in importing countries even as output growth moderates. While a gradual decline in oil and other commodity prices is the most likely scenario, supplies remain very tight. An oil-sector supply shock could be extremely disruptive, driving up oil prices even farther while simultaneously slowing growth and weakening the prices of most nonoil commodities to the detriment of oil-importing developing countries.

These developments are also working to alleviate the global imbalances that have been building over the past nine years. Indeed, very strong domestic demand in developing countries, the recovery in Europe, rising interest rates, lower commodity prices, and an increase in U.S. savings as the housing boom recedes have brought an end to the trend rise in the U.S. current account deficit, which declined to 5.8 percent of GDP in the fourth quarter of 2006. While cyclical factors are at play, the increase in U.S. savings, the decline in commodity prices, and the shift in global growth toward developing countries reflect important structural changes that likely signal a beginning of an orderly resolution to the trend rise in global imbalances. Nevertheless, imbalances remain large, and there is a continuing low-probability risk that they will be resolved in a disruptive manner.

Although interest rates have increased, financial conditions remain supportive by historical measures, and liquidity is ample.[1] As a result, the transition to slower growth is expected to be relatively smooth. The expansion in developing countries is projected to moderate gradually, to about 6 percent in 2009, with all regions slowing but continuing to record strong results. At the same time, growth in the high-income countries is expected to ease in 2007 (mainly reflecting slower U.S. growth) before strengthening in 2008 and 2009, as the United States recovers and the economies of Europe and Japan continue to expand at close to their potential rates.

This positive outlook is subject to significant tensions and uncertainties. Overheating (high inflation and large current account deficits) in a number of middle-income countries increases the risk of a hard landing for at least some of them. Should financial markets react to a sudden policy-induced slowdown (or an increase in internal or external imbalances) in one or more of these countries by re-evaluating the riskiness of emerging market assets, there could be a sharp reversal in capital flows. This, in turn, could provoke significant real-side adjustments among those countries with the largest current account deficits.

The risk of a steep recession in the United States appears to have declined, but the effects of weakness in the housing sector are increasingly being felt in other sectors, and a much sharper than projected slowdown cannot be ruled out. Such a slowdown would have consequences for developing countries, through traditional trade channels but also potentially via financial markets. If, for example, difficulties in the U.S. subprime market were to deepen or spread to other sectors, investors might be forced to close positions in emerging markets to meet obligations in the United States, with adverse effects on developing-market valuations.

For the poorest countries, significantly slower growth could cause commodity prices to weaken more rapidly than projected, potentially placing many developing countries that have so far avoided current account problems in difficulty. Private sector funding of resource-based projects would likely dry up, and lower revenues might make it difficult for some countries to repay some of the private sector and short-term lending that has accounted for much of the increase in financial flows to developing countries in recent years.

The diversion of land and produce into the production of biofuels has greatly reduced global stocks of wheat, rice, and maize. Should 2007 be a poor crop year, the prices of these basic foods could rise by as much as 100 percent. This could have serious near-term consequences for the urban poor in those developing countries where these products represent a large share of total consumption. Estimates suggest that a 40 percent increase in the price of one of these grains could reduce real incomes among the poor in some countries by 6 percent or more.

The global outlook

Despite oil prices that topped $75 a barrel during the course of 2006, world GDP rose 4 percent (5.3 percent in PPP terms), up from 3.5 percent in 2005 (table 1.1). This strong global performance reflects the very rapid expansion of

Table 1.1 The global outlook in summary

% change from previous year, except interest rates and oil price

	1960–80	1980–2000	2005	2006e	2007f	2008f	2009f
Global conditions							
World trade volume	—	5.8	7.6	10.2	7.5	8.2	7.9
Consumer prices							
G-7 countries[a,b]	—	3.6	2.5	2.6	1.6	1.7	1.7
United States	—	3.8	3.4	3.2	1.9	1.5	1.9
Commodity prices ($ terms)							
Non-oil commodities	6.0	−1.8	13.4	24.7	6.3	−8.6	−8.4
Oil price ($ per barrel)[c]	7.1	22.2	53.4	64.3	60.4	58.4	55.2
Oil price (percent change)	16.9	−1.3	41.5	20.4	−6.0	−3.4	−5.4
Manufactures unit export value[d]	6.3	1.1	0	1.6	0.8	0.8	0.8
Interest rates							
$, 6-month (percent)	—	7.9	3.6	5.2	5.4	4.8	4.7
€, 6-month (percent)	—	6.9	2.2	3.1	3.8	4.3	4.3
Real GDP growth[e]							
World	4.7	3.0	3.5	4.0	3.3	3.6	3.5
Memo item: World (PPP weights)[f]	4.7	3.0	4.7	5.3	4.7	4.8	4.7
High-income countries	4.5	2.9	2.6	3.1	2.4	2.8	2.8
OECD	4.4	2.8	2.5	2.9	2.3	2.7	2.7
Euro Area	4.3	2.3	1.3	2.7	2.5	2.2	2.0
Japan	7.4	2.6	2.6	2.2	2.3	2.4	2.1
United States	3.5	3.3	3.2	3.3	1.9	3.0	3.1
Non-OECD	4.5	2.9	5.8	5.7	4.9	5.1	5.0
Developing countries	6.2	3.3	6.7	7.3	6.7	6.2	6.1
East Asia and Pacific	5.6	8.0	9.0	9.5	8.7	8.0	7.9
China	4.9	9.9	10.2	10.7	9.6	8.7	8.5
Indonesia	6.0	5.3	5.7	5.5	6.3	6.5	6.4
Thailand	7.5	6.1	4.5	5.3	4.5	4.5	5.0
Europe and Central Asia	—	—	6.0	6.8	6.0	5.7	5.8
Russia	—	—	6.4	6.7	6.3	5.6	5.8
Turkey	3.6	4.4	7.4	6.0	4.5	5.5	5.4
Poland	5.8	1.7	3.5	6.1	6.5	5.7	5.0
Latin America and the Caribbean	5.5	2.2	4.7	5.6	4.8	4.3	3.9
Brazil	7.3	2.1	2.9	3.7	4.2	4.1	3.9
Mexico	6.7	2.6	2.8	4.8	3.5	3.7	3.6
Argentina	3.4	1.5	9.2	8.5	7.5	5.6	3.8
Middle East and North Africa	6.0	3.9	4.3	5.0	4.5	4.6	4.8
Egypt, Arab Rep. of	6.0	4.9	4.6	6.9	5.3	5.4	6.0
Iran, Islamic Rep. of	6.5	2.9	4.4	5.8	5.0	4.7	4.5
Algeria	4.8	2.2	5.3	1.4	2.5	3.5	4.0
South Asia	3.7	5.4	8.7	8.6	7.9	7.5	7.2
India	3.5	5.6	9.2	9.2	8.4	7.8	7.5
Pakistan	5.9	5.1	7.8	6.6	6.4	6.3	6.1
Bangladesh	2.4	4.3	6.0	6.2	6.0	6.1	6.4
Sub-Saharan Africa	4.3	2.1	5.8	5.6	5.8	5.8	5.4
South Africa	4.7	1.7	5.1	5.0	4.4	5.2	4.9
Nigeria	4.6	1.9	6.9	5.6	6.4	6.6	5.9
Kenya	6.2	3.0	5.8	5.9	5.1	5.2	4.9
Memorandum items							
Developing countries							
excluding transition countries	5.2	4.1	6.9	7.4	6.7	6.3	6.1
excluding China and India	6.5	2.2	5.2	5.9	5.3	5.0	4.9

Source: World Bank.
Note: PPP = purchasing power parity; e = estimate; f = forecast; — = not available.
a. Canada, France, Germany, Italy, Japan, the United Kingdom, and the United States.
b. In local currency, aggregated using 2000 GDP weights.
c. Simple average of Dubai, Brent, and West Texas Intermediate.
d. Unit value index of manufactured exports from major economies, expressed in U.S. dollars.
e. GDP in 2000 constant dollars; 2000 prices and market exchange rates.
f. GDP measured at 2000 PPP weights.

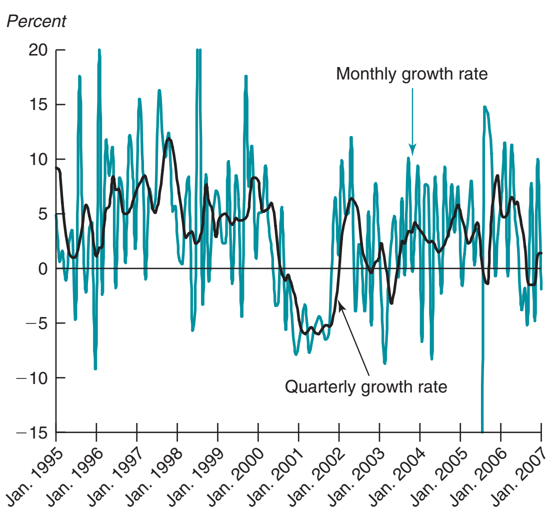
developing economies, which grew 7.3 percent—more than twice the rate in high-income countries (3.1 percent).

Robust growth in China (10.7 percent) and India (9.2 percent) played a significant role in the recent strength of developing countries. Nevertheless, the pickup was broadly based. Even excluding these two countries, developing countries grew 5.9 percent (5.2 percent for small oil exporters), and all regions grew by more than 5 percent.

The outlook for high-income countries

In the *United States,* GDP expanded 3.3 percent in 2006. Output grew very rapidly at the beginning of the year, before higher short-term interest rates, brought on by tighter monetary policy, prompted a sharp correction in the housing market. The ensuing sectoral recession caused economic activity in the housing sector to begin contracting in the second quarter. Residential investment fell 17 percent during the six quarters ending March 2007, contributing to significantly slower GDP growth. Preliminary estimates indicate that the U.S. economy expanded only 1.3 percent in the first quarter of 2007, as weakness in the housing sector weighed upon investment expenditures elsewhere in the economy and falling residential investment slowed orders and industrial production in related sectors (figure 1.1).

Figure 1.1 U.S. industrial production growth



Sources: World Bank; Datastream.
Note: Quarterly and monthly percentages are seasonally-adjusted annualized rates.

These developments were concentrated in the goods sector (including structures, computers, and vehicles), whose contribution to growth fell to zero in both the final quarter of 2006 and the first quarter of 2007 and was reflected in very weak import demand. Consumer demand and production of services have remained robust, partly because the jobs picture remains good and inflation is falling. Export volumes rose 6.6 percent in the six months ending in the first quarter of 2007, rising sharply in the fourth quarter of 2006 before falling in the first quarter of 2007 (seasonally-adjusted annualized rates). In contrast, imports rose just 0.6 percent over this period. Coupled with lower fuel prices, these developments helped reduce the U.S. current account deficit to 5.8 percent of GDP in the fourth quarter of 2006, down from an average of 6.7 percent in the preceding three quarters.

In *Europe* GDP grew 2.8 percent in 2006, driven by strong export growth and a resurgence in domestic demand toward the end of the year.[2] After slowing during the third quarter, GDP accelerated in the fourth quarter, to a 3.1 percent annualized pace, as falling unemployment and strong profitability boosted consumer demand and investment activity. A pickup in private consumption in Germany before a 3 percent hike in the value added tax (VAT) in January 2007 provided an additional fillip to growth, while robust exports to the countries of the former Soviet bloc helped propel economic activity throughout the year.

Data for the first quarter of 2007 indicate that German industrial production was up strongly in the first two months of the year but that retail sales declined 4.5 percent on an annualized basis in response to the increased VAT rate. Nevertheless, consumer confidence improved. Private consumption in France was robust during the first quarter. In contrast to the United States, industrial production in Europe picked up in the final months of 2006 and into 2007. Business sentiment and orders point to continued strong growth in the months to come. Overall, GDP decelerated somewhat, although excluding Germany it picked up in the first quarter of 2007.

In *Japan* GDP increased 2.2 percent in 2006, boosted by investment spending and a modest recovery in consumer demand. As in Europe, growth started the year very strong, weakened toward the third quarter, and strengthened in the fourth quarter. Reflecting falling unemployment and rising wages, consumer demand rose 4.2 percent in the fourth quarter, with private investment also increasing rapidly (these data may be revised). Export growth, which had led the expansion earlier in the year, eased in the fourth quarter, reflecting a stagnant high-tech market and weaker import demand from the United States and the Middle East. Data for the first few months of 2007 suggest that exports have picked up, while indicators for consumer demand and imports suggest that domestic demand has stagnated.

Order books and business sector confidence are strong in both Europe and Japan, suggesting that industrial activity should remain robust for the remainder of the year. In the United States, however, these leading indicators suggest further weakening in investment and industrial activity. Short-term forecasting models based on these data suggest that output in the United States will grow at a less than 2 percent annual pace during the second quarter of 2007. Annualized growth rates could average 2.5 percent in the European Union and 2 percent in Japan during the first half of the year.[3]

Solid growth in Europe and Japan is expected to compensate for slower U.S. growth

In the *United States,* the sharp decline in housing-sector activity, which has already reduced investment in other sectors, is projected to continue to slow economic activity in the second quarter of 2007. However, as activity in the housing sector gradually stabilizes in the second half of the year, growth should pick up, even though knock-on effects in the construction and manufacturing sectors may continue to be felt. Going into 2008, lower stocks, the elimination of the drag on growth from the housing sector, and relatively accommodative interest rates are expected to prompt a recovery in investment, and growth should accelerate to 3 percent in 2008 and 3.1 percent in 2009.

Lower oil prices, slower growth, and higher interest rates in many countries are expected to contain inflationary pressures, obviating the need for further increases in policy interest rates. However, the recent tendency for long-term interest rates to rise in the United States is expected to continue, as expectations for a depreciation of the dollar firm. This should help promote domestic savings, which, along with the weaker condition of the economy in 2007, should be reflected in slower import growth and a further decline in the trade and current account deficits, with the current account deficit reaching about 5.3 percent of GDP in 2009.

Prospects for *Europe* appear increasingly robust. Improved consumer confidence, lower unemployment, high capacity utilization rates, and still-strong order books should translate into solid domestic demand growth, while continued integration of new member states into the European Union should fuel exports. While inflationary pressures are present, lower commodity prices and a gradual tightening of monetary conditions by the European Central Bank should contain them without endangering the expansion. As a result, GDP among European countries is projected to moderate only modestly, to about 2.6 percent (2.5 percent for the Euro Area) in 2007, before easing toward more sustainable growth rates of about 2.2 percent (2 percent for the Euro Area) by 2009.

In *Japan* vigorous growth in developing East Asia, strong business confidence indicators, and reduced drag from corporate consolidation are expected to help maintain growth at 2.3 percent in 2007. Very low interest rates are projected to sustain investment and industrial production as the main drivers of the economy, while tightening labor market conditions should boost consumer demand, permitting the economy to accelerate to a 2.4 percent annual pace in 2008.

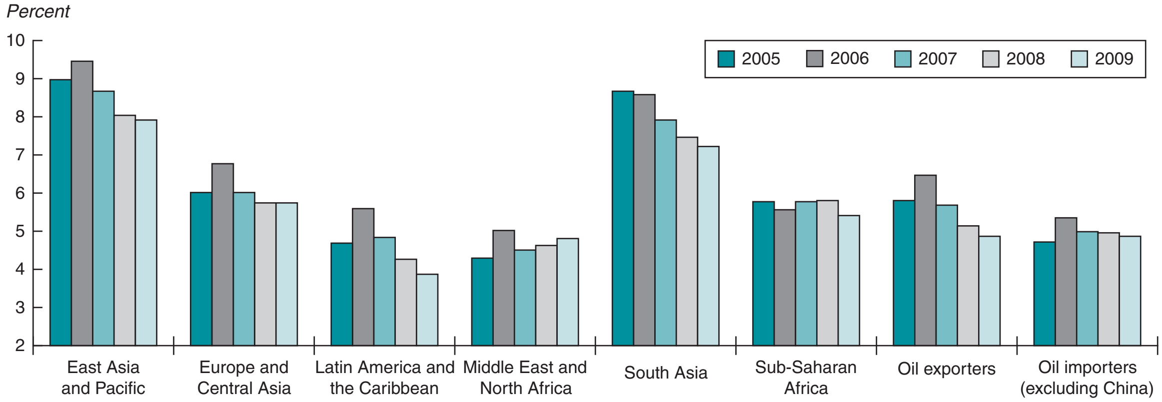
Still-modest consumer demand is expected to bolster Japan's current account surplus in 2007. As private spending increases in 2008 and 2009, however, the current account surplus is projected to ease toward 3.1 percent of GDP by 2009. The recent return to positive inflation is expected to persist, allowing short-term interest rates to gradually rise to about 2 percent by the end of 2008.

The outlook for developing countries

Buoyant external demand (as a result of stronger European and continued robust Japanese growth), low real interest rates, and low bond market interest-rate spreads helped the developing world expand by 7.3 percent in 2006, the fourth consecutive year in which growth exceeded 5 percent.

Growth was particularly strong in China, which grew 10.7 percent, and India, where output rose 9.2 percent. But the strong performance was broadly based, with all developing regions growing more than 5 percent (figure 1.2). Despite

Figure 1.2 Regional growth



Source: World Bank.

the substantial increases in the price of oil during the first half of 2006, growth among the remaining oil-importing developing countries actually strengthened, reaching 5.3 percent for the year as a whole.

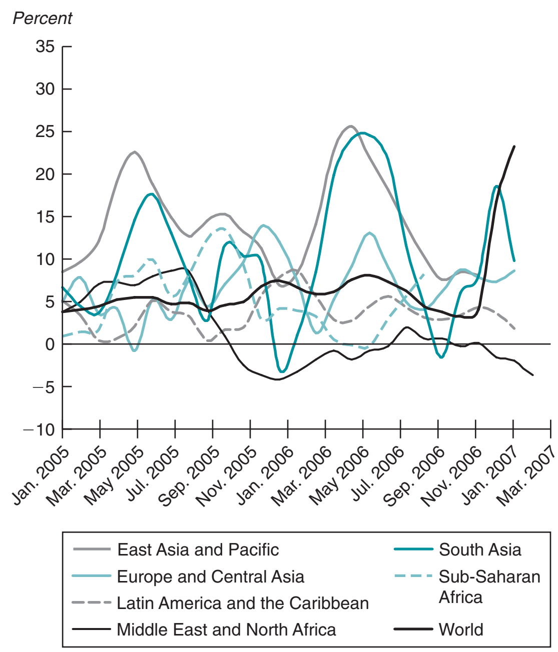
While industrial production and growth in developing countries eased during the third quarter of 2006, activity recovered somewhat in the final quarter and into the early months of 2007 in East Asia and Pacific, South Asia, and Europe and Central Asia (figure 1.3). For the moment, the knock-on effects of the slowdown in U.S. imports have been concentrated in Latin America (the slowdown in the Middle East and North Africa region mainly reflects reduced oil production resulting from OPEC quotas and capacity constraints).

Slower import demand from high-income countries, a weakening of commodity revenues, capacity constraints, and an expected increase in interest rates in response to rising inflation in some countries are expected to ease the pace of growth of developing countries through 2009. As a group, however, low- and middle-income countries should continue to outperform high-income economies by a wide margin. Their strong performance will continue to be a critical driver of global growth.

Administrative restrictions on investment and reduced import demand from the United States are expected to bring Chinese growth down to a more sustainable 8.5 percent by 2009. Higher interest rates and some further fiscal tightening are expected to slow the expansion in India to about 7.5 percent.

Prospects for the remaining oil importers are varied. Many economies, particularly in Eastern

Figure 1.3 Developing-country industrial production growth



Sources: World Bank; Datastream.

Note: Percentages are 3-month/3-month seasonally-adjusted annualized rates.

and Central Europe, have overheated (or are overheating) and have entered a phase of policy tightening. Economic activity in these countries is projected to slow. Notwithstanding weaker import demand from the United States, growth in other developing countries, including Brazil and Mexico, is projected to accelerate or stabilize at high rates, as they continue to benefit from a favorable external climate, including low long-term real interest rates and interest-rate spreads. Overall, growth in developing oil importers, excluding China and India, is projected to slow only gradually, falling from 5.3 percent in 2006 to 4.9 percent in 2009.

For oil exporters (and other large commodity exporters), strong revenue inflows should continue to fuel domestic demand, despite lower prices. These inflows are projected to result in rapid growth of both imports and the noncommodity sectors of these economies.

Meanwhile, capacity constraints (particularly for oil exporters) are projected to limit volume increases in the export sector. As a result, while 2007–09 are expected to be solid years for commodity exporters, the combination of weaker export growth, lower commodity prices, and strong import demand should result in declining current account surpluses and a gradual slowing of growth toward more sustainable long-term rates (4.9 percent for developing-country oil exporters).

Regional outlooks

The regional appendix describes economic developments in low- and middle-income countries in more detail, providing regional forecast summaries and country-specific forecasts (see also http://www.worldbank.org/globaloutlook).

In the *East Asia and Pacific* region, growth, led by China, was once again very strong. While efforts to contain investment and credit growth in some sectors moderated the pace of the expansion toward midyear, it has since picked up. Growth in other countries in the region strengthened, in part because of a relaxation of monetary policy in several countries following the successful dampening of emerging inflationary pressures.

Countries in the region have continued to benefit from strong inflows of foreign direct investment (FDI), with the bulk of FDI going to China. Nevertheless, FDI inflows were down for the year, having been partially replaced by larger equity and portfolio inflows, with the region attracting more than half of all portfolio flows to developing countries. Net capital inflows to East Asia totaled $167 billion in 2006, almost unchanged from 2005.

Partly as a reaction to these strong inflows over the past four to five years, policy makers in the region have adopted increasingly flexible exchange rate regimes. The Chinese authorities have allowed the renminbi to appreciate steadily against the U.S. dollar and appear to have increased the underlying rate of appreciation of the currency from 3 percent to 6 percent during the course of 2006.

Regional growth is projected to slow through 2009, reflecting a tighter policy environment in China and weaker U.S. import demand, especially in 2007. While currencies are expected to appreciate modestly over the forecast period, recent large current account surpluses are expected to decline only marginally.

Economic activity in *Europe and Central Asia* continues to reflect very strong capital inflows into countries that have acceded or expect to accede to the European Union and the direct and indirect effects of very strong spending by regional oil exporters. This very buoyant environment exacerbated internal and external imbalances in a number of countries, with inflation exceeding 5 percent and current account deficits reaching more than 5 percent of GDP in many countries.

Net capital inflows to the region surged in 2006, reaching a record $241 billion, dominated by private flows (both FDI and equity), as countries continued to prepay Soviet-era debts. Corporations headquartered in the region contracted $135 billion in foreign debt in 2006, with most of the funds going into the finance and oil and gas sectors. Significant bank borrowing in several countries has financed a surge in credit growth, accompanied by mounting inflationary pressures and concerns about exchange rate risk. While reserve ratios in most countries have stabilized, in Russia they increased by $120 billion.

Lower oil prices, a diminishing stimulus to growth from EU accession, and a tightening of macroeconomic policy should result in slower but still-robust growth in 2009 of about 6.8 percent for regional oil exporters and 5.2 percent for oil importers.

The expansion in the *Latin America and the Caribbean* region entered its fourth year in 2006, with most economies growing at 4 percent or more. A relaxation of monetary policy in Brazil and Mexico saw output in the region's two largest economies pick up, even as growth in Argentina and República Bolivariana de Venezuela eased toward more sustainable rates.

Net capital inflows to the region increased slightly in 2006, although they fell from 2.8 percent to 2.5 percent of GDP. The decline reflected an absolute decrease in private inflows and an offsetting reduction in the extent to which countries in the region paid off official debt. Net FDI inflows also declined as a percentage of GDP. Large debt buybacks have reduced the average cost of capital of many countries and significantly improved their debt-servicing profiles. Despite improved external debt statistics, uncertainty over the ownership of locally issued bonds makes the extent to which dependence on foreign capital has declined unclear.

Weak import demand in the United States is expected to moderate regional export growth in 2007, but high prices for metals and minerals should sustain the expansion at close to potential rates through 2009. However, a number of countries in the region have recently introduced policy measures that could undermine longer-term growth prospects.

The developing economies of the *Middle East and North Africa* also enjoyed strong growth, despite the conflict in Lebanon, which saw GDP in that country decline by 5.5 percent. While OPEC cut oil output during the course of the year, slowing GDP growth among oil exporters, a 20 percent hike in oil prices fueled domestic demand and imports. This boosted exports of goods and services among the diversified countries of the region, which, along with a rebound in agricultural production following a severe drought in 2005, propelled their GDP growth to 5.6 percent—a 10-year record. Several years of very rapid growth and the removal of some price subsidies have contributed to an uptick in inflation in several countries and a decline in the current account and government balances of oil exporters (which nevertheless remain in surplus).

Booming oil revenues have fueled strong financial flows within the region. FDI flows, which reached 3 percent of regional GDP in 2006, have been associated with a revival in privatization activity and cross-border mergers and acquisitions, particularly in the banking sector. Equity prices in Iraq and the Islamic Republic of Iran remain depressed following global turbulence in May and June 2006, but they have recovered in other markets in the region. Official development assistance to the region has surged, but more than 40 percent of the total went to Iraq.

Increased output by non–OPEC oil producers is expected to keep OPEC quotas tight (see below), which should restrain GDP growth among oil exporters through 2009. However, even if prices and production decline, oil revenues will remain high, fueling domestic demand and contributing to an expected decline in the current account and government surpluses of oil exporters. Spillovers from this strong demand, in the form of investment and remittance inflows, coupled with robust European demand for goods and tourist services should help sustain strong growth among the region's diversified economies.

South Asia also recorded vigorous GDP growth in 2006, propelled by strong exports and burgeoning domestic demand, caused in part by low real interest rates and strong capital and remittance inflows. Central banks in the region reacted to strong growth and rising inflation by increasing nominal interest rates. However, real rates remain negative or close to zero in several countries.

Net capital inflows to the region reached \$40.1 billion (3.6 percent of GDP) in 2006, with most of the funds going to India. Net private debt flows were responsible for more than 100 percent of the \$11.8 billion dollar increase, as prepayment of public sector debt reduced the overall total. FDI was up (particularly in the Indian service sector, in response to new legislation), as were FDI outflows from India, which reflected an increase in cross-border merger and acquisition purchases by Indian companies, mainly in advanced economies. Portfolio inflows fell by more than the increase in net FDI, causing net equity flows to decline, although they still represent almost 60 percent of net private inflows to the region. Despite a sharp increase in the dollar value of reserves, import cover declined as a result of exchange rate movements and robust increases in import volumes.

While falling oil prices should contribute to a stabilization of the region's current account balance and a reduction in government deficits, they are expected to offer only limited inflation relief, because much of the initial hike in oil prices has yet to be passed through to consumers. Weaker U.S. import demand, the removal of temporary restrictions on Chinese exports of selected clothing and textiles, and rising interest rates are projected to reduce GDP growth in the region from 8.6 percent in 2006 to about 7.2 percent in 2009.

Sub-Saharan Africa also benefited from strong global growth. High oil prices have fueled an investment boom among regional oil exporters, supporting a 6.9 percent increase in their GDP. Increased aid flows over the past several years, strong commodity prices, a period of relative peace, improved macroeconomic policies, and the cumulative effects of several years of microeconomic policy reform have combined to yield three years of growth of 5 percent or more among oil importers. This robust performance has been broadly based, with more than half the countries in the region growing by 5 percent or more and only six growing by less than 2 percent.

Net capital inflows to Sub-Saharan Africa reached $39.8 billion, or 5.6 percent of GDP, in 2006. Reflecting high commodity prices and improved fundamentals, net private capital inflows exceeded bilateral aid grants for the first time since 1999. Aid, at $13.2 billion (excluding debt relief) in 2005, remains important, representing more than 5 percent of GDP for 80 percent of countries in the region and exceeding 10 percent in several.

The increase in private flows reflects increased FDI (principally into extractive sectors), portfolio investment, and bank lending (particularly from other developing-country banks). Despite improved fundamentals, only two countries (the Seychelles and South Africa) have accessed the international bond market in the past two decades, although several are expected to issue bonds in 2007 and there has been growing investor interest in local currency bond markets.

Several countries in the region show signs of overheating. While the higher investment rates of the past few years are expected to boost supply, infrastructural weaknesses and capacity constraints in the energy sector are endemic. As a result, while growth is expected to remain robust and per capita incomes should continue to rise, growth is projected to ease to about 5.4 percent by 2009.

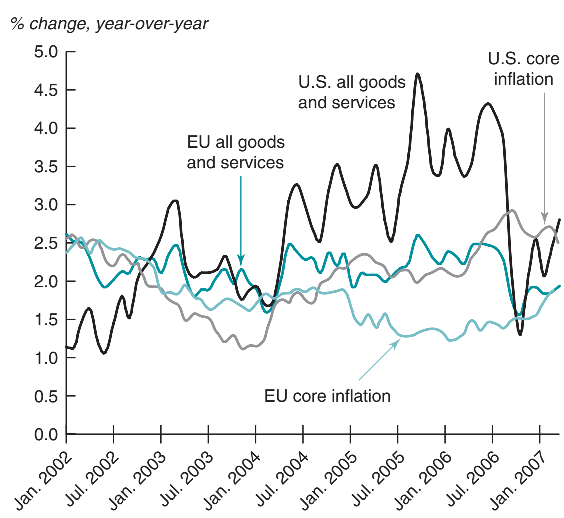
Inflation, interest rates, and global imbalances

The uninterrupted growth of the past several years has been reflected in growing capacity constraints, rising prices in commodity markets (see below), and significant internal and external imbalances in a number of countries. At the same time, a main contributor to the longevity of the current expansion has been the muted response of inflation to high oil prices—particularly in high-income countries—which has allowed monetary policy to remain relatively relaxed and interest rates low.

However, headline inflation is above the comfort levels of central banks in high-income countries, and notwithstanding some easing as a result of the recent decline in oil prices, core inflation remains high in the United States and is rising in Europe (figure 1.4). As a consequence, monetary authorities remain vigilant, and additional hikes of policy rates are expected in both Europe and Japan.

Inflation in low- and middle-income countries has also been generally muted, although recent trends raise some concerns. While inflation in developing countries picked up in response to the initial hike in oil prices in 2003, it began declining soon afterward, in response to monetary policy tightening and limited pass-through. More recently, there are signs that price pressures are

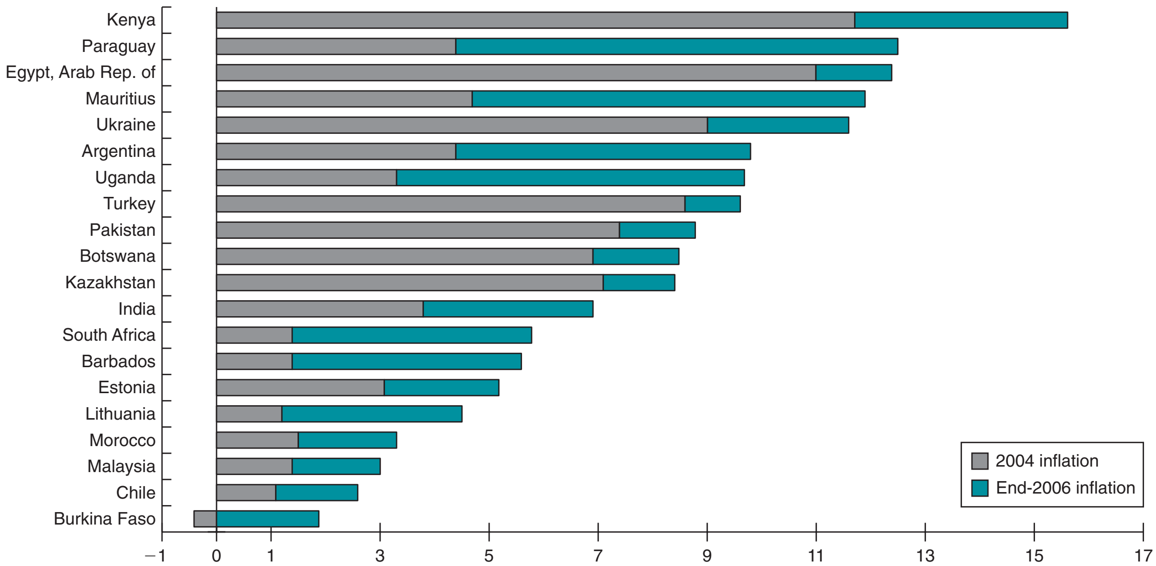
Figure 1.4 Inflation in high-income countries



Sources: World Bank; Datastream.

Figure 1.5 Inflation in selected countries

% change in consumer price index, year-over-year



Source: World Bank.

building in several regions and in a number of countries that have been growing very rapidly (figure 1.5). These increases likely reflect the direct impact of higher oil prices during the first half of 2006, but they may not yet show the full impact of the decline in the second half. Indeed, though year-over-year inflation is up compared with last year, rates are declining in several countries that have experienced an uptick. Higher inflation does appear to reflect overheating in several middle-income countries, including Argentina, India, South Africa, and República Bolivariana de Venezuela, as well as several smaller countries in Europe and Central Asia, the Middle East and North Africa, and South Asia.

At the regional level, inflation has increased in each of the past three years in the Middle East and North Africa and in each of the past six years in South Asia. Developments in Sub-Saharan Africa are also worrisome, though the large weight of food prices in the consumer price basket in that region makes it difficult to determine whether recent increases represent a trend. In Europe and Central Asia, some countries have combated rising inflation with tighter monetary policies, while in others policy has either been neutralized by capital inflows or too timid in response to increased price pressures. The trend toward higher inflation over the past few years is of concern, because it may result in a significant increase in inflation expectations, which can—given the blunt instruments available to monetary authorities—be difficult to lower without a sharp deceleration in economic growth.

Financial conditions for developing countries remain favorable

The pickup in inflation over the past several years, coupled with very rapid growth, has contributed to rising short-term interest rates and the gradual removal of monetary policy stimulus in many countries, most notably in high-income countries, where short-term real interest rates have increased some 200 basis points since mid-2005.[4] Many developing countries have also acted to restrain credit and contain inflation. Policy rates have risen sharply and appear to be slowing inflation in Bulgaria, Indonesia, Thailand, and Turkey. In other countries (Argentina, India, Pakistan, South Africa, and República Bolivariana de Venezuela), the tightening cycle is less advanced. As a result, real interest rates remain low and inflation high.

Despite increases in inflation, real short-term interest rates in most regions are low by historical standards and have been relatively stable or even falling (notably in South Asia) in recent months (figure 1.6). Long-term interest rates are also low. Yields on U.S. government bonds remain about 4.5 percent, and spreads on emerging-market debt are near record lows (figure 1.7).

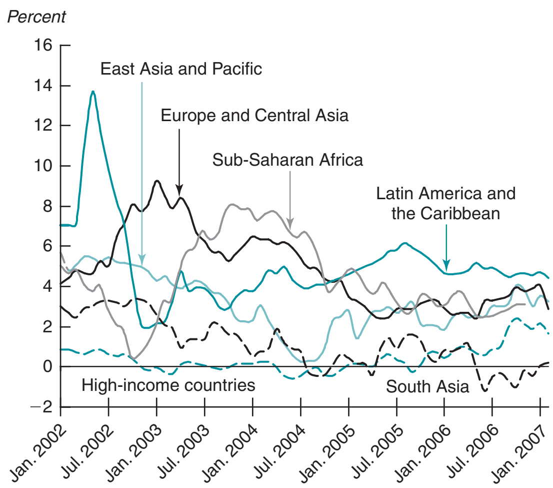
The extended period of low interest rates and low spreads on emerging-market and subprime corporate bonds has led many observers to worry that global liquidity levels are too high—or interest rates too low. Several factors help explain why interest rates are lower than in the past (see World Bank 2005, pp. 11–13). One is the relative stability of inflation, especially in the face of higher oil prices, caused partly by more credible monetary policy and partly by the entrance of China and the former Soviet Union into the world trading system. The extended period of very accommodative monetary policy in high-income countries and the recycling of oil revenues have also had a dampening effect on interest rates. While there is no universally accepted measure of liquidity, measures produced by the OECD (2006) based on global money supply or bank lending suggest that liquidity may be as much as 15 percent higher than normal given the current level of economic activity.

Many observers worry that, should the expectations of investors change rapidly or their evaluations of underlying risk change, interest rates could increase rapidly and capital inflows, which have been strong, could reverse (see chapter 2). Indeed, the sensitivity of financial markets to changes in perceptions was illustrated in May and June 2006, when markets became uncertain of the future conduct of U.S. monetary policy, and more recently in February and March 2007, following the recognition of problems in the U.S. subprime mortgage market and concerns of currency undervaluation in some Asian markets.

While developing-country bond markets were shaken and volatility in both bond and equity markets increased (particularly among the most vulnerable countries and those with large current account deficits, such as Turkey), emerging markets suffered relatively minor ill effects from these episodes. Indeed, the 21–basis point increase in emerging-market spreads in February and March 2007 compares favorably with the 39–basis point increase in the yield on high-income country subprime corporate debt (emerging-market spreads remain 100 basis points higher than those of subprime corporates) (figure 1.8). Moreover, while emerging-market spreads have fallen below their previous levels, subprime spreads remain elevated.

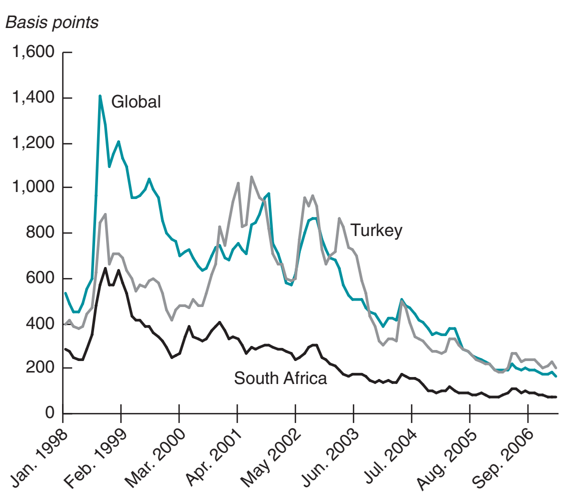
If the increase in spreads reflected investors' revaluation of risk, the smaller upward adjustment for emerging-market debt (and its subsequent decline) supports the view that improved fundamentals explain at least part of the decline in

Figure 1.6 Real policy interest rates, by region



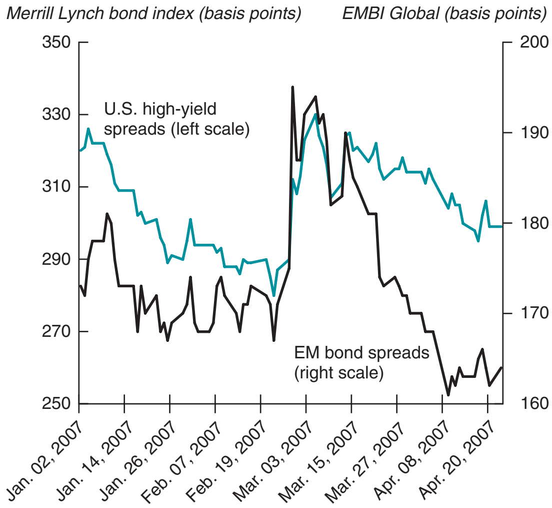
Sources: World Bank; Datastream.
Note: Percentages are GDP-weighted averages, deflated by CPI inflation.

Figure 1.7 Spreads on emerging-market bonds compared with 10-year U.S. Treasuries



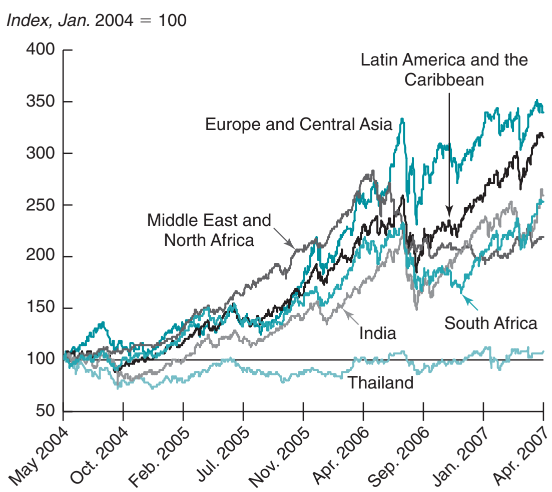
Sources: Datastream; JPMorgan Chase; World Bank.

Figure 1.8 Spreads on emerging-market debt and subprime corporate bonds in 2007



Sources: World Bank; JPMorgan Chase.

Figure 1.9 Emerging-market stock market valuations



Sources: Datastream; Standard & Poors; World Bank.

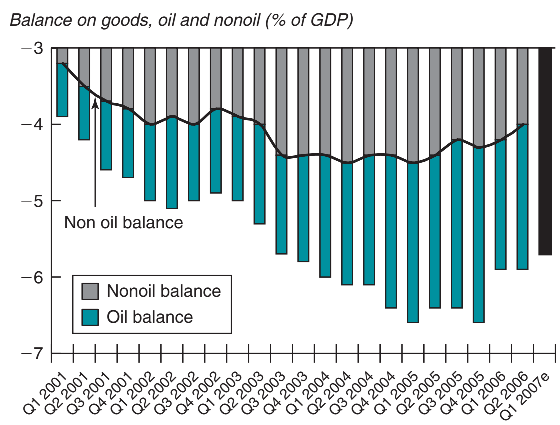
emerging-market spreads over the past several years. Despite the increase in volatility in emerging stock markets, valuations remain very high, up 100–400 percent since 2003 (figure 1.9). Emerging-market spreads are at very low levels, and financial conditions for developing countries remain very favorable, factors reflected in the strong capital inflows (see chapter 2) that have been fueling these countries' growth.

Global imbalances begin to narrow

The imbalances in global spending patterns that have characterized the world economy over the past five years showed signs of stabilizing in 2006. Following several years of steady increases, the U.S. current account deficit declined in the fourth quarter of 2006, coming in at 5.8 percent of GDP, down considerably from the 7 percent level recorded in the same quarter of 2005, when oil prices were lower.[5] Preliminary data for the first three months of 2007 suggest that the current account deficit has fallen even farther, to about 5.7 percent of GDP. Indeed, the nonoil trade deficit, which had been broadly stable, at about 4.4 percent of GDP since 2004, has been declining since early 2006 and stood at 4 percent of GDP in the first quarter of 2007 (figure 1.10).

While the cyclical slowdown in U.S. growth was a factor in the improvement in the nonoil balance, structural adjustments are also at work. The pattern in the nonoil balance mirrors the stabilization of the savings rate in the United States that began in 2004 and its subsequent rise beginning in 2006.[6] Overall, the savings rate has increased by 1 percent of GDP. This is likely a permanent increase in savings, reflecting a return to more normal levels following the artificial decline in savings caused by higher consumer spending from increased wealth during the housing boom. The increase in savings also reflected the decline in the government deficit, from 3.7 percent of GDP in 2005 to 2.4 percent of GDP in 2006.

Figure 1.10 U.S. trade balance is improving



Sources: U.S. Department of Commerce; World Bank.
Note: e = estimate.

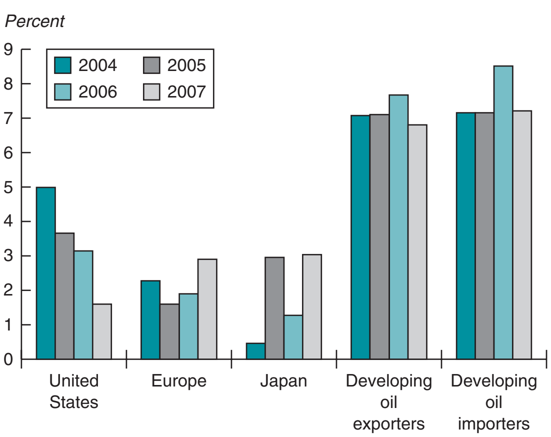
Residential investment spending declined sharply, from a peak of 6.3 percent of nominal GDP in the fourth quarter of 2005 to 5 percent of GDP in the first quarter of 2007. Assuming a return to the long-term average of 4.6 percent of GDP, investment is likely to fall farther, resulting in a concomitant reduction in the current account balance.

The decline in oil prices during the second half of 2006 also helped reduce the U.S. current account deficit. This decline was probably also structural in nature, because the lower oil prices reflect a natural response to earlier price hikes that slowed demand growth and induced additional supply (see the discussion of the commodity market below). Over the medium term, energy prices are expected to fall farther, which should provide additional relief to global imbalances by reducing both the U.S. trade deficit and the surpluses of oil-exporting countries.[7]

While higher savings in the United States remains a critical component of any long-term solution to global imbalances, demand elsewhere will have to pick up the slack. In this regard, the recovery of demand in Europe and Japan, their return toward potential output, and strong growth in the developing world should help sustain world output and reduce global imbalances (figure 1.11). This shift in growth is expected to continue into the forecast period, although it will be more moderate in 2008 and 2009, as growth in the U.S. recovers.

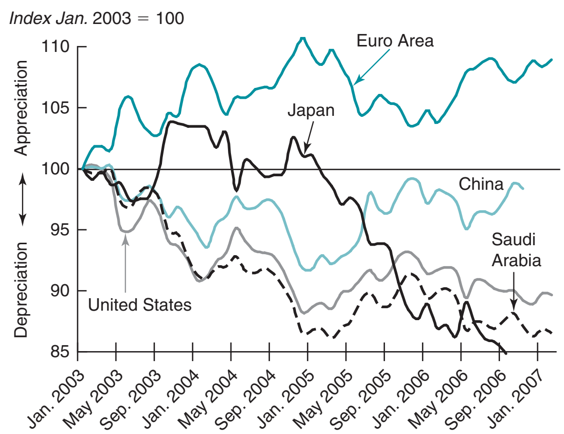
The rapid increase in import demand by oil exporters should also help reduce global imbalances. In dollar terms, the export revenues of oil exporters

Figure 1.11 Growth in domestic demand, by region



Source: World Bank.

Figure 1.12 Movements in exchange rates



Source: World Bank.
Note: All figures in graph are real effective exchange rates.

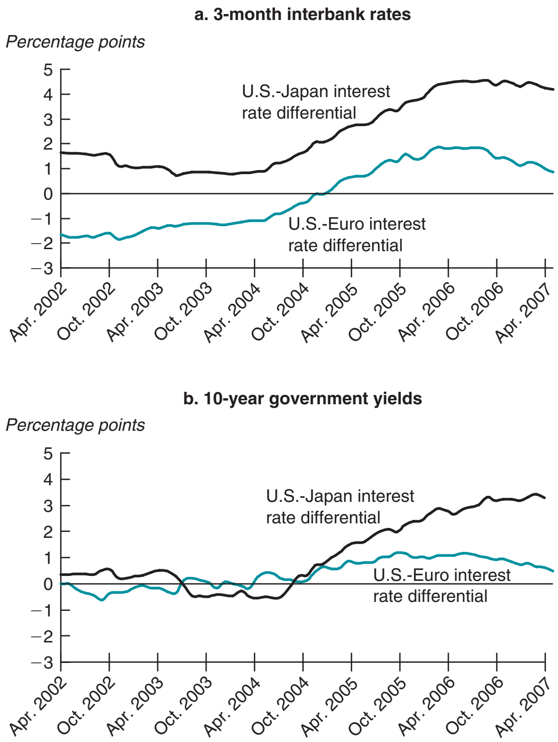
are up $1.8 trillion since 2003, and their imports are up $1.5 trillion. As oil prices decline and domestic demand catches up with the increase in revenues, these trade surpluses are projected to decline.

Exchange rate movements are playing a limited role in the overall adjustment process. Since 2003 the U.S. dollar has depreciated by 10 percent in real effective terms, and the euro has appreciated by 9 percent (figure 1.12). Along with increased savings, these shifts have likely played a role in the relative strength of exports and weakness of imports in the United States over the past year. By increasing the competitiveness of U.S. exports, such shifts, which are projected to continue, should facilitate a reduction of global imbalances as long as domestic savings continue to adjust (Obstfeld and Rogoff 2004).

Exchange rates in China, Japan, and oil-exporting nations have not appreciated in real-effective terms, and, as a result, their movements have not served to support a smooth adjustment in the same way. Notwithstanding an acceleration in the steady rate at which the renminbi appreciated against the dollar to a 6 percent annual rate, the Chinese currency has remained broadly stable in real effective terms since 2003,[8] while the currencies of many oil exporters that maintain a fixed exchange rate with respect to the dollar have actually depreciated in real effective terms.

Partly as a result, China's current account surplus continues to grow, reaching $230 billion in 2006 (9.3 percent of GDP). A reinforcement of measures being introduced to stimulate domestic

Figure 1.13 Difference between U.S. and Japanese/European interest rates



Sources: World Bank; Datastream.

demand, supported by a more flexible exchange rate regime, may be necessary before China's surplus begins to decline. In addition to contributing to a reduction in global imbalances, such steps would also distribute some of the economic fruits of its very strong growth more broadly within China.

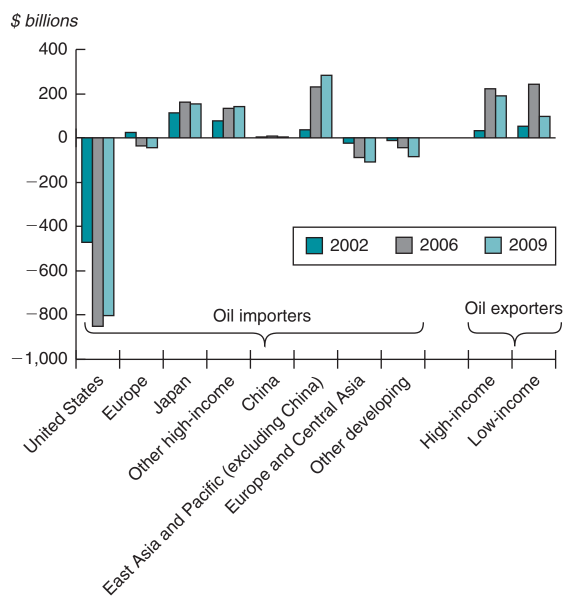
Low interest rates in Japan (and to a lesser extent in Europe) and the carry trade that they have induced partially explain the relative strength of the dollar. As of early May 2007, the interest-rate differential in favor of the dollar was some 400 basis points at the short end of the market and 300 basis points at the longer end (figure 1.13). With U.S. monetary policy near or at the end of its tightening cycle, these differences are expected to narrow. In the baseline forecast, this narrowing and slower growth in the United States are projected to cause the dollar to depreciate by about 5 percent a year against the euro through 2009, which should further facilitate the unwinding of global imbalances. Should downward pressures be more severe, however, the depreciation could be larger or the rise in U.S. interest rates greater.

Taken together, these factors suggest that a continued narrowing of global imbalances is to be expected. Nevertheless, imbalances remain large, and there are several countervailing pressures.

First, the size of the imbalance—in both China and the United States—is very large. The value of U.S. imports is 50 percent larger than the value of U.S. exports, implying that even if exports and imports were to grow at the same rate, the trade deficit would continue to widen. Therefore, for progress to be made, exports will have to increase at a substantially faster rate than imports.

Second, with each year of additional current account deficit, the stock of U.S. financial liabilities increases, as do the interest payments due on them. Thus, the longer imbalances remain at current levels, the more difficult it will be to overcome them, even if the trade balance improves. Here, two factors work in favor of reducing global imbalances. The first is the large gap between the rates the United States pays on its external debt and the returns it earns on investments abroad. The second is the fact that currency depreciation tends to increase the value of U.S. assets abroad relative to foreign-owned U.S. assets. Over the medium term, both factors are expected to continue to hold sway, improving global imbalances modestly (figure 1.14).

Figure 1.14 Current account balances



Source: World Bank.

However, as discussed in past editions of *Global Development Finance* and *Global Economic Prospects,* the possibility of a disruptive adjustment to these still-large global imbalances is real. Were global investors to revise their expectations about the future value of the U.S. currency, they could demand a significantly higher return on dollar-denominated assets. Such an increase would serve to slow U.S. growth, with serious knock-on effects on commodity prices and growth in developing economies (see the analysis surrounding table 1.6 in World Bank 2005).

Partly reflecting the stabilization of global imbalances, the rapid accumulation of reserves by developing countries during the first few years of this decade has changed character. Although developing-country reserves increased by some $630 billion in 2006 (see chapter 2), the vast majority of countries increased reserves only in line with rising imports, keeping the number of months of imports that their reserves could finance broadly stable (figure 1.15). Oil-importing countries saw their import cover ratios remain stable or decline and the import cover ratios of most countries remain well above the normally accepted benchmark of three months. Reserves among oil exporters have not risen as might have been expected because most of them have put the bulk of their surplus revenues into investment trusts, which do not count as reserves.

In contrast, China and Russia accumulated a total of $366 billion in additional reserves in 2006, 40 percent more than the total for all other developing countries, including other oil exporters. The level of reserves they currently hold—14 months of imports in China and almost 17 months of imports in Russia—exceeds normal prudential levels by a wide margin.

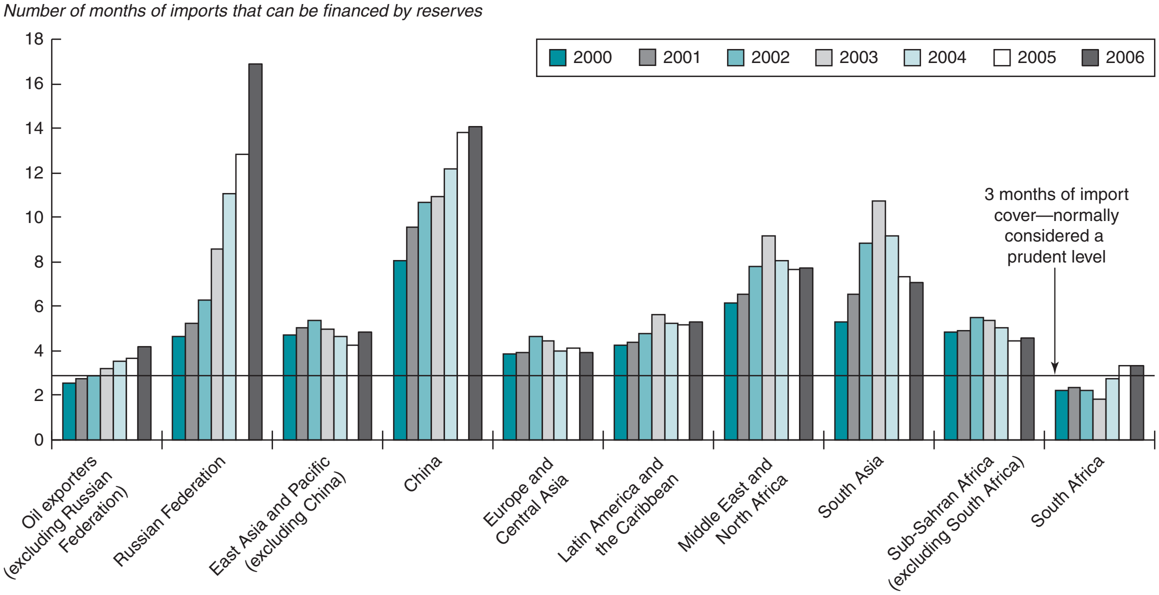
World trade

Much like industrial production, the growth in the volume of global merchandise trade slowed in the third quarter of 2006, before picking up toward the end of the year to reach year-over-year growth of 11 percent. Most of the deceleration occurred in China, Japan, and Europe. U.S. exports were relatively strong, increasing 10.5 percent for the year as a whole, while U.S. imports rose just 5.8 percent.

Weaker consumption and investment growth in the United States, combined with rising incomes among oil exporters and other developing countries boosted U.S. export volumes, which expanded at double-digit rates in the last two quarters of 2006.[9] Similar strength was observed in Europe.

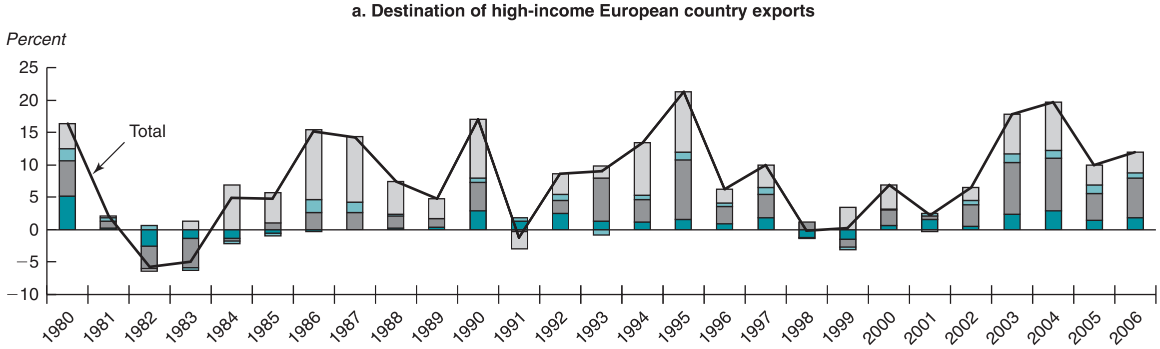
Figure 1.15 Foreign exchange reserves

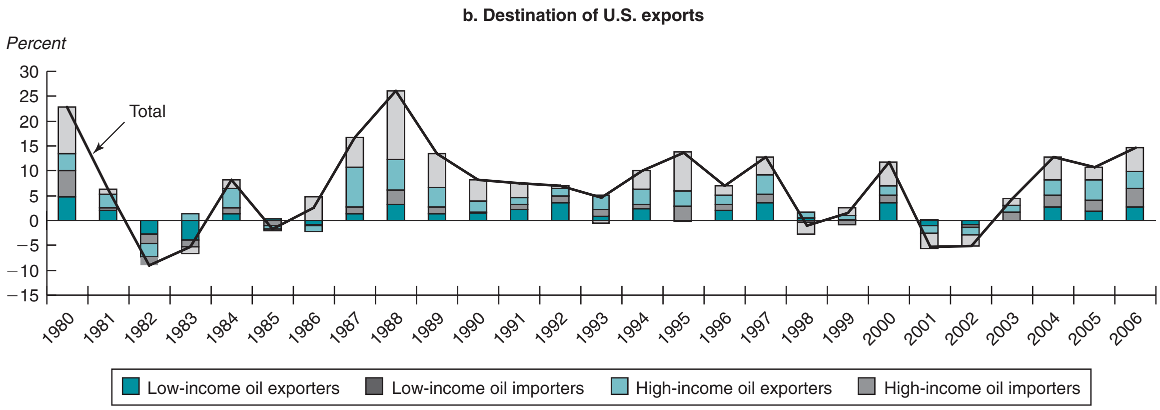
Number of months of imports that can be financed by reserves



Source: World Bank.

Figure 1.16 Sources of export growth for high-income countries





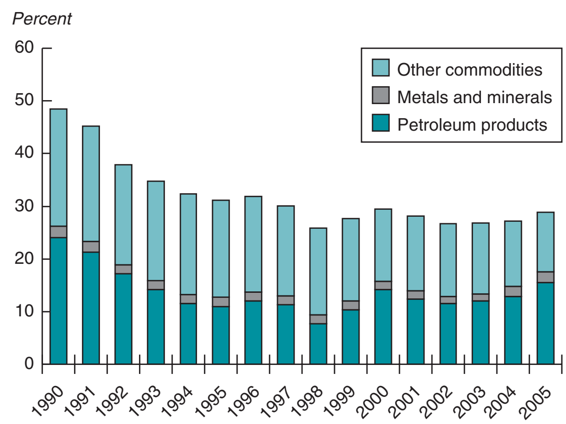
Sources: World Bank; IMF.
Note: Figures show contribution to dollar value of export growth, by aggregate.

Much of the demand for these exports originated in developing countries. Over the past three years, the average contribution of demand from oil exporters and low-income oil importers to U.S. export growth was 8.7 percentage points (5.2 percentage points for low-income countries alone). This is more than double the increment to demand from high-income countries (4 percentage points) and compares favorably with the 1990s, when these countries' contribution to U.S. exports rarely exceeded 5 percent (figure 1.16).

Oil exporters and low-income oil importers are boosting exports in Europe by even more, reflecting the expansion of trade between Europe and countries of the former Soviet bloc.

Notwithstanding the rapid rise in commodity prices over the past several years, manufacturing remains the main source of export revenue for developing countries, even when China is excluded from the data (figure 1.17). If oil exporters are excluded, the result is even stronger, with the overall weight of nonoil commodities falling from 24 percent to 12 percent of developing-country (excluding China) exports between 1990 and 2005.

Figure 1.17 Sources of export revenues for developing countries



Sources: World Bank; Comtrade.
Note: Figure shows share of commodities in total merchandise export values of developing countries (excluding China).

On the trade policy front, the Doha Round negotiations resumed at the beginning of 2007, following a six-month suspension, partly because of concerns that the United States' fast-track authority would expire and not be renewed. Progress toward sketching an outline of an accord remains limited, however, and a serious risk exists that negotiations will last several years, undermining confidence in the multilateral system. The proliferation of bilateral and regional trade agreements of the kind currently being signed is not a substitute for a multilateral accord, especially because many of the smaller and poorer developing countries are among the least likely to take effective part in them.

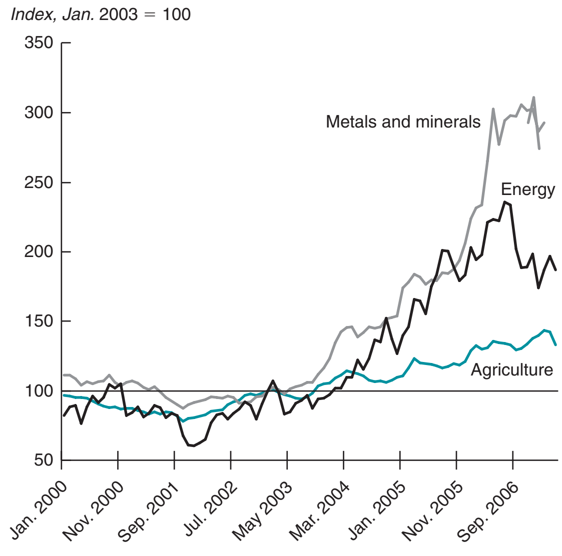
For developing countries with a strong specialization in the textiles and clothing sector, the removal of partial restrictions on Chinese exports of these goods to the European Union and the United States in 2008 is expected to dampen export volumes and prices in 2008 and 2009. However, many of these countries have succeeded surprisingly well in the face of the earlier liberalization of the sector in 2006. To the extent that they continue to achieve the kind of efficiency improvement that has underpinned this strong performance, they can be expected to survive this additional pressure relatively well—and indeed, may be well placed to exploit further scale efficiencies.

Commodity markets

Strong global growth, especially the rapid expansion of output in developing countries, is largely responsible for the rise in commodity prices over the past several years. Weaker industrial production and output growth toward the end of 2006 and into 2007 contributed to a leveling off and decline in some metals prices, as well as the more widely followed decline in oil prices. Agricultural commodity prices remain robust, in part because high oil prices have pushed up fertilizer and other production costs and increased interest in biofuels has boosted demand for many agricultural products.

While increases in oil prices received the bulk of media attention, the price of metals and minerals rose much more rapidly in 2006 (figure 1.18). Continued strong growth in global output, low stocks, numerous supply disruptions, and speculative demand pushed the prices of metals and minerals up 47 percent. Agricultural prices also posted gains in dollar terms, rising 13 percent in 2006, but they were broadly stable (up 1.3 percent) expressed in euros.

Figure 1.18 Commodity prices

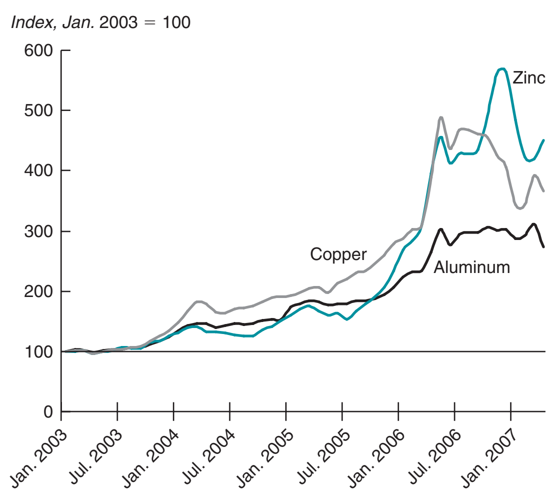


Source: World Bank.

Metals and minerals prices level off

The prices of copper and zinc, two of the metals whose prices rose most markedly in recent years, fell sharply in late 2006 and early 2007, as demand weakened and stocks increased (figure 1.19). Both

Figure 1.19 Prices of selected metals



Source: World Bank.

substitution away from these products, as a result of the sharp rise in their prices during 2006, and cyclical factors, notably the decline in demand for copper from the U.S. housing sector and reduced demand for steel from the auto sector, played a role.

Destocking in China, which accounts for 22 percent of world demand for copper, and the resulting decline in import demand also caused prices to fall. A boost in Chinese exports explains much of the 26 percent drop in the price of zinc in the early months of 2007. After strong demand and weak supply pushed the global price of zinc up 137 percent in 2006 (26 percent in the fourth quarter), China (the world's largest miner) stepped into the market, increasing apparent supply and nearly eliminating the price gains of the previous three quarters. The rising role of China may also be seen in the behavior of aluminum prices, which, unlike those of zinc and copper, rose by much less, despite rapid growth in demand, principally because China has been steadily expanding its exports.

The prices of many other metals continued to rise, as a result of low stocks, strong demand, rising costs, and supply shortfalls. Nickel prices, in particular, have soared, reflecting very strong demand for stainless steel, supply disruptions, and delays in the start-up of new projects. Stocks of other products, such as aluminum and copper, have increased, suggesting an easing of their prices going forward.

Coupled with slower global growth, notably in the U.S. housing and auto sectors, metals prices are projected to peak during 2007 (copper in 2006). They are likely to decline in 2008 and 2009, as additional supply comes on stream and capacity constraints ease, with the global supply of copper rising 7 percent, to about 1 million tons, and the supply of zinc rising 9 percent, to about 0.8 million tons (7 and 9 percent), with a 10 percent increase expected in African output. In contrast, nickel prices are not projected to ease, because no significant new supply is expected in the immediate term.

Some uncertainty remains as to the speed at which metals prices will decline, both because global growth is projected to remain relatively rapid and because supply problems that have challenged the industry over the past few years may persist.

Agricultural prices continue to rise

Agricultural prices rose 12 percent in 2006, reflecting a weaker dollar, higher energy and fertilizer prices, crop-specific supply shortfalls, droughts, low carryover stocks, and strong increases in demand, especially for biofuels. While real agricultural prices have increased substantially since their cyclical lows in 2001, the increase has done little to reverse the longer-term downward trend that has seen real agricultural prices fall 56 percent over the last 46 years (figure 1.20).[10]

High energy prices contributed directly to a surge in the price of some agricultural commodities that are either used as energy crops (biofuels) or compete with synthetic products made from petroleum. The price of sugar, which is being diverted to ethanol production for automotive fuel in Brazil, rose 50 percent, while that of natural rubber (a substitute for synthetics produced from petroleum products) was up 40 percent. The price of maize, which is used as the feedstock for ethanol production in the United States, rose 23 percent in 2006.

High energy prices also increased the price of fertilizer, raising farmers' cost of production and reducing yields as farmers use less of it. The offsetting increase in world prices likely benefits developing-country producers disproportionately, because they use less fertilizer and machinery per hectare. As a result, their overall production costs are likely to have increased by less than those of producers in high-income countries. However,

Figure 1.20 Agricultural prices

Sources: World Bank; Datastream.
Note: Figure shows real prices deflated by U.S. CPI.

higher food prices work to the detriment of the poorest households, for whom basic foodstuffs account for a significant share of total spending (see section on risk).

Lower petroleum (and fertilizer) prices should help increase agricultural yields and contribute to the weakening of agricultural prices over the next several years. Dollar prices of agricultural goods are expected to rise by about 5 percent in 2007 and to decline 1.5 percent in 2008. Commodities such as natural rubber and sugar, which saw the largest price increases during 2006, are expected to suffer the largest declines, with the price of natural rubber falling 5 percent and the price of sugar tumbling 20 percent. If it were not for continued increases in the demand for the agricultural raw materials used in the production of biofuels, the expected decline in agricultural prices would likely be more pronounced.

Although lower fuel prices should reduce the economic viability of these alternatives, government subsidies and other policy measures are expected to keep expanding, sustaining pressure on such inputs as maize and sugar cane. Twenty percent of the U.S. maize crop is already being used to produce ethanol, and the figure is expected to rise to 30 percent over the projection period. Fifty percent of Brazilian sugar cane is being diverted to ethanol production, and demand for soybean and rapeseed oils, which are used to produce biodiesel fuel, is rising.

As more land is shifted into production of biofuel inputs, price pressures on other agricultural commodities will build. Partly as a result of this process, stocks of many grains are extremely low, which could result in a sharp increase in their prices should demand rise more than expected or weather or other supply disruptions cause a poor crop year (see section on risk). Increased use of maize for ethanol production in the United States has already led to higher maize prices, which have been reflected in higher meat prices in the United States and higher tortilla prices in Mexico.

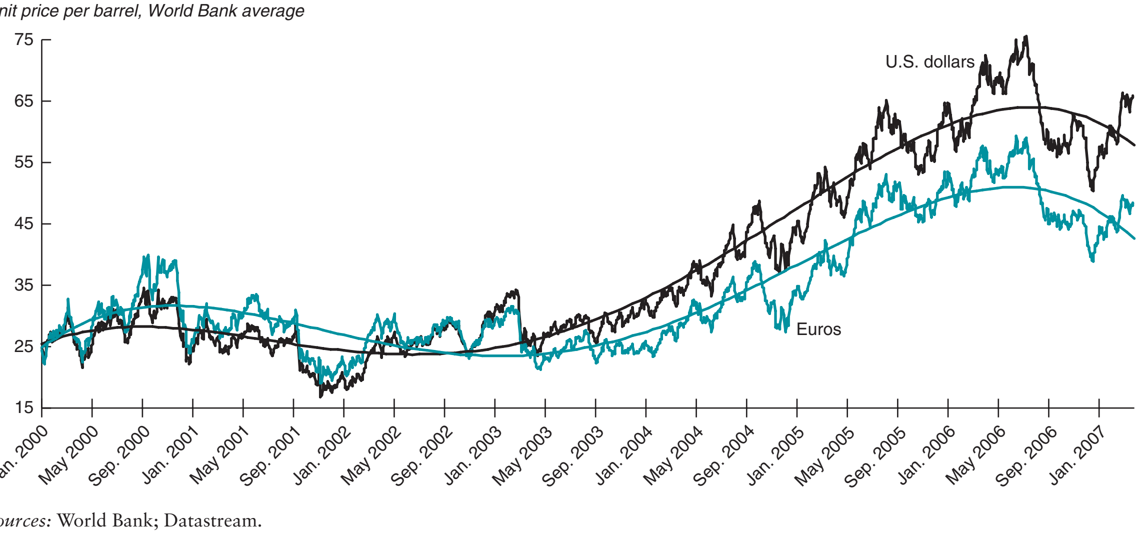
Among other agricultural commodities, coffee prices are expected to increase in 2007 (with robusta prices rising 11 percent), as demand increases in developing countries and Vietnam continues to have difficulties increasing supply. In contrast, tea prices should decline, as output in Kenya rises following last year's drought. Timber prices are expected to increase 15 percent in 2007 and an additional 5 percent in 2008, as a result of strong demand (especially from China and India) and limits on timber exports from developing countries, motivated by environmental concerns and efforts to control illegal logging.

Oil market

After shooting up in the first half of 2006, the price of oil declined in the second half of the year, falling to less than \$51 a barrel during January 2007 (figure 1.21). Oil prices have since rebounded,

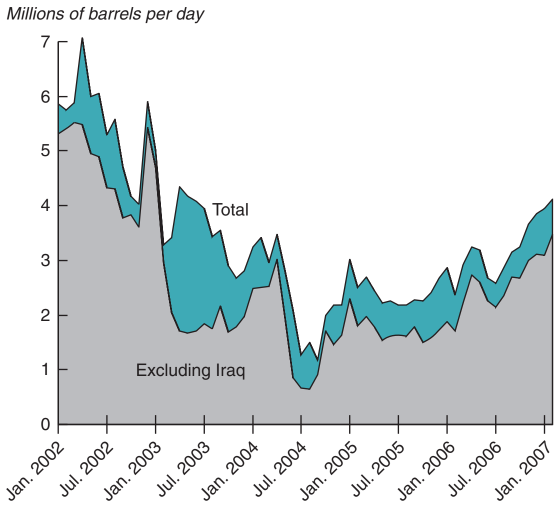
Figure 1.21 Oil prices

Unit price per barrel, World Bank average



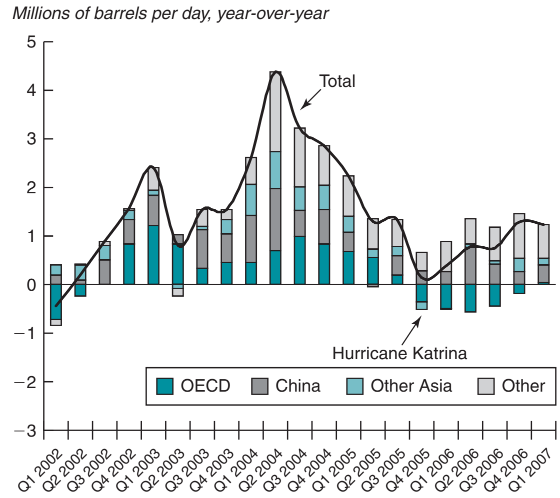
Sources: World Bank; Datastream.

Figure 1.22 Spare oil-production capacity within OPEC



Sources: World Bank; International Energy Agency.

Figure 1.23 Demand for oil



Source: International Energy Agency.

reaching about $65 a barrel in early May 2007—almost $5 less than a year before.

The decline in the price of oil in the second half of 2006 and early 2007 was consistent with an end of the trend rise in oil prices. However, low levels of spare capacity continue to make prices sensitive to small changes in the external environment (figure 1.22). Indeed, the decline in prices in January 2007 was associated with a relatively warm early winter. Prices reversed when colder weather arrived in February. While weather clearly affects demand, the swings observed appear to be out of step with changes in stocks and demand levels. The rise in prices toward the end of March mainly reflected concerns that supply would be disrupted because of the buildup of political tensions in the Persian Gulf. As these tensions dissipate, the price of oil is expected to begin to gradually decline.

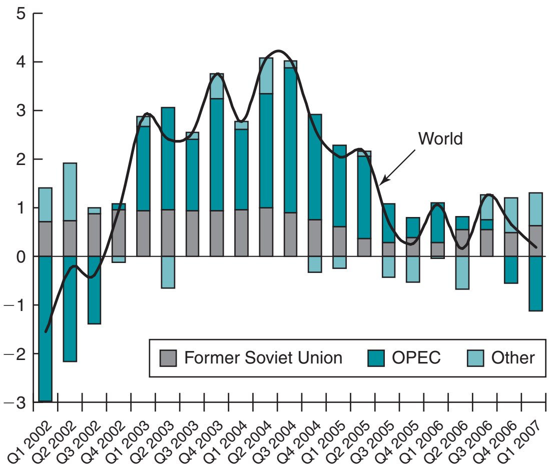
Looking forward, the recent period of very weak growth in demand for oil shows signs of ending, suggesting that the moderating influence that higher oil prices have had on additional demand may be weakening. Energy demand has picked up somewhat, rising from 0.8 additional barrels a day in the four quarters ending the first quarter of 2006 to 1.1 additional barrels a day in the fourth quarter (figure 1.23). Nevertheless, the pace of increased demand at the end of 2006 remains well below the increase that would be expected given the growth of output during this period and well below the peak of 2.4 million barrels a day in 2004, suggesting that high prices continue to induce significant substitution and conservation efforts.

At the same time, supply is accelerating. After an extended period during which supply showed only limited responsiveness to higher prices, output among non–OPEC producers accelerated in the second half of 2006. The main change was significant increases in Canada and the United States (in particular from oil sands in Canada and deepwater Gulf fields in the United States) following two years of steady declines, as well as smaller declines in North Sea production and increased production in Australia. These changes augmented continued gains elsewhere, notably in the former Soviet Union, West Africa, and Brazil (figure 1.24). OPEC responded by agreeing in November 2006 to cut production by 1.2 million barrels a day and agreeing to an additional 0.5 million barrels a day cut in early 2007 (about 1 million barrels a day had been cut by early March 2007), reinforcing the sense that the supply constraints that underpinned the earlier rise in oil prices have eased substantially.

Over the medium-term, supply from non–OPEC countries (including new OPEC member Angola, which is not subject to production restraints this year) is projected to rise by

Figure 1.24 Change in sources of oil supply

Millions of barrels per day, year-over-year



Source: International Energy Agency.
Note: Figure shows change in oil deliveries.

1.4–1.6 million barrels a day during 2007 and 2008. This contrasts with an annual average of only 0.5 million barrels day per between 1985 and 2006, when output gains were held back by aging fields and low investment rates caused by weak prices.

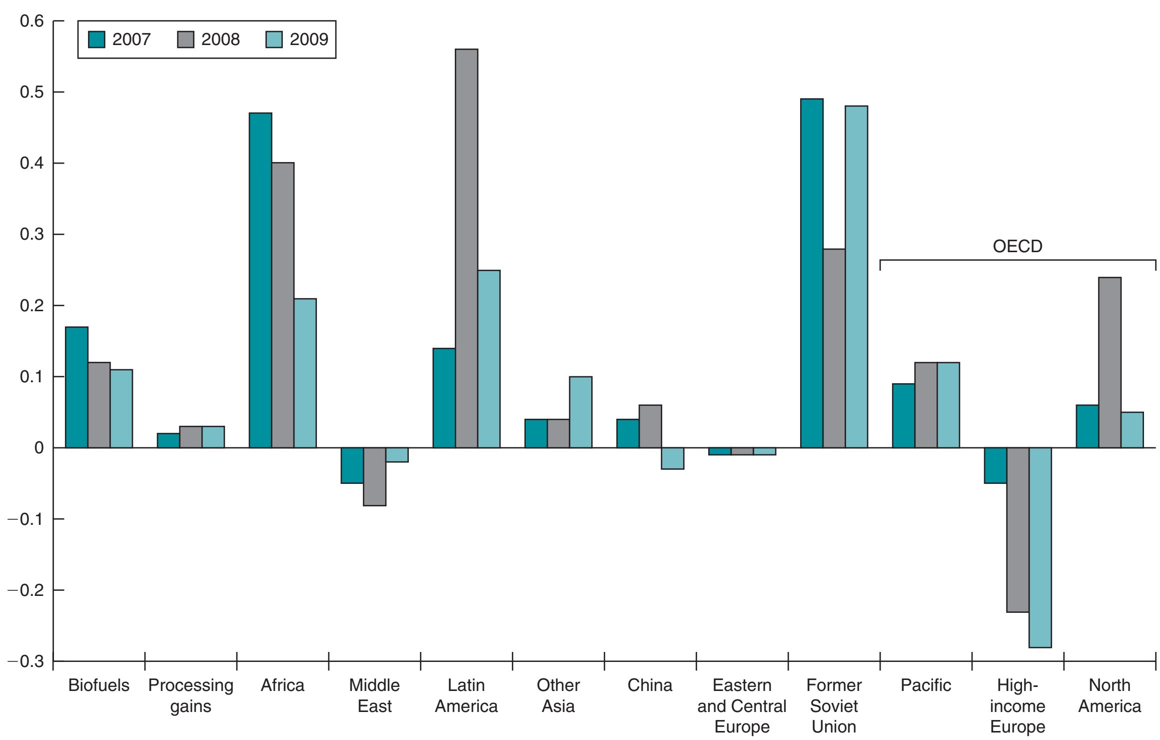
The anticipated pickup in supply reflects upstream investment projects that are already well under way (figure 1.25). Among OECD countries, new fields are expected to yield only modest net gains in production, as a result of the depletion of old fields in the North Sea, the United States, and Mexico. Production in Canada is expected to continue its climb, with additional output concentrated in oil sands.

The largest increase in production is likely to come from the former Soviet Union, with Azerbaijan and Russia each expected to increase annual output by 0.2 million barrels a day. The increase by Azerbaijan reflects the opening of the Baku-Tiblisi-Ceyhan pipeline to the Mediterranean. Production in Kazakhstan is unlikely to rise substantially before 2009, given transport capacity constraints.

Increased production in Africa is projected to yield the second-largest increment to supply, with the bulk of the additional output emanating from

Figure 1.25 Expected growth in non-OPEC oil production

Millions of barrels per day



Sources: World Bank; International Energy Agency.

Angola. Significant increases in output are also expected from relatively new producers Mauritania and Sudan, each of which will produce an estimated 0.2 million barrels a day.

Most of the anticipated increase in Latin America reflects the coming on stream of Brazil's deepwater fields, which will produce an additional 0.7 million barrels a day by 2008 and 1 million barrels a day by 2009. Output from other producers (notably Argentina, Colombia, Ecuador, Mexico, and República Bolivariana de Venezuela) is expected to stagnate or decline, because of production inefficiencies and underinvestment. The supply of biofuels is projected to double, from about 0.8 million barrels a day in 2006 to 1.5 million barrels a day in 2009, with the cumulative increase in supply equivalent to about 18 percent of the expected gains from traditional non–OPEC sources during the same period.

Over the near term, high oil prices should continue to moderate demand for petroleum products and sustain incentives to invest in new capacity. Projects already underway are expected to increase gross oil production by about 15 million barrels a day by 2010 (9.2 million barrels a day net), with annual expected increases in demand of 1.5–2 million barrels a day. Spare capacity can thus be expected to increase by 1–3 million barrels a day by 2010. Over the medium term, the recent buildup in additional spare capacity, additional non–OPEC supply, and slower growth should keep supply-side constraints at a minimum. As a result, the price of oil is projected to decline modestly over the next two years, reaching an average level of $55 a barrel in 2009.[11]

Supply conditions in the oil market, although relaxing, remain tight. A 2 million barrel a day supply disruption—an event whose likelihood in the next 10 years is estimated at 70 percent (Beccue and Huntington 2005)—could send oil prices as high as $100 a barrel, reducing global growth by as much as 1 percent (1.7 percent for developing countries) (see the discussion surrounding table 1.5 in World Bank 2005 for more details).

A period of uncertainty

A number of factors suggest that the soft-landing scenario outlined above is the most likely outcome. Tighter monetary policy in high-income and a number of developing countries is slowing growth, which is easing commodity prices and inflationary tensions in high-income countries. Meanwhile, interest rates and emerging-market spreads remain low. These favorable external conditions for developing countries should allow them to grow at a slower but still-robust pace of 6.1 percent in 2009.

However, the global economy is at a turning point, following several years of very strong growth. Such periods imply higher risk. As an extreme example, the period immediately preceding the Asian financial crisis in 1997 was characterized by strong growth, robust capital flows, and generalized optimism.

In the current context, the extended period of very rapid growth (particularly in developing countries) has generated a number of tensions. It has contributed to a surge in commodity prices,

Table 1.2 Simulated impact of an increase of 200 basis points in emerging-market spreads

	2007	2008	2009	2010	2011
Interest rates (percentage point change in fourth-quarter level from baseline)					
World	0.3	0.3	−0.1	−0.1	0
High-income	0	−0.3	−0.4	−0.4	−0.2
Low- and middle-income	1.6	2.7	1.3	1.3	0.8
Real GDP (% change from baseline)					
World	−0.2	−0.9	−0.4	0	0.7
High-income	−0.1	−0.6	−0.2	0	0.8
Low- and middle-income	−0.6	−1.7	−0.9	−0.3	0.6
Inflation (change in inflation rate)					
World	0	0.3	−0.6	−0.6	−0.6
High-income	0	−0.2	−0.7	−0.7	−0.6
Low- and middle-income	−0.1	−0.6	−0.3	−0.3	−0.4

Source: World Bank.

higher consumer price inflation, and increased prices in a number of asset markets (notably emerging-market equities and real estate markets in high-income countries). It has also been accompanied by unprecedentedly large imbalances in the balance of payments.

The projected slowdown in growth that has already begun in some of the world's largest economies is helping dampen these tensions in a relatively smooth manner. Oil and metals prices are declining, inflation is down in high-income countries, equity and home prices are no longer rising at unsustainable rates, and external imbalances are beginning to stabilize. Nevertheless, tensions persist and remain significant.

The rest of this chapter explores the implications for developing economies of three alternative scenarios in which these tensions resolve themselves in a more turbulent manner than projected in the baseline scenario.

Overheating in some developing countries could reverse favorable financial market conditions

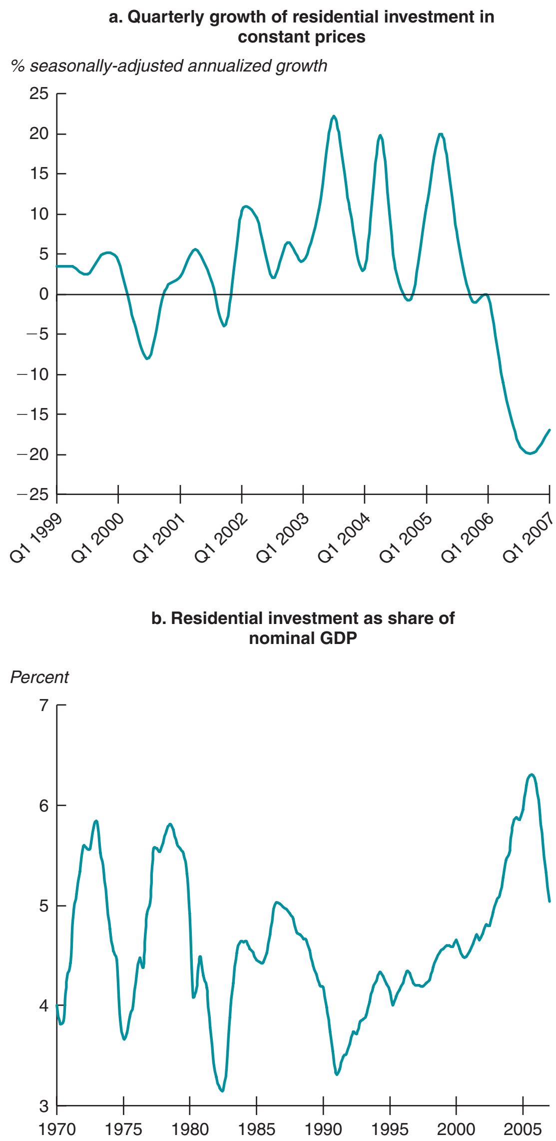
The very rapid growth of developing economies has generated significant internal and external imbalances (rising inflation and rising current account imbalances) in a number of countries. While a generalized tightening of macroeconomic policy is projected to slow growth in many economies, policy remains relatively relaxed in others, where imbalances are either growing or receding only slowly.

Should these imbalances continue to grow or international investors' tolerance (or expectations) for them change abruptly, significant financial market turmoil could ensue. Both the May 2006 and February–March 2007 episodes of increased financial volatility offer insights into the possible consequences. In each case, valuations in equity markets declined abruptly and risk premiums in debt markets jumped, with countries with large debt burdens and current account deficits suffering the largest declines. While in both instances the turmoil proved short-lived and currency adjustments were largely limited to unwinding earlier (arguably excessive) appreciations, a future shock could be more severe, with longer-term consequences.

Table 1.2 outlines the impact of a scenario in which some event (political or economic) undermines confidence in a large emerging-market economy, generating a generalized flight of capital toward "quality." The scenario is assumed to boost average spreads by some 200 basis points, with more-heavily indebted countries affected most severely. Increased perceptions of risk cause long-term interest rates in high-income countries to rise by 100 basis points.

The overall impact of this scenario is to reduce global output by 0.9 percent compared with the

Figure 1.26 Housing sector investment



Source: World Bank.

Table 1.3 Simulated impact of a prolonged recession in the United States

	2007	2008	2009	2010	2011
Interest rates (percentage point change from baseline)					
World	0	−0.2	−0.1	−0.1	−0.2
High-income	0	−0.2	−0.3	−0.3	−0.3
Low- and middle-income	−0.1	−0.1	0.5	0.5	0.4
Real GDP (% change from baseline)					
World	−0.2	−1.0	−1.5	−1.6	−1.5
High-income	−0.3	−1.1	−1.7	−1.8	−1.7
Low- and middle-income	−0.1	−0.6	−1.0	−1.0	−0.9
Inflation (change in inflation rate)					
World	0	−0.4	−1.1	−1.1	−1.4
High-income	0	−0.4	−1.3	−1.3	−1.6
Low- and middle-income	0	−0.4	−0.4	−0.4	−0.5

Source: World Bank.

baseline by 2008. Developing countries are more severely affected, with output down an estimated 1.7 percent. Slower growth eases inflationary pressures in developing countries, which means that nominal interest rates decline relatively quickly, although real rates remain elevated. Weaker global growth lowers commodity prices as compared with the baseline, which causes the current account balances of developing countries as a whole to deteriorate by 0.1 percent of GDP.

In general, lower debt-to-GDP ratios, the prepayment of sovereign debt obligations, and the adoption of more flexible exchange rate regimes should make most developing countries less sensitive to such a scenario than they would have been in the past. As a result, the contagion and real-side consequences are expected to be more moderate than they were during the Asian crisis. However, impacts on more-heavily indebted countries, such as Brazil and Turkey, are more marked, with increased debt-servicing charges causing the current account to deteriorate by 0.4 percent of GDP in Brazil and 0.9 of GDP in Turkey.

Table 1.4 Grain price forecast

	2006	2007	
		Baseline	High scenario
Wheat	$192	$220	$275
Maize	$122	$140	$175
Rice	$305	$320	$400
% increase			
Wheat		14.6	43.2
Maize		14.8	43.4
Rice		4.9	31.1

Source: World Bank.

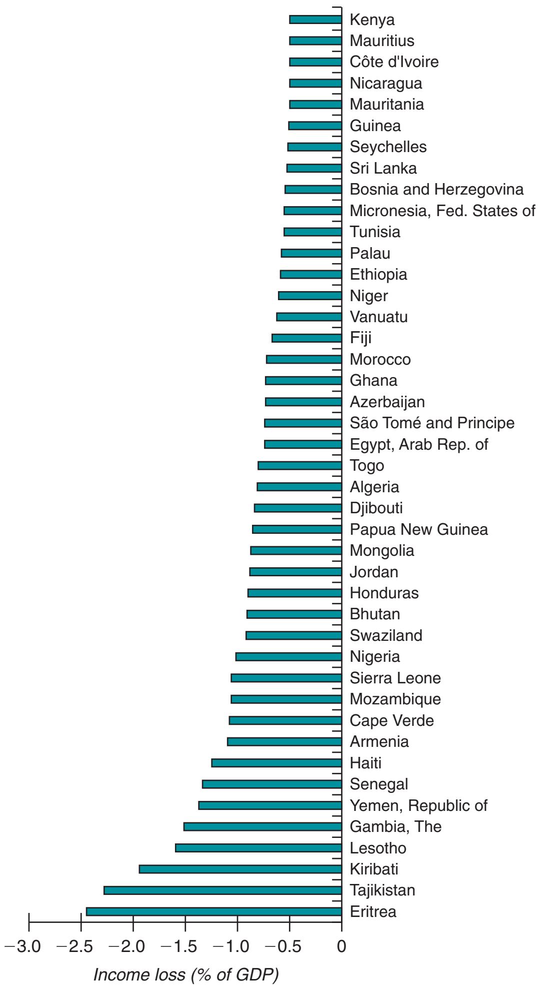
Housing-sector adjustment in the United States could be more severe

A significant uncertainty for the outlook concerns the depth and durability of the adjustment in the U.S. housing sector. While the adjustment process is already well advanced (housing starts increased in February 2007, following several months of decline), the stock of unsold homes remains large. Current inventories currently represent about six months of sales—much more than the normal level of two to four months. Moreover, while the pace at which residential investment is declining has stabilized, both real and nominal investment levels remain high suggesting that a prolonged period of rapidly falling housing-sector investment and prices cannot be ruled out.

Should residential investment continue to decline, bringing it back to levels (as a percent of GDP) consistent with long-term averages (figure 1.26), spillovers to other parts of the economy are likely to intensify. Indeed, there are already increasing signs of spillover from the construction sector to other parts of the economy, notably durable goods consumption and investment.

Table 1.3 outlines the expected impact of a scenario in which spillovers from the construction sector to other parts of the economy intensify. Under this scenario, the United States experiences a prolonged recession. The recession in residential investment, which in the baseline is expected to begin easing in the third quarter of 2007, deepens and extends to other investments. As a result, aggregate investment declines at a 5 percent annualized rate throughout 2007 and 2008, with GDP in the United States increasing by only 1 percent a

Figure 1.27 Simulated impact of a grain-sector supply shock on selected developing countries



Source: World Bank.

year during this period. Slower import growth in the United States transmits to the rest of the world as reduced export demand. It also generates a decline in interest rates, which has a positive effect on global output.

For heavily indebted countries, the slower growth and larger current account deficits translate into increased risk perceptions and higher interest rates beginning in 2009, intensifying the slowdown in growth in these countries. Consistent with the results recently produced by the International Monetary Fund (IMF 2006), those countries, such as China and Mexico, that have the closest trade ties with the United States experience the sharpest declines in growth. These declines are about half as intense as in the United States itself, and in the case of China they are minor compared with its baseline growth rate of 8–9 percent. The impact on other developing countries is weaker and takes longer to materialize, partly because the slowdown in these economies reflects the secondary impacts of import demand in China.

Low grain stocks pose a risk for the poor in developing countries

Partly because of the diversion of a substantial proportion of maize to the production of biofuels, stocks of and supply conditions for a number of grains are very low. In the United States, the world's largest producer and exporter of maize, ethanol production in 2007 is projected to consume 25 percent more maize than in 2006, when

Table 1.5 Estimated poverty impact of a 40 percent increase in rice and wheat prices in selected countries

	Initial poverty headcount	Change in poverty headcount		Percent change in the incomes of the poor	
		Rice	Wheat	Rice	Wheat
Rural population					
Pakistan	16.4	−0.1	0.6	0.1	−2.4
Vietnam	2.4	−0.1	0	0.2	−0.2
Nicaragua	61.1	1.9	0	−3.7	0
Zambia	80.0	0.1	0.1	−0.4	−1.0
Urban population					
Pakistan	8.0	0.1	0.9	−0.4	−3.8
Vietnam	0.9	0.1	0	−6.3	−0.3
Nicaragua	32.1	1.5	0	−3.6	0
Zambia	46.9	0.3	0	−0.6	−0.1

Source: World Bank.
Note: Poverty defined as $1.08 per day in PPP terms.

20 percent of the crop was used for this purpose. Although plantings are expected to rise another 15 percent (at the expense of other crops, notably soybeans), supply remains constrained As result, maize prices are up 75 percent since the summer of 2006.

This reorientation of agricultural output toward biofuels, together with a change in stocking policy in China, has reduced global grain stocks to 16 percent of annual consumption. Low stocks are a principal factor behind the 15 percent increase in wheat and maize prices incorporated into the baseline. But supply conditions are so tight that a major supply shock could result in the price of these grains rising much more rapidly, with wheat and maize prices possibly rising more than 40 percent (table 1.4). Indeed, stocks are currently only slightly higher than the levels observed before the more than doubling of grain prices in 1972–74 and the roughly 40 percent increase in 1994–96.

A hike of 40 percent or more, such as outlined in table 1.4, would have serious consequences for major importing countries. Simulations suggest that the first-round income effects (before substitution effects) would be more than 0.5 percent of GDP for a wide range of developing countries, with as many as 13 enduring a loss of 1 percent of GDP or more (figure 1.27). Among these countries, Armenia, Cape Verde, Eritrea, Mozambique, Senegal, and Sierra Leone already have current account deficits that exceed 5 percent of GDP. For these countries, the additional import costs may be particularly disruptive, requiring substantial real-side adjustments.

The impacts would be much more pronounced for nonfarm poor families, because of the importance of grain products in their consumption.[12] In Kenya, for example, maize accounts for 36 percent of households' caloric intake (58 percent for the poorest households) and 28 percent of total food expenditures.

Calculations based on estimates of the share of various grains in the overall expenditures of poor households suggest that a 40 percent increase in grain prices could reduce real incomes among households living at or below the extreme poverty line of $1 a day by as much as 6.3 percent for some urban populations (table 1.5). In countries such as Nicaragua, a 40 percent increase in grain prices could be enough to push an additional 2 percent of the population into extreme poverty.

Notes

1. The Organisation for Economic Co-operation and Development (OECD 2006) estimates liquidity, as measured by the sum of global M3 or outstanding loans, to be about 15 percent above normal levels.

2. For the purposes of this publication, "Europe" includes only high-income European countries. Developments among middle-income European countries are discussed in the context of the Europe and Central Asia Region.

3. The European Commission publishes quarterly forecasts based on such indicators every month (see http://ec.europa.eu/economy_finance/indicators/euroareagdp_en.htm). The OECD does so on a quarterly basis.

4. As of early May 2007, real policy interest rates were about 3 percent in the United States, about 2 percent in Europe, and about 2 percent in Japan.

5. Crude oil prices averaged $69 a barrel in the fourth quarter of 2006, up from $56 in the same period of 2005 (although the comparison is skewed by the disruptions caused by Hurricane Katrina). The rise boosted imports of gasoline while slowing imports of crude oil. Net import volume growth was probably about 2 percent higher than normal in the fourth quarter of 2005.

6. Low interest rates in the wake of the bursting of the Internet bubble and the subsequent housing boom contributed to a sharp decline in the national net savings rate in the United States, from an average of 6.2 percent in 1999 to less than 1 percent in 2004. During most of 2004 and 2005, it remained at about 1 percent. In 2006 it rose again, to an average of 2 percent, as a result of higher interest rates and the ending of the housing-market boom.

7. Assuming oil prices decline as projected, the U.S. current account deficit could fall by another 0.2 percent of GDP.

8. Relatively low inflation in China and the fact that the currencies of its other trading partners appreciated with respect to the dollar explain this result.

9. Preliminary data suggest that U.S. export growth in the first quarter of 2007 was much weaker. Unfortunately, direction of trade is not yet available to extend the analysis to cover this period.

10. Agricultural prices are quoted in U.S. dollars and have therefore been deflated by U.S. inflation.

11. For the past few years, the World Bank has used a technical assumption for its oil forecasts, because, given low stocks, a wide range of short-term outcomes was judged to be consistent with fundamentals. Accordingly, the price of oil is assumed here to decline gradually toward a long-term real price of $40 a barrel (2006 dollars) in 2015. This real price is then converted into a nominal price using long-term projections for the unit value of manufactures.

12. To the extent that they produce more than they consume, farm households benefit from the higher costs of food products.

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