

Global Outlook and the Developing Countries

FOLLOWING VERY STRONG GROWTH of 3.8 percent last year, the world economy is slowing. Output increased particularly quickly in the first half of 2004, driven by solid U.S. performance and a torrid export-led expansion in China. But higher oil prices and the effects of exchange rate appreciation caused quarterly output in many high-income countries to decline in the second half, notably in Germany, Italy, and Japan. Developing economies outgrew high-income countries, with aggregate GDP rising by some 6.6 percent for the year as a whole—a record expansion. In addition to China, India and Russia also grew very quickly. But all developing regions grew faster in 2004 than they did during the past decade.

Very strong world demand was reflected in emerging capacity constraints, rising prices in commodity markets, and increased inflation in some developing regions, notably South Asia, Latin America, and some parts of developing Europe. Oil prices rose 31 percent, while other commodity prices increased 18 percent, with mixed consequences for developing countries. Oil and other commodity exporters were able to build up current account surpluses, while importers (the majority of developing countries) saw a significant rise in their import bills. In contrast to earlier episodes of rising commodity prices, developing countries, notably China, were the principal source of increased demand over the past few years.

Increases in U.S. interest rates, the waning effect of earlier fiscal loosening, and, in Europe, the effects of the 25 percent real effective appreciation of the euro since February 2002 contributed to a slowing of GDP growth in the second half of 2004 and into 2005. These same factors are projected to

cause GDP growth among high-income countries to slow to about 2.5 percent in 2005. Moreover, coupled with reduced demand for imports, those factors are expected to reduce growth in low- and middle-income economies—although continued gains in market share should temper the slowdown. Thus, while growth should decline, these economies are nevertheless expected to expand by a robust and above-trend 5.7 percent in 2005. Partly as a result, oil and metal prices are expected to rise further in 2005, before softening in 2006 and 2007 as new capacity comes onstream.

Over the period through 2007, a gradual pickup in activity outside of the United States, coupled with higher U.S. interest rates and a limited tightening of fiscal policy should reverse the rising trend in the U.S. current account deficit, which is projected to fall from 5.6 percent of GDP in 2004 to about 5.3 percent in 2007. At the same time surpluses in the developing world are projected to decline from 2.7 to 1.4 percent of GDP. Although these changes will not significantly reduce the supply of dollars on world financial markets, higher U.S. interest rates should increase the appetite of private sector investors for dollar-denominated assets, so that the currency is likely to depreciate only modestly over the projection period.

The depreciation of the dollar to date against most currencies has increased the importance of domestic demand outside the United States as a driver of global growth. A further rotation of trade patterns is projected, with the volume of exports from the United States expected to grow by about 8 percent in 2007. Up to now, most developing countries have experienced only moderate fluctuations in their real effective exchange rates, either because of co-movements of their

exchange rate with that of their dominant trading partner or because the effect of the dollar's depreciation has been offset by the appreciation of the euro and the yen. While changes in bilateral exchange rates are likely to impose some adjustment costs, the export growth of low- and middle-income countries is expected to remain strong because their overall real-effective exchange rates have moved relatively little. As a result, these countries are projected to continue increasing their share of world markets.

This is a relatively benign scenario. However, an abrupt increase in interest rates, a further large and precipitous depreciation of the dollar, a larger-than-anticipated hike in oil prices, or a resurgence of protectionist sentiment could provoke a significant slowdown or even recession in the global economy.

Policy can help reduce the likelihood and potential severity of a weaker outturn. A significantly tighter U.S. fiscal policy would reduce the extent to which higher interest rates in the United States (or lower rates in Europe) will be required to support the dollar. For their part, developing economies need to ensure that they do not accumulate excessive liabilities, the future repayment of which, under conditions of higher interest rates and slower world growth, could pose serious problems. In addition, in some countries a managed appreciation might help alleviate domestic inflationary pressures and facilitate the sharing of the benefits of economic growth by lowering the costs of imported consumer goods and services. While a move away from a strict dollar peg by some developing currencies would tend to cause the dollar to depreciate more, it would likely dissipate some of the tensions in international financial markets caused by thus-far-unrealized expectations of such a depreciation. Meanwhile, the multilateral trade liberalization process is in need of a kick start. Without it, the Doha Round runs the risk of yielding few gains for developing economies.

While a coordinated international policy response would likely be optimal, the policy steps outlined above should be taken even in the absence of coordination because they would benefit each identified group even if the others failed to act.

Global growth

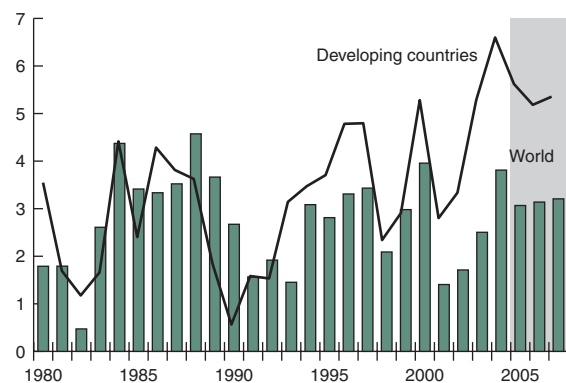
World GDP is estimated to have increased 3.8 percent in 2004, supported by an impressive 10.3 percent increase in trade volumes

(table 2.1). Growth among high-income countries came in at a robust 3.1 percent, led by the United States (up 4.4 percent), but moderated by weaker performance in Japan (2.6 percent growth) and Europe (1.8 percent). While growth in Japan and Europe was stronger than in 2003, the appreciation of their currencies contributed to the weakening of their exports in the second half of the year. Overall, output in Germany and Italy actually declined in the third and fourth quarters, although several other major European economies, including France and Spain, recorded growth in excess of 2.5 percent. Meanwhile, the depreciation of the dollar supported U.S. export growth despite a slowing in world trade volumes. This, plus strong consumer and investment spending in an environment of very low interest rates, kept U.S. growth robust in the second half. Japan also recorded negative growth in the second and third quarters, but a pickup in inventory accumulation in the fourth quarter returned the economy to a positive growth track.

At 6.6 percent, growth among developing economies was the fastest it has been at any time in the past 30 years (figure 2.1). China led the way with growth of 9.5 percent, driven by strong domestic demand and very large increases in both exports and imports. As a result, China's performance has become an increasingly important factor in global growth prospects, particularly for East Asia. Both India and Russia grew around 7 percent, led by exports in the case of India and strong oil-revenues in the case of Russia. Growth in the remainder of the developing world

Figure 2.1 Developing-country and world growth, 1980–2007

% GDP growth (1995 constant dollars)



Source: World Bank.

Table 2.1 The global outlook in summary*(percentage change from previous year, except interest rates and oil price)*

	2003	2004 ^e	2005 ^f	2006 ^f	2007 ^f
<i>Global conditions</i>					
World trade volume	5.6	10.3	7.7	7.7	8.0
<i>Consumer prices</i>					
G-7 countries ^{a,b}	1.6	1.8	1.7	1.6	1.6
United States	2.3	2.7	3.0	3.5	3.2
<i>Commodity prices (U.S. dollar terms)</i>					
Non-oil commodities	10.2	17.5	4.7	-5.2	-5.4
Oil price (US\$ per barrel) ^c	28.9	37.7	42.0	36.0	33.0
Oil price (percent change)	15.9	30.6	11.3	-14.3	-8.3
Manufactures unit export value ^d	7.5	7.0	3.0	2.8	1.9
<i>Interest rates</i>					
\$, 6-month (percent)	1.2	1.6	3.5	4.6	5.0
€, 6-month (percent)	2.3	2.1	2.1	2.8	3.2
<i>Real GDP growth^e</i>					
World	2.5	3.8	3.1	3.1	3.2
Memo item: World (PPP weights) ^f	3.9	5.0	4.3	4.2	4.3
High income	1.9	3.1	2.4	2.6	2.6
OECD countries	1.8	3.1	2.3	2.5	2.6
Euro Area	0.5	1.8	1.2	2.2	2.6
Japan	1.4	2.6	0.8	1.9	1.9
United States	3.0	4.4	3.9	3.0	2.6
Non-OECD countries	3.2	6.2	4.4	4.4	4.3
Developing countries	5.3	6.6	5.7	5.2	5.4
East Asia and Pacific	8.0	8.3	7.4	6.9	7.2
Europe and Central Asia	5.9	6.8	5.5	4.9	5.0
Latin America and the Caribbean	1.7	5.7	4.3	3.7	3.7
Middle East and North Africa	5.8	5.1	4.9	4.3	4.3
South Asia	7.8	6.6	6.2	6.4	6.7
Sub-Saharan Africa	3.4	3.8	4.1	4.0	4.1
<i>Memorandum items</i>					
Developing countries					
excluding transition countries	5.2	6.7	5.7	5.3	5.5
excluding China and India	3.9	5.8	4.8	4.4	4.4

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

a. Canada, France, Germany, Italy, Japan, United Kingdom, United States.

b. In local currency, aggregated using 1995 GDP weights.

c. Simple average of Dubai, Brent, and West Texas Intermediate crude oils.

d. Unit value index of manufactured exports from major economies, expressed in U.S. dollars.

e. GDP in 1995 constant dollars; 1995 prices and market exchange rates.

f. GDP measured at 1995 PPP weights.

Source: World Bank.

was also robust, with GDP expanding by more than 5.5 percent.

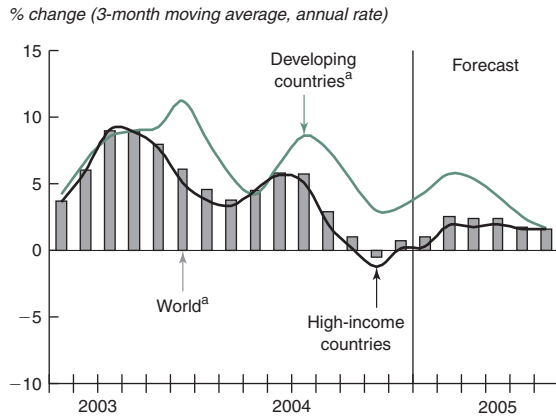
Strong investment growth has played a major role in these results. Low interest rates helped increase ratios of investment to GDP to 28 percent for low- and middle-income economies as a group. Double-digit increases in trade were also central to this strong performance, as developing countries exploited low domestic costs, market openings, and other structural reforms to increase their share in world exports (from 20 to 25 percent since 1999).

High-frequency data suggest that the rate of expansion among developing countries slowed

during 2004, with industrial-production growth easing from 12 percent in the first half to 8 percent in the second half (figure 2.2). Merchandise trade volume also moderated, slowing from an annualized rate of 18 percent in the first quarter to some 14 percent in the second half. Slowing trends have continued into 2005, although leading business indicators suggest that a turnaround can be expected during the course of the year.

Looking forward, rising interest rates and high oil prices, combined with the waning of the fiscal stimulus that has supported growth in the recent past should continue to dampen world

Figure 2.2 Slowing industrial production, September 2003–May 2005



^aExcluding China.
Source: World Bank.

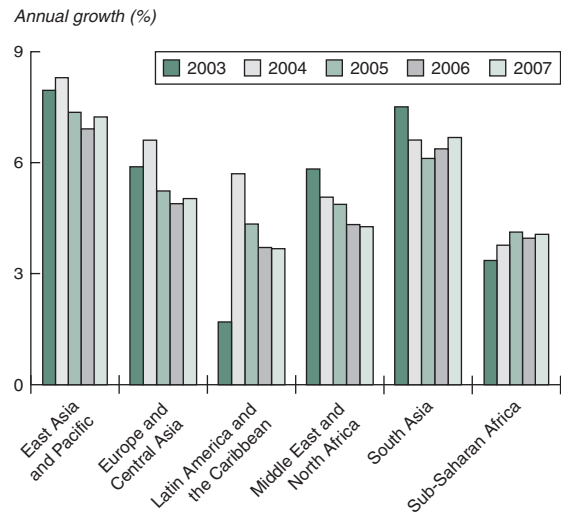
growth. As a result, global economic activity is projected to slow fairly sharply in 2005 before stabilizing in 2006 and picking up somewhat in 2007.

As the Federal Reserve moves to a more neutral stance of monetary policy in the United States, higher interest rates are expected to slow the pace of both consumption and investment activity. At the same time, however, the depreciation of the dollar should stimulate export growth, helping to sustain activity at a relatively high level. In Japan, sharply falling world demand for high-tech products, slowing global trade, the appreciation of the yen, and the domestic investment cycle contributed to a weak second half in 2004. The economy is projected to expand by just 0.8 percent in 2005.

Moderate wage growth in Europe and high oil prices have cut into consumer demand, while the appreciation of the euro has hurt exports. These negative factors are counterbalanced by significant pent-up demand for capital goods, following years of subdued investment—already evident in the steady (if unspectacular) acceleration in investment activity over the past year. Further strengthening of investment and the waning negative influence of the euro’s appreciation are projected to result in a gradual firming of euro zone growth rates to about 2.6 percent in 2007.

While the human costs of the December 2004 tsunami were horrific, its economic impacts are expected to remain localized. Disaster-related declines in output are projected to slow growth

Figure 2.3 Regional growth projections, 2003–7



Source: World Bank.

during the first half of 2005 in Indonesia, the Maldives, Sri Lanka, and Thailand, with the brunt of the impact borne by the coastal regions immediately affected. As reconstruction efforts get underway, growth should firm toward the end of the year. However, the overall impact of these changes will be difficult to discern in regional growth rates.¹

The projected slowdown among high-income economies will be reflected in slower trade and output growth among developing economies, while higher world interest rates will also slow the expansion of domestic demand (figure 2.3). As a group, however, low- and middle-income countries should again outperform the high-income economies by a large margin through to 2007. And growth rates are expected to exceed the levels observed in the 1990s.²

Growth in the economies of the *East Asia and Pacific* region will continue to reflect developments in China. There, administrative controls have succeeded in slowing the pace of investment in some sectors, and there are increasing signs that personal incomes and expenditures are rising less quickly than in the immediate past. As a result, GDP growth is expected to moderate, and inflation should stay in check. Elsewhere in East Asia, exports are being affected by falling world demand for high-tech products and somewhat less robust Chinese investment demand. Overall, regional GDP growth is projected to ease to 7.4 and 6.9 per-

cent in 2005 and 2006 before picking up somewhat in 2007. For the region excluding China, a similar pattern is expected, with growth at about 5.4 percent in 2005 and picking up to 6.2 percent by 2007.³

GDP increased in the *Europe and Central Asia* region by 6.8 percent in 2004, spurred on by very strong growth in the Russian Federation, where high oil prices have boosted incomes. Regional GDP and trade growth were also enhanced by investment flows related to the accession of several countries to the European Union—a factor reflected in very high rates of increase in both imports and exports. A sharper-than-expected decline in Turkish inflation boosted real incomes, triggering strong domestic demand and a steep increase in its current account deficit. Elsewhere in the region, inflationary pressures are building. This is expected to provoke a tightening of domestic monetary policy that, in combination with expected increases in world interest rates, should see regional interest rates rise even further, slowing investment and consumption. A leveling-off of oil incomes and the negative influence of a strong real effective appreciation by a number of the region's economies⁴ are expected to dampen regional growth to about 5 percent by 2007.

Economic activity in *Latin America and the Caribbean* increased by some 5.7 percent during 2004, substantially faster than the region's 0.4 percent average growth rate over the preceding three years. Strong world demand for commodities contributed to large output gains in Brazil, Chile, and Mexico. Argentina's substantial rebound following its 45 percent real effective depreciation between late 2001 and early 2005 contributed to the strong performance of the region. The expected leveling-off of commodity prices in 2005 and 2006 means that the contribution to growth from increases in resource-based incomes will decline. Nevertheless, still-high prices imply that incomes will remain elevated, continuing to support demand at high levels. Rising interest rates, prompted by higher world rates and growing domestic inflationary pressures, will be a further drag on growth, which is projected to slow to about 3.7 percent by 2007.

The economies of the *Middle East and North Africa* continued to profit from high oil prices in 2004. GDP growth among developing oil exporters was strong at 5.5 percent, but down from 6.7 percent in 2003 as capacity constraints made themselves felt. Labor-abundant and resource-poor

countries benefited from strong world demand, notably from regional oil exporters, causing their exports to grow by 6.2 percent. Economic activity among regional oil exporters is projected to slow to about 4 percent in 2006, partly because the full impact of stronger domestic demand will be partly offset by leakages in the form of accelerating imports. This strong import demand, coupled with the easing of oil prices beginning in the second half of 2005 (see the commodities discussion below) and the entry into force of preferential trade agreements with the European Union will nudge up growth among oil importers to about 5.2 percent in 2006.

GDP increased some 6.6 percent in *South Asia* in 2004, down from 7.8 percent the year before. Most of the slowdown occurred in India and reflected poor crops. Nevertheless the Indian economy led the region, expanding by 6.8 percent. Growth among other South Asian countries actually picked up a bit, coming in at 5.9 percent. Overall regional GDP is projected to slow in 2005 to 6.2 percent, reflecting more moderate Chinese and OECD import demand, before regaining strength in 2006 and 2007, when it should increase by about 6.7 percent. Rising inflation in Pakistan and Sri Lanka will require a strong response from domestic authorities, weakening near-term growth prospects in those countries.

Economic activity in *Sub-Saharan Africa* increased by an estimated 3.8 percent in 2004, with virtually all countries reporting positive growth (Côte d'Ivoire, the Seychelles, and Zimbabwe being notable exceptions). A large number of countries saw output increase by 5 percent or more. Growth in the region is projected to pick up in 2005 to 4.1 percent as the benefits from past reforms and a globally more peaceful environment are reflected in improved growth rates. Still-high metals and minerals prices will contribute to good performance in many countries, notably South Africa, while continued tightness in the oil market will benefit regional oil exporters such as Nigeria. Ethiopia and Sierra Leone are expected to perform particularly well as they continue to benefit from more peaceful conditions. The projected upturn in Europe, the region's main trading partner, should also stimulate growth, while rising exports to China will play an increasing role. Despite substantially improved performance, per capita GDP growth in the region will lag the rest of the world by a significant margin, implying a further widening of income gaps.

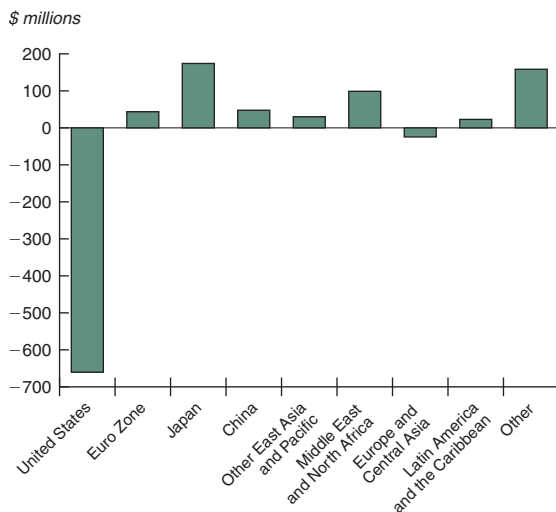
Global imbalances, currencies, and inflation

The current account of the United States has been in deficit throughout the past two decades, with the sole exception of 1990. Following several years of deterioration, it reached a new high of \$666 billion, or 5.6 percent of GDP in 2004. As a consequence of these repeated deficits, the United States has been transformed from a significant net international investor in the 1970s to the world's largest debtor. Its net external liability at the end of 2003 was estimated at \$2.7 trillion (23 percent of U.S. GDP, or 7.5 percent of world GDP).

Reflecting these developments, but also a wide range of structural policies that have improved economic performance, the current account position of most developing countries has improved, and now virtually all major regions are running modest current account surpluses (figure 2.4).

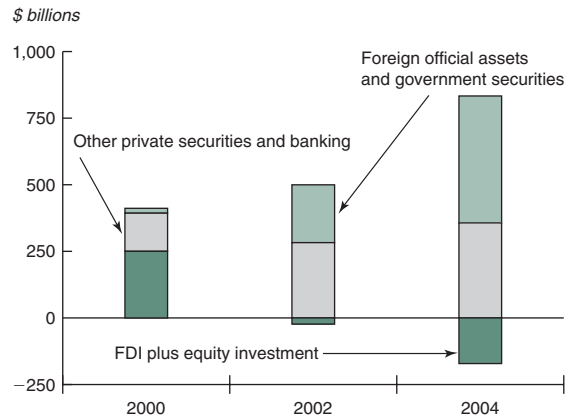
Until recently, the U.S. deficit was financed largely through private capital inflows in the form of foreign direct investment (FDI) and purchases of U.S. corporate securities. Beginning in 2001, however, this changed. Net foreign purchases of private sector assets dried up and actually turned negative in the first half of 2004. For the year as a whole, most of the current account deficit was financed by sales of public sector assets and securities (figure 2.5). Moreover, a substantial share of these

Figure 2.4 Estimated global imbalances in current accounts, 2004



Source: World Bank.

Figure 2.5 Financing the U.S. current account: net flows by asset type, 2000, 2002, and 2004



Sources: U.S. Department of Commerce; World Bank estimates.

purchases is finding its way into the rapidly rising official reserves of foreign central banks, notably those of developing countries (chapter 3).

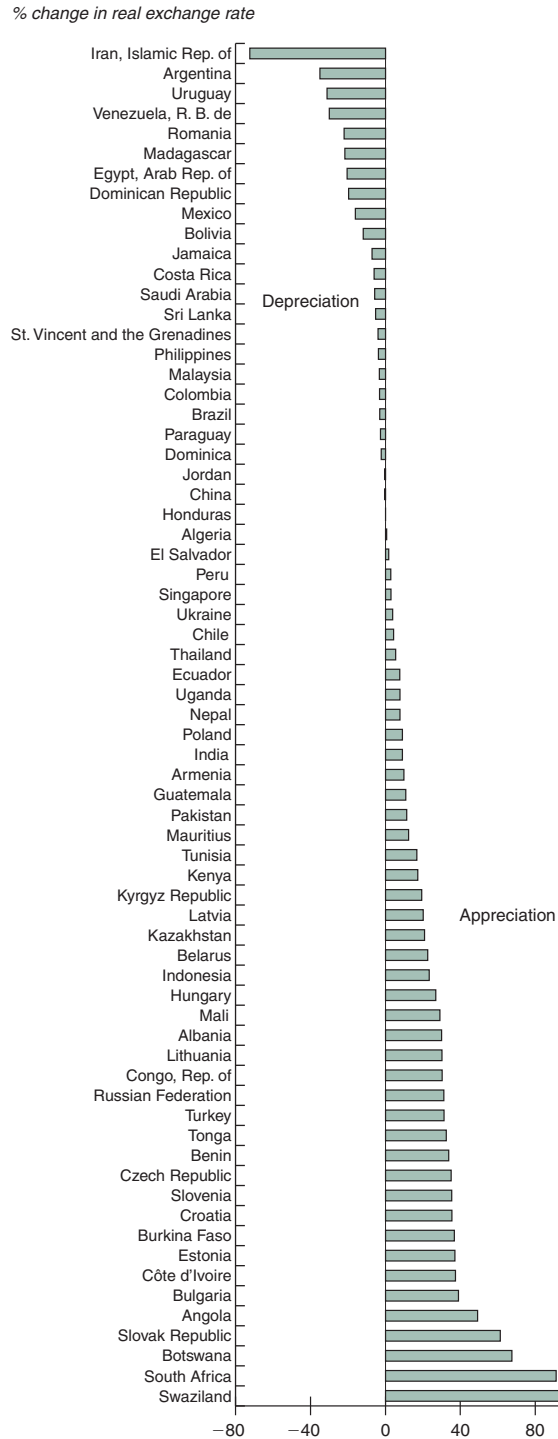
Partly as a consequence of the net outflow of private sector investment, the dollar began to slide, not just against the euro but also against most developing-country currencies, both nominally and in real terms (figure 2.6).

These imbalances are expected to stop increasing and may even diminish somewhat. In particular, the U.S. current account deficit is expected to stop rising and gradually decline—reaching 5.3 percent of GDP in 2007.

Several factors are expected to contribute to this development.

- Both U.S. short- and long-term interest rates are projected to continue rising, reaching about 5 percent by 2007 as the Federal Reserve Bank moves towards a more neutral monetary policy stance. As a result, real interest rates, which have been negative in recent years, will turn positive. This should induce an increase in net private savings,⁵ which currently represent less than 1 percent of household income, and reduce imports—thereby contributing to a lower current account deficit.
- A modest tightening of U.S. fiscal policy is projected, with the general government deficit expected to decline from an estimated 4.4 percent of GDP in 2004 to some 3.5 percent in

Figure 2.6 Appreciation of developing-country currencies against the dollar between January 2002 and February 2005



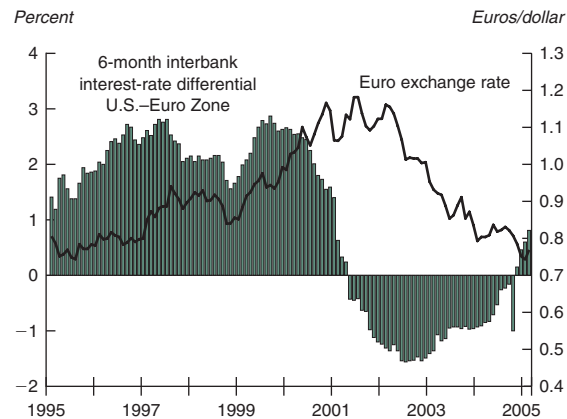
Source: World Bank.

2007. This, along with the cumulative effect of the dollar depreciation, will also help constrain overall demand and contribute to a decline in the current account deficit.

- Continued strong growth in developing economies and robust demand for imports will increase U.S. exports. In particular, domestic demand is projected to be very strong among oil-exporting countries, leading to a reduction in the current account surplus of oil-exporting Middle East countries equal to 8 percent of their GDP.

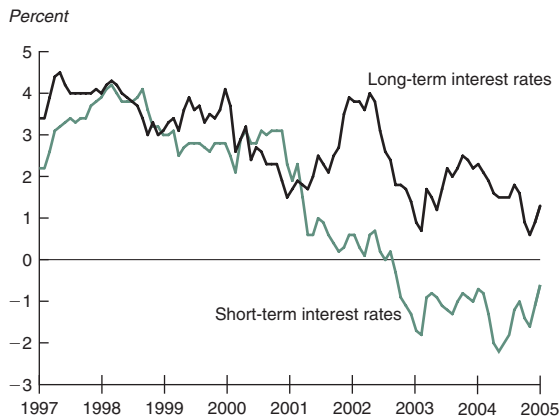
In addition to the stabilization and even modest shrinking in the U.S. current account deficit, rising interest rates in the United States relative to rates elsewhere should alleviate downward pressure on the dollar by increasing investors' willingness to finance the deficit. Specifically, short-term U.S. interest rates are projected to increase more than European rates until 2006, opening up a gap of almost 200 basis points between them. These higher returns on dollar-denominated assets should be sufficient to induce additional private sector purchases of dollar-denominated bonds. As a result, the dollar is expected to depreciate only modestly, by about 10 percent over the forecast period. Estimates suggest that the increases in U.S. interest rates already observed (figure 2.7) have been sufficient to almost eliminate financial incentives to continue the "carry trade" against the dollar (Moore 2004).⁶

Figure 2.7 Interest rates and the weakening dollar, 1995–2005



Source: World Bank.

Figure 2.8 Very low real interest rates in the United States, 1997–2005



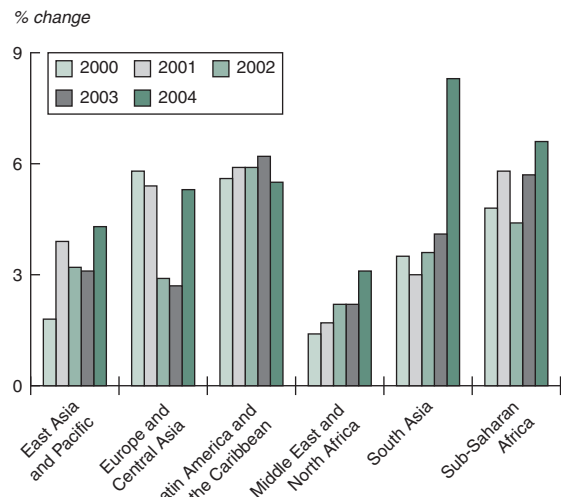
Note: Long-term rates are 10-year yields on U.S. government bonds. Short-term rates are the federal fund rate. Both are deflated by consumer inflation.
Source: World Bank.

The recent period of very low real interest rates (figure 2.8) has been particularly beneficial to developing economies. Together with narrower risk premia, low rates have allowed developing countries to reduce their financing costs (chapters 1 and 3) and pursue strong investment growth.

However, this strong economic performance has brought on a pickup in inflation in many developing countries (figure 2.9). Inflation increased from 3.8 percent in the fourth quarter of 2003 to 6.2 percent by the third quarter of 2004. Since then, it has eased somewhat and was 4.8 percent in February 2005. The largest hikes have been in commodity prices. Regionally, inflation has picked up markedly in South Asia (India, Pakistan) and to a lesser extent in Latin America (Argentina and Mexico) as emerging capacity constraints have made themselves felt. Most recently, falling food prices (see the discussion of commodity prices below) have contributed to some easing of inflationary pressures.

In contrast, there are few signs of rising inflation among high-income countries, except perhaps in the United States, partly reflecting higher import prices following the slide in the dollar. Rather, widespread asset inflation, notably in housing prices, and a strong increase in investors' tolerance for risk (as evidenced by reduced risk premia on junk bonds and developing-country debt⁷) are the most visible signs of abundant liquidity and underlying inflationary pressures in high-income countries.

Figure 2.9 Rising consumer inflation, 2000–4



Source: World Bank.

As global interest rates rise, these pressures should dampen. However, inflation in developing countries is projected to continue rising in 2005 as growth remains at or above trend rates. In Europe, the disinflationary effects of the euro's appreciation and still-large output gaps should limit price increases. In contrast, the lower dollar can be expected to generate additional upward price pressure in the United States. In particular, import prices are expected to begin contributing to rising inflation in the United States, as rising inflation in developing countries is passed through as higher U.S. import prices.⁸

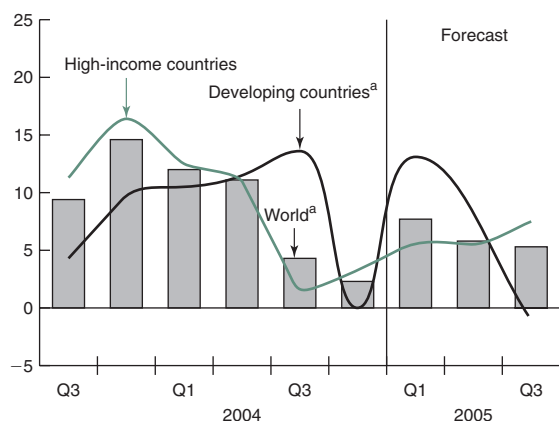
World trade

World trade expanded dramatically in 2004, increasing by some 10.3 percent. China's integration into the global marketplace continued, with exports and imports increasing by some 30 percent. The pace of trade expansion elsewhere in the developing world was more moderate (12.3 percent), but nevertheless much higher than the 8.5 percent expansion registered by high-income countries. High-frequency data indicate that trade growth slowed toward the end of the year (figure 2.10).

In line with the projected moderation of global economic activity, international trade is forecast to slow as compared with 2004 as a

Figure 2.10 Slower trade growth, 2003–5

Export volumes (quarterly, annualized growth rates, %)



^aExcluding China.
Source: World Bank.

whole. Trade volumes are expected to increase by around 7.7 percent in 2005 and 2006, which is nevertheless quicker than during the 1990s.

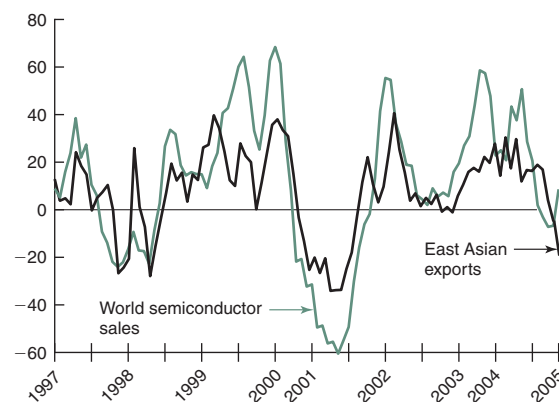
In addition to slower trade growth due to reduced import demand, developments in specific markets will influence the overall pattern of trade. In particular, a sharp slowdown in the high-tech cycle has hit exports from East Asia and the Pacific, where such products represent as much as two-thirds of some countries' exports.⁹ The high-tech market is characterized by sharp swings in demand but over a relatively short cycle (figure 2.11). Thus, while exporters in the region are expected to go through a difficult patch over the next several months, demand should pick up toward the end of 2005 and remain strong in 2006. As discussed in the following section, demand for commodities is also expected to remain strong.

Impact of dollar depreciation on developing economies

Notwithstanding the broad depreciation of the dollar and appreciation of the euro, most developing-country currencies have been relatively stable in real effective terms (figure 2.12). Of the 69 low- and middle-income countries for which data permit the calculation of real effective exchange rates, only 15 have experienced an appreciation of more than 10 percent since February 2002, when the dollar began to slide, and more than half have depreciated. The revaluation of many developing-

Figure 2.11 World semiconductor sales and East Asian technology exports, 1997–2005

% change (3-month moving averages, seasonally adjusted annualized rates)



Sources: Semiconductor Industry Association; World Bank.

country currencies was relatively moderate because in many cases the depreciation of the dollar and the appreciation of the euro were offsetting, leaving countries' real effective position broadly unchanged.

For those countries for which the United States or the euro zone represent a disproportionate share of trade, co-movements in their own currencies have largely mitigated the impacts that these fluctuations might otherwise have had. Most developing countries that did experience a significant real effective revaluation did so because of domestic factors or a strong terms-of-trade impact following the recent run-up in commodity prices (South Africa).

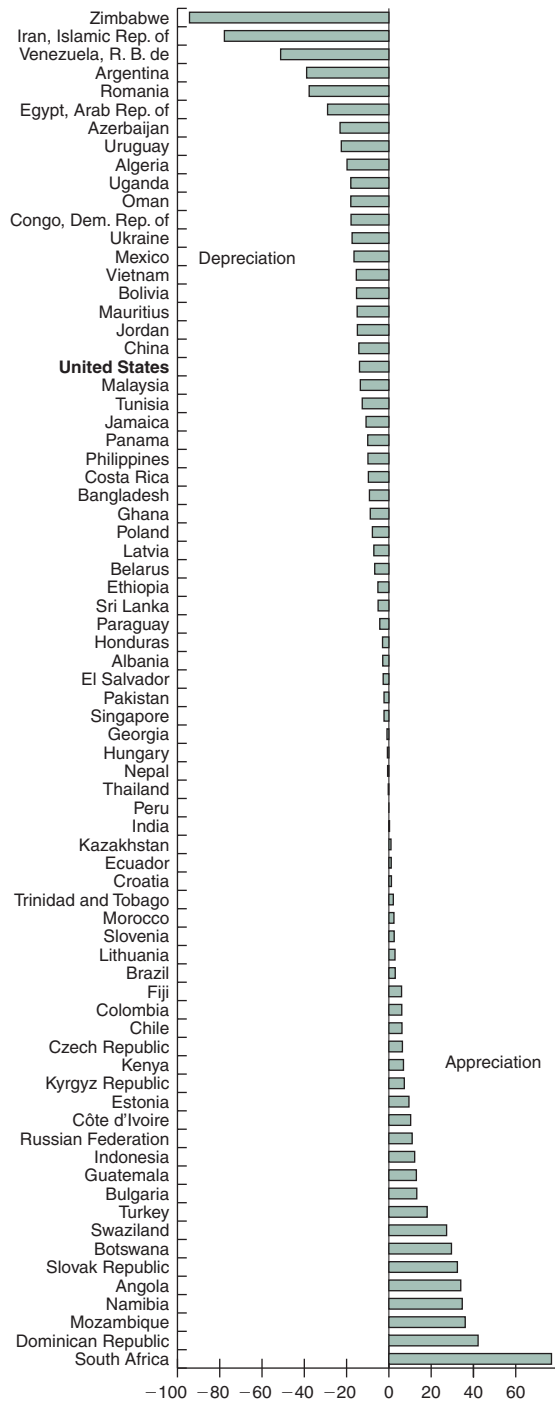
While small compared with the shift in the euro/dollar bilateral exchange rate, the currency fluctuations experienced by developing countries are likely to have consequences for the real economy over the projection period.

Unless compensating policy measures are taken, growth will be stimulated in depreciating countries, possibly overheating their economies. By the same token, economic activity is likely to be weaker among countries that appreciate. Or, if exporters lower margins to retain market share, incomes will decline.

The realignment of currencies will influence the pattern of exports and imports and could impose adjustment costs.¹⁰ For individual developing economies the impact will depend importantly

Figure 2.12 Real effective revaluations of developing-country exchange rates, 2002–5

% change in real effective exchange rate between February 2002 and January 2005



Source: World Bank.

on preexisting trade patterns. Countries that trade more or less equally in Europe and the United States (Namibia, Paraguay, Poland) will find it easier to exploit changes in competitiveness because firms already have knowledge of the foreign market and networks with which to deal. In contrast, firms (and nations) whose trade is particularly focused on the United States may encounter significant delays before lost sales in the U.S. market can be recuperated through increased sales in Europe or elsewhere. Even countries that followed the dollar in its depreciation (many South American and East Asian countries) will face adjustment costs in the form of higher inflation and lost competitiveness among firms that rely on non-U.S. imports.

Finally, although evidence is not conclusive, some research (for example, Esquivil and Larráin 2002) suggests that volatility in the exchange rates of major economies tends to introduce uncertainty into international trade and may therefore contribute to a slowdown in global trade volumes.

Longer-term prospects for trade expansion

Notwithstanding these costs, low- and middle-income countries are projected to continue increasing their world market shares. Over the past five years developing countries as a whole have increased their share of world exports from 20 to 25 percent. China actually doubled its market share during this period from 2.5 to more than 5.4 percent.

This trade expansion has been a critical motor for economic betterment. Those countries that have been most successful in expanding their market shares have registered the sharpest reduction in poverty over the past 15 years.¹¹

Overall, 40 percent of the total increase in the exports of developing countries was due to increased market share. This reflects several factors, including a gradual exposure of underlying comparative advantages following the numerous trade liberalizations of the past two decades. These saw developing-world tariffs fall from some 30 to less than 10 percent. In addition, improved macroeconomic policies, lower inflation, reduced government deficits, and improved current account positions contributed to better trade performance by reducing uncertainty for investors and traders alike.

In the baseline forecast, these conditions are assumed to persist. As a result, developing-country market shares should increase a further 1 percentage point between 2004 and 2007.

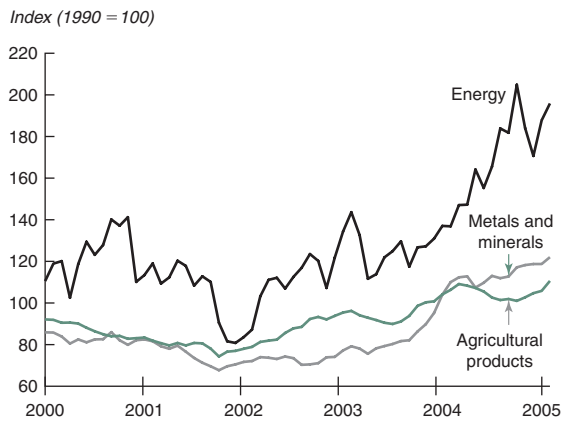
Commodity markets

The run up in commodity prices since 2002 (figure 2.13) reflected very strong demand for commodities and emerging capacity constraints in producing countries. Overall, energy prices rose some 30 percent in 2004. Metals and minerals prices were up 37 percent, and, as yet, show no sign of easing. In contrast, the prices of most agricultural commodities peaked in the second quarter of 2004 before beginning to decline, but still registered a 10.5 percent annual gain.

Unlike previous episodes of overheating, the main sources of excess demand were developing countries, notably China.

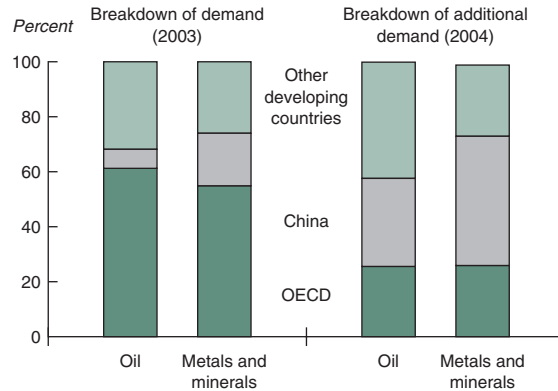
Indeed, 74 percent of the total increase in crude-oil demand during 2004 came from developing economies (figure 2.14)—almost twice their share in total demand. Almost half of the increment came from China, whose thirst for raw materials also underpinned the increase in demand for metals and minerals. Overall, low- and middle-income countries were responsible for 74 percent of the additional demand for metals in 2004, but only 45 percent of total demand. Developing-country demand was particularly pronounced in the zinc and aluminum markets, where their share in the increase in demand exceeded 80 percent in 2004.

Figure 2.13 Commodity prices, 2000–4



Source: World Bank.

Figure 2.14 Developing-country demand and commodity prices, 2003 and 2004



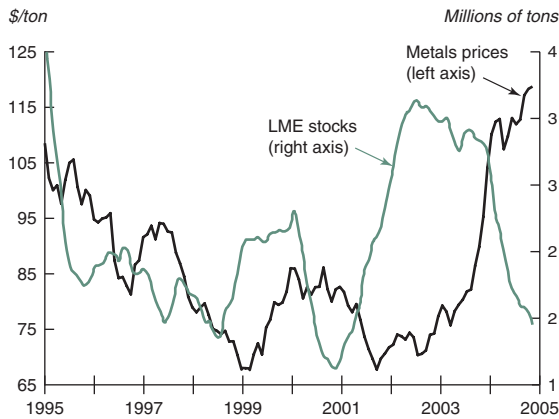
Source: World Bank.

This is unlikely to be an isolated development. The share of developing economies in world demand for commodities is projected to continue rising. Partly this reflects the progressive transfer of an increasing proportion of the world’s labor-intensive manufacturing activity to these countries. It also reflects faster population growth and rising incomes, which are projected to increase demand for resource-intensive products such as automobiles—placing further pressure on commodity markets. Such factors underpin the prediction of the International Energy Agency (IEA 2004) that by 2030 the demand for oil from economies currently classified as low- and middle-income will more than double to some 50 percent of world demand.

Notwithstanding the run up in commodity prices and the increasing importance of developing economies in these markets, commodity prices are projected to ease over the next three years. In agriculture, increased supply—following endogenous reactions to high prices and recovery from poor crop years—is already pushing down the prices of a number of agricultural commodities, notably soybeans and cotton. Further supply increases and the projected global slowdown are expected to reduce agricultural prices by about 6 percent in 2006.

Simple models of the derived demand for oil suggest that the developing world’s demand for petroleum products will continue to grow quickly. Although daily world production is expected to

Figure 2.15 Metals—lower stocks mean higher prices



Sources: London Metals Exchange; World Bank.

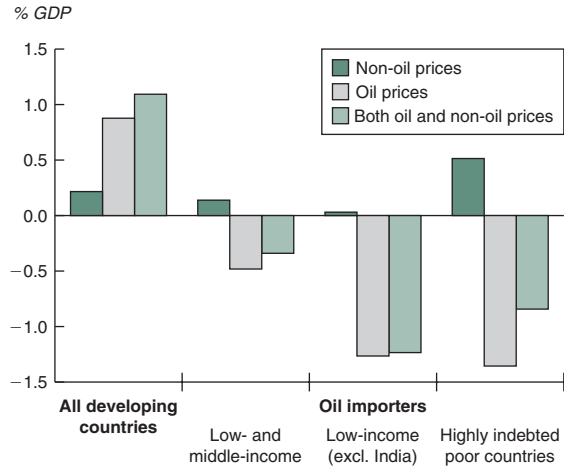
increase by about 1.5 million barrels, low stocks and robust demand are projected to keep oil prices high during the first half of 2005 before they begin to ease. For the year as a whole, they are projected to average some \$42 in 2005.¹² As the growth of demand moderates further and new supplies come onstream, prices are expected to decline slowly, reaching \$33 by 2007.

Conditions in the mineral and metal market remain very tight (figure 2.15). Excess demand, emanating particularly from China, drove prices up some 37 percent in 2004 and caused inventories to fall by 50 percent (60 and 90 percent in the case of lead and copper). Firms have reacted to high prices by substituting less-expensive materials (using lower quality nickel in the production of steel, for example), which should help ease demand pressure. However, these conditions are projected to keep pushing metals prices up during the first half of 2005, before increasing supplies trigger a cyclical decline later in the year. A big uncertainty in this projection is Chinese demand. If it fails to moderate as expected but remains at the levels seen in the first half of 2004, metals prices (notably steel and iron ore), coal prices, and freight rates could remain high for an extended period or even rise further.

Regional consequences of higher commodity prices

Higher commodity prices have contributed substantially to the solid economic performance of commodity-exporting countries over the past sev-

Figure 2.16 Terms-of-trade gains to developing countries from commodity price changes, 2001–4



Source: World Bank.

eral years (figure 2.16). This is particularly true for oil exporters, for whom higher oil prices have meant a terms-of-trade gain of an estimated 5.6 percent of GDP. But net exporters of other commodities also gained. Exporters of metals and minerals benefited strongly, while the positive effect for agricultural exporters was less marked.

However, as discussed in more detail in last fall's *Global Economic Prospects 2005* (World Bank 2004), although high commodity prices are good for developing countries in aggregate, most developing countries are oil importers. For them the net effect of the commodity price increases observed to date has been negative. For South Asia as a whole, the effect was equivalent to terms-of-trade -2.2 percent of GDP.

Risks and policy priorities for the global economy

In the baseline outlook, increased private and public savings in the United States and strong growth among developing countries begin to redress global imbalances and generate a modest decline in the U.S. current account deficit. Combined with the opening of a positive gap between U.S. and European short-term interest rates, this is expected to reduce, but not eliminate, downward pressure on the dollar. The currency will continue to depreciate, but in a gradual and orderly manner.

This scenario is exposed to a number of risks:

- Higher interest rates
- The possibility that oil prices rise further or fail to moderate as projected
- An overshooting or a disorderly depreciation of the dollar, and
- Endogenous reactions to high prices and the emergence of protectionist sentiment.

The first and arguably most important risk is that both short-term and long-term interest rates rise by more than projected. Several distinct but related factors contribute to this risk.

Rates could rise even further either because the current bearish sentiment of investors vis-à-vis the dollar intensifies or because Asian central banks, which have financed much of the U.S. current account deficit (chapter 3), decide to slow the pace at which they accumulate reserves. In either case, investors would demand higher rates before taking on more debt or additional risk. Indeed, recent suggestions by some Asian authorities that they might be diversifying their reserve portfolios sparked brisk sell-offs that ceased only when firm denials of such diversification were subsequently issued. Higher U.S. interest rates would likely put upward pressure on interest rates in other countries as well.

Another factor that might lead to globally higher rates is investors' appetite for risk. Risk premia for sub-investment-grade corporate and emerging-market bonds are at very low levels. Should investors' appetite for or perceptions of underlying risk change, interest rates in these markets could rise sharply, rapidly drawing liquidity out of international capital markets.

Many developing countries have made significant strides in reducing their overall financial vulnerability and are, therefore, in relatively strong positions to withstand such a deterioration in international financial conditions. However, countries with weak domestic banking and capital markets remain fragile. Those with high debt burdens are especially vulnerable to sudden reassessments of country risk (chapters 3 and 4).

Finally, if the excess liquidity engendered by low interest rates manifests itself as rising inflation, real interest rates would rise even further as the monetary authorities react.

To the extent that increases in asset prices are a reflection of unusually low interest rates, interest-

rate hikes could generate substantial losses in wealth, with significant negative impact on consumer demand. For example, if housing prices were to stabilize at current levels, the elimination of the positive wealth effect that higher housing prices have contributed to consumer demand would be sufficient to reduce consumer spending in the United Kingdom and the United States by more than 1 percent.¹³ Were asset deflation to occur, the impact could be much more serious.

Figure 2.17 reports the results of three simulations that attempt to quantify the real-side impacts of these risks.¹⁴

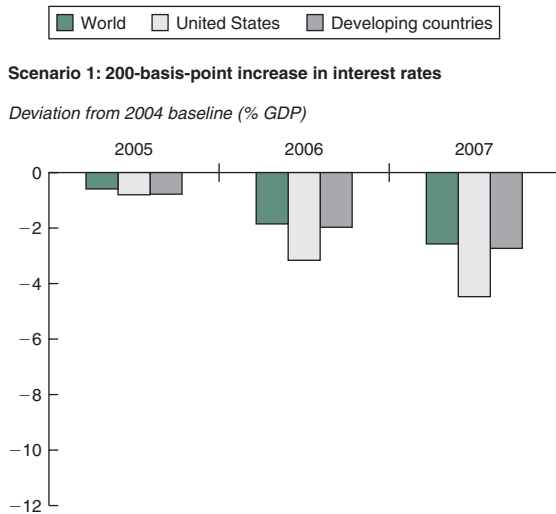
The first scenario assumes that U.S. short- and long-term interest rates rise by 200 basis points more than in the baseline scenario due to increases in investors' required rate of return on dollar-denominated assets. Real interest rates abroad react endogenously, rising by somewhat less than in the United States. Growth in the United States slows by about 1 percentage point in 2005 compared with the baseline and by 2 percentage points in 2006, but a recession is avoided. Slower growth in the United States dampens the expansion of global trade. As a result, growth in developing economies slows by about 1 percentage point in each of 2005 and 2006.

The second scenario builds on the first and assumes that reduced global liquidity from the above tightening causes both bond and emerging-market spreads to return to normal levels. This compounds the effects of the first scenario in developing economies by provoking additional reductions in consumption and investment demand due to higher interest rates. Growth in the United States is broadly unchanged.

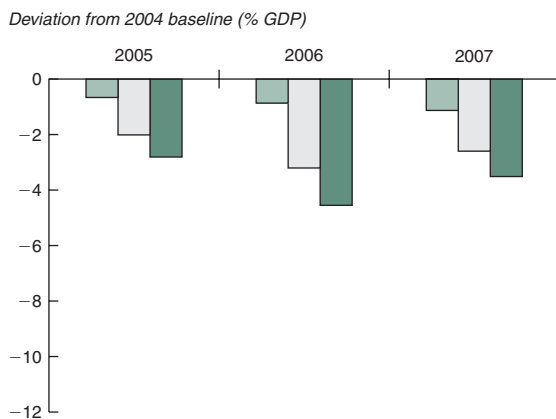
Prospects for developing economies are much weaker, with a cumulated loss in output of close to 4.6 percent of GDP. Highly indebted countries are hit particularly hard.

The final scenario combines these effects, adding a substantial wealth effect in France, Spain, the United States, and the United Kingdom, as higher interest rates are assumed to trigger a 10 percent decline in housing prices and therefore in consumer wealth in each of these countries. This contributes to further slowing in demand. In this case, the United States enters a relatively deep recession in 2006, leading a significant global slowdown in which world growth declines to about 1 percent.

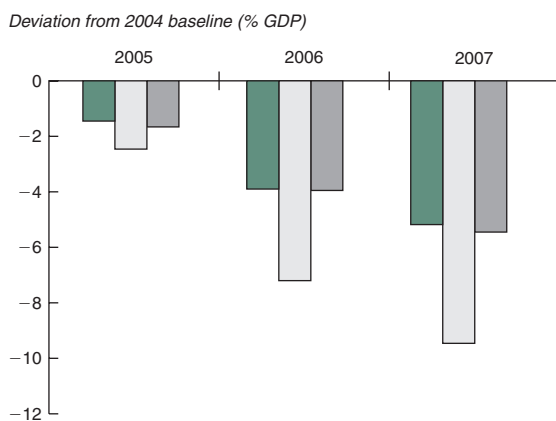
Figure 2.17 Effects of higher interest rates on GDP growth, 2005–7



Scenario 2: Scenario 1 plus a 60-percent increase in emerging-market spreads



Scenario 3: Scenario 2 plus a wealth effect



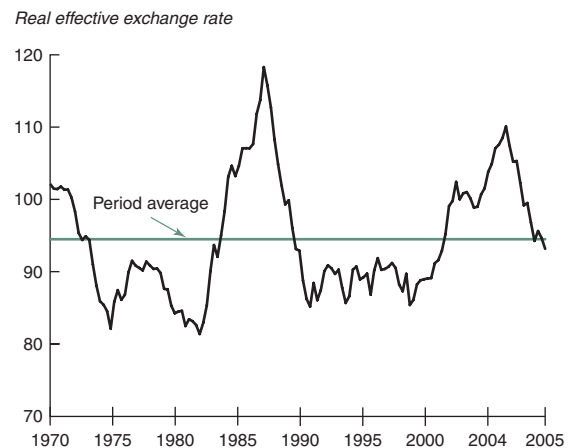
Source: World Bank.

The risk that oil prices would rise further or fail to decline by as much as projected was discussed in detail in the World Bank's *Global Economic Prospects 2005* (2004, 12–14). That report concluded that a further \$10 hike in oil prices would slow global growth by about 0.5 percent the next year. For oil-importing developing countries, the terms-of-trade shock of the hike would be about –2.4 percent of GDP. Moreover, because such countries have limited access to international financial markets, the impact on domestic demand of such a shock would be much higher than in high-income countries.

The possibility that the dollar will overshoot its equilibrium value and become undervalued for a prolonged period is a risk in the medium term. The depreciation to date has brought the dollar close to its long-run average level in real effective terms (figure 2.18). If it were to depreciate by much more, as it might if public and private savings behavior does not change, it could well overshoot its long-run equilibrium value. Such an event would increase adjustment costs as exporters lost sales in some markets and had to increase market penetration elsewhere. As the dollar eventually returned to its long-run equilibrium value, these costs would be incurred a second time.

In addition, large swings in the dollar could have significant financial impacts for developing countries (chapter 3). For countries with substantial dollar reserves, a depreciation would imply

Figure 2.18 The dollar in historical perspective, 1970–2004



Source: J.P. Morgan.

large paper losses that could have implications for fiscal policy. In contrast, countries with significant dollar-denominated debt would benefit from a depreciation because it would erode the local-currency value of their debt.

Finally, the global slowdown could result in a slowing of trade liberalization or the emergence of protectionism. The recent pursuit of initiatives to deepen trade has coincided with a period of strong growth for both developing and developed countries. Weaker economic conditions could prompt a break in that trend, by derailing the Doha process or limiting the extent to which any eventual agreement would benefit low-income countries. At the extreme it could provoke a protectionist backlash among high-income countries. In either case, the access of developing countries to rich-country markets could be curtailed to the detriment of growth and poverty reduction. Similarly, should lower growth in developing countries reduce the pace of structural reform, which underpins much of recent economic gains, the impact on future growth prospects could be severe.

Policy challenges

Policy can help avoid and limit the severity of the scenarios discussed above. A significantly tighter U.S. fiscal policy would increase aggregate saving in the U.S. economy, narrow the current account deficit, and reduce the extent to which higher interest rates will be required to support the dollar. In Europe, policy should seek to maintain interest rates at relatively low levels. Not only would this bolster domestic demand, thereby compensating for weaker exports following the appreciation of the euro, it would also decrease the relative attractiveness of euro-denominated financial assets—thereby reducing the likelihood of a further appreciation and discouraging a disorderly shift away from dollars. In this regard, should inflationary pressures arise it may be desirable to pick up the pace of fiscal consolidation to reduce the likelihood of overheating.

Faced with the prospect of a slowing world economy and the possibility of a pronounced slowdown, policymakers in developing countries need to redouble efforts to consolidate their fiscal positions and take advantage of today's low interest rates to restructure debt—as indeed many have done. Moreover, they must be particularly prudent

to ensure that they do not accumulate excessive liabilities or spending obligations, the future financing of which under conditions of higher interest rates and slower world growth could pose serious problems. In addition, a careful reassessment of exchange-rate policy in some countries might reveal that a managed appreciation of their currencies would help alleviate emerging inflationary pressures, while facilitating the sharing of the gains from recent growth among the entire population by lowering the cost of imported consumer goods.

While a coordinated international policy response would likely be optimal and would minimize the costs for developing countries, the domestic benefits of each of the policy steps outlined above will accrue whether or not the other economies take action.

Notes

1. The East Asia and Pacific region suffered the greatest damage from the tsunami, followed by South Asia and, to a much lesser extent, Sub-Saharan Africa.

2. All told, three quarters of developing countries saw their growth rates increase during the first four years of this decade, compared with the 1990s. This contrasts with high-income countries, about half of which saw improvement and half declines.

3. This chapter's companion Web site, Prospects for the Global Economy, <http://globaloutlook.worldbank.org>, presents more detail on regional economic developments and forecasts.

4. Bulgaria, the Russian Federation, and the Slovak Republic all recorded appreciations in excess of 10 percent.

5. Household savings net of capital accumulation (OECD 2004).

6. The term "carry trade" describes the practice of borrowing money at low interest rates in one currency and investing it in a second currency at higher rates of return. Such interest rate arbitrage likely explains some of the strong swings in the bilateral exchange rate of the dollar and euro.

7. While significant improvements in fundamentals underpin some of the improvement in emerging-market risk premia, the concurrent compression of corporate spreads suggests that abundant global liquidity is also playing a key role.

8. Until the third quarter of 2002, U.S. import inflation was negative, reflecting a rising share in both imports and GDP of low-cost developing-country imports and falling import prices due to strong growth in developing-world productivity.

9. In 2003, high-tech products represented 13 percent of Thailand's exports, but more than 50 percent of Taiwanese, Malaysian, and Philippine exports.

10. These adjustment costs and the mechanisms by which they effect output are qualitatively similar to those described by Lilien (1982) in the context of oil price hikes, another international price shock.

11. The correlation coefficient between per capita increases in incomes and increases in trade shares is 0.5.

12. A simple model of oil demand suggests that an increase in demand of some 1.8 million barrels per day would be consistent with World Bank output projections. Coupled with expected increases in output of 1.5 million barrels (IEA 2004), there is little prospect for a substantial easing of oil prices in 2005.

13. The stock of housing in the United States is estimated by the Federal Reserve Bank to be equal to \$15.2 trillion or about 138 percent of GDP. A 10 percent change in the value of that stock would represent 13.8 percent of GDP or 19 percent of consumption. Econometric estimates suggest that the long-term marginal propensity to consume from housing wealth is .05 (see, for example, Catte and others 2004 and Benjamin and others 2004), implying a reduction in consumption of 1.35 percent.

14. Chapter 3 discusses in more detail some of the potential financial-sector impacts of higher interest rates.

References

- Benjamin, J. D., P. Chinloy, and G. D. Jud 2003. "Real Estate versus Financial Wealth in Consumption." *Journal of Real Estate Finance and Economics* 29 (3): 341–54.
- Catte P., N. Girouard, R. Price, and C. André. 2004. "Housing Markets, Wealth and the Business Cycle." Economics Department Working Papers 394, Organisation for Economic Co-operation and Development, Paris.
- Esquivel, Gerard, and Felipe Larraín. 2002. "The Impact of G-3 Exchange Rate Volatility on Developing Countries." G-24 Discussion Paper Series 16, United Nations Conference on Trade and Development, Geneva.
- International Energy Agency. 2004. *World Energy Outlook 2004*. Paris: IEA.
- Lilien, David M. 1982. "Sectoral Shifts and Cyclical Employment." *Journal of Political Economy* 90 (4): 777–93.
- Moore, J. 2004. "2004 Carry Trade Update." Barclays Capital, December 22.
- OECD (Organisation for Economic Co-operation and Development). 2003. *Economic Outlook* No. 74. Paris: OECD.