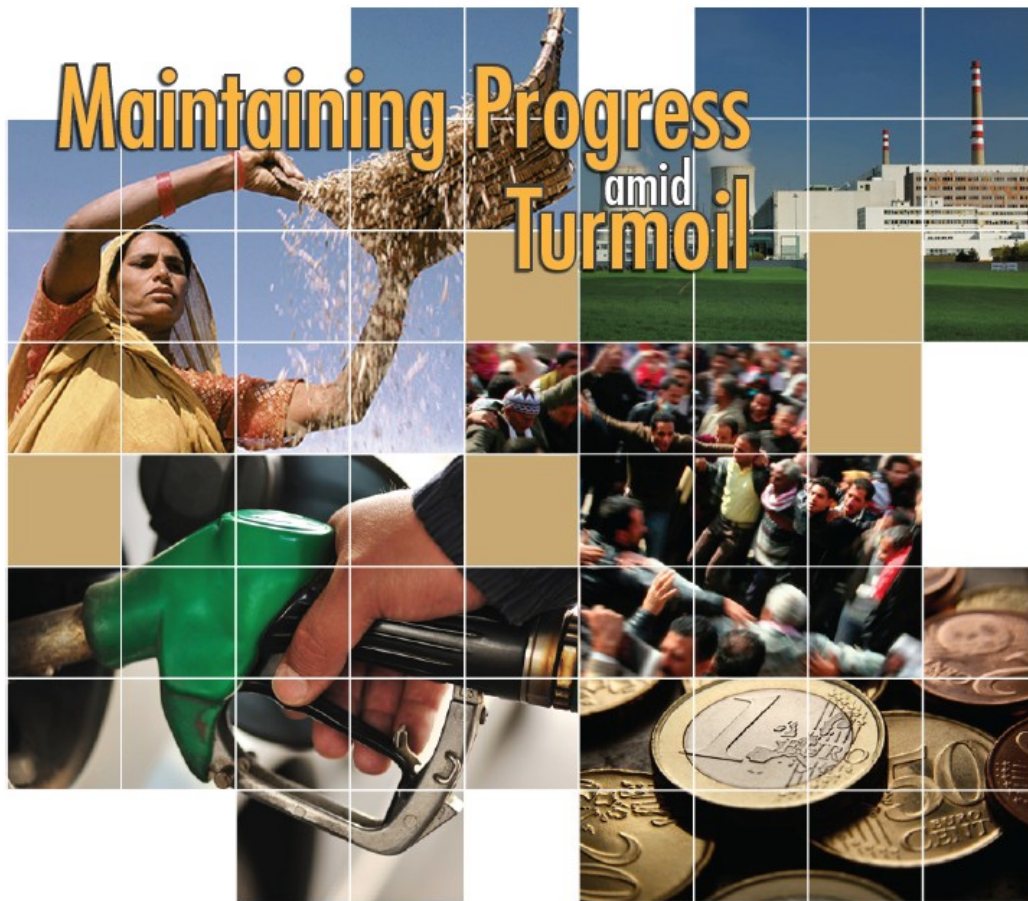


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# Global Economic Prospects



The World Bank

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# Global Economic Prospects

Maintaining progress amid turmoil

June 2011

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# Global Economic Prospects June 2011:

## *Maintaining progress amid turmoil*

### Overview & main messages

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

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

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

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

- **Policy tightening and the earthquake in Japan, among other factors, are projected to reduce growth in high-income countries to 2.2 percent in 2011.** Subsequently, the expansion is expected to firm to near 2.6

percent in 2012 and 2013, as the negative effects of household, banking and government budget consolidation begin to fade and rebuilding in Japan intensifies. Excluding Japan, high-income growth will be more stable, slowing only marginally in 2011 and strengthening to 2.7 percent in 2012 and 2013.

- **As output gaps close, aggregate growth in developing economies is projected to ease to a still strong 6.3 percent pace in 2011 through 2013**—broadly in-line with these countries' underlying potential growth rate. The good performance is broadly-based with non-BRIC countries projected to grow by around 4.5 percent (3 or more percent in per capita terms).

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

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

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

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

Source: World Bank.

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

1. Canada, France, Germany, Italy, Japan, the UK, and the United States.

2. In local currency, aggregated using 2005 GDP Weights.

3. Simple average of Dubai, Brent and West Texas Intermediate.

4. Unit value index of manufactured exports from major economies, expressed in USD.

5. Aggregate growth rates calculated using constant 2005 dollars GDP weights.

6. Calculated using 2005 PPP weights.

7. In keeping with national practice, data for India, Pakistan and Bangladesh are reported on a fiscal year basis in Table 1.1. Aggregates that depend on these countries, however, are calculated using data compiled on a calendar year basis.

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

counteract so effectively the cyclical effects of the financial crisis.

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

- **Further increases in food and fuel prices cannot be ruled out.** Although prices are expected to moderate, supply conditions remain tight.
  - *A worsening of conditions in the Middle-East and North Africa* could derail global growth. If oil prices were to rise sharply and durably — either because of increased uncertainty or due to a significant disruption to oil supply, global growth could be reduced by around 0.5 percentage points.
  - *A poor harvest during the 2011/12 crop year*, or a second substantial increase in oil prices could cause domestic food prices in developing countries to rise much higher, with dire consequences for poverty.
  - *Domestic food prices may come under upward pressure in many countries.* Since June 2010, local food prices in developing countries increased 7.9 percent—much less than the 40 percent surge in international dollar prices. International prices are expected to moderate in the second half of 2011 and into 2012/13. However, if crops disappoint or oil prices (an important cost-side determinant of food prices) rise, lagged pass through of high international prices could see local food prices increase further — with important negative impacts for poverty in many developing countries.
- **Concerns about fiscal sustainability in high-income countries persist.** High fiscal deficits and rising sovereign debt pose medium-term challenges to a wide-range of OECD countries (gross sovereign debt is projected to reach 103 percent of OECD GDP in 2012). Although steps being taken by authorities to resolve short-term problems

in the euro-zone should prevent an acute crisis, a loss of confidence such as envisioned in ECB stress-test scenarios could have large (but manageable) negative implications for developing countries.

- **Further financial stresses may emerge, as monetary policy in high-income countries begins to tighten.** As short- and long-term interest rates and re-financing costs rise, both banks and firms may find their balance sheets coming under renewed pressure — requiring additional measures to address shortcomings.

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

## Recent economic developments

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

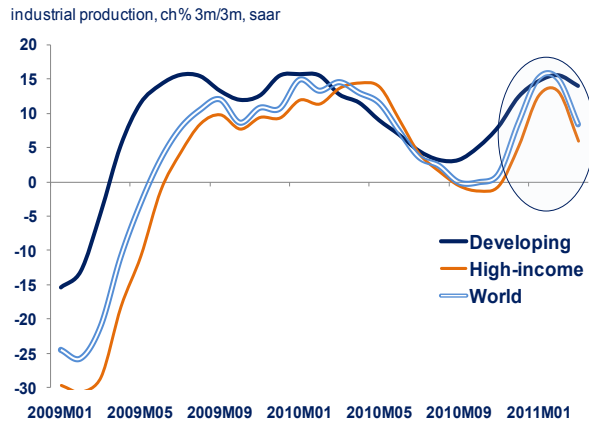
### The recovery in industrial activity is progressing at a moderate pace

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

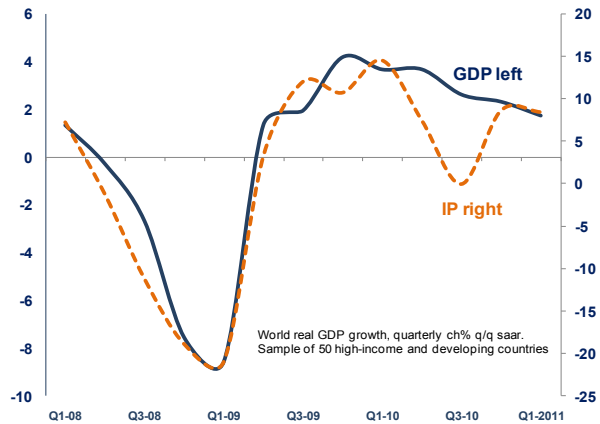
After marking a pause in the third quarter of 2010, industrial production in both high-income- and developing countries expanded at a more-than 15 percent annualized rate (3m/3m, saar) toward the end of 2010. Output once again

**Figure 1 Industrial production has been more volatile than global demand**

Global industrial production slowing once again



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



Source: World Bank, Thomson/Reuters.

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

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

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

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

**Box 1 Short-term impact of the disaster in Japan**

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

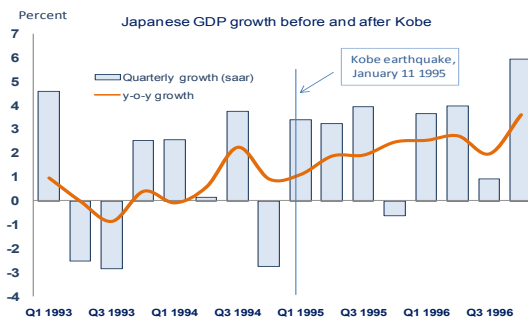
**Impacts of the 1995 Kobe and 2011 Tohoku earthquakes**

	Kobe 17-Jan-95	Tohoku 11-Mar-11
Dimension of tragedy		
- size of tremor (Richter scale)	7.3	9.1
- Lives lost	6434	15,202
- Missing		8,718
- people left homeless	300,000	450,000
- Estimated Property Damage (% of GDP)	2.5	4.5
- Initial disruption to power system (% of generating capacity)		7.3
- Medium-term disruption to power system (% gen. cap.)		3.8
- Industrial production growth (month of disaster)	-0.1	-15.3
- Quarterly GDP growth (quarter of disaster)	2.9	-3.7

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

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

**Kobe had no noticeable impact on growth**



Source: Japanese statistical bureau.

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

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

## The expansion of global demand has been more stable

Recent developments in trade is described in more detail in the prospects for trade annex (<http://go.worldbank.org/ZOPGGNPVD0>).

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

## World trade has also bounced back

Reflecting the high content of manufactures in global trade, the recovery in world merchandise

export and import volumes also paused during the middle of 2010, but is now expanding at a moderate to strong pace across economies.

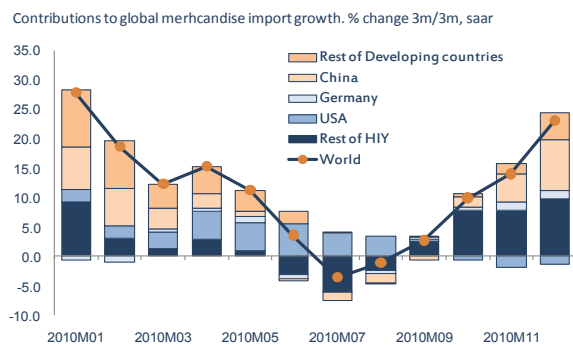
Importantly, demand from developing countries was responsible for more-than 50 percent of the increase in global import volumes (first panel, figure 2). Strong developing-country import expenditures partly reflect robust domestic demand growth in these economies. Global retail sales have posted positive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

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

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

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

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



Source: World Bank. Thomson Datastream.

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

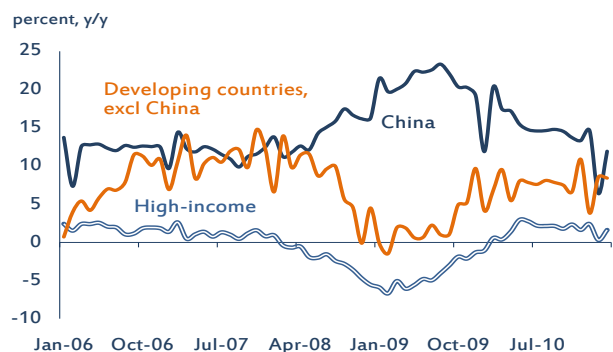
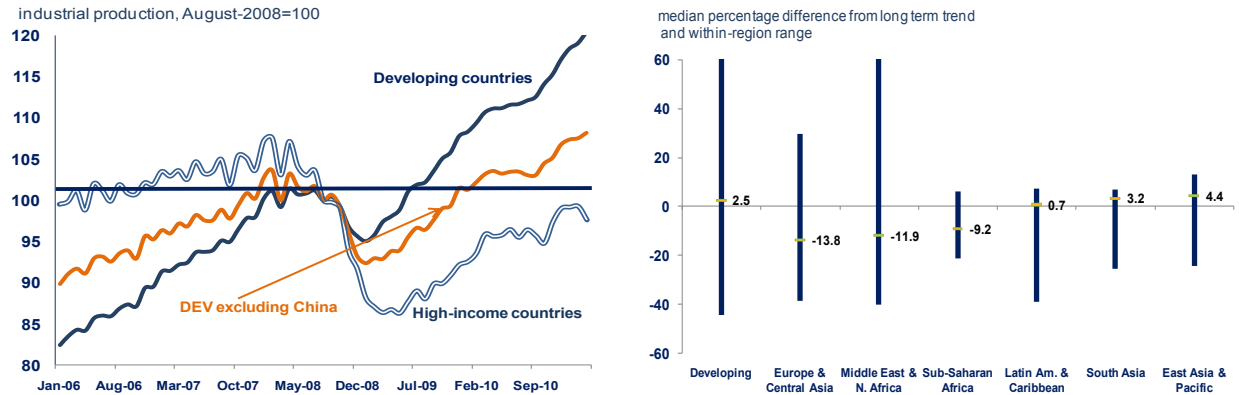


Figure 3. Industrial production has recovered pre-crisis trends in many developing countries



Source: World Bank, Thomson/Datastream.

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

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

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

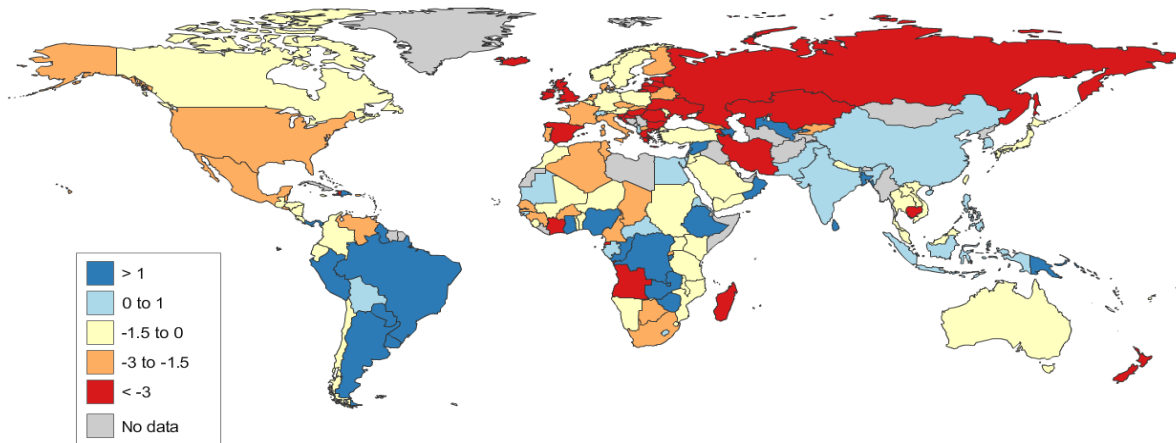
Industrial output in China is more than 40 percent above its pre-crisis peak, and 36 percent higher for the East Asia region considered as a whole. After booming during the first half of 2010, output growth in South Asia slowed toward the end of 2010. Nevertheless, output stands 24 percent higher than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

production now stands 2.5 percent below.

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

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

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



Source: World Bank.

**The rise in international fuel, metals and food prices**

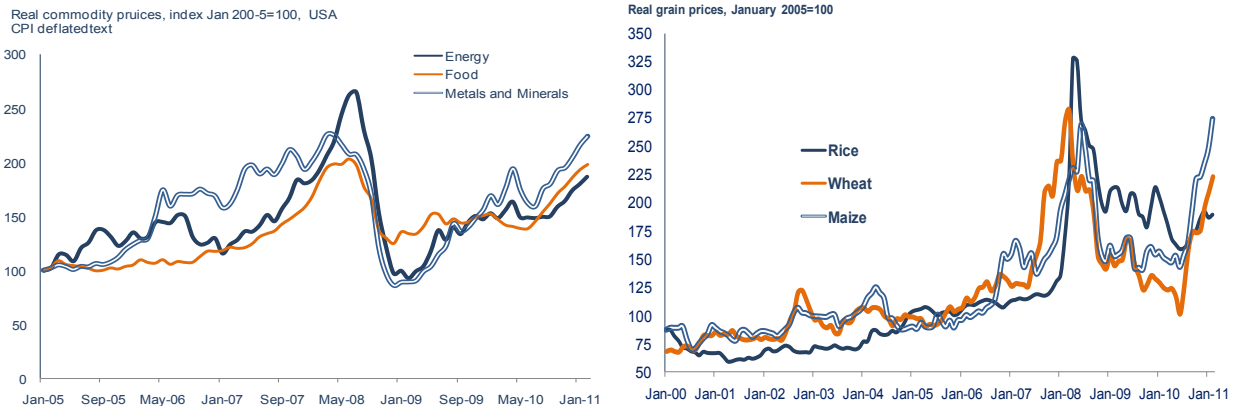
Recent developments in, and prospects for, these markets are described in more detail in the commodity annex (<http://go.worldbank.org/5KM5S6POA0>).

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

second half of 2010 in the face of only gradually rising demand (box 3).

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

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



Source: World Bank.

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

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

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

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

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

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

**Chinese demand dominates metals markets**

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

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

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

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

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

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

**Box 3 Understanding the recent rise in global agricultural prices**

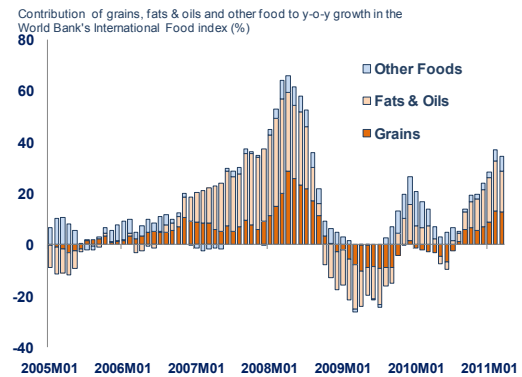
The rapid rise of global agricultural prices in the latter half of 2010 and into 2011 reflects a combination of factors. Some agricultural commodities are used as raw materials, and demand and capacity constraints for these picked up in the second half of 2010, leading to sharp increases in, for example,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

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

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

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

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

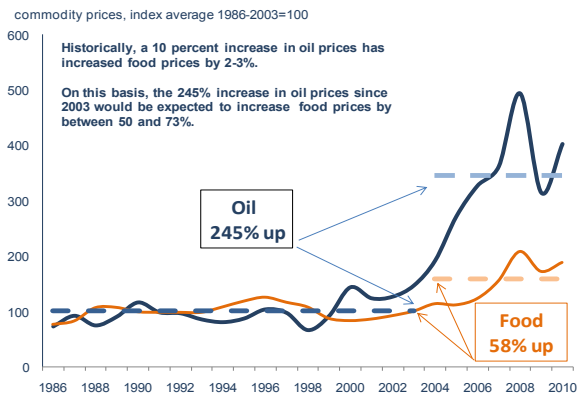


Source: World Bank.

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

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

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



Source: World Bank

level as in 2010.

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

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

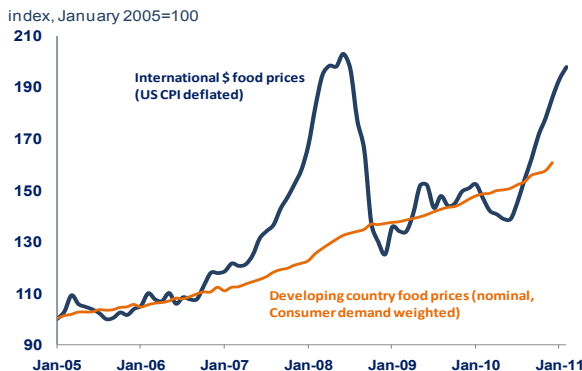
- International prices are quoted in dollars, but the dollar is depreciating against most developing country currencies (down 9 percent in nominal effective terms since June 2010)— so even if all of the price increase were passed through, the price rise in local currency terms would be smaller.
- In addition, local transport costs, price controls and other market imperfections introduce significant gaps and lags between international and local prices.
- The weights used to calculate international food price indexes are those of commodities in international trade, not in consumption. Because the vast majority of food is not traded internationally, the price of

domestically produced and consumed foods enters in local price indexes with a bigger weight than in the international food price index. Most important for local food price indices are grains prices, including the price of rice (which has not increased much), cassava and other products whose prices are only loosely connected to international markets.

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

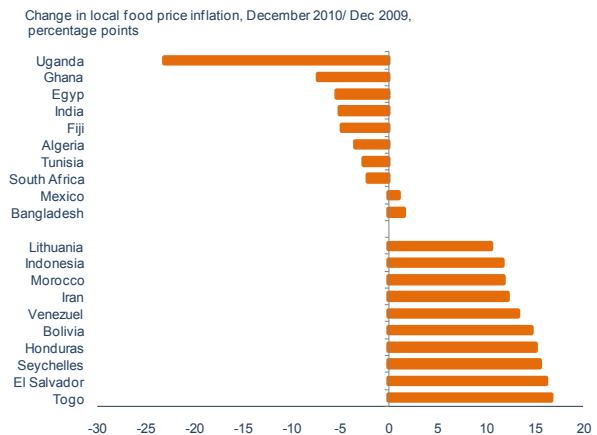
Overall, pass-through of world prices to local prices (even of the same commodity) is weak (see commodity annex for a fuller discussion). On average, only about one quarter of international price increases are passed on to local prices in the space of a year, although over the long-run this ratio tends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

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



Source: World Bank.

**Figure 8 Biggest changes in food inflation**



Source: World Bank, ILO food price database.

**Box 4. Trends in the global demand for food**

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

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

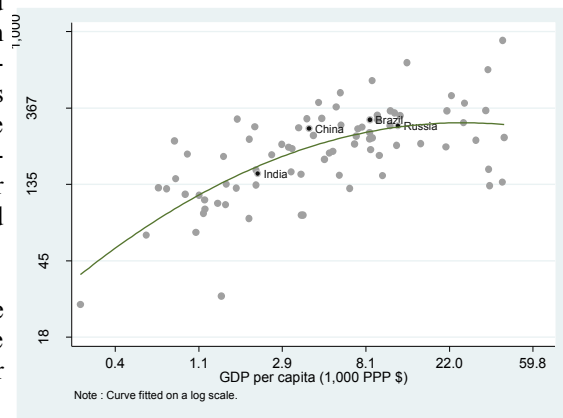
The somewhat higher growth rates for grains and edible oils projected for this decade reflect the diversion of some of these products to biofuels<sup>7</sup> — biofuel-related demand for food products is expected to grow rapidly over 2010-2019.

**Global food demand trends, 1960-2030**

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

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

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



Source: World Bank, FAO.

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

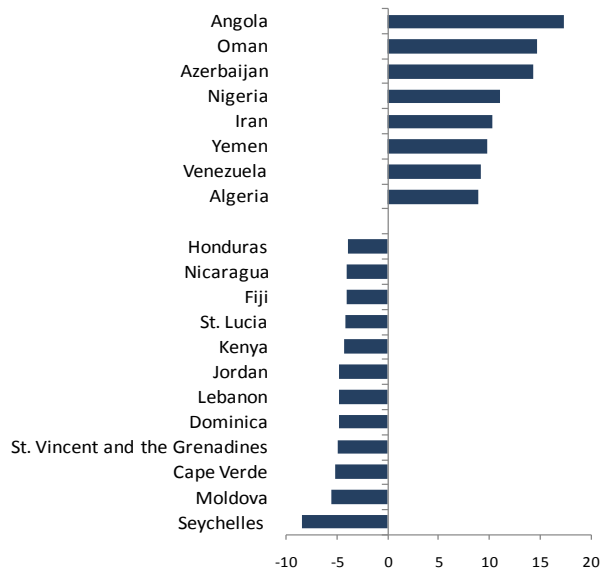
Of course, some countries are much more dependent on imported food, and therefore more sensitive to fluctuations in international food prices. Many island states and countries in the Middle-East and North Africa import large proportions of their food (import ratios for some grains exceed 80 percent in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

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

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

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

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



Source: World Bank.

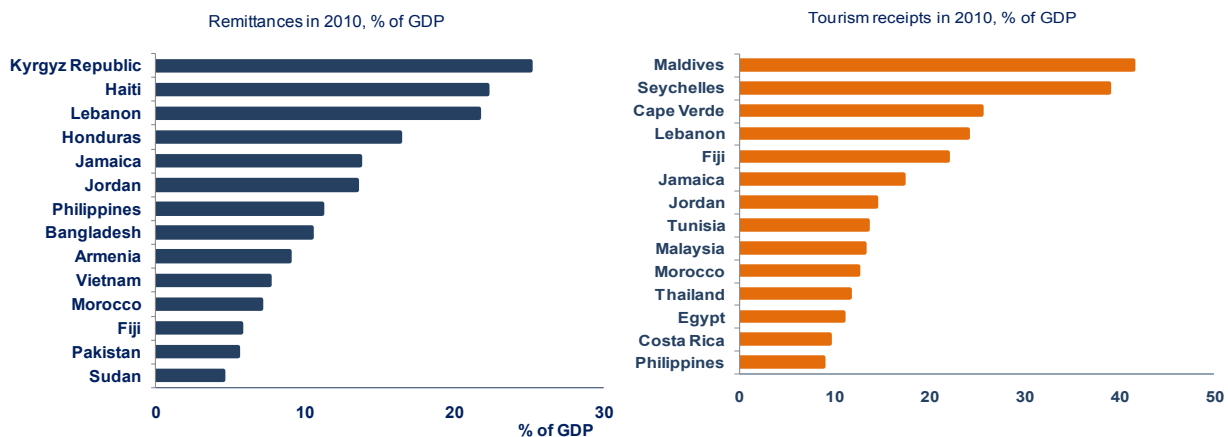
poor oil-importing countries. Despite oil prices expected to average about \$107/bbl, terms of trade impacts for many oil importers are not as large as might be expected, because other commodity prices (food, as well as metals and minerals) are also high and rising, which tends to generate offsetting effects. The ten countries experiencing largest positive terms of trade effects saw gains exceeding 8 percent of GDP, and were concentrated among oil exporters. The largest negative effects were smaller in scale,

generally less than 6 percent of GDP, and included significant impacts in small island states such as Seychelles, Cape Verde and St. Vincent and Grenadines — all of which are oil importers and dependent on imported food (figure 9).

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

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

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



Source: World Bank, UN International Tourism Organization

and 10 percent respectively, with intra-regional tourism in the Middle-East and North Africa playing a big role.

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

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

### Capital flows to developing countries have recovered

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

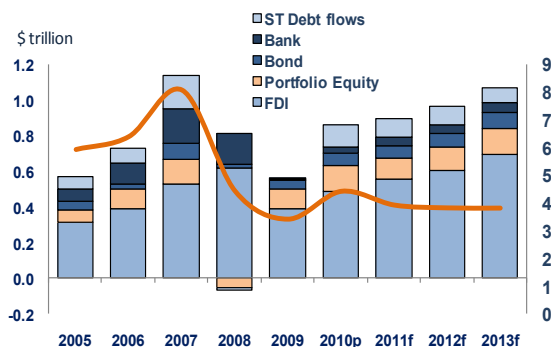
Capital flows to developing countries recovered substantially in 2010, reaching about 4.6 percent of developing country GDP (table 2). Flows remain well below their peak levels of 2006 and 2007, with most of the compression endured by

Europe and Central Asia, while flows as a share of GDP for other developing regions have been much more stable.

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

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

Figure 11 Net private capital flows to developing countries



Source: World Bank.

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

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

Source: World Bank.

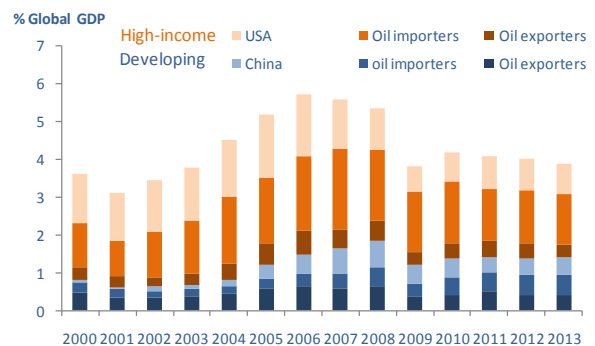
Note: e = estimate, f = forecast

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

### Global imbalances are expected to remain well below 2007 levels

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

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

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

Source: World Bank.

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

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

## Growth will slow but remain robust

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

*The recovery in the United States* has gained strength over the past 6 months and shows signs of becoming more self-sustaining. Significant gains in levels of manufacturing and services activity, business investment have helped to improve conditions in U.S. labor markets (employment has been growing by more than 115 thousand per month since March 2010, and the unemployment rate dropped to 9.1 percent as

of May 2011). Following a relatively weak weather-influenced first quarter GDP results, and some flagging in the pace of the recovery in the second quarter, GDP growth is expected to pick up in the second half of the year, with whole year gains of 2.6 percent in 2011 and 2.9 percent in 2012, and with growth easing to 2.7 percent by 2013.

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

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

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

## Box 5. Synopsis of regional outlooks

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

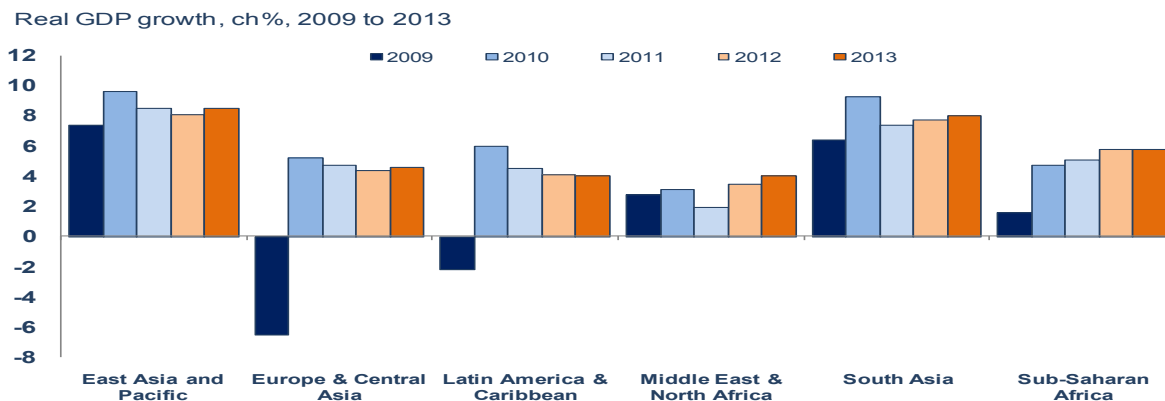
Growth in developing *East Asia and the Pacific* (<http://go.worldbank.org/Q2V3HPR0F0>) is projected to slow from 9.6 to 8.5 percent between 2010 and 2011, reflecting the shorter term adverse consequences of the Japanese earthquake for regional exports, as well as a tightening of both monetary and fiscal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

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

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

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

### Developing country growth rates to stabilize at historically elevated rates



Source: World Bank.

**Box 5. Synopsis of regional outlooks (cont.)**

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

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

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

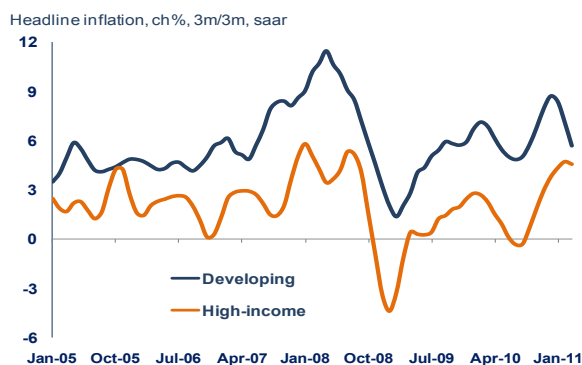
and 2013. The slowdown for high-income countries (from 2.7 percent in 2010 to 2.2 percent in 2011) mainly reflects very weak growth in Japan due to the after-effects of the earthquake and tsunami (see earlier box 1). Growth in the remaining high-income countries is expected to remain broadly stable at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

to prevent a more serious downturn.

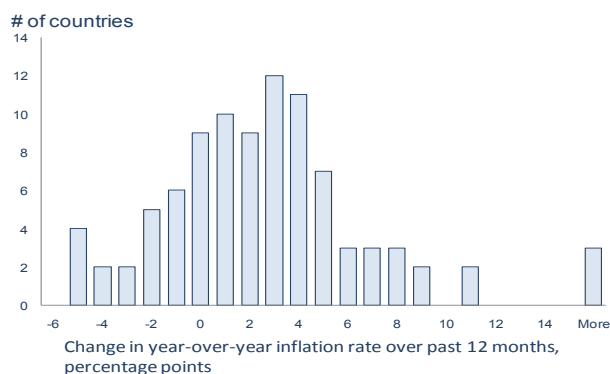
For developing countries growth is projected to decline from 7.3 to 6.2 percent between 2010 and 2012 before firming somewhat in 2013, reflecting an end to bounce-back factors that served to boost growth in 2010 and the tightening of monetary and fiscal policies as capacity constraints become increasingly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

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

Median headline inflation rates

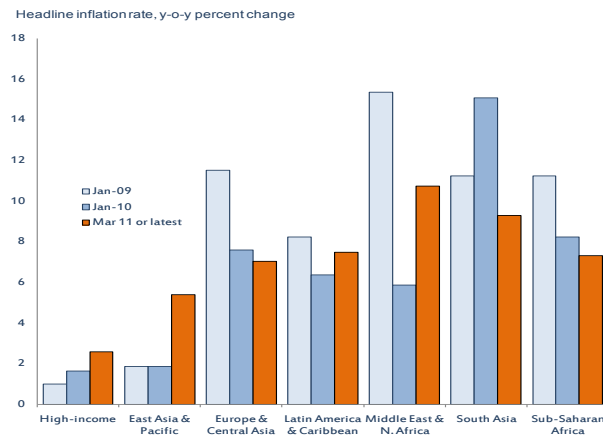


Distribution of increase in developing country inflation rates



Source: World Bank.

**Figure 14 Regional changes in inflation**  
Year-over-year inflation



Source: World Bank.

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

## Rising inflation poses macroeconomic policy challenges

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

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

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

The extent of the increase and its main determinants varies markedly across countries,

Quarterly inflation (3m/3m saar)



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

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

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

**Box 6 Should developing countries accommodate external price shocks?**

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

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

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

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

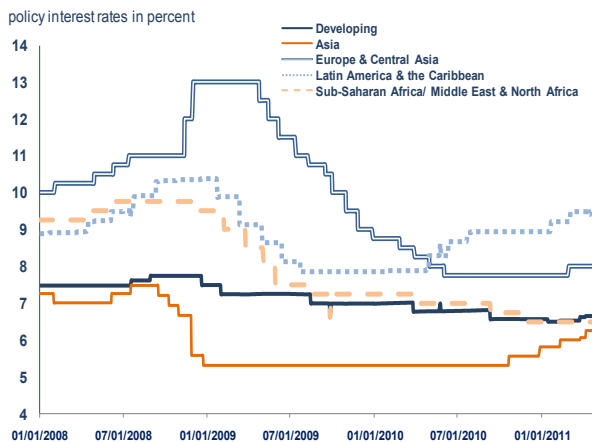
and because of the imposition of new policies to alleviate the impact of the price hikes. Several countries in the Middle-East and North Africa increased food and/or fuel subsidies (Algeria, Egypt, Jordan, Morocco, Syria and Tunisia), with associated increases in government deficits exceeding 2 percent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

subsidy spending in several Asian economies, including India, Pakistan and Indonesia.

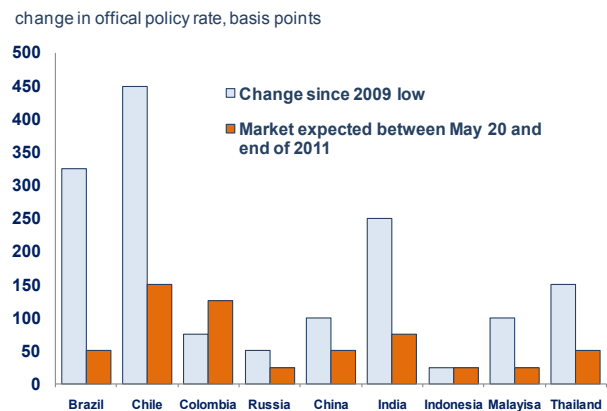
Responding to the rise in inflation and the closing of output gaps, authorities in many developing countries have begun the process of adjusting macroeconomic policy, which had been loosened in the wake of the financial crisis, to a

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

Rates are on the rise in many developing regions

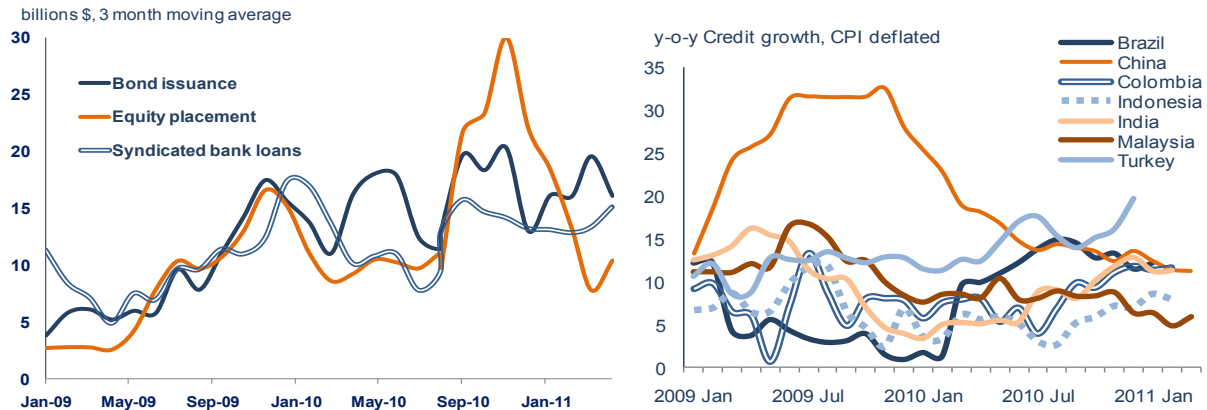


And markets expect further increases



Source: World Bank, Thomson/Reuters, Bloomberg.

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



Source: World Bank using Dealogic, IFS.

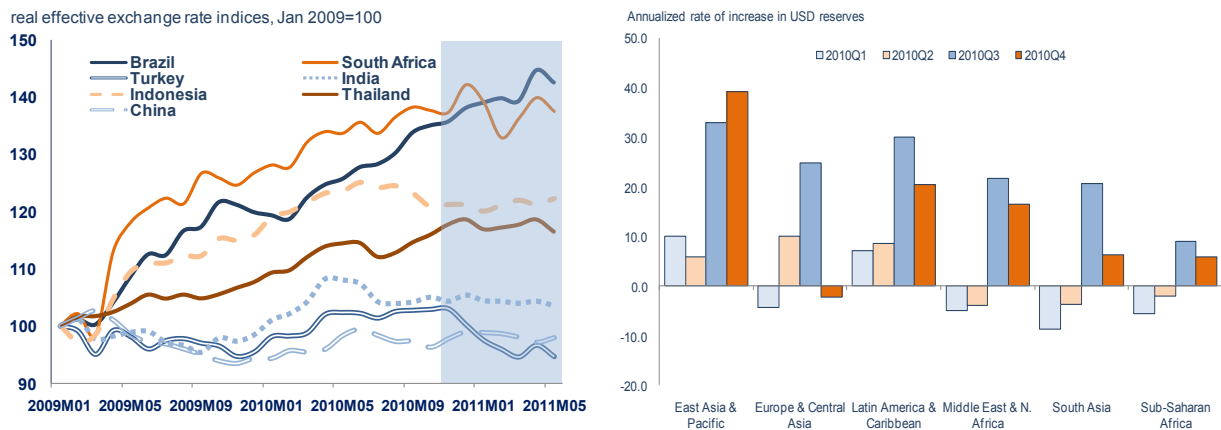
Note: Data refer to gross flows of new bond and equity issues and syndicated bank loan commitments.

more neutral stance.

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

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

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



Source: World Bank, IFS.

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

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

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

Whatever the reason for the reduced inflows, they were reflected in an easing in the upward pressure on the currencies of many middle-income countries, and a slowing in the pace of international reserve accumulation throughout

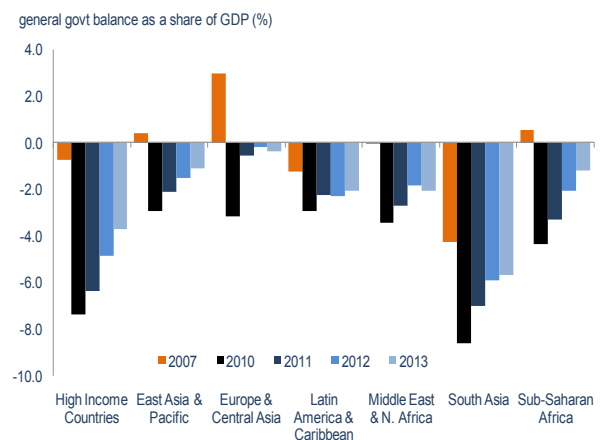
much of the developing world, East Asia forming a notable exception (figure 17).

### Fiscal policy will likely have to do more going forward

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

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

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



Source: World Bank.

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

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

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

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

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

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

## **Risks to the global economy**

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

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

There are several potential downside risks.

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

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

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

Source: World Bank.

the poor.

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

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

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

prices could remain high or even increase further — with serious consequences for global growth.

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

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

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

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

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

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

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

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

at any price; in the former oil would be available — but at higher cost.

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

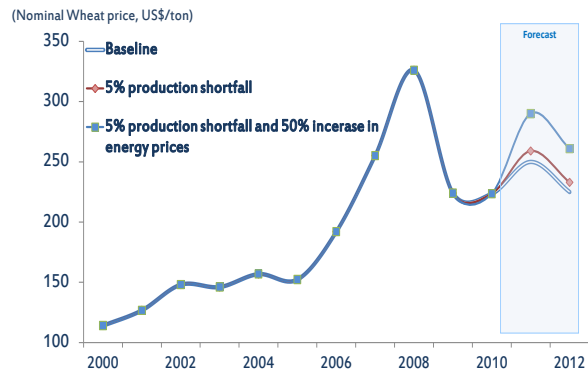
The surge in international food prices during the second half of 2010 provoked concerns of a “second food crisis”, of similar magnitude to that of 2007-08. Indeed, international food prices increased to levels close to their 2008 peaks.

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

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

Simulations suggest that if the June 2011/May

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



Source: DEC Prospects Group, World Bank.

Source: World Bank.

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

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

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

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

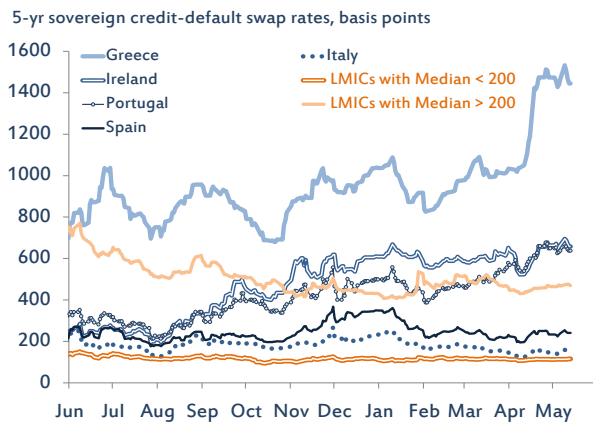
GDP in 2011 and gross debt to exceed 230 percent.

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

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

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

**Figure 20 Renewed pressure on high-income country debt**



Source: World Bank, Thomson/Datastream..

**Table 4 Results of ECB stress test**

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

Source: ECB (2011).

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

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

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

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

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

Moreover, as outlined in the January edition of *Global Economic Prospects 2010* (World Bank, 2010), higher long-term rates may be associated with a temporary slowing of trend growth rates in developing countries, as higher borrowing costs

are reflected in a less capital-intensive growth path—an effect that is incorporated into the baseline forecast.

## **Concluding remarks**

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

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

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

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

## Notes

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

income gain.

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

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

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