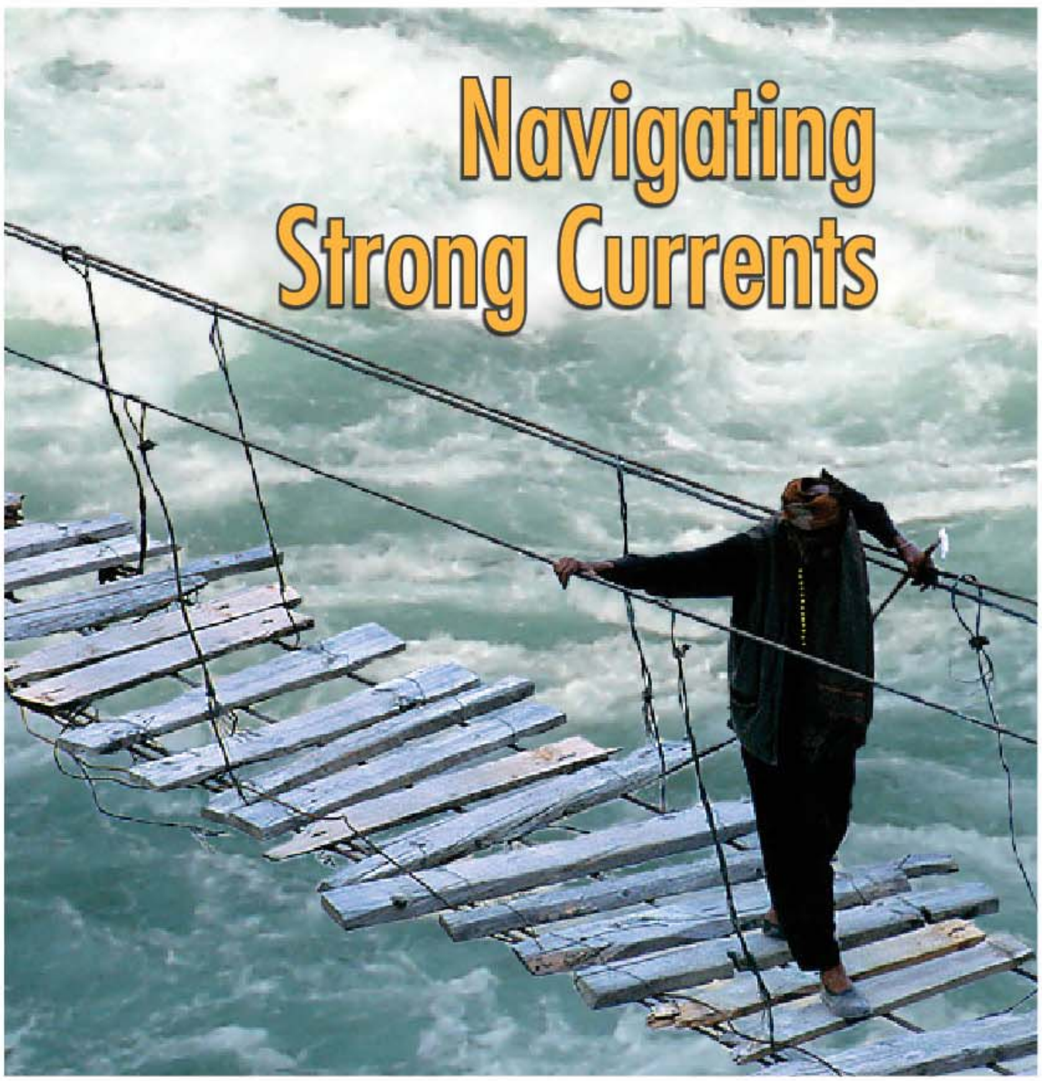
Global Economic Prospects

Volume 2 | January 2011



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Global Economic Prospects January 2011: *Navigating strong currents*

Overview & main messages

Economic activity in most developing countries has, or is close to having, recovered. Supported by a resurgence in international and domestic financial flows and higher commodity prices, most of the spare capacity in developing countries that was created by the crisis has been reabsorbed, and developing countries have regained trend growth rates close to those observed in the pre-crisis period.

In contrast, the recovery in many high-income countries (and several economies in developing Europe and Central Asia) has not been strong enough to make major inroads into high unemployment and spare capacity. Prospects in these economies, many of which were at the center of the financial boom and bust, continue to be weighed down by banking-sector restructuring, high consumer debt and a right-sizing of economic sectors that grew unsustainably large during the boom period.

The robust recovery in developing countries is all the more remarkable because it mainly reflects an expansion of their internal markets. Developing countries are not just leading the recovery. Increasingly they are an important source of stability, with many of the risks to global growth centered in high-income countries and reflecting as yet unresolved imbalances generated by the boom period.

Very low policy-induced interest rates in high -income countries plus better growth prospects in developing countries prompted a strong recovery in capital flows, mainly to middle-income countries. Overall net private capital flows to developing countries expanded 44 percent in 2010, but remain well below record 2007 levels. For most countries, the increase in flows was beneficial, helping to finance growth enhancing investment.

Capital inflows into some middle-income countries have placed undue and potentially damaging upward pressure on currencies. Many of these flows are short-lived, volatile and sometimes speculative in nature. Left unchecked, such flows can lead to abrupt real appreciations and depreciations that are out of line with underlying fundamentals, and can do lasting damage to economies. The biggest increases were in short-term debt flows, equities and bonds, notably corporate bonds. Long-term bank lending also posted large percentage increases, but from a very low base. Foreign direct investment (FDI) rose a relatively modest 16 percent given earlier large declines.

Low-income countries experienced modest declines in capital flows in 2009 and modest increases in 2010, partly reflecting their reliance on relatively stable FDI. However, many low-income countries did benefit from stronger remittance inflows, a recovery in tourism and higher commodity prices. South-South flows are increasingly important for low-income countries.

Global growth is expected to weaken somewhat in 2011, before picking up in 2012 (Table 1). Real GDP is estimated to have expanded by 3.9 percent in 2010, once again led by strong domestic demand in developing countries. Restructuring and right-sizing in the banking and construction sectors, combined with necessary fiscal and household consolidation, will continue to drag on growth in many high-income economies and developing Europe and Central Asian countries. At the same time, growth is projected to slow in other developing countries due to emerging capacity constraints. Overall global GDP is expected to grow 3.3 percent in 2011, before picking up to 3.6 percent in 2012 as the drag on activity from restructuring in high-income countries eases somewhat.

Strong growth of domestic demand in developing-country will continue to lead the world economy. Developing countries domestic demand is playing a major role in the recovery, representing 46 percent of global growth in 2010. GDP in low- and middle-income countries expanded 7 percent during 2010 (5.2 percent excluding India and China) and is projected to increase 6.0 and 6.1 percent in 2011 and 2012. As such it will continue to outstrip growth in the high-income countries (2.8, 2.4 and 2.7 percent in 2010, 2011 and 2012).

Serious tensions and pitfalls persist in the global economy, which in the short-run could de-rail the recovery to differing degrees. These include the possibility that:

- market concerns over debt sustainability in Europe escalate;
- continued very low interest rates in high-income countries once again prompt large and volatile flows of capital toward developing countries that contribute to destabilizing movements in exchange rates, commodity prices, and asset-prices.
- although real food prices in most developing countries have not increased as much as those measured in U.S. dollars, they have risen sharply in some poor countries; and if international prices continue to rise, affordability issues and poverty impacts could intensify.

Longer-term risks center around the possibility that policy in the economies most directly hit by the crisis fail to shift focus from short-term crisis management toward measures that address the underlying (and difficult to resolve) structural issues that contributed to the crisis in the first place. These include:

- putting in place credible plans for restoring fiscal sustainability;
- placing more emphasis on fiscal measures that facilitate the re-employment of displaced workers; and, in many countries, programs to improve longer-term competitiveness.
- completing the re-regulation of the financial sector;
- pursuing policies that permit exchange rates to gradually adjust in-line with relative fundamentals; and,
- reducing the volatility of major reserve currencies in order to sustain confidence in them as stores of value and facilitators of trade.

The remainder of this report is organized as follows. The next section discusses recent developments in global production, trade, and financial markets, and presents updates of the World Bank's forecast for the global economy and developing countries. It is followed by a discussion of the serious short- and longer-term challenges facing the global economy. This is followed by a short section of concluding remarks.

Recent economic developments and outlook

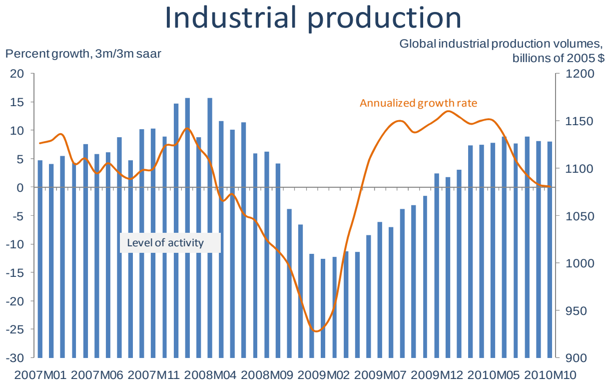
The global economy is transitioning from a rapid, bounce-back phase of recovery, toward a slower, more sustainably paced phase. Going forward, the recovery will be characterized by close to potential growth rates among those countries that were least directly involved in the excesses of the pre-crisis boom period.

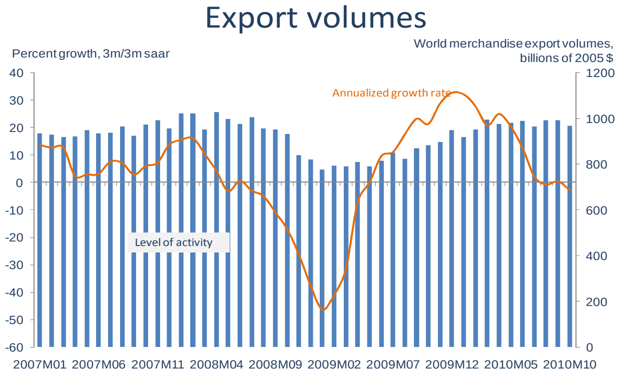
Among those that were more closely implicated, including many high-income economies and developing Europe and Central Asia countries, aggregate activity will continue to be burdened by the restructuring required to undo the excesses of the boom period. As a result, unemployment is expected to decline only slowly.

The rebound in industrial activity

The rebound phase of the recovery came to an end toward the middle of 2010, when global industrial production and trade regained their pre -crisis levels of activity (dated here as August 2008 the month prior to the collapse of Lehman's and the onset of the acute phase of the crisis[1]). Almost at the same time, the pace of the expansion slowed abruptly, with 3-month industrial production and global exports

Figure 1 Industrial production and world trade volumes have regained pre-crisis levels





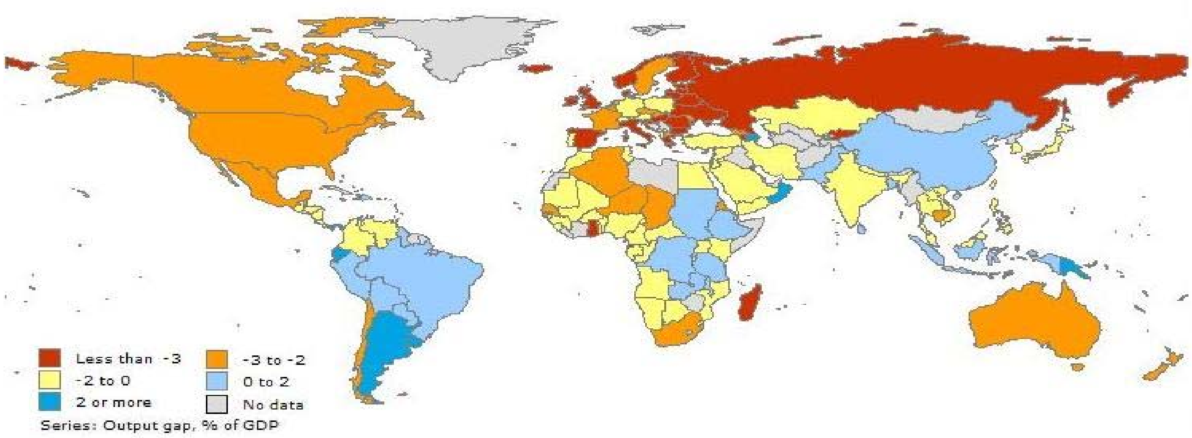
Source: World Bank.

annualized growth rates slowing from more than 10 and 20 percent respectively in early 2010 to near zero by September and only began to strengthen again in October (Figure 1).

Each developing region experienced the crisis differently. Industrial production in East and South Asia hardly declined at all, but growth rates did slow well below the pre-crisis trend of 10.5 percent in East Asia and 8.6 percent in South Asia. Production in the Middle-East and North Africa as well as in Sub-Saharan Africa declined only modestly, while it was harder hit in Latin America and the Caribbean. Developing Europe and Central Asia, where many economies overheated during the boom period, was hardest hit by the crisis, with output having fallen 20 percent at the trough.

The bounce-back phase of recovery was also

Figure 2 Output in most developing countries has rejoined with underlying potential, while gaps remain large in some high-income and developing Europe and Central Asia Economies
(% difference between actual and potential GDP in 2010)



Source: World Bank.

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

	2008	2009	2010e	2011f	2012f
Global Conditions					
World Trade Volume (GNFS)	2.7	-11.0	15.7	8.3	9.6
Consumer Prices					
G-7 Countries [1,2]	3.1	-0.2	1.3	1.1	1.6
United States	3.8	-0.4	1.9	1.5	2.0
Commodity Prices (USD terms)					
Non-oil commodities	21.0	-21.6	26.6	-0.1	-4.3
Oil Price (US$ per barrel) [3]	97.0	61.8	79.0	85.0	80.4
Oil price (percent change)	36.4	-36.3	28.0	7.6	-5.4
Manufactures unit export value [4]	6.7	-4.2	0.7	-2.9	-3.0
Interest Rates					
$, 6-month (percent)	3.2	1.2	0.5	0.5	0.9
€, 6-month (percent)	4.8	1.5	1.0	0.8	1.1
International capital flows to developing countries (% of GDP)					
Developing countries					
Net private and official inflows	4.5	3.7	4.4		
Net private inflows (equity + debt)	4.4	3.2	4.0	4.0	3.8
East Asia and Pacific	3.3	3.0	4.0	3.8	3.3
Europe and Central Asia	7.5	2.2	3.6	4.3	4.4
Latin America and Caribbean	4.1	3.8	4.5	4.4	4.1
Middle East and N. Africa	2.4	2.7	2.4	2.8	2.6
South Asia	3.6	4.3	4.0	3.6	3.9
Sub-Saharan Africa	3.5	3.9	4.6	4.9	5.2
Real GDP growth [5]					
World	**1.5**	**-2.2**	**3.9**	**3.3**	**3.6**
Memo item: World (PPP weights) [6]	2.6	-0.8	4.8	4.1	4.4
High income	**0.2**	**-3.4**	**2.8**	**2.4**	**2.7**
OECD Countries	0.1	-3.5	2.7	2.3	2.6
Euro Area	0.3	-4.1	1.7	1.4	2.0
Japan	-1.2	-6.3	4.4	1.8	2.0
United States	0.0	-2.6	2.8	2.8	2.9
Non-OECD countries	2.5	-1.8	6.7	4.4	4.8
Developing countries	**5.7**	**2.0**	**7.0**	**6.0**	**6.1**
East Asia and Pacific	8.5	7.4	9.3	8.0	7.8
China	9.6	9.1	10.0	8.7	8.4
Indonesia	6.0	4.5	5.9	6.2	6.5
Thailand	2.5	-2.3	7.5	3.2	4.2
Europe and Central Asia	3.9	-6.6	4.7	4.0	4.2
Russia	5.2	-7.9	3.8	4.2	4.0
Turkey	0.7	-4.7	8.1	4.1	4.3
Romania	7.1	-7.1	-1.9	1.5	4.4
Latin America and Caribbean	4.0	-2.2	5.7	4.0	4.0
Brazil	5.1	-0.2	7.6	4.4	4.3
Mexico	1.5	-6.5	5.2	3.6	3.8
Argentina	6.8	0.9	8.0	4.7	4.5
Middle East and N. Africa	4.2	3.1	3.3	4.3	4.4
Egypt [7]	7.2	4.7	5.1	5.5	6.0
Iran [7]	2.3	1.4	1.5	3.0	3.0
Algeria	2.4	2.4	2.4	4.1	4.1
South Asia	4.8	7.0	8.7	7.7	8.1
India [7, 8]	5.1	7.7	9.5	8.4	8.7
Pakistan [7]	1.6	3.6	4.4	2.6	3.8
Bangladesh [7]	6.2	5.7	5.8	6.1	6.3
Sub-Saharan Africa	5.2	1.7	4.7	5.3	5.5
South Africa	3.7	-1.8	2.7	3.5	4.1
Nigeria	6.0	5.6	7.6	7.1	6.2
Kenya	1.6	2.6	5.0	5.2	5.5
Memorandum items					
Developing countries					
excluding transition countries	5.8	3.2	7.5	6.3	6.3
excluding China and India	4.2	-1.8	5.2	4.3	4.5

Source: World Bank.
Notes: PPP = purchasing power parity; e = estimate; f = forecast.
1. Canada, France, Germany, Italy, Japan, the UK, and the United States.
2. In local currency, aggregated using 2005 GDP Weights.
3. Simple average of Dubai, Brent and West Texas Intermediate.
4. Unit value index of manufactured exports from major economies, expressed in USD.
5. Aggregate growth rates calculated using constant 2005 dollars GDP weights.
6. Calculated using 2005 PPP weights.
7. In keeping with national practice, data for Egypt, Iran, India, Pakistan and Bangladesh are reported on a fiscal year basis. Expressed on a calendar year basis, GDP growth in these countries is as in the table on the right.
8. Real GDP at market prices. Growth rates calculated using real GDP at factor cost, which are customarily reported in India, tend to be higher and can vary significantly from market price GDP. Starting with FY2009-10, factor cost GDP is: 7.7, 8.7,9, 8.5 percent – see Table B5.2 in the regional annex.

	2009e	2010f	2011f	2012f
Egypt	5.9	4.9	5.3	5.7
Iran	2.1	1.7	2.3	3.0
India	5.7	9.2	8.5	8.7
Pakistan	2.6	2.8	3.5	3.2
Bangladesh	6.0	5.8	5.9	6.2

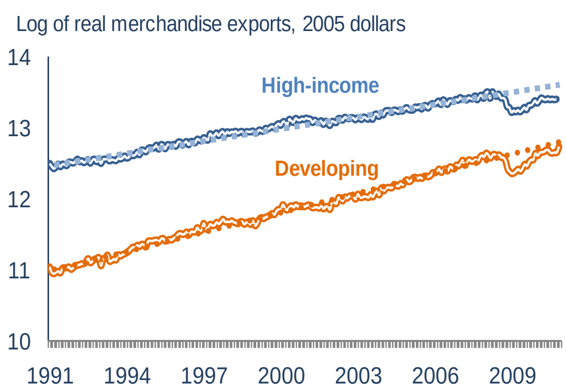
uneven, with countries and regions that were the least caught-up in the excesses of the boom period having recovered their pre-crisis growth paths most rapidly. Thus, as of October 2010, industrial production in many developing countries had surpassed pre-crisis (August 2008) activity levels by 10 percent or more (for example, China, India, Nigeria, Sri Lanka), while many others had drawn even with their pre-crisis activity levels. However, industrial activity in other countries—including many high-income countries and developing economies in Europe and Central Asia— remains some 5 percent or more below August 2008 levels.

Simple estimates of whole-economy potential output suggest that, based on pre-boom period performance (see Box 1 and annex for more details), most developing countries have regained or are close to regaining full capacity, while several high-income and developing Europe and Central Asia economies remain plagued by ample spare capacity (Figure 2).

Trade too has bounced back

The rebound in industrial activity was mirrored in the volume of goods traded, which also regained pre-crisis levels by mid 2010, with almost 50 percent of the global increase in import demand emanating from the faster growing developing countries. Although overall activity in high-income countries remains relatively depressed, by October 2010 their export volumes had regained 98 percent of their

Figure 3 Trade has yet to recover pre-crisis trend



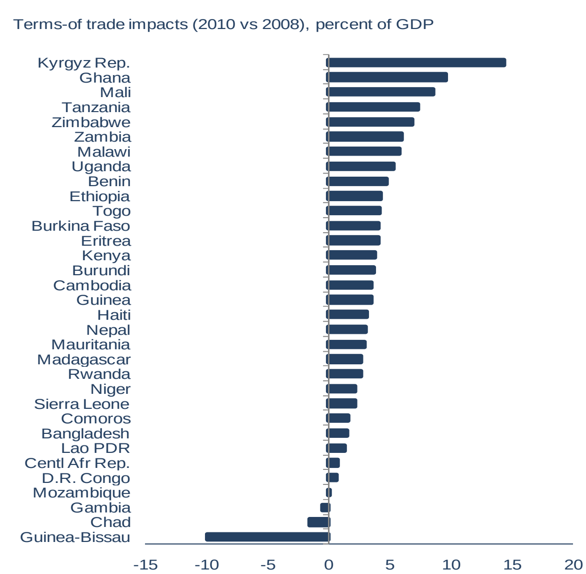
Source: World Bank.

August 2008 levels (up from 8.3 percent below that level at the beginning of the year). Developing country exports were some 16 percent higher than pre-crisis levels as of November.

While the recovery from pre-crisis levels is encouraging, trade volumes remain well below their pre-crisis peaks and the level that might have been expected to prevail had trade continued to grow at pre-crisis rates. Indeed, high-income countries export volumes are at the same level as in the beginning of 2007 (implying almost 3 years with no growth) and still some 10 percent below their pre-crisis peak of April 2008. Compared with their pre-boom trend, high-income exports are 19 percent below that which might have been expected, and developing country exports are 7 percent lower (Figure 3). In contrast, high-income imports are 14 percent below their long-term trend, whereas developing countries imports are some 7 percent higher than their long-term trend.

Despite the recovery in export volumes, much lower commodity prices (oil prices are 33 percent lower than they were in August 2008) meant that the U.S. dollar export earnings of developing countries remained between a quarter

Figure 4 Lower-energy prices translate into improved terms of trade gains for most low-income countries



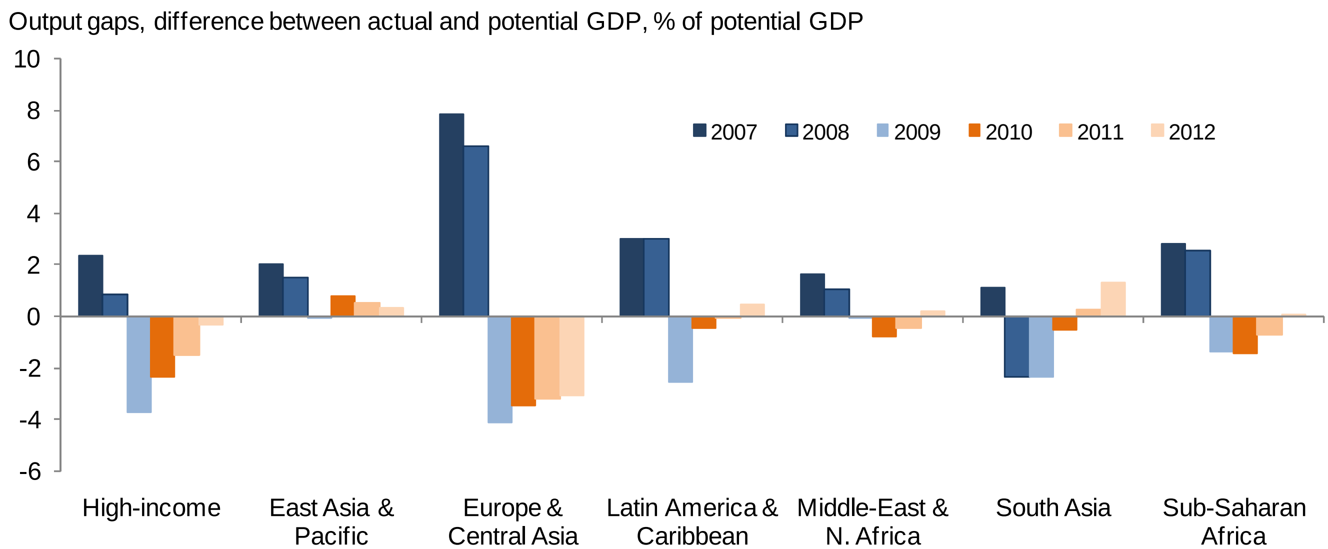
Source: World Bank.

Box 1 Estimating the level of economic slack

Though regaining pre-crisis activity and trade levels are important milestones, the extent of slack in an economy depends on both how far output declined, and its underlying trend growth rate. In fast-growing economies such as China, with an average annual industrial production growth rate of 14 percent during the first 5 years of the 2000s, merely regaining the August 2008 level of activity would imply an almost 20 percent shortfall in activity compared with what might have been expected in the absence of the crisis.

Estimates of potential output attempt to take into account the growth forgone during a crisis, and are based on activity in the whole economy — not just industry (see Annex for more detail). Such estimates confirm that the difference between actual demand levels and the productive potential of most economies largely disappeared or is about to disappear (Figure B1.1). Thus, while estimates of this output gap for high-income countries are more than 2 percent of GDP, they are less than 1 percent of GDP in every developing region except Europe and Central Asia. Even within that region, spare capacity is concentrated in 6 countries (Bulgaria, Kazakhstan, Lithuania, Romania, Russian Federation, and Ukraine). Elsewhere in the region, output gaps are close to zero. Similarly, relatively large output gaps in high-income countries are concentrated among countries that were most caught up in the excesses of the boom period, including transition economies such as Hungary and the Czech Republic. Unemployment rates in Estonia, Greece, Ireland, Lithuania, Ukraine, and the United States were in excess of 8 percent in late 2010, more than three times pre-crisis levels in some cases.

Figure B1.1 Spare Capacity is concentrated in high-income and developing Europe and Central Asian economies



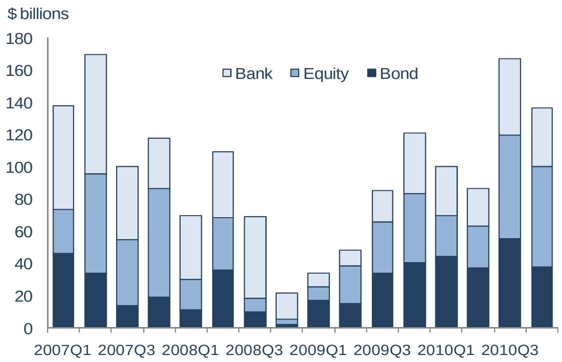
Source: World Bank.

and a third lower than pre-crisis levels. Overall, 29 percent of developing countries have seen their export earnings fall by 20 percent or more, substantially reducing incomes. By and large this has been offset by lower import costs. As a result, terms-of trade developments since 2008 have been generally positive for most non-oil-exporting developing countries—particularly low-income ones (Figure 4).

A surge in international capital flows

The rebound in real-side activity was supported by a global recovery in capital markets, partly reflecting loose monetary policy in high-income countries and resulting very low interest rates that have made equity and high-yielding bonds more attractive worldwide. As a result, despite still weak banking-sectors and little improvement in overall lending (net lending has increased sharply in percentage terms but remains quite low), equity markets in both high-income and developing countries have regained much of the value lost during the acute phase of the crisis, though they remain between 25.2-and 16.3 percent below previous peaks. The sharpest increase was in short-term debt flows (debt with an original maturity

Figure 5 Non-bank gross capital flows to developing countries surged in 2010

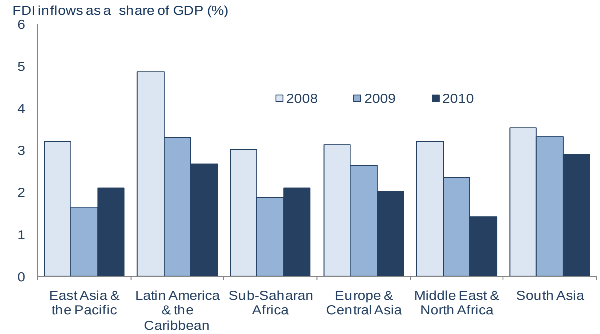


Source: World Bank using Dealogic.
Note: Data refer to gross flows of new bond and equity issues and syndicated bank loan commitments.

of one year or less). These flows tend to be mostly trade related in developing countries, and jumped to an estimated $86 billion in 2010 from $6.4 billion in 2009.

Gross equity flows to, and bond issuance by, developing countries increased by more than 60 percent between 2009 and 2010, reaching almost three-times the level recorded in 2008 (Figure 5). Private corporations were particularly active, taking advantage of investor's search for yield to compensate for weak bank flows (down 36 percent from 2009). Such firms issued 50 percent of all developing-country bonds –well in excess of their average 40 percent share during 2008-2009.

Figure 6 While up globally, FDI fell further as a percent of GDP in three of six developing regions.

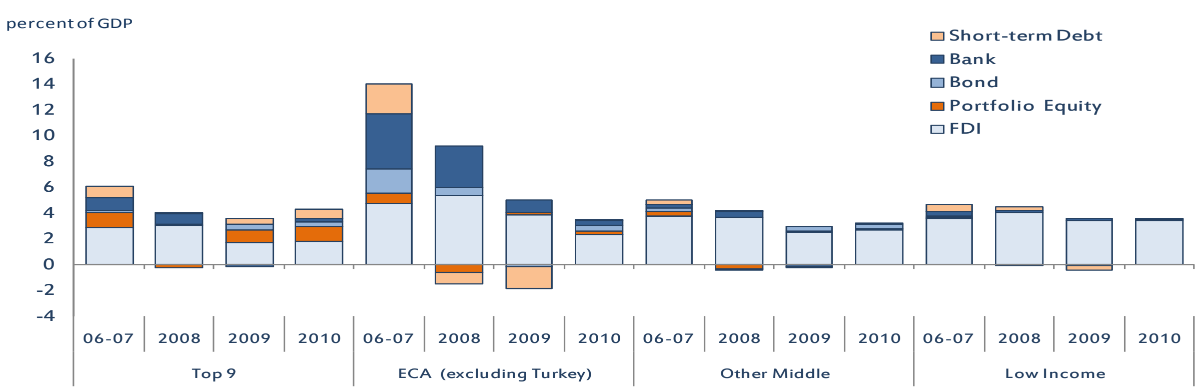


Source: World Bank.

The recovery in FDI was more muted, with net flows to developing countries rising by an estimated 16 percent to $410 billion after falling 40 percent in 2009. Among developing regions, Europe and Central Asia recorded the largest cumulative shortfall in FDI inflows as a share of regional GDP (Figure 6).

An important factor in the rebound of FDI has been increases in South-South FDI, particularly from Asia. FDI outflows from developing nations rose to an estimated $210 billion (1.1 percent of their GDP) in 2010, surpassing the previous record of $207 billion of 2008. More than 60 percent of these flows originated in Brazil, Russia, India and China, with the bulk (60 percent) going to other developing nations — mostly in the form of greenfield investment. In contrast, South-North FDI mainly took the

Figure 7 Capital flows to low-income countries are dominated by FDI and therefore more stable than in middle-income countries.



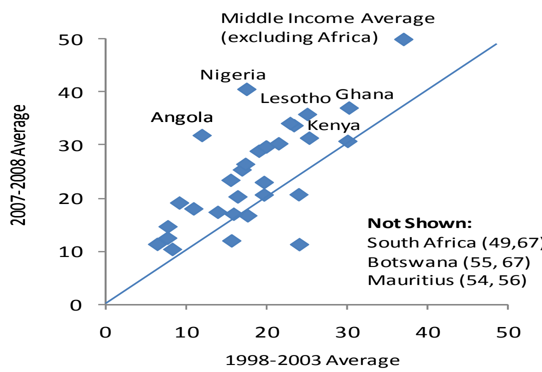
Source: World Bank.
Note: Top 9 comprise Brazil, China, India, Indonesia, Malaysia, Mexico, South Africa, Thailand, and Turkey.

Box 2 Sub-Saharan Africa's increasing attractiveness as a destination for international capital flows

Outside of South Africa, foreign private capital flows into Sub-Saharan Africa come almost exclusively in the form of foreign direct investment (FDI). And while such flows represent as much as 20 percent of total gross capital formation in the region, for years FDI inflows have been almost exclusively focused on the extractive sector. Indeed, the high commodity prices of recent years have supported large capital inflows to many resource-rich African countries and helped to sustain these flows even during the crisis.

However, several Sub-Saharan African countries appear to be better positioned to receive more international capital flows in the current cycle. The investment climate in most countries is improving (Figure B2.1); and many have improved their macroeconomic policies and debt sustainability (Radelet 2010). As a result, market makers are increasingly talking of several African countries' being on the verge of an economic takeoff (McKinsey 2010; Young 2009; and Pinkovsiy and Xala-i-Martin 2009). In fact, for global investors, several countries in the region represent relatively untapped large and rapidly growing markets (regional GDP is projected to grow by more than 5 percent annually between 2010 and 2012).

Figure B2.1 Improved investment climate in African countries



Source: Institutional investor country ratings.

As a result, multinationals are increasingly recognizing Africa's potential and getting interested in entering the local market to take advantage of the opportunity to service the local economy. The region has been attracting FDI into new sectors in services (telecom, banking). For example, Walmart has made an offer of 13 times the pre-tax earnings of the South African MassMart (290 stores in 13 African countries), in order to secure itself a foothold on the continent. Africa is also becoming an attractive destination for portfolio investment flows. Countries like Ethiopia, Ghana, Nigeria, and Rwanda are identified by several fund managers as possible destinations for Africa-centric investment funds.

Increased investment and trade ties with other developing countries have been playing an important role. While some of the South-South flows are intra-regional (coming from Tanzania, South Africa and Kenya), inter-regional South-South investment from China, Brazil, India and Malaysia has surged in recent years. The recent acquisition of telecom company Zain Africa by Indian Bharti for $10.7 billion was the largest South-South acquisition ever.

The potential and promise of Africa's future is clear. But continued success is not guaranteed. Concerns about the quality of growth and political stability remain. The realization of Africa's promise will depend on the continuation of policy reforms and institutional development that have underpinned the recent improvement in economic performance, building on the foundation that has been laid. And, even if the potential is realized, the absorption capacity of these countries will be a crucial determining the extent to which they benefits from better access to international capital flows. With limited experience of dealing with large capital flows, some countries may have difficulty managing the volatility that can accompany them.

form of mergers and acquisitions.

Because most of the surge in international capital flows was in short-term debt, equity and bonds (notably corporate bonds), the increase in inflows was mainly directed toward middle-income countries. As a percent of recipient GDP, capital flows increased significantly in the nine largest developing economies (Figure 7). But even for these countries, capital flows as a percent of GDP

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

	2003	2004	2005	2006	2007	2008	2009	2010e	2011f	2012f
Current account balance	126.6	185.0	322.8	448.9	476.7	434.6	279.6	298.2	272.5	265.9
as % of GDP	1.9	2.3	3.4	4.0	3.4	2.6	1.7	1.6	1.3	1.1
Financial flows:										
Net private and official inflows	262.3	342.2	464.9	610.3	1110.4	743.8	597.9	825.9		
Net private inflows (equity+debt)	274.3	366.3	528.9	679.9	1110.4	716.0	521.5	753.2	838.6	874.5
Net equity inflows	178.8	243.6	341.1	451.0	643.2	533.9	462.2	563.0	631.1	724.2
..Net FDI inflows	152.5	206.7	273.6	343.3	508.1	587.1	354.1	409.6	486.0	589.9
..Net portfolio equity inflows	26.3	36.9	67.5	107.7	135.1	-53.2	108.2	153.4	145.1	134.3
Net debt flows	83.6	98.6	123.8	159.3	467.2	209.9	135.6	262.9		
..Official creditors	-11.9	-24.1	-64.0	-69.6	0.0	27.8	76.4	72.4		
....World Bank	-2.5	2.4	2.7	-0.2	5.2	7.3	17.7	19.3		
....IMF	2.4	-14.7	-40.2	-26.7	-5.1	10.0	26.5	16.3		
....Other official	-11.8	-11.8	-26.6	-42.6	0.0	10.6	32.2	36.8		
..Private creditors	95.5	122.7	187.8	228.9	467.2	182.1	59.2	190.5	207.5	150.3
....Net M-L term debt flows	38.3	69.8	113.3	145.0	283.0	196.1	52.8	104.1		
......Bonds	23.1	34.3	48.3	31.7	88.2	24.1	51.1	66.5		
......Banks	19.5	39.7	70.3	117.9	198.5	176.8	3.2	37.6		
......Other private	-4.4	-4.1	-5.3	-4.7	-3.7	-4.8	-1.6			
....Net short-term debt flows	57.2	52.9	74.5	83.9	184.2	-14.0	6.4	86.4		
Balancing item /a	-103.5	-127.3	-372.9	-411.3	-495.5	-700.2	-250.2	-649.0		
Change in reserves (- = increase)	-285.5	-399.9	-414.8	-647.9	-1091.7	-478.2	-627.3	-475.1		
Memorandum items										
Net FDI outflows	23.6	46.1	61.6	130.5	148.7	207.5	153.9	210.0	250.0	275.0
Workers' remittances	137.4	159.3	192.1	226.7	278.0	325.0	307.1	325.0	346.0	374.0
As a percent of GDP										
	2003	2004	2005	2006	2007	2008	2009	2010e	2011f	2012f
Net private and official inflows	3.88	4.26	4.88	5.42	8.03	4.52	3.72	4.40		
Net private inflows (equity+debt)	4.05	4.56	5.56	6.04	8.03	4.35	3.24	4.01	4.00	3.77
Net equity inflows	2.64	3.03	3.58	4.01	4.65	3.24	2.73	3.00	3.01	3.12
..Net FDI inflows	2.25	2.57	2.87	3.05	3.67	3.57	2.09	2.18	2.32	2.54
..Net portfolio equity inflows	0.39	0.46	0.71	0.96	0.98	-0.32	0.64	0.82	0.69	0.58
..Private creditors	1.41	1.53	1.97	2.03	3.38	1.11	0.35	1.01	0.99	0.65

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

were lower than the pre-crisis period (2006-07).

Low-income countries were subjected to relatively small declines in overall capital flows during the crisis, and relatively small gains in the recovery, because they receive very little in the form of bonds or equity. Indeed, equity flows were close to zero in half of the 128 developing countries for which data exist, and more than 2/3 have *never* accessed the international bond market.

Given these patterns, the increase in capital flows expressed as a share of GDP was uneven across regions. Aggregate flows increased in all regions except South Asia, and the Middle East and North Africa (see Box 2 on FDI prospects for Sub-Saharan Africa).

Looking at 2010 as a whole and at capital flows in net terms (new flows less repayments), private capital flows to developing countries rebounded an estimated 44 percent, reaching about $753 billion, or 4 percent of recipient GDP (Table 2).

Recovery in remittances, tourism and commodity prices were positives for low-income countries

Although low-income countries did not benefit from the recovery in capital flows to the same degree as middle-income countries, their recoveries in 2010 were supported by a modest pickup in remittances, tourism and commodity prices.

Remittances are a very important source of income for a number of poorer developing economies, representing more than 20 percent of GDP in several (Figure 8). Overall, the dollar value of remittances to individuals living in developing countries rose an estimated 6 percent in 2010, after falling 5.4 percent in 2009 (World Bank, 2010b). However, the depreciation of the U.S. dollar against many developing country currencies reduced the extent to which the incomes of the poor were increased. At the aggregate level, the real-local currency value of remittances is estimated to have declined 3.9 percent in 2010, with losses in economies that appreciated against the dollar offsetting gains in those that were pegged to or depreciated with respect to the dollar.

Tourism is also an important source of income for some developing countries, representing 10 percent or more of GDP in 13 countries. For these economies, an estimated 7.6 percent increase in tourism arrivals in 2010 more than compensated for the 1.4 percent decline recorded in 2009 (World Tourism Organization, 2010). The Middle-East, East Asia, and South Asia saw the biggest estimated increases in volumes, up 13, 7.6, and 14 percent respectively, with intra-regional tourism in the Middle-East and North Africa playing a big role.

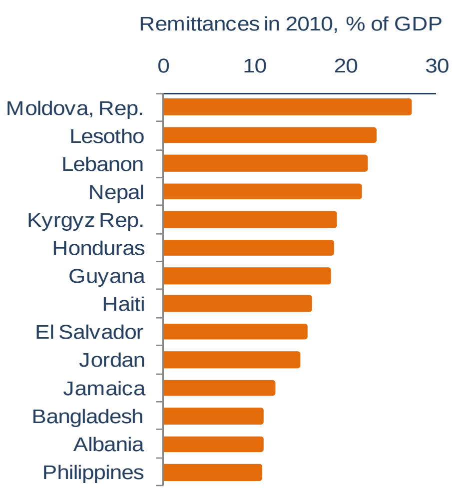
The strong rebound in metals and minerals prices, and to a lesser extent energy prices, boosted incomes in resource-rich developing countries, and helped economies to meet fiscal challenges.

A mid-year pause in the recovery

Growing supply-side bottlenecks in countries where the recovery was most advanced, and ongoing restructuring in those most directly affected by the financial crisis, contributed to a mid-year pause in growth. In the final quarter of 2010, this began giving way to what is expected to be slower growth more in line with longer-term trends.

The slowdown partly reflected the coming to an end of the easy ramping up of previously idled capacity, and of the investment cycle (a standard

Figure 8 Increased tourism and remittances boosted incomes in many low-income countries



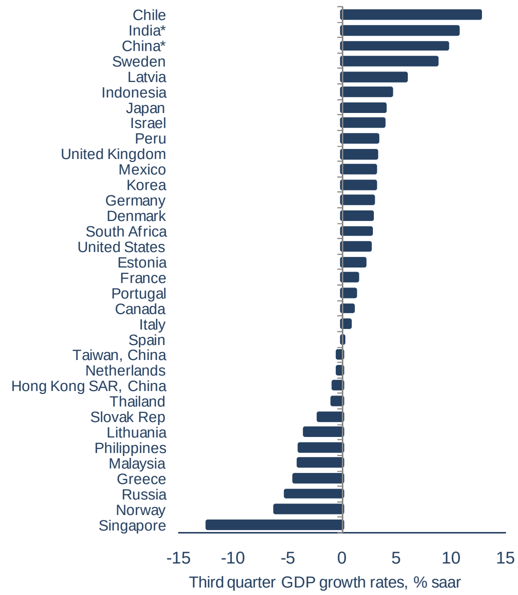
Source: World Bank.

Source: World Bank, UN International Tourism Organization.

mechanism underpinning recovery) in most developing countries. As activity rebounded, investment also picked up, partly driven by the need to replace depreciating equipment and by improving growth prospects. By the third quarter of 2010 aggregate investment rates in developing and high-income countries had regained near-normal levels. In aggregate, investment remains depressed in high-income countries, partly because of ongoing restructuring in some sectors. In the United States for example, outside of the residential sector, investment rates are almost back to normal levels (Box 3).

Indeed, the sharp mid-year slowdown in industrial production and global trade appears to have reflected an overshooting of activity rather than a decline in demand. Demand growth in the third quarter of the year (the same quarter over which the production figures appear to have stalled) was actually very strong both in high-income countries, and in most developing economies reporting quarterly GDP data (Figure 9). Negative growth was concentrated among countries enduring sharp fiscal consolidations or that are particularly specialized in industrial

Figure 9 Generally strong in 2010 Q3 growth



Source: Datastream.

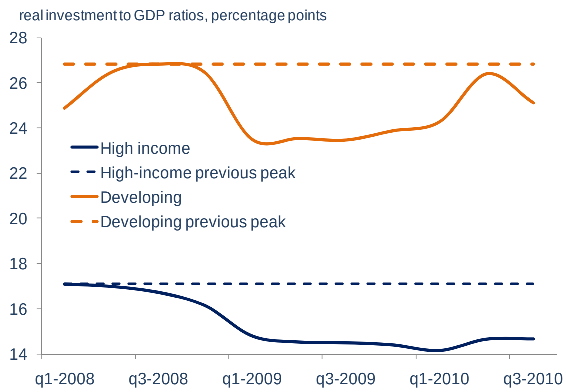
production.

Most concurrent and forward-looking indicators for the fourth quarter of 2010 point to a strengthening of economic activity. For example,

Box 3 The investment recovery

The crisis saw investment rates in both developing and high-income countries fall dramatically (down 3 percent of GDP in high-income and 3.4 percent of GDP in developing countries). With the recovery, investment has rebounded significantly. Real investment rates in developing countries, for which quarterly Q3 2010 GDP data are available, were less than 1/2 of percentage point lower than their pre-crisis peak in 2010 Q2, before falling back to 1.7 percentage point gap in the third quarter (Figure B3.1). In East Asia investment rates have recovered previous peaks, while in developing Europe and Central Asia and Latin America investment remains relatively depressed, down 5 and 2.5 percentage points from pre-crisis peaks.

Figure B3.1 Fixed investment is recovering in developing countries



Source: World Bank.

As of the third quarter of 2010, the investment to GDP ratio in high-income countries remained 2.5 percentage points below its pre-crisis peak. This partly reflects the nature of the pre-crisis investment boom. For example, in the United States, although aggregate investment remained 2.7 percentage points below its pre-crisis peak, this mainly reflected continued weakness in the housing sector. Business-sector investment was only 0.1 percentage points below its pre-crisis highs (the nominal ratio is 1.5 percentage points below its long-term average). Aggregate investment rates could take years to fully recover, as the boom -period overinvestment in housing only slowly works its way out of the system.

the pace of industrial production growth in China, which came close to zero during the two months ending June 2010, had returned to 15.1 percent by November 2010. And other BRIC countries are also showing signs of accelerating activity. Similarly, strengthening retail sales data and purchasing manager's indexes for the globe's largest economies point to a continued expansion of output (Figure 10). Although recent export order surveys look less bullish than earlier in the year, they remain in positive territory and new orders are accelerating.

Nevertheless, momentum growth rates in the United States and Europe remain weak, and some smaller economies continue to suffer from intense post-crisis restructuring. In addition, the renewed turmoil in European sovereign debt markets may dampen investment spending, while plans to tighten budget positions are likely to exert drag on growth — unless deficit reduction strategies improve consumer and business confidence and spending, by enough to offset the direct negative effects of reduced government spending.[2]

Outlook is for steady but slower growth in 2011 and 2012

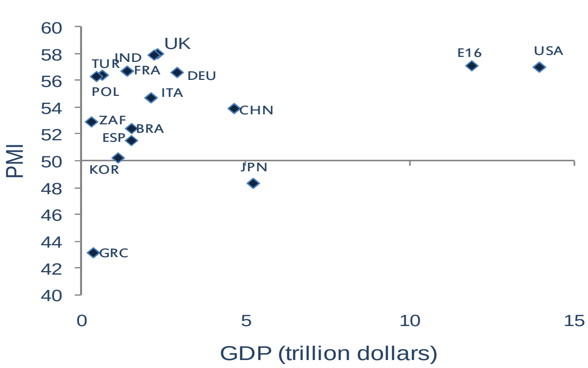
After the sharp growth deceleration of 2008 and the contraction in 2009, global GDP is estimated to have increased 3.9 percent in 2010. The pickup in growth among high-income countries (a 6.2 percentage point improvement in growth rates) was more marked than in developing countries (5 percentage point increase in growth rates); but at 7 percent, growth in developing countries was more than twice as strong as in high-income countries. As a result, low and middle-income countries contributed almost half of global growth (46 percent) in 2010. Moreover, all of developing country growth was due to increased domestic demand.

Growth in both high-income and developing countries is expected to slow somewhat in 2011, mainly reflecting the easing already observed in the second half of 2010, before picking up again toward mid 2011, settling at rates close to their longer-run potential. Global GDP is projected to increase by 3.3-and 3.6 percent during 2011 and 2012, with developing economies expanding by 6-or more percent in each year, more-than twice the 2.4 and 2.7 percent growth expected for high -income countries. Unfortunately these growth rates are unlikely to be fast enough to eliminate unemployment and slack in the hardest-hit economies and economic sectors.

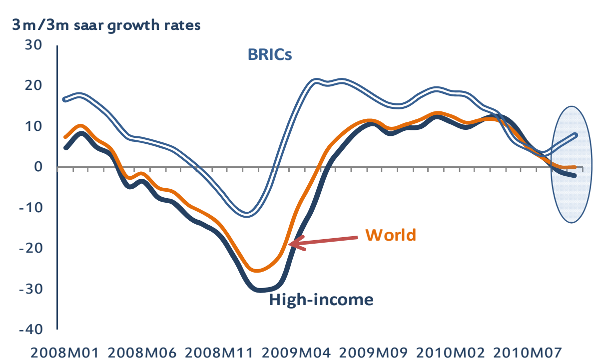
The continued recovery should be supported by further strengthening of capital flows to developing countries in 2011 and 2012. However, carry-trade flows are expected to decline, as monetary policy tightens in high-income countries and interest rates rise. Partly as a result, total inflows to developing countries will rise less quickly — at just over 10 percent in 2011 and under 5 percent in 2012 (Figure 11). Because nominal GDP is expected to rise faster

Figure 10 Some indicators point to strengthening fourth quarter growth

Purchasing manager indexes point to strengthening

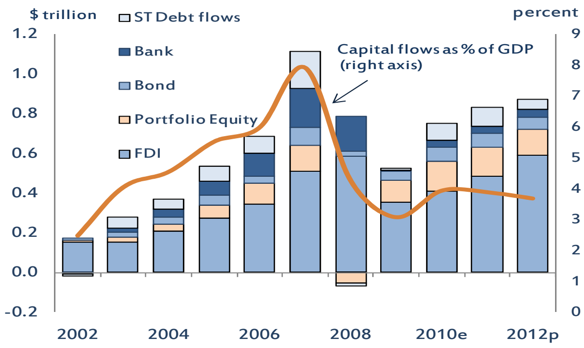


Industrial production may be picking up again



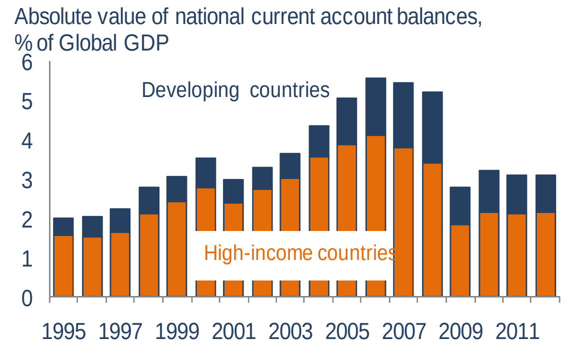
Source: World Bank.

Figure 11 Net private capital flows to developing countries



Source: World Bank.

Figure 12 Global imbalances have declined substantially and are expected to continue falling



Source: World Bank.

(10 and 12 percent), despite rising in dollar terms flow are projected to decline as a share of GDP, to around 3.7 percent in 2012.

A combination of lower commodity prices (compared with 2008) and a rebalancing of trade volumes in favor of high-income countries, has served to reduce global imbalances; and this trend is not expected to be reversed over the forecast period. The absolute value of the current account balances of the world's economies has declined from a peak of 5.6-to about 3.3 percent of global GDP in 2010 (Figure 12). Most of the decline reflects smaller imbalances in high-income countries (the current account deficit in the United States narrowed from 6-to 2.7 percent of GDP between 2005 in 2009, before bouncing back to 3.5 percent of GDP in the third quarter of 2010). Imbalances in developing countries have also declined from 1.5 percent of global GDP in 2006 to about 1.1 percent in 2010.

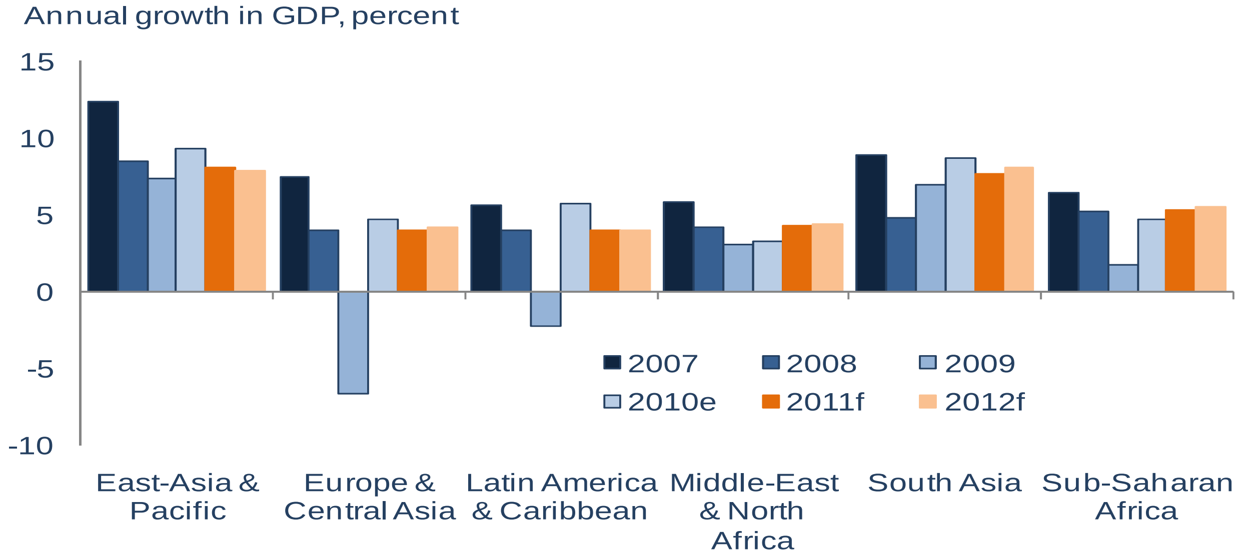
Looking forward, global imbalances are expected to decline marginally in 2011 and 2012, as whole economy savings in high-income countries continues to rise. Any tendency for private savings rates in high-income countries to decline due to cyclical improvements in the economy are expected to be countered[3] by higher public-sector savings as fiscal deficits decline and by an offsetting tendency for private savings to rise as interest rates increase with the withdrawal of monetary stimulus.

High-income countries

Activity in the *United States* is expected to continue to be characterized by strong domestic demand growth, but relatively disappointing GDP growth, as the economy continues to deal with high-unemployment and the shrinking of an overgrown housing sector. Notwithstanding the 9 percent real-effective depreciation of the dollar since January 2009, and stronger exports, leakages, both in the form of imports and capital outflows, continue to stymie efforts to grow the economy through demand stimulus. Boosted by the additional stimulus measures passed late in 2010, GDP is projected to expand 2.8 percent in 2011 and 2.9 percent in 2012.

In *high-income Europe*, the recovery will continue to face headwinds from the uncertainty surrounding sovereign debt in several countries as well as planned fiscal tightening on a wider scale. Nevertheless, growth in the larger economies is expected to remain close to- or slightly above past trends, helping to slowly re-absorb unemployment and spare capacity. Among those high-income European countries most deeply affected by the crisis, growth is not expected to be strong enough to reduce unemployment very rapidly, partly because of the intense restructuring that some of these economies are undergoing. Overall, Euro Area GDP, after expanding 1.7 percent in 2010, is projected to slow to 1.4 percent in 2011 and pickup to 2 percent in 2012, reflecting both a gradual tightening of fiscal policy and the

Figure 13 Developing country growth rates to stabilize at historically elevated rates



Source: World Bank.

region's reliance on bank lending, as opposed to equity and bond flows, to finance private-sector investment.

After a solid third quarter, *Japanese* growth is expected to contract in the fourth quarter of 2010, but an anticipated rebound in exports should see the economy renew growth in the first quarter of 2011. Overall, growth for 2010 is estimated at 4.4 percent, but is expected to moderate to 1.8 percent in 2011 and advance by 2 percent in 2012.

Developing countries

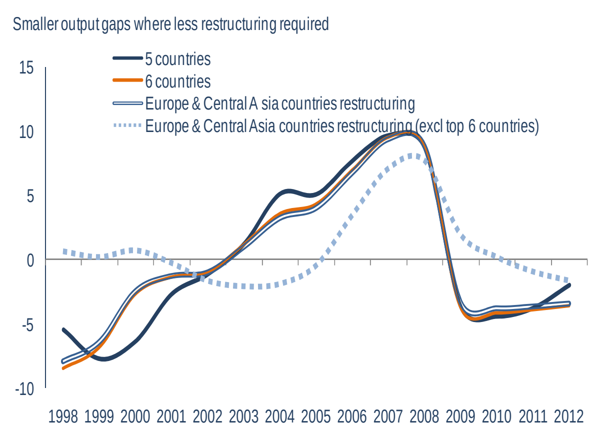
In-depth discussion of prospects in the different developing regions, including country-specific forecasts, are available in the regional annexes to this volume and online at: http::\www.worldbank.org\globaloutlook.

With the exception of the Europe and Central Asia region, most developing regions are projected to enjoy strong recovery (Figure 13), with growth close to underlying potential and output gaps close to or approaching zero (Figure 14). This apparent homogeneity masks important differences within regions, reflecting among other factors, countries' exposure to international capital flows, and their reliance on remittances, tourism and commodities. The following paragraphs examine the prospects of developing countries from this perspective.

Middle-income countries undergoing restructuring

On average, middle-income countries underwent a much more pronounced cycle than low-income countries, with GDP for middle-incomes growing only 1.9 percent in 2009, before rebounding 5.9 percent in 2010. Among those economies whose underlying structure was most

Figure 14 Output gaps in restructuring Europe and Central Asian economies remain large



Source: World Bank.

Table 3 Developing country GDP developments by economic category

	Real GDP growth							Economy-wide output gap 2010
	2000 - 2004	2005-2008	2008	2009	2010	2011	2012	
Fragile states	3.0	4.1	3.8	3.0	5.0	5.2	5.1	-0.7
Countries undergoing restructuring in Europe and Central Asia	6.9	7.3	5.3	-7.3	3.2	4.0	4.1	-3.9
5 most affected countries	7.2	7.0	4.4	-8.2	1.7	3.1	4.3	-4.4
6 most affected countries	6.9	7.1	5.0	-8.0	3.1	3.9	4.1	-4.2
Europe and Central Asia (excl the 6 most affected countries)	6.7	10.9	9.1	1.6	4.7	4.7	4.8	0.2
Top-9 capital inflow countries	5.6	7.8	6.0	3.7	8.4	6.8	6.8	-0.1
o/w those with pre-crisis current account surpluses	8.2	10.3	8.7	7.7	9.4	8.1	7.9	0.6
o/w those with pre-crisis current account deficits	3.8	5.5	3.5	-0.3	7.3	5.3	5.6	-0.8
LIC tourism and remittance dependence countries	4.8	6.1	5.6	4.3	5.3	6.4	6.3	-0.7
Remittance dependent	4.8	6.0	5.4	5.2	5.5	5.8	6.2	0.0
Tourism dependent	5.1	8.9	8.8	4.4	6.5	9.0	7.9	-1.6
LIC: Resource dependent economies	6.6	7.2	5.8	4.7	6.4	6.6	6.6	-0.5
MIC: Resource dependent economies	4.1	6.3	5.1	1.4	3.9	4.5	4.6	-0.8
Other: LIC	4.6	7.7	8.6	5.7	6.0	6.7	7.0	-0.3
Other: MIC	2.5	6.5	4.4	1.9	5.9	4.3	4.3	1.1

Source: World Bank.
Note: Top 5 (6) countries include: Bulgaria, Kazakhstan, Lithuania, Romania, (Russian Federation), and Ukraine.

distorted during the boom period and whose households and banking sectors are most burdened by bad debt,[4] output gaps are more-than 4 percent of GDP and unemployment remains endemic. To a large extent this reflects developments in 6 middle-income countries that experienced very pronounced booms during the period 2003-2007 and whose economies are currently undergoing severe restructuring.[5]

All of these countries are located in the Europe and Central Asia region. Partly as a result, the region's aggregate growth has been slow, with GDP increasing only 4.7 percent in 2010 after declining 6.6 percent in 2009 (see earlier Table 1). High levels of household indebtedness and widespread unemployment have held back consumer demand, while banking-sector consolidation and large quantities of bad-loans are limiting new lending. In addition, tepid growth and financial restructuring in high-income Europe has meant a weak recovery in foreign capital inflows, export revenues and remittances for developing Europe and Central Asia. In the five countries undergoing the most intense restructuring, output fell 8.2 percent in 2009, and rebounded by just 1.7 percent in 2010 (Table 3). Including Russia in the tally, output collapsed by 8 percent in 2009, but the growth rebound was stronger (3.1 percent) as Russia benefitted from the recovery in oil prices and state revenues.

Excluding the six most affected economies, the growth impact was less severe for Europe and Central Asia, with positive growth (1.6 percent) in 2009, and expectations for increases in a high 4-percent range through the projection period. Output gaps for these countries are slightly positive in contrast to the much larger gaps for the restructuring economies (Figure 14). Indeed, even by 2012, output gaps in the restructuring economies are expected to remain high, with growth coming in at less than half its pre-crisis rates.

Very strong capital inflows boosted growth in some countries

While most countries experienced a bounce back in capital flows during 2010, GDP in the 9 countries[6] that attracted the bulk of these flows surged 8.4 percent in 2010, after rising 3.7 percent in 2009.[7] The bounce-back in growth was strongest among current-account deficit countries within the group (7.6 percentage points) as renewed capital inflows eased domestic demand growth constraints (particularly investment and private consumption related).

Both groups have seen output gaps close rapidly, though gaps in current account deficit countries remain moderately negative. Growth in both groups of countries is expected to remain strong, albeit easing from the very fast rates posted in 2010. In the baseline projections continued strong capital inflows are projected to push GDP in each group to within 1/2 of a percentage point of potential by 2012 (Figure 15). However, if capital inflows accelerate further and growth escalates to above baseline projections, already existing inflationary pressures and asset price bubbles could build further — especially among those countries that continue to resist upward pressure on their currencies. For others, continued appreciation will cut into domestic competitiveness, reducing net exports and help to mitigate inflationary pressures.

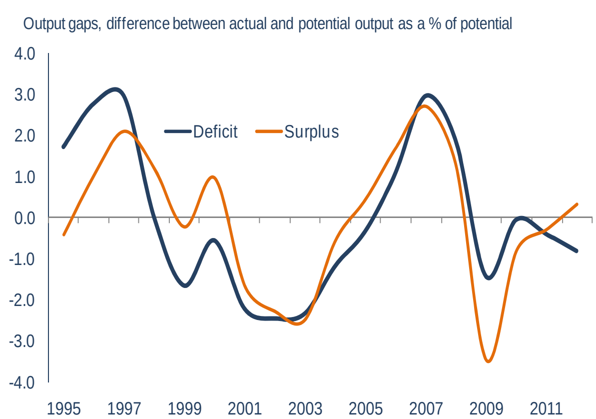
High commodity prices should continue to support robust growth among resource-dependent economies

The crisis affected both low– and middle-income resource-dependent countries less dramatically than other countries. For low-income exporters (many of which in Sub-Saharan Africa), GDP growth eased by about a percentage point into 2009, rebounded to 5.3 percent in 2010 and is anticipated to sustain rates of about 6.5 percent throughout the forecast period, as strong commodity prices continue to support incomes and government finances. The crisis slowed activity in resource-dependent middle-income countries more than like low-income countries mainly as these economies were more financially integrated with the world economy, and were characterized by larger manufacturing sectors. Moreover, many low-income resource-rich countries are still expanding production at a rapid rate, a process that continued despite the crisis. Middle-income resource-dependent economies are expected to grow 4.5-and 4.6 percent in 2011 and 2012, moderately above their average growth of 4.1 percent during the pre-boom period 2000-2004.

Further recovery in remittance and tourism revenues underpins expectations of gradual acceleration

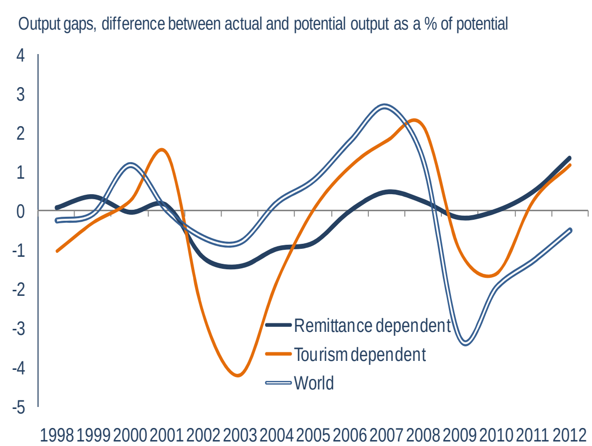
The impact of the crisis on low-income remittance and tourism dependent countries was limited, with growth declining from 5.6-to 4.3 percent between 2008 and 2009. Partly as a result, economy wide capacity utilization is already back to long-term trend levels (Figure 16). Tourism dependent economies were harder hit by the crisis, as declining incomes and uncertainties in tourism-originating countries yielded lower tourist volumes and/or reduced

Figure 15 Strong capital flows contributed to rapid closure of output gaps in some countries



Source: World Bank.

Figure 16 Output in remittance dependent developing countries was broadly stable



Source: World Bank.

spending.

The rebound in remittances-dependent economies is expected to be modest over the next two years, as employment conditions in high-income countries improve only slowly. Tourism is also not expected to bounce back very forcefully in most countries, as prospects in originating countries strengthen only slowly.

Assuming no further turmoil, growth in fragile states is expected to continue accelerating

The impact of the great recession on fragile countries[8] was relatively small, with growth falling off from 3.8 percent in 2008 to 3 percent in 2009. Assuming that domestic conditions continue to improve, growth is anticipated to average 5 percent per year or more over 2010-2012, well above the 3 percent average growth recorded during the pre-boom period. Of course, should political conditions in one or more countries deteriorate, growth could suffer markedly.

Remaining countries are projected to outperform pre-boom growth rates

Growth slowed in aggregate for the remaining low-income countries by almost 3 percentage points between 2008 and 2009; but growth is viewed to pick up to 7 percent by 2012. This strong performance, which is mirrored in other categories of low-income countries, reflects in part these countries' relatively weak links to international financial markets, which means they avoided the worst parts of the "boom-bust" cycle. However, improved macroeconomic management and earlier debt relief also increased their ability to react and adapt to volatile external conditions.

The remaining middle-income countries (excluding countries that are undergoing restructuring, receiving hot money inflows or that are resource rich) have also benefitted from the rebound in international financial conditions. FDI flows, which increased by about 20 percent to this group, contributed to strong growth of 5.9 percent in 2010. On average, output in these economies remains high relative to potential. Partly as a result, and reflecting a near term slowing of growth elsewhere in the world, the pace of expansion in these economies is viewed to establish a 4 percent pace over the projection period.

Challenges facing the global economy

The global recovery has gained strength, matured and broadened to include more countries and more components of demand. This dynamic appears to be well established, particularly among developing countries. As a result, concerns of a double-dip recession have eased. However, the recovery remains exposed to significant short and long-term risks that could derail it. The remainder of this section discusses these, beginning with short-term risks and concluding with longer-term ones.

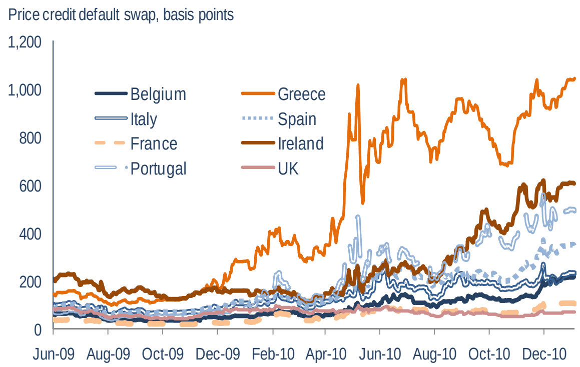
Short-term risks to the global recovery

As discussed earlier, the main short-term risks to the global economy include: the possibility of further disturbance and contagion in Euro area sovereign debt markets; the possibility that very low interest rates in high-income countries induces a second "boom-bust" cycle among one or more developing countries; and the possibility that rising commodity prices threaten recovery and/or poverty reduction in developing countries.

Financial turmoil in high-income Europe

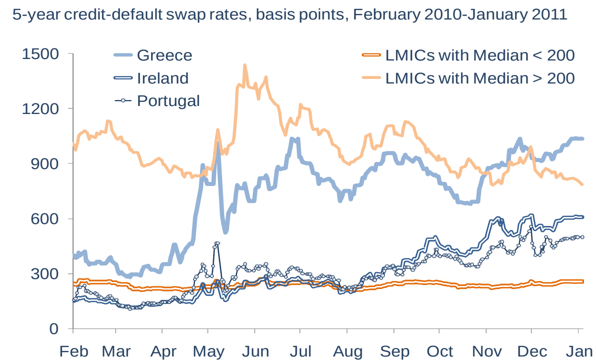
Market concerns about fiscal sustainability and the crisis resolution system in the Euro area intensified once again in final quarter of 2010, as Ireland became the second Euro-area state to receive external financial support from the European Union and the IMF. The package amounts to some 54 percent of Irish GDP, of which an amount equivalent to some 11 percent of GDP will be provided from Ireland's own resources. It's objective is to provide support to the banking sector. To date, however, calm has not been restored to the markets.

Figure 17 Renewed market anxieties concerning European sovereign debt have rebounded



Source: World Bank, Datastream

Figure 18 High-income sovereign debt woes have limited effect on developing countries credit costs



Source: World Bank, Datastream.

Concerns that banking sectors in other markets might require further support, and lingering uncertainty about the capacity of currently existing frameworks to address the potential financing needs of the economies involved placed upward pressure on the price of credit default swaps for Belgium, Greece, Ireland, Italy, Portugal and Spain during the fall of 2010 (Figure 17). Uncertainties also contributed to a decline in equity market valuations of between 1.2-and 8.9 percent. Equity markets recovered somewhat in early December, after the European Central Bank began to actively purchase outstanding bonds, but CDS spreads after an initial decline continued to rise or remained high through to the end of the year.

So far, the skittishness of investors concerning high-income European debt has not been passed onto the price of swaps of the majority of developing countries, although the price of CDS swaps of countries that initially had spreads in excess of 600 basis points also tended to move upwards (Figure 18). However, the uncertainty in November did contribute to an easing in capital flows to developing countries. Flows also remained low in December, a seasonally slow month for capital flows.

The implications of this renewed bout of investor nervousness are unclear. The most likely scenario, and the one retained in the baseline projections, assumes that although market nervousness continues, it will have limited impacts on the real economy — as was the case in May 2010 when the first bout of market nervousness regarding Euro-Area sovereign debt arose (see World Bank, 2010 for more).

However, if market volatility persists, investors may hold back on investment projects and/or consumers may delay durable goods purchases. Such behavior could slow growth and possibly lead to a double dip recession in some countries. Moreover, market nervousness may prompt countries to intensify fiscal consolidation strategies, further slowing the pace of the recovery in 2011. The simulations in Table 4 assume an 1 percent of GDP additional fiscal consolidation being introduced in the second quarter of 2011, and a 2.5 percentage point

Table 4 Estimated impact of increased fiscal consolidation and investor nervousness
(Percent deviation in the level of GDP from baseline)

	2010	2011	2012
World	**0.0**	**-0.6**	**-0.9**
High-income	0.0	-0.7	-1.1
Developing countries	**0.0**	**-0.1**	**-0.2**
Middle-income	0.0	-0.1	-0.2
Low-income	0.0	-0.1	-0.2
East Asia and Pacific	0.0	-0.2	-0.3
Europe and Central Asia	0.0	-0.1	-0.1
Latin America and Caribbean	0.0	-0.1	-0.1
Middle East and N. Africa	0.0	-0.1	0.0
South Asia	0.0	-0.2	-0.4
Sub-Saharan Africa	0.0	-0.1	-0.1

Source: World Bank.

reduction in investment compared with the baseline. This results in a slowing in growth of as much as 0.6 percentage points in 2011 and 0.3 percentage points in 2012. Most of the slowdown would be borne by high-income countries (a cumulative 1.1 percentage points). The more constrained environment would affect growth in developing countries to a lesser extent – in part because developing countries are not assumed to implement additional fiscal consolidation measures.

Although market nervousness about sovereign debt in the Euro Area has had limited impacts on the real economy so far, the consequences of a disorderly resolution to European fiscal tensions, unlikely as it may be, is still an important source of uncertainty for both high-income and developing countries—particularly those with close trading and financial ties with concerned economies.

As a consequence of the growing financial integration in the Euro area and the high-income world in general, there are extensive cross-exposures among high-income country banks. As of the second quarter of 2010, the Bank for International settlements estimates that European Banks held some $1.6 trillion in assets from Greece, Ireland, Portugal and Spain, or more than 8 percent of total claims of the European banking system — down substantially from the 10 percent of claims held in late 2009 (Figure 19).

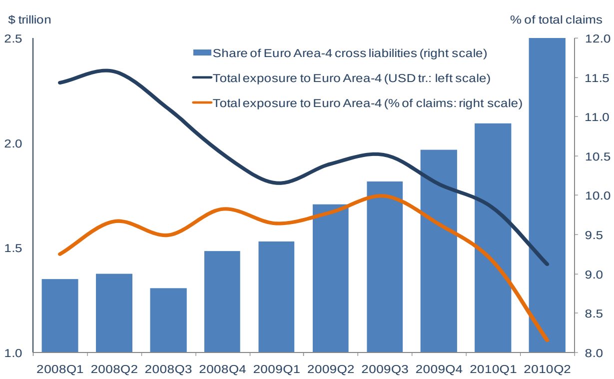
Another potential transmission channel could be through the financial sector. Banks in the countries under close financial market scrutiny hold international claims in emerging markets of around $0.7 trillion. Albania, Bulgaria, Romania, and Serbia are economies that have benefitted in the past from heavy capital inflows from Greek financial institutions. Similarly, banks in Portugal and Spain are an important source of finance in Latin America (Figure 20).

Overall, the public and private sectors in Latin America have borrowed some $320 billion or 8 percent of GDP and those in emerging Europe owe some $400 billion or 13 percent of GDP. Spanish banks own over 25 percent of bank capital in Mexico, Chile, and Peru. Approximately 11 percent of deposits in Latin America and the Caribbean are deposited with Spanish banks, while loans from Spanish banks represent 9 percent of total banking assets in the region. Portuguese banks play an important role in Brazil and account for 30 percent or more of banking assets in African countries such as Angola and Mozambique.

Should banks in high-income Europe be forced to re-capitalize or retrench, they (and their client companies) may have to pull back their investments to cover their losses. If this were to happen capital flows to the developing regions noted could contract.

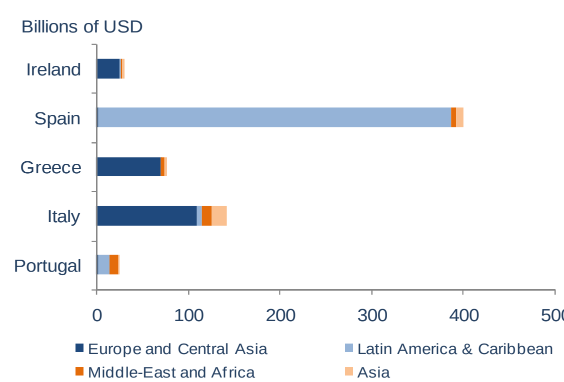
That said, capital shortages are unlikely to materialize in the case of Latin America and its

Figure 19 European banking-sector claims on assets of Greece, Ireland, Portugal and Spain



Source: Bank of International Settlements.

Figure 20 Distribution among developing regions of out-standing claims of banks in stressed-euro-zone countries



Source: Bank for International Settlements.

linkages to the Spanish Banking system, in part because most of these banks operate as subsidiaries and are subject to independent capital and regulatory requirements in the host country. Indeed, the main Spanish banks are increasingly reliant on earnings from their Latin American operations, and several have expanded their developing world holdings in 2010. For example, Santander bought the rest of its Mexican division from Bank of America Corp for $2.5 billion, while the Spanish bank BBVA took joint control of Turkish peer Garanti Bank in a $5.8 billion deal.

Beyond these financial linkages, FDI flows may also be affected, in particular to Latin America. Approximately 13 percent of FDI flows into the region in 2009 came from Spain, and that ratio is as high as 25 percent in Argentina and Mexico. Moreover, these high-income European economies are important trading partners for many developing countries (Figure 21). The Middle-East and North Africa, Europe and Central Asia and Sub-Saharan Africa regions have the closest trade ties Greece, Ireland, Italy, Portugal and Spain. At the country level, these countries account for 20 percent or more of the exports of Albania, Azerbaijan, Cameroon, Cape Verde, Morocco, Tunisia, and Namibia. How hard these countries are hit, will depend on the extent of the fiscal contraction initiated, and how successful they are in shifting sales to other markets.

Simulations conducted in the context of June's edition of Global Economic Prospects, suggest that a major default could have cumulative impacts as high as -4.1 percent of global GDP in the event of a serious loss of confidence (World Bank, 2010).

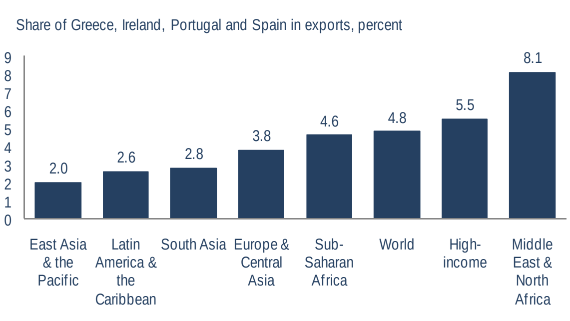
Implications of low interest rates for developing countries

The very different stances of macroeconomic policy being pursued in developing and high-income countries is another source of short-term risk. As discussed above, most developing countries have closed or are near-to-closing output gaps, while many high-income and developing European and Central Asian economies are still plagued by high unemployment and GDP levels well below pre-crisis growth trends.

As a result, in contrast to the immediate post-crisis period when macroeconomic policy throughout the globe was strongly expansionary, many developing countries are now tightening policy, even as high-income countries maintain an overall loose stance.

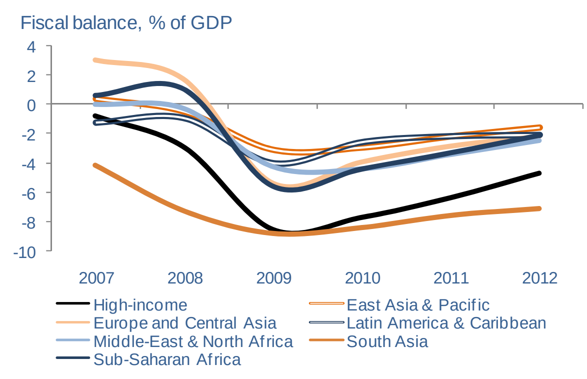
Thus, fiscal deficits are estimated to be less than 4.5 percent of GDP in every developing region except South Asia, where the ratio is estimated to top 8 percent in 2010 (Figure 22). Moreover, though fiscal policy is tightening in some high-income countries, it remains very loose (more than 10 percent of GDP in the United States,

Figure 21 Trade linkages with stressed economies



Source: World Bank, Comtrade.

Figure 22 Fiscal policy is much more relaxed in high-income countries



Source: World Bank.

Box 4 Alternative policy reactions to increased capital inflows

Policy makers can pursue a variety of strategies, none of which are mutually exclusive, when faced with strong capital inflows.

Perhaps, the simplest reaction is to allow the currency to appreciate. Such a policy has the advantage of preventing capital from adding to inflationary pressures (under perfect flexibility, foreign financial inflows have no impact on the money supply), but does so at the risk of causing long-term damage to their export and import-competing sectors.

Alternatively, countries can try to manage the upward pressure on the currency by accumulating reserves. This has an initial effect of increasing domestic money supply, which can be countered through monetary policy tightening. In some cases, this sterilization strategy may amplify inflows by magnifying the interest-rate differential between the country at the receiving end of the carry trade and the interest rates paid by investors abroad. In such instances, monetary tightening can be pursued through administrative rules, like increasing bank's reserve requirements.

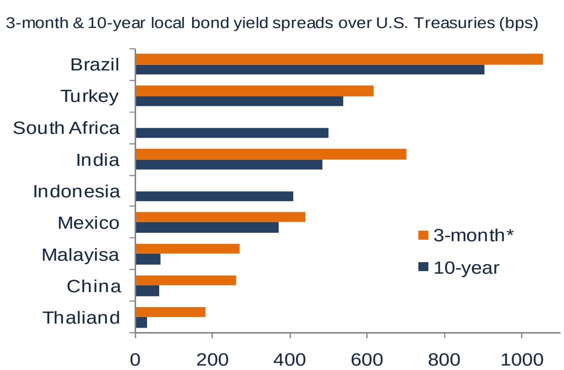
A third option is to try to dampen the capital inflows or encourage outflows with some form of capital controls or other regulatory strategies. These can involve the relaxation of pre-existing restrictions on outflows, the introduction of taxes on short-term foreign holdings or even stricter prohibitions on certain kinds of capital inflow.

To the extent that sterilization efforts are stymied in this manner, the capital inflows can expand domestic credit, generate inflation and spur asset bubbles.

more than 7.5 percent in Japan, and just under 6.5 percent in the Euro area).

Monetary policy is also at odds. Several developing countries (Brazil, China, India, Malaysia, Peru, Indonesia and Thailand to name few) have taken steps to tighten monetary policy toward a more neutral stance to preempt, or counter, rising (or already high) inflation. In contrast, monetary policy in high-income countries remains extremely loose, with nominal short-term policy interest rates close to zero, and real rates in negative territory.

Figure 23 Large interest rate differentials between high-income and developing economies.



Source: World Bank, Bloomberg.
Note: 3-month yield data for Indonesia and South Africa are not available.

Large-scale asset purchases and quantitative easing have also pushed down long-term interest rates.[10] As a result, even after the recent surge in yields that followed increased market concerns about fiscal sustainability in Europe, 10-year U.S. treasuries are still yielding a very low 3.3 percent, while similar German bonds are yielding 2.9 percent. As a result the gap between high-income and developing country short and long-term interest rates are high (Figure 23), contributing to a carry-trade where investors borrow in low interest rate high-income countries and invest in higher interest-rate developing countries.

Dealing with surging capital inflows

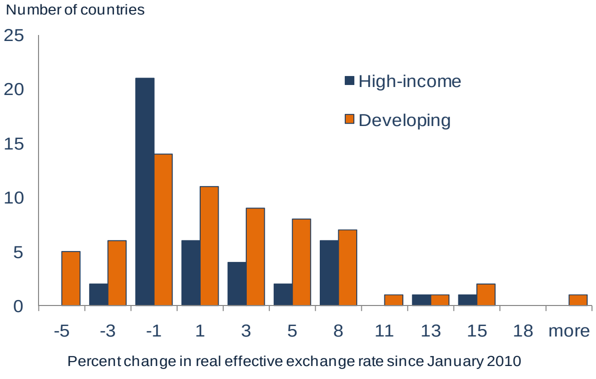
As discussed above, the recovery in capital flows to developing countries in 2010 reflects both these countries strong fundamentals and the very low opportunity cost of money implied by these low borrowing rates. Most developing countries

Table 5 Selected measures recently implemented to contain exchange rate pressures

Country		Measures taken
Brazil	·	Oct 18: Increased IOF tax on bond inflows to 6% from previously 4% (Oct 5) and 2% (Oct 22, 2009);
	·	IOF tax rate on nonresidents' margin deposits for derivative contracts was hiked from 0.38% to 6%
Chile	·	Administrative measures to reduce exporters' transaction costs
Colombia	·	Intermittent $20m daily purchases in spot market for 4 months, started in March 2010
	·	In November 2010, reduced tarrifs
	·	Proposed elimination of tax exemption for foreign borrowing;
Mexico	·	Policy of reserve accumulation, central bank selling dollar put options of $600m per month
China	·	Eased restrictions on foreign banks' investments in yuan-denominated Chinese bonds held offshore
Indonesia	·	July 7: Implemented a 1-month minimum holding period for central bank money market certificates
Korea	·	Implemented caps on size of banks' FX derivatives books as "macro-prudential measures".
Thailand	·	Imposed a 15% tax on interest income and capital gains earned by foreign investors.
Russia	·	The central bank abolished the ruble's R26-41 fluctuation band against the 0.55$/0.45€ currency basket in place since January 2009
Turkey	·	Increased daily foreign exchange purchase auction limits to $140m; increased bank reserve requirements, reduced short-term interest rates.
South Africa	·	Intervention in foreign exchange market to build reserves. Residual exchange controls on residents will be relaxed further.

absorbed the increased flows relatively easily, and these flows have played an important supporting role in their recoveries. However, for some others they have created serious policy challenges.

Figure 24 Histogram of real-effective appreciations since January 2010



Source: World Bank, JP Morgan, IMF

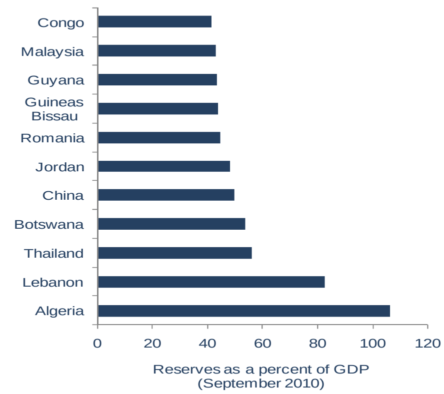
Policy makers can deal with capital flows through a variety of strategies including currency appreciation, sterilized intervention, and different kinds of capital control (Box 4). In the event, most countries have pursued a mix of these strategies. And for most developing countries the upward pressure on their currencies was manageable. Indeed, during the first 10 months of 2010, 60 percent of developing countries appreciated in real-effective terms, either through nominal appreciation or increased inflation, with many appreciating by substantial margins (Figure 24). In contrast, most high-income countries depreciated only marginally.

However, several countries (mainly middle-income countries with well developed debt and equity markets) were subject to very large capital inflows that either have caused their currencies to appreciate by more than warranted by their fundamentals, or have forced them to take extraordinary measures to prevent a disruptive appreciation, including accelerating the pace at which they accumulate foreign reserves, enacting administrative measures aimed at either slowing the rate of capital inflows (or increasing the pace of outflows), including policies to boost outward foreign direct investment (Table 5).

Although the benefits of preventing a too rapid appreciation are real, there are costs associated with resisting appreciation. Among countries that were more successful in resisting the upward pressure on their currencies, several have observed a rapid expansion in the money supply, and signs of mounting inflation pressures in both consumer goods and asset markets (Box 5).

For example, taken together the money supply in Brazil, Russia, China and India grew at a 27 percent annualized pace in 2010, 38 percent in the case of Russia. At the same time, real-estate prices have increased an average of 17 percent per annum since 2007 among the eight East Asian countries reporting data. And, inflation is high or on the rise in many developing countries, notably China, India, Indonesia and Sri Lanka. In Europe and Central Asia rising headline inflation mainly reflects drought-related increases in food prices.

Figure 25 Many countries have reserves in excess of what is required for prudential reasons



Source: World Bank, IMF IFS.

In addition, there are real fiscal and developmental costs associated with reserve accumulation. Several developing countries now have reserves that exceed 40 percent of their GDP (Figure 25). The costs of holding such large reserves can be high (especially considering the exchange rate risk when they are concentrated in one currency). For example, the

Box 5 International capital flows and macroeconomic volatility

International capital flows can play an important role supplementing domestic savings and overcoming deficiencies in domestic intermediation systems. However, they can be disruptive if they are volatile or exceed a country's capacity to sustainably absorb them.

The situation can be particularly dangerous when the influence of capital inflows on a country's currency becomes a factor inducing further flows. Although initially inflows may have been attracted by fundamentals, investors may redouble efforts because of the quick returns that can be made by investing in an appreciating currency. Such a strategy is inherently unstable. The initially self-reinforcing cycle of expected-appreciation-induced capital flows will inevitably and abruptly reverse itself when the ultimately unsustainable tensions produced by the speculative bubble (lost competitiveness, large current account deficits, increased indebtedness) eventually cause a sudden reversal in expectations. In the interim, for individuals and firms that invest in relatively liquid and or short-term assets, and who assume that they will be able to exit the market before the currency depreciates, the potential rewards of betting on further appreciations are large.

Faced with large inflows countries can allow their currency to appreciate, which will reduce the competitiveness of domestic industry, increase imports, reduce exports and lower domestic activity. Assuming that the increase in inflows is permanent and not so large as to exceed the economy's ability to adjust and appreciation may be the best strategy for a country to follow.

Alternatively, if the capital inflows are too large or viewed to be the result of temporary or speculative factors and therefore likely to reverse themselves in the future, a country may choose to resist the upward pressure on its currency. Indeed, as the crisis of 2008 in Europe and Central Asia bears testament, excessive capital inflows can distort the structure of demand and prove very burdensome and costly to unwind.

cost of holding foreign reserves equal to 50 percent of GDP could be as much as 1 1/2 percent of GDP per year (assuming the sovereign borrowing rate is 300 basis points higher than the reserves themselves earn). If a country is financing the deficit by issuing long term paper, and its reserves are mainly invested in short-term USD securities — which are currently yielding less than 1 percent, the financing costs could be closer to 3 percent of GDP.

Not only is maintaining large scale reserves expensive it denies resources to other growth-enhancing activities, such as infrastructure investment, education and health spending. For countries like China that have been resisting upward pressure on their currency for years, the recent decision to allow the currency to float more freely is likely to bring important advantages to the economy, including increased incomes and consumption opportunities for the poor, while at the same time helping to control domestic inflationary pressure as the cost of imported goods decline. Indeed, even more real appreciation in line with underlying productivity growth differentials may be warranted.

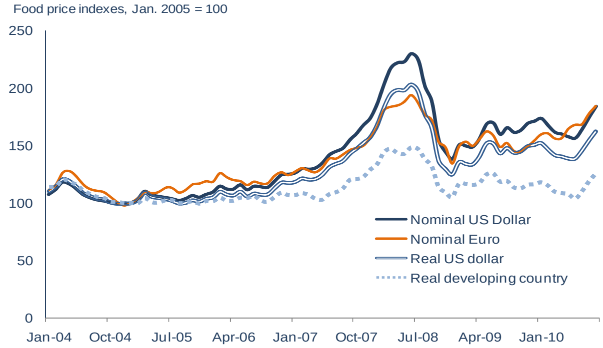
Nor can the success of such strategies be guaranteed. Despite efforts to control inflows and resist appreciation, Brazil, Colombia, Thailand and South Africa were among those countries whose currencies appreciated more than 7 percent in real-effective terms since January 2010, and by between 20 and 30 percent since January 2009.[11]

Among countries where inflows are of a more temporary nature and where overheating is becoming an increasing issue, a significant further tightening of fiscal policy may be required to tighten demand conditions in the domestic economy.

The search for yield may also be affecting international commodity prices

The gap between high-income and developing country macroeconomic policy has also affected commodity markets, both because of exchange rate movements and because of the search-for-yield that low interest rates have induced.

Figure 26 In real-terms food prices remain well below 2008 peaks



Source: World Bank.

The dollar prices of virtually every commodity grouping rose during the second half of 2010 (see the appendix on commodities for more information on recent commodity market developments), suggesting that common factors may have been at play. Part of the explanation lay in the depreciation of the U.S. dollar during the course of the year. While the dollar value of commodities was rising, expressed in Euros and until mid 2010, commodity prices were more stable (Figure 26).

Indeed, the depreciation of the dollar against most currencies, and the cumulative effect of the rise in price of other goods and services, means that during the past few years, the real at-the-border local currency price of internationally traded commodities in developing countries has increased much less than the U.S. dollar price normally quoted (Table 6). In economies where currencies have appreciated against the dollar, until most recently real prices have been broadly stable.

For example, despite the rise in the nominal dollar price of food, across developing countries considered as a whole, real local currency internationally-traded food prices in September 2010 were 25 percent higher than they were in January 2005 and almost 15 percent below their mid 2008 peaks. Since, then U.S. dollar prices have risen a further 17 percent, which has likely brought these real-at-the-border local currency

Box 6 The recent rise in international food prices, implications for poverty

The sharp rise in the dollar price of internationally traded grains in the second half of 2010 induced fears of a repeat of the 2008 food crisis, with potentially dire consequences for poverty. International food prices in dollar terms ended the year 7 percent below their June 2008 peak. However, they declined less in real currency terms. For example, between June 2008 and September 2010 (a period for which we have complete data) international dollar prices declined by 20 percent versus a 15 percent decline in real domestic currency terms. In a longer-term perspective while dollar food prices are up 84 percent since January 2005, real local currency prices have increased much less (25 percent) as of September 2010 (Table 6).

The real concern lies in the possibility that prices continue to rise, either because energy prices rise (as they did in 2008) or because further negative supply shocks result in a second year of bad crops. In such circumstances, prices could continue strengthening and become once again a major source of increased poverty. And while global developments ultimately are critical determinants of the long-term trend of local prices, in the shorter-run they are one of many influences.

Ultimately for the poor, what matters is how the prices of the foods that they consume evolve relative to their own income. Here the story becomes much more complicated. The vast majority of food consumed in the developing world is produced locally. Internationally traded maize, rice and wheat represent between 7 and 19 percent of global production of these grains, and a much smaller share of total food consumption in developing countries. The price of the food actually consumed by the poor depends more on local crop conditions, taxes, subsidies, transportation and distribution costs, than it does on movements in international dollar prices and exchange rate movements.

As a result, even as international wheat, maize and rice were rising in the summer of 2010 due to poor crops in several major grain exporting countries, prices at the local level were rising even more quickly in countries where local conditions were weak, and declining much more sharply in countries where local conditions had improved (including in many African countries) — see Table S4.3 in the Commodity Annex. Moreover, consumers have substitution opportunities among various food commodities.

While a rising trend in internationally-traded food prices would be of concern, the recent rises have not yet been reflected in local prices of maize, rice and wheat in many countries. And even where they have, they may overstate the increase in the cost of food actually consumed by the poor.

prices closer to their peak 2008 levels.

Of course, what matters for poverty is what happens to the prices paid by the poor for the food they consume, relative to their incomes (Box 6). And, while international prices play an important role in determining local price changes over the longer run, both the level of, and short-run changes in, local prices depend importantly on local production conditions, trade policies, infrastructure and distance from major production centers.

Table 6 Commodities domestic pricing

	September 2010 price relative to January 2005			
	Nominal USD	Nominal euros	Real USD	Real developing country
Energy	70	71	50	22
Metals and minerals	132	133	105	76
Agriculture	90	90	67	26
Food	84	84	62	25

	September 2010 price relative to June 2008			
	Nominal USD	Nominal euros	Real USD	Real developing country
Energy	-43	-32	-43	-43
Metals and minerals	7	27	6	-18
Agriculture	-11	6	-11	-8
Food	-20	-5	-20	-15

Source: World Bank.

Another common factor frequently debated has been increased investor interest in commodities as a new asset class, with relatively low correlation with other assets. According to this view, the emergence of actively traded commodity-based investment vehicles in recent years has allowed financial speculation in commodity markets to expand, thereby contributing to higher price volatility. Following this logic, low interest rates may be driving even more investors into taking such commodity positions. While intuitively reasonable, to-date empirical studies have produced mixed evidence on the effect of investment fund activity on

Box 7 The evidence for and against investment-based demand and the rise in commodity prices

For much of the 20th century regulations in the U.S. and elsewhere limited the extent to which financial investors could take positions in commodity markets. A reform of these rules in the U.S. in 2000 opened the door for investors to take indirect positions in commodities and commodity futures, mainly in the form of market index funds. These allow non-commercial actors (e.g., managers of sovereign wealth funds, pension funds, and other entities) hold commodities in their portfolios to hedge against future inflation (Hamilton 2010), diversification (Gordon and Rouwenhorst 2004), higher returns (Rogers 2004), or because of the belief that commodities (especially from extractive industries) have entered a long period of increasing prices, also known as the super-cycle hypothesis (see Heap (2005), Jerrett and Cuddington (2008), and Radetzki and others (2008)).

Investment in financial vehicles has grown rapidly during the past 5 years. As of mid-2010, $320 billion were invested in commodities (more than half in energy), about 1 percent of the assets held by global pension and sovereign wealth funds.

Despite the "smoking gun" of a substantial rise in the price of commodities along with the increase in financial investment in commodities, most industry and econometric studies (see Baffes and Haniotis, 2010 for a review) have failed to establish a strong link between these investments and the rise in commodity prices. However, more recent academic papers are increasingly leaning towards the view that investment has been responsible for at least part of the volatility in commodity prices during the post-2000 period.

commodity prices (see Box 7).

A final factor cited, and one that underpins some market expectations that commodity prices (especially metals and minerals) are destined to continue rising relative to other goods and services, is based in the strong growth of developing countries, their rising share in global commodity demand and their growing economic weight. According to this view, the world may be entering into a super-cycle during which commodity prices will continue to rise (or stay elevated) as supply seeks to meet demand.

Once again, the evidence is mixed. The growing size of developing countries and their progression up the income scales are all factors that are likely to increase their demand for commodities. The issue, however, is whether or not supplies can keep pace. Although supply growth over the past 15 years in a number of metals and energy products has been relatively slow, this reflects a period when prices were low and demand growth slower.

Prices are now higher, making economically viable exploration projects and known reserves that could not be profitably pursued when prices were lower. The question is whether supply will respond rapidly enough to meet that demand (and importantly how higher prices will affect demand). For most metals and energy sources, experts concur there are no impending supply constraints, and that today's prices (or prices close to them) will induce sufficient new investment and supply so as to meet demand.

However, there are investment lags and long lead-times necessary to develop large, complex projects. Moreover, there are issues concerning access to resources, rising monopoly power (in the case of oil), higher costs, and diminishing returns. Technological change, substitution toward relatively abundant alternatives and the cost-structure of known but as yet unexploited reserves are among the factors likely to limit the increase in prices over the medium term.

Longer-term risks and policy challenges

How policy moves forward in the near term may have important long-term consequences as well. Currently, policy continues to be focused on dealing with the immediate (mostly demand oriented) repercussions of the global financial crisis. So far, this focus has paid dividends and spared the global economy from what could have been a much deeper and long-lasting recession. Increasingly, however, the remaining challenges are structural rather than cyclical in nature, implying a decreasing role for demand management going forward. Policy needs to begin shifting its attention to dealing with these more difficult problems if solid medium-term growth rates are to be re-established.

Restoring market confidence by implementing credible fiscal consolidation packages that support structural reform

The strong counter-cyclical fiscal policy response in the immediate wake of the crisis played an essential role in ensuring that a more worrisome and deeper downturn was avoided. However, the current stance of policy in many countries cannot be maintained without running into serious debt sustainability issues.

While fiscal consolidation measures can have negative impacts on growth in the short-run, they can make important positive contributions to future growth, especially when compared with a situation where debt dynamics are allowed to grow to the point they become or are expected to become destabilizing (see for example, European Commission 2010).

For maximum efficiency, the path back to a sustainable fiscal stance needs to be clearly articulated and credible (i.e., market participants need to believe that they are achievable and that governments are committed to carrying through with them). Simulations suggest that, if credible, the negative short-term effects of even a large-scale fiscal consolidation program can be quickly overcome by the positive effects it has on borrowing costs and the expectations of investor about future tax rates (see World Bank, 2010 for the case of fiscal consolidation among G-20 countries).

To maximize their effectiveness, consolidation measures need to re-establish the long run sustainability of public finances and contribute to resolving pre-existing structural problems in economies. For example, in many high-income European and developing Europe and Central Asian economies with aging populations, a well designed consolidation program might include reducing age-related contingent liabilities such as benefits in unfunded pay-as-you-go pension systems. In South Asia, plans might combine efforts to improve the efficiency of expenditure by reducing the extent of subsidization while at the same time increasing taxes so as to better mobilize domestic resources (tax revenues in several countries are less than 10 percent of GDP). In Latin America and the Caribbean the focus needs to be more on putting in place countercyclical fiscal tightening, both to reduce inflationary pressures, and to restore the fiscal buffers that served the region so well in responding to the acute phase of the financial crisis.

Conclude the financial-sector reform agenda

While financial markets have withdrawn from many of the activities that generated the worst excesses of the boom period, and which lay at the center of the crisis, the re-regulation agenda is not yet complete. As a result, the risk is that the same (or different) kinds of behaviors may redevelop, setting the stage for a new crisis. Indeed, the very low interest rates that characterize the current policy environment, while designed to prevent deflation in high-income countries, are promoting many of the same kind of risky behaviors that preceded the crisis, including capital inflows attracted by unsustainable expectations of currency appreciation, search-for-yield motivated investment in risky ventures, and bubbles in real-estate and financial markets.

The nature that these reforms should take, and the balance that they should strike between encouraging more responsible lending on the one hand and prudent risk-sharing on the other, goes beyond the scope of this report. But given the integrated nature of global financial markets, reforms will need to extend beyond individual national efforts. Strong global coordination may not be required. However, recent efforts within the context of the G-20 to agree a set of principles (including cooperation among national supervisory authorities) that take account of developing-country concerns and could be implemented at the national level are likely to be a critical element in the final reform.

Reforms might include greater global regulatory and supervisory coordination, the inclusion of explicit macro-prudential risk assessment

Box 8 How much demand slack is there?

Among the many challenges facing policymakers following a major financial crisis is determining how much of the resulting slack is structural and how much reflects insufficient demand. The January 2010 edition of *Global Economic Prospects* (World Bank, 2010a) explored the sensitivity of potential output to investment rates, while the fall edition of the IMF's *World Economic Outlook* (IMF, 2009b) examined the impact of past financial crisis on potential output of those countries most directly involved. The World Bank study indicated that even for countries not directly involved in the excesses of the boom period, scarcer capital and higher borrowing costs could reduce potential output growth rates by as much as 0.5 percentage points for several years resulting in a reduction in potential output of about 4 percent. The IMF work, which is explored in more detail in Abiad and others (2009), reports that on average for countries directly involved in a financial crisis, potential output was 7 percent lower than it would have been in the absence of the crisis even 7 years afterwards.

The very concentrated nature of unemployment in the United States, high-income Europe and developing Europe and Central Asia suggests that some significant portion of current joblessness may be structural in nature.[i] In the United States 46 percent of all the job losses between August 2008 and September 2010 were in the construction and manufacturing sectors, sectors that combined represented only 15 percent of employment at the outset of the crisis. Similarly, of the net job losses in the EU (over 4 million) between 2008 and 2009 occurred in these two sectors. In Russia, for instance, almost 2/3 of the two million jobs lost between 2008 and 2009 were in manufacturing and construction. Those job losses were concentrated in western Russia, Moscow and the Urals — the industrial heartland of both the Russian Federation and the whole CIS region.

Moreover, in Europe job-losses have been geographically concentrated, with Spain accounting for over a third of all EU job losses between 2008 and 2009. Indeed, unemployment in Germany is actually lower now than it was in August 2008 in stark contrast with Greece, Slovak Republic, Ireland and Spain where it increased by 4 percentage points or more.

[i] IMF (2010) estimates that between 1 and 1¾ percentage points of the 3.5 percent of the labor force increase in unemployment since August 2008 may be structural in nature. Similarly, Fujita (2010) finds that the extension of unemployment benefits has caused workers that would have otherwise left the labor force to remain, raising the reported unemployment by between 0.9 and 1.7 percent of the labor force.

mandates with a cross sectoral focus that addresses those weaknesses. Also, the "perimeter" of the regulatory and supervisory frameworks should be widened, to include what is sometimes called the "shadow banking system" (hedge funds, OTC derivative markets, etc.), previously largely excluded from usual supervisory and prudential requirements. The creation of the Financial Stability Board to coordinate the development and implementation of effective regulatory, supervisory and other financial sector policies may help in this regard.

Similarly, G-20 commitments to reduce procyclicality in financial regulation are welcome steps, such as the promotion of over-the-cycle provisioning should be introduced, so that banks prepare for downturns in times of windfall profits. Increases in the capital requirements of banks may also be required so that they are better able to deal with losses (this discussion is incorporated in the so-called "Basel III" rules). Additionally, the role of credit rating agencies in sanctioning certain types of risk provisioning and "herd-like" investment behavior by banks and other economic agents (like investment and pension funds) should be addressed.

As fiscal policy is scaled back, greater emphasis should be placed on targeting measures that support structural and labor market adjustment

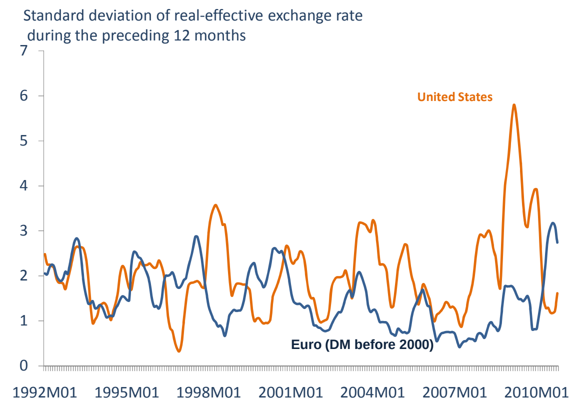
As the recovery progresses and the extent of demand slack in the economy shrinks (Box 8), an increasing share of it will be concentrated in those sectors, such as construction, that grew unsustainably large during the boom period. To be effective, fiscal policy needs to become increasingly targeted on assisting unemployed workers in these sectors to move into new areas, both to avoid the potential scarring effect of an extended period of unemployment, but also to support growth in new healthy sectors of the economy. In this regard, studies suggest that the growth impact of targeted fiscal measures can be larger than those of untargeted actions (European Commission, 2010a). For example, investment support measures can have effects 4 times as large, and credit to liquidity constrained households up to 2 times as large as blanket support measures. In regions such as Europe and Central Asia where significant barriers to labor mobility remain, targeted reforms can deliver between 50 and 80 percent of their long-run growth gains in as little as two years after implementation.[12]

Policy may also need to focus on improving competitiveness, both through productivity enhancing micro-economic reforms (including governance, investment climate, infrastructure, education, and energy efficiency), and better macroeconomic management. Research suggests that increasing competition in wholesale sectors and the reduction of the administrative burden (area-wide weaknesses) and some labor-market reforms (reduction of benefit replacement rates and wage mark ups) are relatively fast-acting (European Commission, 2010b).

Finally countries may wish to accelerate moves towards more flexible exchange rate regimes

Among the lessons to be learned from the crisis and the ensuing recovery, which is consistent with lessons from the great depression (Eichenberg and Wilson, 2010) is that economies with floating exchange rate regimes, suffered less economic distortions during the upswing of the cycle and therefore less disruption during the crisis. For example, countries in Europe and Central Asia that followed less tightly managed exchange rate regimes were better able to absorb the shocks of

Figure 27 Increased volatility of major reserve currencies may be of long-term concern



Source: World Bank, IMF IFS, JP Morgan.

the crisis. In contrast, those that went into the crisis with less flexible regimes, suffered the most in terms of inflationary pressures, asset–price bubbles and the accumulation of (unhedged) external liabilities. During the recovery phase, some of these countries have moved toward more flexible frameworks (Belarus, Russia and Ukraine), that have allowed for necessary adjustments to proceed in a smoother fashion.

Stresses in the United States and the euro zone may have longer-term implications for the international financial system

The very loose monetary policy and the depreciation of the dollar may be having impacts on global confidence in the dollar as the international reserve currency, which could have important and potentially unforeseen longer-term consequences. The situation is made all the more uncertain given that globe's second major currency, the euro, is also facing serious challenges arising from the sovereign debt crisis. Although unlikely, should conditions in sovereign debt markets and the economies concerned deteriorate much further, confidence in the euro as a reserve asset could be affected.

Indeed, over the past several years, both the value of the euro and the U.S. dollar have oscillated a great deal (Figure 27), potentially reducing their qualities as a stable store of value that partly explains their use as international currencies. Although the past offers little in the way of strong parallels, earlier episodes of sustained weakness in the international monetary system have been associated with significant economic upheavals. Both the abandonment of the gold standard during the great depression, and the collapse of the Bretton Woods system during the 1970s were associated with extended periods of slow growth.[13]

To date the dollar remains and is likely to remain for a long-time the dominant reserve currency in the global economy (as witnessed by financial markets return to dollar safe-haven assets during times of crisis). In the long-run a gradual move toward reliance on new or additional currencies is both likely and arguably desirable. In the medium-run, however, were the dollar and euro to cease anchoring the international monetary system as they have until now (as unlikely as such an event may be), this could give rise to a further bout of protectionism and disruptive exchange rate volatility, with damaging effects for global growth and poverty reduction.

Concluding remarks

The global economy is transitioning from the bounce-back phase of the recovery toward a period of slower but more sustainable growth. Growth in most developing countries is increasingly running into capacity constraints, while in high-income and developing Europe and Central Asia growth is hampered by the concentrated nature of slack and ongoing restructuring. In this environment, policy needs to be moving away from short-term demand stimulus toward measures that generate additional employment by enhancing the supply potential of economies.

The global policy environment has become highly charged and uncertain, and presents multiple risks to prospects for developing countries. As emphasized at the recent G-20 meetings in Seoul (G-20 2010), both developing and high-income countries will need to take care to minimize the negative external consequences of their domestic policy actions. Concretely, this means that while countries must remain mindful of domestic conditions, when opportunities present themselves to pursue domestic policy objectives in a manner that support adjustment elsewhere in the global economy these should be taken up.

In general, for developing countries, macroeconomic policy needs to tighten. For many countries this implies reducing fiscal deficits and replenishing some of the fiscal space that was expended in the immediate wake of the crisis. It also means tightening monetary conditions. This can be achieved both through higher interest rates and regulatory changes, but also through controlled currency appreciation in line with underlying differentials in productivity growth— something that the recent easing in capital inflows may make easier.

Notes

1. Alternatively pre-crisis production levels could be dated mid 2007, the point when industrial production in high-income countries began to decline. The August 2008 date has the advantage of being more directly related to the financial crisis, and preceding the point in time when activity collapsed. Indeed, arguably the process of until-then orderly unwinding of domestic and global imbalances was unfinished in August 2008 and both trade and industrial production were above their equilibrium levels.

2. Although in the classical Keynesian framework a tightening of fiscal policy would result in slower growth, under Ricardian equivalence this effect may be offset if firms and consumers recognize that the increased frugality now means less taxes and stronger income growth in the future (as compared with the no action alternative) and therefore spend more now.

3. At this stage, the cyclical recovery is broadly complete among developing countries so no further increase in savings rates is anticipated.

4. The countries in the Europe and Central Asia that are undergoing significant restructuring include: Albania, Armenia, Azerbaijan, Bulgaria, Belarus, Georgia, Kazakhstan, Kyrgyz Republic, Lithuania Moldova, Macedonia, FYR, Romania, Russian Federation, Ukraine and Uzbekistan

5. The 6 developing countries undergoing the most serious restructuring include: Bulgaria, Kazakhstan, Lithuania, Romania, Russian Federation, and Ukraine.

6. Nine countries (Brazil, China, India, Indonesia, Malaysia, Mexico, South Africa, Thailand, and Turkey) received 95% of portfolio equity and 74% of short-term debt flows and almost half of bond flows in 2010.

7. Maldives, Lesotho, Costa Rica, Venezuela and Kiribati also appreciated sharply for diverse reasons — including being pegged to an appreciating middle-income currency and high inflation.

8. A fragile state is defined as an IDA-eligible (International Development Association), low-income country or territory (including those countries which may currently be in arrears) with a Country Policy and Institutional Assessment (CPIA) score of 3.2 or below or those countries without a CPIA score. CPIA rankings are revised annually and are available at http://www.worldbank.org/ida/idalloc.htm.

9. The EU/ IMF funded Irish package came in at €85 billion versus market expectations of €100-120 billion, with €17.5 billion of it is actually to come from Ireland's own pension fund.

10. Initially the primary motivation for these non-traditional interventions was to stabilize these markets (including those for long-term government bonds, secondary mortgages, and corporate bonds). Increasingly, they seek to stimulate demand by reducing long-term real interest rates both by lowering nominal rates and raising inflation expectations.

11. Of course, higher inflation and an appreciating real exchange rate are part and parcel of the process of economic development, and therefore all emerging economies shall experience that. Here we distinguish between this long term, unavoidable and ultimately beneficial trend and the short run overshooting caused by unsustainable capital flows.

12. In particular, the reduction of mark-ups in wholesale sectors and the reduction of the administrative burden (region-wide weaknesses) deliver between 50 and 80% of all their long-run growth gains in as little as two years after implementation (European Commission 2010).

13. As today, the causality is likely two way. Real-side weakness contributed to a dilution of international confidence in the international monetary system, which exacerbated the real-side crisis. (see Eichengreen and Irwin 2010 for an interesting discussion in the context of Great Depression and the end of the gold standard).

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