Global Economic Prospects

Overview and Global Outlook

2005

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Frequently Cited Regional Trading Agreements and the Parties to Them

Agreement	Full name	Members
AFTA	ASEAN Free Trade Area	Brunei, Darussalam, Cambodia, Indonesia, Lao People's Democratic Republic, Malaysia, Myanmar, Philippines, Singapore, Thailand, Vietnam
CACM	Central American Common Market	Costa Rica, El Salvador, Guatemala, Honduras, Nicaragua
CAN	Andean Community	Bolivia, Colombia, Ecuador, Peru, República Bolivariana de Venezuela
CARICOM	Caribbean Community and Common Market	Antigua and Barbuda, Bahamas, Barbados, Belize, Dominica, Grenada, Guyana, Haiti, Jamaica, Monserrat, Trinidad and Tobago, St. Kitts and Nevis, St. Lucia, St. Vincent and the Grenadines, Suriname
CEMAC	Economic and Monetary Community of Central Africa	Cameroon, Central African Republic, Chad, Republic of Congo, Equatorial Guinea, Gabon
CIS	Commonwealth of Independent States	Azerbaijan, Armenia, Belarus, Georgia, Moldova, Kazakhstan, Russian Federation, Ukraine, Uzbekistan, Tajikistan, Kyrgyz Republic
COMESA	Common Market for Eastern and Southern Africa	Angola, Burundi, Comoros, Democratic Republic of Congo, Djibouti, Arab Republic of Egypt, Eritrea, Ethiopia, Kenya, Madagascar, Malawi, Mauritius, Namibia, Rwanda, Seychelles, Sudan, Swaziland, Uganda, Zambia, Zimbabwe
EAC	East African Community	Kenya, Tanzania, Uganda
ECOWAS	Economic Community of West African States	Benin, Burkina Faso, Cape Verde, Gambia, Ghana, Guinea, Guinea-Bissau, Côte d'Ivoire, Liberia, Mali, Niger, Nigeria, Senegal, Sierra Leone, Togo
EFTA	European Free Trade Association	Iceland, Liechtenstein, Norway, Switzerland

Agreement	Full name	Members
GCC	Gulf Cooperation Council	Bahrain, Kuwait, Oman, Qatar, Saudi Arabia, United Arab Emirates
MERCOSUR	Southern Common Market	Argentina, Brazil, Paraguay, Uruguay
NAFTA	North American Free Trade Agreement	Canada, Mexico, United States
SACU	Southern African Customs Union	South Africa, Botswana, Lesotho, Swaziland, Namibia
SADC	Southern African Development Community	Angola, Botswana, Democratic Republic of Congo, Lesotho, Malawi, Mauritius, Mozambique, Namibia, South Africa, Swaziland, Seychelles, Tanzania, Zambia, Zimbabwe
SAFTA	South Asian Free Trade Area	Bangladesh, Bhutan, India, Maldives, Nepal, Pakistan, Sri Lanka
SAPTA	South Asian Preferential Trade Arrangement	Bangladesh, Bhutan, India, Maldives, Nepal, Pakistan, Sri Lanka
WAEMU	West African Economic and Monetary Union	Benin, Burkina Faso, Côte d'Ivoire, Guinea Bissau, Mali, Niger, Senegal, Togo

Overview

THE PROLIFERATION OF regional trade agreements (RTAs) is fundamentally altering the world trade landscape. The number of agreements in force now surpasses 200, and it has risen sixfold in just two decades. Today more than one-third of global trade takes place between countries that have some form of reciprocal RTA.[1] The European Union (EU) and United States are playing a prominent role in this proliferation (figure 1).

This report addresses two questions:

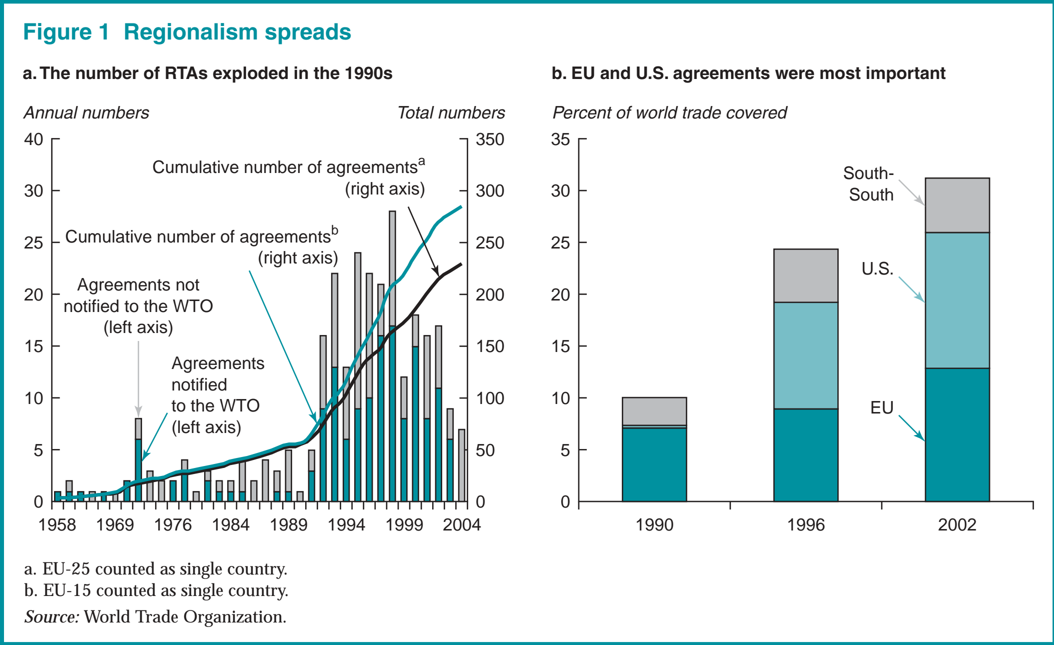
- What are the characteristics of agreements that strongly promote—or hinder—development for member countries?
- Does the proliferation of agreements pose risks to the multilateral trading system, and how can those risks be managed?

Identifying What Works: Open Regionalism

RTAs are often one component of a larger political effort to deepen economic relations with neighboring countries.[2] As such, they can create opportunities to expand trade through joint action to overcome institutional as well as policy barriers to trade. At a basic level, it is often easier to motivate reciprocal reductions in border barriers when the participants are fewer and the policymakers feel more in control of outcomes. Moreover, RTAs have the flexibility to pursue trade-expanding policies not addressed well in multilateral trading rules. Trade agreements therefore usually go beyond slashing tariffs to include measures to reduce trade impediments associated with standards, customs and border crossings, and services regulations—as well as broader rules that improve the overall investment climate. Finally, these agreements often form cornerstones of larger economic and political efforts to increase regional cooperation. RTAs can help motivate and reinforce broader reforms in domestic policy; they can be designed to contribute to a political environment that is more conducive to stability, investment, and growth.

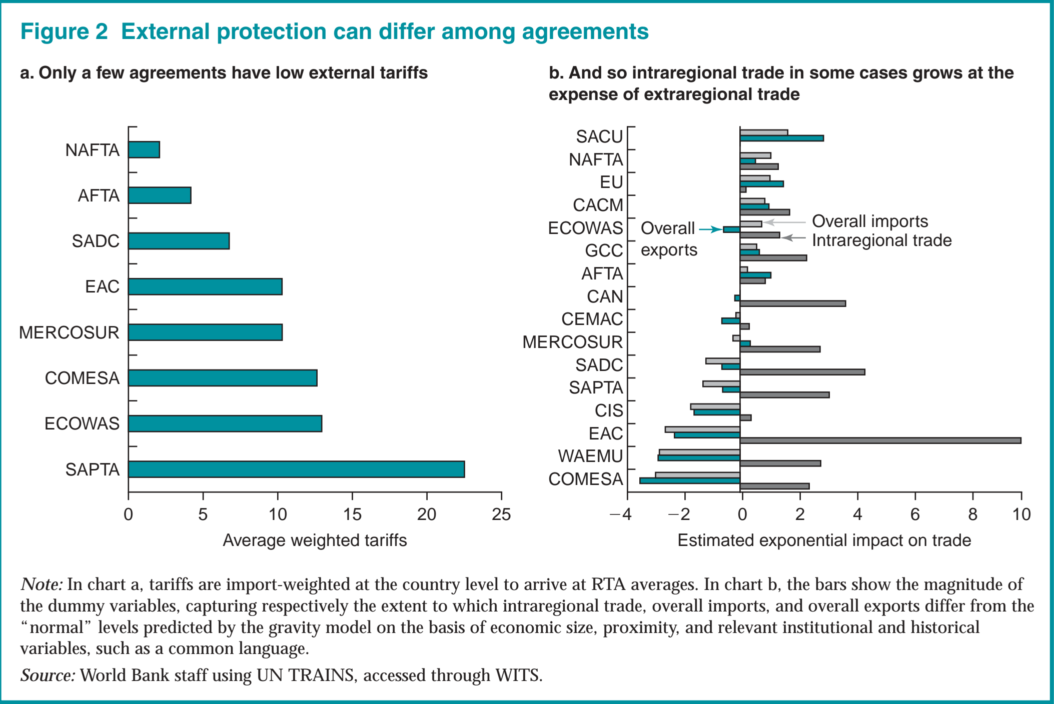
Not all agreements create new trade and investment. Those RTAs with high external border protection are particularly susceptible to the adverse effects of trade diversion (figure 2). In fact, a statistical analysis based on findings from several econometric studies suggests that many agreements cost the economy more in lost trade revenues than they earn, because they discriminate against efficient, low-cost suppliers in nonmember countries. Of course, this finding does not take into account the potential dynamic gains, the positive effects associated with services liberalization, or any of the benefits from adopting new regulations. But it does underscore the point that regional agreements carry risks that merit close scrutiny by would-be participants.

Figure 1 Regionalism spreads



a. EU-25 counted as single country.
b. EU-15 counted as single country.
Source: World Trade Organization.

Figure 2 External protection can differ among agreements

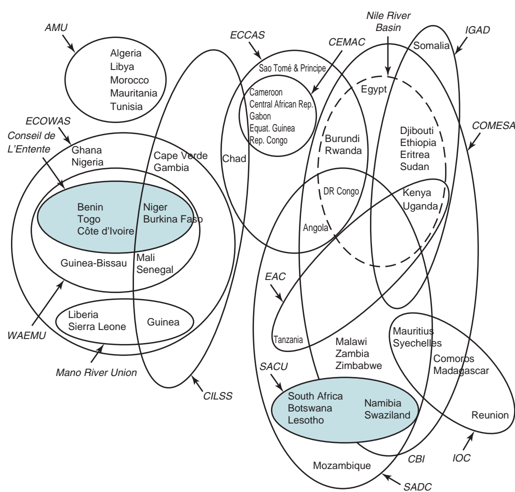


Note: In chart a, tariffs are import-weighted at the country level to arrive at RTA averages. In chart b, the bars show the magnitude of the dummy variables, capturing respectively the extent to which intraregional trade, overall imports, and overall exports differ from the "normal" levels predicted by the gravity model on the basis of economic size, proximity, and relevant institutional and historical variables, such as a common language.
Source: World Bank staff using UN TRAINS, accessed through WITS.

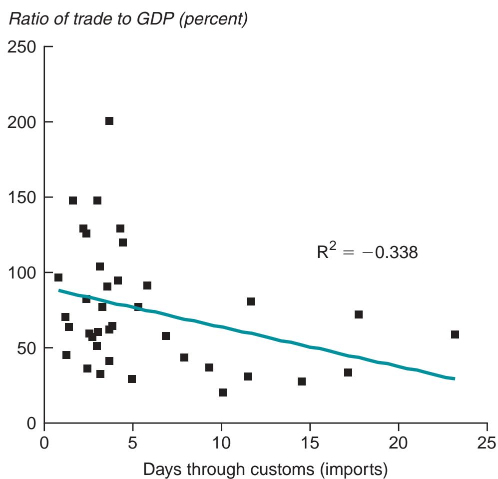
As agreements proliferate, a single country often becomes a member of several different agreements. The average African country belongs to four different agreements, and the average Latin America country belongs to seven agreements. This creates a "spaghetti bowl" of overlapping arrangements (figure 3). Each agreement has different rules of origin,

Figure 3 RTAs can complicate customs administration

a. African agreements are overlapping



b. More efficient customs are associated with more trade



Sources: Chart a, Schiff and Winters (2003). Chart b, Investment Climate Surveys data and Global Trends as cited in Subramanian and others (2003).

different tariff schedules, and different periods of implementation, and together they complicate customs administration. Customs agents report that it takes longer to process goods covered by preferential arrangements, and longer processing times drive up the cost of trade. In general, the longer the delays in customs, the smaller the role of trade in GDP.

So what characteristics lead to expanded trade and development? A prerequisite for the success of any trade policy is that it be integrated into a sound domestic policy framework. It is virtually impossible for entrepreneurs to take advantage of new opportunities—whether they originate in market access through an RTA, through a multilateral agreement, or other sources—if the domestic investment climate is not supportive. Macroeconomic stability, basic property rights, and adequate infrastructure regulation are all key. Indeed, trade agreements can reinforce positive elements in the domestic reform program by anchoring policy to the agreement itself. But an RTA cannot substitute for sound domestic policies.

With prerequisites in place, the RTAs most likely to increase national incomes over time are those designed with:

- Low external MFN tariffs,
- Few sectoral and product exemptions,
- Nonrestrictive rules-of-origin tests that build toward a framework common to many agreements,
- Measures to facilitate trade,
- Large ex-post markets,
- Measures to promote new cross-border competition, particularly in services, and
- Rules governing investment and intellectual property that are appropriate to the development context.

Low external tariffs and wide coverage minimize the risks of trade diversion, while nonrestrictive rules of origin allow for increased trade. The practice of excluding many agricultural products is common, and it can limit development payoffs. Trade facilitation measures, though worthwhile in and of themselves, receive more policymaker attention

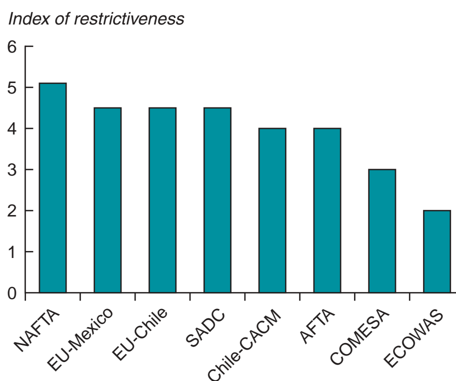
when they are embedded in an RTA, and they often have positive trade-creating effects for all trade partners.

Well designed agreements are of limited value if they are not implemented, and many RTAs have more life on paper than in reality. Weak implementation often afflicts South-South agreements. Monitoring mechanisms are often inadequate and do not receive the sustained high-level political attention necessary to drive institutional improvements in, for example, adherence to tariff reduction schedules, customs, and border crossings.

Against these benchmarks of success, it is difficult to give universally high marks to any single category of agreement. In general, North-South agreements score better on implementation than South-South agreements. Because North-South agreements can integrate economies with distinct technological capabilities and other different factor proportions, and because they usually result in larger post-agreement markets, the potential gains are usually greater. However, tighter rules of origin, more restrictive exclusions for particular sectors (such as agriculture), and a preoccupation with rules not calibrated to development priorities can undercut these benefits (figure 4). North-South agreements, particularly those with the United States, have been more effective in locking in new services liberalization; they have pressed intellectual property rights beyond World Trade Organization (WTO) rules; and expanded the sphere of investment protections; but they contain few provisions to liberalize the temporary movement of labor.

Some South-South agreements are better at focusing on merchandise trade, minimizing exclusions, adopting less restrictive rules of origin, and lowering the border costs. For example, the Caribbean Community (CARICOM) and the Common Market of Eastern and Southern Africa (COMESA) have had some success in reducing border costs. But in general, South-South agreements have not adhered to implementation schedules, and they suffer from their small market size and economic similarity. And like the North-South agreements, South-South agreements rarely provide for the temporary movement of labor.

Figure 4 Rules of origin in North-South agreements are more restrictive than in South-South agreements



Note: Higher values of the index equals to more restrictive rules of origin derived from Estevadeordal and Suominen (2004).

Consequences for the Multilateral System

The development consequences of RTAs are not limited to their effects on members—they also have cumulative effects on the multilateral system. In one sense, RTAs are a step toward greater openness in the whole system, by promoting more trade and generating new domestic constituencies with an interest in openness. Moreover, some regional trade policies are effectively nondiscriminatory, such as measures to improve customs, speed transactions at ports or border crossings, or in some cases open services markets. These measures can complement unilateral and multilateral policies.

However, this view overlooks the effects that RTAs can have on excluded countries. Preferences for some countries mean discrimination against others. Indeed, the General Agreement on Tariffs and Trade (GATT), borne out of the sad experience of discrimination in the prewar years, was founded on the

principle of nondiscrimination. Today, the adverse consequences for the excluded countries are much less severe than at GATT's inception, because tariffs and other barriers have come down sharply, mitigating the exclusionary effects of regional arrangements. The exception—and it is not trivial—is agriculture. Another mitigating factor is that many countries excluded by trade agreements between the United States and the EU enjoy some degree of preferential access through voluntary preference schemes, such as the Generalized System of Preferences (GSP), America's Growth and Opportunity Act (AGOA), and the EU's Everything But Arms (EBA) program. To be sure, these programs lack the certainty of market access that MFN agreements and RTAs provide, because preferences are voluntary and subject to political whim, but they do mitigate the effects of exclusions for selected, very low-income countries. Finally, some developing countries—the spokes in the hub-and-spoke analogy—are signing bilateral agreements with each other and with other hubs.

Inevitably some countries get left out of trade agreements, either because they are not favored politically, because they cannot afford the costs of many separate negotiations, or because their neighborhood is less open. Countries as diverse as Bolivia, India, Mongolia, Pakistan, and Sri Lanka do not enjoy the same level of access to the United States or the EU as Chile, Jordan, or Mexico, and they see their trade diminished when bilateral agreements are signed.

RTAs can also undercut the incentives of governments to press for multilateral liberalization, which would improve global trade rules. This study finds little evidence that major players in the current WTO negotiations have changed their negotiating positions or retreated from the multilateral process, even as they avail themselves of regional trade deals. However, as the discussions become politically difficult, the risk is ever present that even they will abandon multilateralism in favor of "satisficing regionalism." One consequence of the spread of regional agreements is that many poorer developing countries have diverted scarce negotiating resources to regional negotiations at the expense of more active participation in the Doha discussions. The average developing country belongs to five separate RTAs and is negotiating more all the time. In the future, will countries that now enjoy preferences fight multilateral liberalization, or even oppose further regional liberalization, to keep their privileged market access? A few small developing countries are indeed likely to lose advantages in preferential markets, and they may scuttle a deal if their legitimate concerns are not addressed.

The Importance of Doha to Open Regionalism

The policy solution to these twin concerns—the need to design regional agreements that create trade and regional agreements that have minimal exclusionary effects—comes together in the form of low MFN tariffs and other border barriers. An agreement that lowers border protection around the world promotes open regionalism by mitigating trade diversion. At the same time, it would diminish the exclusionary effects of discriminatory preferences built into regional agreements. The first order of business for the international community is to accelerate progress on the Doha Agenda and to fill in the blanks of the August 2004 framework agreement with reductions in protection, especially for products produced by the world's poor.

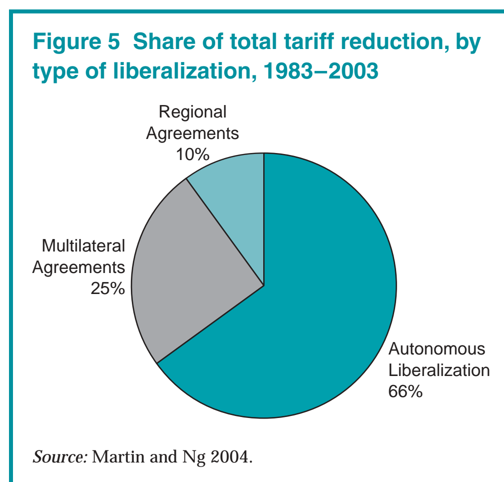
For Developing Countries, a Three-Part Strategy

Developing countries wishing to harness trade to their development strategy should see regional integration as one element in a three-pronged strategy that includes unilateral liberalization, multilateral liberalization, and regional liberalization.

Historically, *unilateral liberalization,* which is usually linked to a broader program of domestic reform, has accounted for most of the reductions in border protection. Most comprehensive trade reforms among large countries (Argentina, Brazil, and China in the early 1990s, and more recently, India) were primarily unilateral reforms that were undertaken to increase the productivity of the domestic economy. The same process took place in many small countries as well. In fact, of the 21 percentage point cuts in average weighted tariffs of all developing countries between 1983 and 2003, unilateral reforms account for roughly two-thirds of the reduction. Tariff reductions associated with the multilateral commitments in the Uruguay Round accounted for about 25 percent, and the proliferation of regional agreements amounted to about 10 percent of this reduction (see figure 5).

Autonomous liberalization promotes global competitiveness by lowering costs of inputs, increasing competition from imports to drive productivity growth, and integrating the national economy into the global economy. Autonomous trade reform is, ironically, more important than ever in the presence of RTAs; low border barriers minimize the risks of trade and investment diversion. Low external barriers promote trade in world markets, and this is highly correlated with increases in intraregional trade, irrespective of the presence of an RTA.

Figure 5 Share of total tariff reduction, by type of liberalization, 1983–2003



Source: Martin and Ng 2004.

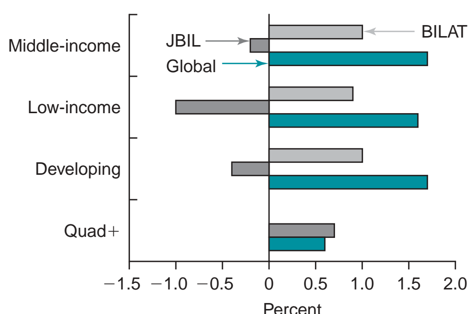
Multilateral liberalization leverages domestic reforms into increased market access around the world. Developing countries collectively stand to gain much more in the WTO arena than in any smaller regional market. Moreover, this multilateral forum is the only place that developing countries, working together, can press for more open markets in agriculture and can seek disciplines on trade-distorting agricultural subsidies and on contingent protection.

Some have argued that RTAs can be an alternative to multilateral liberalization. They are not. Gains for all developing countries from these agreements, even under the most generous of assumptions, are usually only a fraction of those from full multilateral liberalization. Of course, if one of the partner countries is a high-income, large-market economy, and if most other countries are excluded from preferential access, the countries signing the first trade agreement may benefit individually and substantially—but those benefits wither as new countries sign additional agreements. In fact, the scenarios in this study show that all developing countries would collectively lose if they were all to sign preferential agreements with the Quad (Canada, the EU, Japan, and the United States) (figure 6). Therefore, developing countries have a powerful collective interest in an effective Doha Agenda—even if they all are scrambling to gain preferential market access to the Quad.

Forging policies on *open regionalism* is the third component of trade policy strategy. Desirable as multilateral liberalization is, the Doha Round is likely to realize only part of its development potential. For some types of policy, collective regional actions may be the first, best course, and may result in effective nondiscriminatory benefits.[3] For example, RTAs can reduce regional political tensions, take advantage of scale economies in infrastructure provision, and lead to joint programs to improve border crossings or to motivate liberalization in services. But countries should sign on with

Figure 6 Multilateral liberalization is far more beneficial than RTAs

Change in real income in 2015 compared to baseline



Note: Global refers to the global merchandise trade reform scenario; *JBIL* corresponds to the simulation where all developing countries sign bilateral agreements with the Quad-plus countries; and *BILAT* corresponds to the simulation where the bilateral agreements are signed individually. Results reflect unweighted regional averages.

Source: World Bank simulations with the Linkage model and GTAP release 6.04.

their eyes wide open. The lessons of this study (and others before it[4]) are that, much as with unilateral or multilateral policies, design and implementation determine the ultimate effects. It is important to use trade policy to leverage domestic reforms that promote growth. For South-South agreements, it is essential that the focus be on some combination of full trade liberalization behind low external border protection, greater services deregulation and competition, and proactive trade facilitation measures that together positively affect both intra- and extra-regional trade.

High-Income Countries and Development

High-income countries, in order to realize their broad development objectives, must intensify their efforts to realize the development promise of the Doha Agenda. This has the potential to open up trade, particularly in agriculture, in a way that would benefit low-income groups around the world. Because the high-income countries are the large players in the system, they have a special interest in—and responsibility for—using effective multilateral reforms to discipline the discretionary aspects of the regional agreements.

Allowing developing countries to concentrate scarce negotiating resources on the multilateral agenda may require that high-income countries decelerate their efforts at expanding RTAs. Irrespective of the pace of new agreements, high-income countries could consider the following rules of thumb when designing agreements to promote development. First, reducing the extensive exclusions for agriculture would transfer the income gains to rural areas in participating developing countries. Second, adopting more common and nonrestrictive rules of origin across agreements would reduce the administrative barriers that often undermine agreements and that increase the burden on customs administration. Third, working with prospective partners to ensure that new regulations regarding investment and intellectual property are appropriate to the level of development would reduce risks of undue enforcement costs. Finally, providing trade-related technical assistance, not only in the implementation phase but also in the negotiating phase, would promote greater liberalization of services and lower MFN tariffs.

Acting Collectively to Mute the Effects of Discrimination

To minimize the discriminatory effects of RTAs at the multilateral level, all countries must assume greater responsibility for maintaining the multilateral system. The international community, working through the WTO, should revisit Article V of its charter. If the stated disciplines cannot be enforced in the near term for collective political reasons, then increasing transparency and information should become a priority. At present, the WTO collects little if any information updating specific provisions, their implementation, and the trade consequences. It even fails to take advantage of extant public monitoring efforts in

specific regions, which could inform their data collection effort. Collecting and publishing specific information on RTAs would allow members that find themselves excluded to challenge these agreements in the court of public opinion. Even the more modest goal of transparency will require building a new consensus and providing the staff of the WTO with more resources than they have currently available.

Nonetheless, WTO members should consider enhancing the existing rules to ensure that regional agreements have positive development and systemic outcomes. This could include (based on a modest tightening of current practice) setting quantitative indicators that define "substantially all trade." It could include efforts to simplify and harmonize the rules of origin that are applied to both developed and developing countries. These items are on the Doha Agenda and may be ready for action.

Organization of This Study

As is customary, chapter 1 of this study presents the World Bank's view of the global economy. The short-term section analyzes the main forces shaping the global outlook and the implications for developing countries; the long-term analysis focuses on structural changes in the global economy that will affect poverty rates and the prospects for attaining the Millennium Development Goals. A novel feature of this year's report is the introduction of a companion online feature (see www.worldbank.org/prospects), where the reader can find additional information on regional trends and commodity prices, and tools to design scenarios to his or her own specifications.

Chapter 2 introduces the issues associated with regional trade agreements and provides an overview of regional trading trends. Subsequent chapters focus on the content and consequences of regional agreements for trade creation (chapter 3), trade facilitation (chapter 4), and services, investment, intellectual property rights, and labor mobility (chapter 5). Chapter 6 returns to the issue of making regional agreements more compatible with a nondiscriminatory multilateral system.

Notes

1. Negotiated as bilateral or multicountry treaties, regional trade agreements grant members assured preferential market access, usually at zero tariffs for eligible products. Following WTO convention, the term "regional trade agreement" includes both reciprocal bilateral free trade or customs areas and multicountry (plurilateral) agreements. These are distinct from nonreciprocal voluntary agreements, such as the generalized system of preferences (GSP). Also, for statistical purposes, unless otherwise noted, intra-EU trade is excluded from quantitative trade analysis. The EU is defined as including the 15 countries that belonged to the union before its enlargement in 2004.

2. See Devlin and Estevadeordal (2004) and Schiff and Winters (2003), among others.

3. See Robert Lawrence (1997), who develops the idea of subsidiarity as applied to regional agreements.

4. See Schiff and Winters (2003).

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1

Global Outlook and the Developing Countries

World growth accelerated sharply in 2004, with GDP advancing an estimated 4 percent (table 1.1). All developing regions are now growing faster than their average growth rates of the 1980s and 1990s. The ongoing economic boom in China was a major factor, as were the surges in activity registered in Japan and the United States. The economic recovery was slower to take hold among European high-income countries, which contributed to the less marked increase in growth rates there. Meanwhile, very strong import demand—because of the torrid expansion in China and the continued tendency for domestic demand in the United States to substantially exceed production—contributed to an exceptional 10.2 percent increase in world trade volumes.

Economic growth is expected to slow in 2005 and 2006, expanding by 3.2 percent in each year. Several factors are likely to contribute to this more moderate pace of activity. First, the investment cycle in the United States has likely peaked, implying a slowdown in growth there.[1] Second, world demand has outstripped supply, resulting in substantial increases in oil and other commodity prices that have cut into incomes, moderating demand in many countries. Third, higher interest rates will slow investment growth as central banks continue shifting monetary policy from a loose to a more neutral stance. Fourth, the large fiscal impulse that has helped propel the U.S. economy in recent years will weaken in 2004—although the deficit will remain high; and in Europe, budgetary policy is expected to tighten as countries seek to regain control over deficits, which in many cases exceed Maastricht limits. Finally, efforts in China to bring growth down to a more sustainable pace should also contribute to weaker, but still strong, demand over the medium term.

Given this external environment and especially the less rapid expansion of trade, growth in most low- and middle-income countries is also expected to moderate but remain strong. The extent of the slowdown should be mitigated because of the far-reaching structural reforms carried out in many countries, which have contributed to recent gains in market share and economic growth. Recent efforts to reduce general government and current account deficits and to pay down debt should enable most developing countries to withstand the higher interest rates expected over the next few years without excessive adjustment costs. However, there is little room for complacency—especially for the more highly indebted countries.

These favorable prospects for the next two years represent a solid starting point for longer-term growth through 2015 and increase the likelihood that developing countries meet the Millennium Development Goals (MDGs). Improvements in macroeconomic fundamentals, enhanced structural flexibility, a stronger investment climate, and further progress toward reducing trade barriers should, if sustained, support the ability of developing

Table 1.1 The global outlook in summary

Percentage change from previous year, except interest rates and oil prices

	2002	2003	2004e	Forecast 2005	Forecast 2006
Global Conditions					
World Trade Volume	3.7	5.5	10.2	8.4	7.8
Consumer Prices					
G-7 Countries[a,b]	1.0	1.6	1.7	1.4	1.2
United States	1.6	2.3	2.7	2.2	1.7
Commodity Prices (USD terms)					
Non-oil commodities	5.3	10.2	17.0	−3.1	−4.2
Oil Price (World Bank average)[c]	24.9	28.9	39.0	36.0	32.0
Oil price (percent change)	2.4	15.9	35.0	−7.7	−11.1
Manufactures unit export value[d]	−1.3	7.4	5.2	−0.8	−0.3
Interest Rates					
$, 6-month (percent)	1.8	1.2	1.6	3.5	4.7
€, 6-month (percent)	3.3	2.3	2.1	2.4	3.6
Real GDP growth[e]					
World	1.7	2.7	4.0	3.2	3.2
Memo item: World (PPP weights)[f]	2.9	3.9	4.9	4.2	4.1
High income	1.3	2.1	3.5	2.7	2.7
OECD Countries[g]	1.3	2.0	3.5	2.6	2.6
Euro Area	0.9	0.5	1.8	2.1	2.3
Japan	−0.3	2.5	4.3	1.8	1.6
United States	1.9	3.0	4.3	3.2	3.3
Non-OECD countries	2.2	3.1	5.9	4.6	4.4
Developing countries	3.4	5.2	6.1	5.4	5.1
East Asia and Pacific	6.7	7.9	7.8	7.1	6.6
Europe and Central Asia	4.6	5.9	7.0	5.6	5.0
Latin America and the Caribbean	−0.6	1.6	4.7	3.7	3.7
Middle East and North Africa	3.2	5.7	4.7	4.7	4.5
South Asia	4.6	7.5	6.0	6.3	6.0
Sub-Saharan Africa	3.1	3.0	3.2	3.6	3.7
Memorandum items					
Developing countries					
excluding transition countries	3.2	5.1	5.9	5.4	5.1
excluding China and India	2.1	3.8	5.4	4.6	4.3

Note: PPP = purchasing power parity; e = estimate.
a. Canada, France, Germany, Italy, Japan, the United Kingdom, and the United States.
b. In local currency, aggregated using 1995 GDP weights.
c. The World Bank average is the unweighted mean of one barrel of West Texas Intermediate, Brent, and Dubai oil.
d. Unit value index of manufactured exports from major economies, expressed in U.S. dollars.
e. GDP in constant dollars at 1995 prices and market exchange rates.
f. GDP measured at 1995 PPP weights.
g. Now excludes the Republic of Korea, which has been reclassified as high-income OECD.
Source: World Bank.

countries to achieve rapid and sustained per capita growth at a level of 3.5 percent per annum between 2006 and 2015—double the growth rate of the 1990s. Such growth would enable many developing countries to halve the incidence of extreme poverty by 2015, which is a key development goal. However, even if the higher growth of recent periods were sustained, some regions, notably Sub-Saharan Africa, will fail to reduce poverty to this degree. In Sub-Saharan Africa, per capita growth has been slow, and progress to reduce poverty has been minimal. It would take implausibly high growth rates during the next 10 years to achieve the poverty target along with substantial enhancements to pro-poor policies and significantly more assistance. Finally, even if many regions are expected to

achieve the MDG to reduce poverty, many are off track for reaching other important MDGs, such as reducing child and maternal mortality. In many cases economic growth is not enough. A more targeted approach and a realignment of spending priorities are also necessary.

Despite the relatively positive picture for both medium- and long-term prospects, downside risks are ever present and could have negative impacts in the near future and in the long term. An additional rise in oil prices, or a failure of them to moderate, could further restrain global demand and reduce incomes in most less developed countries. While oil prices are expected to decline from present highs, especially given substantial efforts to increase supply by oil exporting countries, existing demand conditions are such that a significant increase cannot be ruled out. Such a rise would have important negative effects on all oil-importing economies, particularly those of low- and middle-income countries that face current account constraints. For these countries, difficulties accessing international finance mean that they cannot absorb the increased costs associated with higher oil prices by increasing their current account deficit. Instead, the additional costs must be accommodated by lower imports, consumption, and investment volumes—implying a significant real-side adjustment. For the most vulnerable of such countries, an additional $10 a barrel increase in oil prices could reduce domestic incomes by as much as 4 percent. On average, incomes of oil-importing low-income countries would fall by about 1 percent of GDP.

Financing requirements of the U.S. current account and government deficits, and renewed downward pressure on the dollar, may cause long-term interest rates to rise more than forecasted. If interest rates rise, short- to medium-term impacts might include a slowing in world economic growth, sharply increased financing costs, and economic hardship for heavily indebted countries. Increased financial-market turbulence might also ensue—especially for those developing countries most exposed to the U.S. dollar. Over the medium- to long-term, failure to rein in the U.S. budget deficit, which would also tend to reduce its current account deficit, could result in an ever increasing stock of dollar-denominated debt and rising future financing burdens. Moreover, higher interest rates would depress investment levels, provoking a prolonged slowing in the rate of increase of potential output. All of these factors heighten the risk of a resurgence in protectionist sentiment, which would thwart the pace at which developing countries are able to achieve their poverty reduction objectives.

Finally, if current efforts to slow the unsustainable pace of growth in China fail, major disruptions could result. Currently, investment levels may be unsustainably high, and there are some signs that rapidly rising food-price increases are feeding into production costs, which could ultimately choke off competitiveness, (although for the moment there are no clear indications that this is happening). Either problem could provoke a much more abrupt slowdown than described in the baseline. Given China's growing importance as a driver of world trade growth, such a sharp slowdown could have a significant damping effect on global economic activity, particularly among China's major trading partners.

The Global Economy: From Recovery to Expansion

The world economy accelerated sharply in 2004, expanding by an estimated 4 percent (figure 1.1). The United States and Japan, whose economies grew by more than 4 percent, continued to lead Europe in the recovery. Even stronger growth was experienced by a number of large developing countries, notably China (8.8 percent), Russia (8.0 percent), and India (6.0 percent). Their performance helped power developing countries as a whole to an anticipated 6.1 percent growth rate in 2004—an expansion without precedent over the past 30 years. Moreover, it marks a second year of very strong growth, and it may be the first time that recovery in developing countries preceded, rather than followed, recovery in high-income

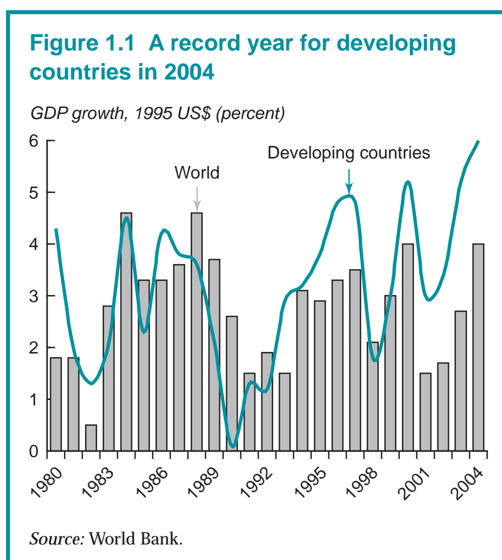


Figure 1.1 A record year for developing countries in 2004

Source: World Bank.

countries. In contrast to the United States, where the surge was initially led by investment and household consumption, exports were the main source of growth in Europe and Japan—and much of the increase in external demand came from developing countries.

Across the developing world virtually every region enjoyed solid growth, and rapidly rising trade volumes played an important role. Even excluding China, India, and Russia, economic activity in developing countries is expected to have risen 5 percent in 2004. While easy credit contributed to China's remarkable performance, the benefits of WTO accession were also a major factor, and the increase of over 30 percent in Chinese import demand helped underpin growth among neighboring East Asian countries. Russia and the oil-producing countries in the Middle East and North Africa Region benefited from very strong oil revenues, which were reflected in strong import demand and the solid export performance of their trading partners. Increasing market shares, following substantial inward investment flows associated with the accession of many of the Europe and Central Asian Region's members to the EU, also contributed to these positive outcomes. Elsewhere, a strong cyclical recovery is under way in Latin America, and there are signs of a more modest recovery in Sub-Saharan Africa.

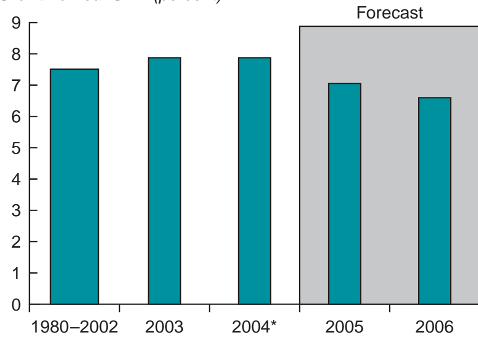
Growth should moderate in 2005 and 2006, led by a slowing of the expansion among developed countries. In the United States, as the output gap closes, productivity growth is projected to slow and unit labor costs to rise; these factors, in addition to external inflationary pressures from commodity prices, likely reflect the Fed's decision to tighten monetary conditions. This, plus the maturation of the investment cycle, a tailing off of fiscal stimulus, and the impact of higher oil costs, will contribute to slowing growth. Similar factors explain the anticipated slowdown in Japan, where output is expected to increase at about trend rates. In contrast, because of its later start and the fact that investment is only now beginning to recover, Europe's growth is expected to continue gaining momentum through 2005 and into 2006, notwithstanding fiscal tightening and a slowdown in the rate of growth of world demand. Overall estimates suggest that the hike in oil prices already observed can be expected to dampen output in 2005 by about 0.5 percent of GDP.

Moderating growth in the OECD economies and a soft landing in China should translate into slower but still buoyant growth in developing countries (figure 1.2).

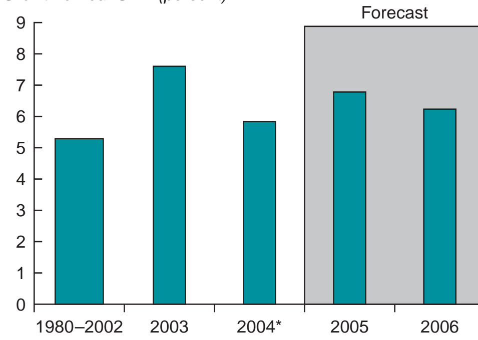
- In *East Asia,* efforts to stem the flow of credits into selected sectors of the Chinese economy are already having observable effects (figure 1.2a). The growth of imports of raw materials such as steel, copper, and various ores have moderated significantly in recent months. Steel imports have collapsed, although iron ore import volumes were growing by more than 25 percent (year/year) in September. However, there are indications that consumption demand continues to grow rapidly, and the Chinese authorities report that GDP increased 9.1 percent in the third quarter. The baseline forecast predicts that a soft landing (growth slowing to 7.1 percent by 2006) will be

Figure 1.2 Strong growth across most regions

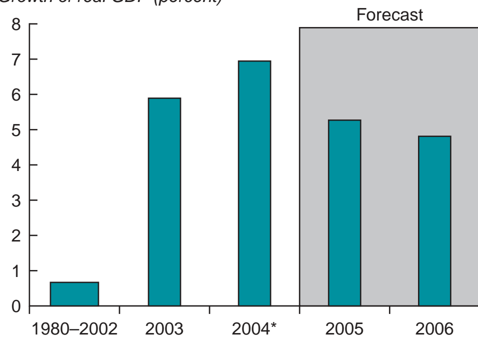
a. East Asia and Pacific



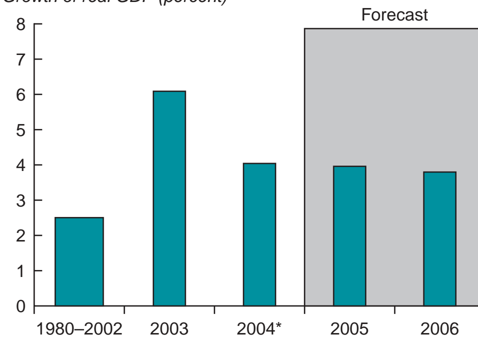
b. South Asia



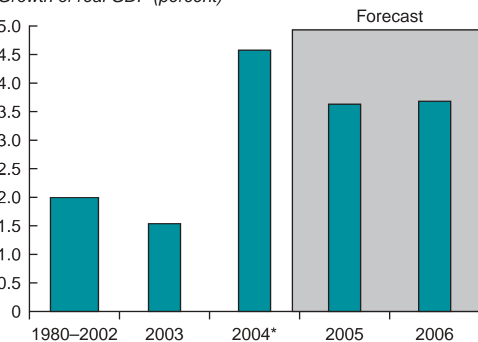
c. Europe and Central Asia



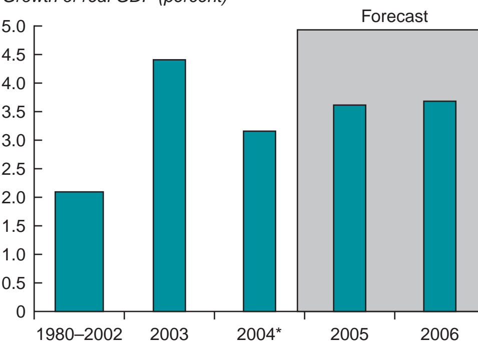
d. Middle East and North Africa



e. Latin America and the Caribbean



f. Sub-Saharan Africa



Note: * = estimate.
Source: World Bank estimates.

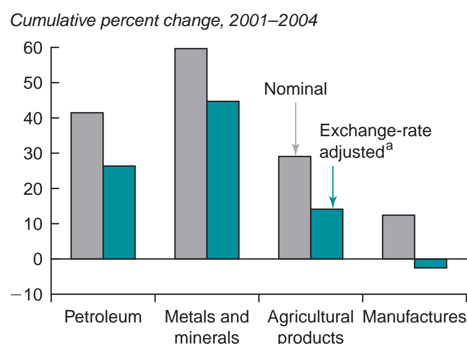
achieved and will contribute to slowing throughout the region.

- In *South Asia,* despite the moderation of the Chinese and OECD economies, growth is expected to accelerate in 2005, reflecting the enduring impacts of structural reforms, market opening, and stronger domestic demand as the dampening impact of last year's poor crop fades. As agricultural production and related incomes return to trend growth rates in 2006, GDP growth is projected to moderate somewhat.
- Output in *Europe and Central Asia* is forecast to remain strong, with still-high oil prices supporting demand in Russia and the exports of its trading partners. Central and Eastern European countries will continue to benefit from rapid investment growth following the EU accession of some of their members. However, policymakers need to prepare for the next downturn by pursuing fiscal consolidation to reduce worryingly high government and, in some cases, current account deficits.
- Growth in the *Middle East and North Africa* region is expected to remain robust, but well below the highs observed in 2003, which were boosted by sharp increases in oil production. All countries, but especially those of the Maghreb, should benefit from the strengthening export demand emanating from Western Europe; but consumption demand, reflecting still high oil incomes, will continue to be the main source of growth for the region as a whole.
- The return to growth in *Latin America and the Caribbean* is projected to continue, with only Argentina experiencing a significant slowdown as the competitive advantage from its depreciation in 2002 wears off. Elsewhere, growth should remain strong, with Brazil expanding steadily at between 3.7 and 3.9 percent. Because Latin America and the Caribbean is a heavily indebted region, outturns will ultimately depend on the success with which policymakers deal with rising interest rates and higher payments on debt (see the risks section in this chapter). Here, country-specific conditions and the degree to which fiscal consolidation programs are maintained will play an important role.
- *Sub-Saharan Africa* will also benefit from the revival in Europe, its main trading partner, but many oil-importing countries in Africa remain vulnerable due to high oil prices. Notwithstanding substantially improved performance, growth in the region will continue to lag the rest of the world by a significant margin, implying a further widening of income gaps. Moreover, the terms of trade appear to be turning against this region as non-oil commodity prices are expected to ease. Although additional development aid and debt relief would help, continued efforts to improve fundamentals and the efficiency of public expenditure are also required to speed the pace at which these countries achieve their poverty-reduction objectives.

Commodity Markets

Strong world demand and supply shortages were responsible for commodity prices rebounding sharply during the global recovery (figure 1.3). In dollar terms, metals and minerals

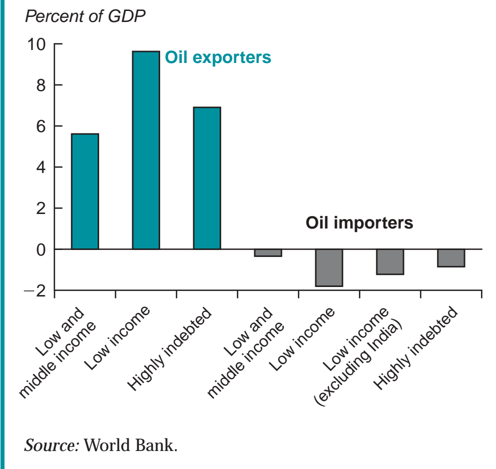
Figure 1.3 Tradable price developments



a. The adjusted data show the price change expressed as a trade-weighted average of domestic currency prices.

Source: World Bank.

Figure 1.4 Terms of trade impacts from higher commodity prices, 2001–04



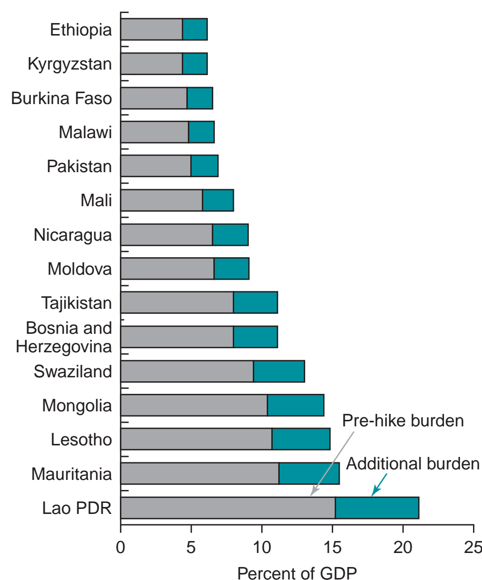
Source: World Bank.

prices have increased the most since 2001 (up almost 60 percent), but the 40 percent hike in petroleum prices has had the largest economic effect. In domestic currency terms, the impact of these price hikes was less important for many countries because of the 15 percent depreciation[2] of the dollar over the same period.

Higher commodity prices since 2001 have boosted incomes of low- and middle-income countries as a whole by an estimated 1.1 percent of GDP. However, virtually all of the gain accrued to low- and middle-income oil exporters. Most developing country oil importers suffered net terms of trade losses (figure 1.4). The major beneficiaries were the Middle East and North Africa, Europe and Central Asia, and Latin America and the Caribbean Regions—all of which include major oil exporters. In contrast, the net gains from non-oil commodity prices for low-income countries were modest or even negative. This is partly because most of the non-oil commodity price gains were concentrated in metals and minerals prices, which restricted the benefits to a few resource-rich countries. Moreover, many industrializing low-income countries, notably India and Pakistan, are now net commodity importers. The terms-of-trade impact on incomes of oil exporting developing countries was 5.6 percent of GDP, whereas for oil importers the impact was a loss of 0.3 percent.

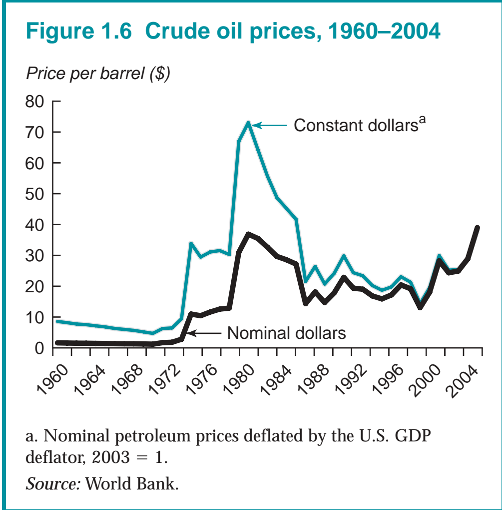
For the poorest oil-importing countries, high oil prices have dramatically exacerbated already serious poverty. Many of these countries remain particularly vulnerable to high oil prices. Even before the oil price hikes, a number of these countries were spending more than 5 percent of GDP to cover oil imports. The unweighted average of West-Texas Intermediate, Brent, and Dubai crude oils is estimated to have been $39 in 2004.[3] At this level, it is estimated that as many as seven countries will have oil-import bills in excess of 10 percent of GDP; these countries would be forced to make substantial cuts in spending elsewhere in their economies to compensate for the additional burden (figure 1.5). Indeed, for the poorest countries the net additional burden in 2004 is expected to consume 75 percent of the World Bank funding they receive for all development programs, and

Figure 1.5 The oil-import burden for selected countries



Source: World Bank.

Figure 1.6 Crude oil prices, 1960–2004



a. Nominal petroleum prices deflated by the U.S. GDP deflator, 2003 = 1.

Source: World Bank.

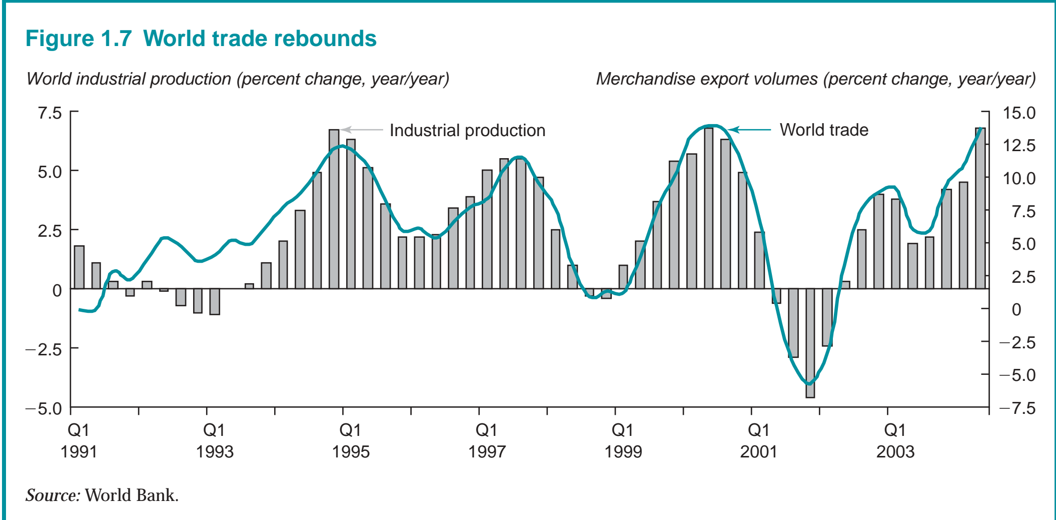
12 percent of all the bilateral aid they receive. To keep development projects on track, high-income countries will need to increase commitments substantially—at least as long as high oil prices continue.

Although a substantial rise in oil prices is not the most likely scenario, given new sources of supply and reduced oil intensities in the world economy, there remains considerable scope for higher oil prices, particularly given the current sensitivity of oil markets to localized disruptions in production (figure 1.6). Indeed, OPEC excess capacity is estimated to have fallen from 4.6 million barrels per day in 2001 to only 1.4 million barrels per day in 2004. Moreover, oil prices remain well below past peaks. Corrected for inflation and expressed in 2003 dollars, oil prices averaged more than $72 in 1980, and actually reached more than $100 in November of the previous year. Viewed from this perspective, further hikes would not be unprecedented.

World Trade

World trade growth averaged 10.2 percent in 2004, reflecting rapid increases in industrial production and investment activity (figure 1.7). The expansion in trade volumes in 2004 is reminiscent of the increase observed in 2000 and mirrors the rapid recovery in industrial production that began to take shape in the second half of 2003 and continued into 2004. More than 20 percent of the increase in world merchandise trade volumes was represented by China, whose imports increased by 32 percent—reflecting both the positive impact of its accession to the WTO and unsustainable rates of investment and consumption demand.

Figure 1.7 World trade rebounds

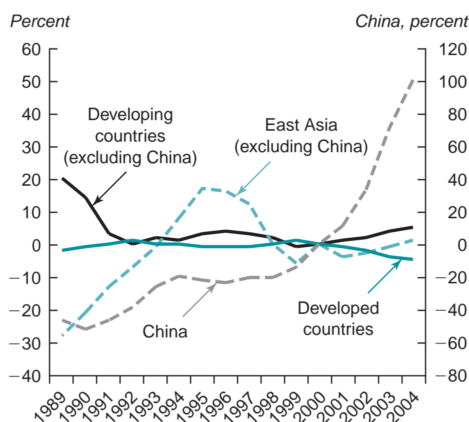


Source: World Bank.

Trade in raw materials and investment goods was particularly strong. As discussed above, robust demand for raw materials was an important factor underlying the trade expansion in a number of developing countries. In particular, oil, steel, and minerals trade was strongly influenced by the rapid increase in Chinese manufacturing and construction sectors. Similarly, fast-growing global investment expenditures were particularly important in spurring export demand in countries such as Germany and Japan that specialize in the fabrication of machinery and other physical capital.

As a whole, developing countries have grown their share in world markets by about 19 percent (figure 1.8), up from 19 to 23 percent since 2000. Much of this rise is attributed to China, which has seen its share in world exports double from 2.9 to 5.8 percent between 2000 and 2004. Excluding China, the improvement in the export share of low- and middle-income countries has been more modest (from 16 to 17 percent), although developing countries in the South Asia and Europe and Central Asia regions have increased their market shares considerably. Other regions either maintained their market share (the rest of the Eastern Asia and Pacific and the Middle East and North Africa) or lost market share (Sub-Saharan Africa and Latin America and the Caribbean).

Figure 1.8 Export performance, percent change in market share since 2000



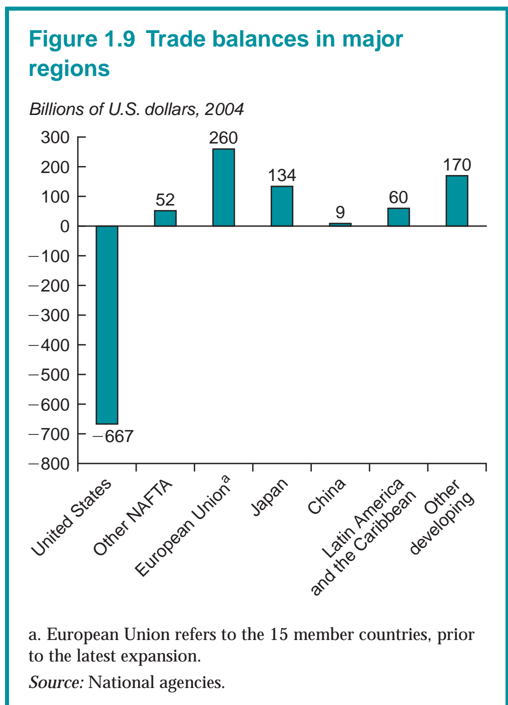
Source: World Bank.

Within regions the performance of specific countries continues to be dictated, in part, by domestic factors. So notwithstanding very strong Chinese import demand, exports in the rest of East Asia failed to increase as quickly, partly because political instability held back industrial and investment activity in the Philippines and Indonesia. In Latin American and the Caribbean, export volumes in Brazil and Argentina grew briskly under the continued influence of currency devaluations 2 years ago, while strong world demand for metals and minerals gave special impetus to Chilean exports.

Slower activity throughout the global economy should translate into less rapid trade expansion in 2005 and 2006. Trade in goods and nonfactor services is forecast to expand by about 8.5 percent in 2005, down from an estimated 10 percent in 2004. Much of the deceleration is conditional on the success of efforts to dampen the pace of activity in China, which should be reflected in slower import growth in China and slower exports among its trading partners. Looking to other regions, the easing of activity in the United States, coupled with broadly stable growth in Europe, is expected to result in a somewhat more pronounced deceleration of trade volumes in Latin America as compared with Africa, the Middle East, and Eastern European areas.

Major imbalances in the world trading environment persisted during 2004 and will likely continue to play a large role in 2005–06 (figure 1.9). Notwithstanding the sharp acceleration in world import volumes, the U.S. current account deficit reached 5.7 percent of GDP in the second quarter of 2004, as American consumption and investment volumes exceeded domestic production by a wide margin (higher oil prices represented 0.6 percentage points of the 1.4 percentage point deterioration in the current account since the first quarter of 2002). The expansion in the trade deficit since the mid-1990s has been the main

Figure 1.9 Trade balances in major regions



a. European Union refers to the 15 member countries, prior to the latest expansion.

Source: National agencies.

factor behind the rise in the U.S. current account deficit—itself a major factor behind the 15 percent real effective depreciation of the currency since February 2002. Barring a substantial increase in domestic savings by, for example, a tightening of fiscal policy, downward pressure on the U.S. dollar is likely to resume as U.S. foreign borrowing requirements remain high, and the already large amounts of external debt continue to accumulate (see, for example, Bergsten and Williamson 2004).

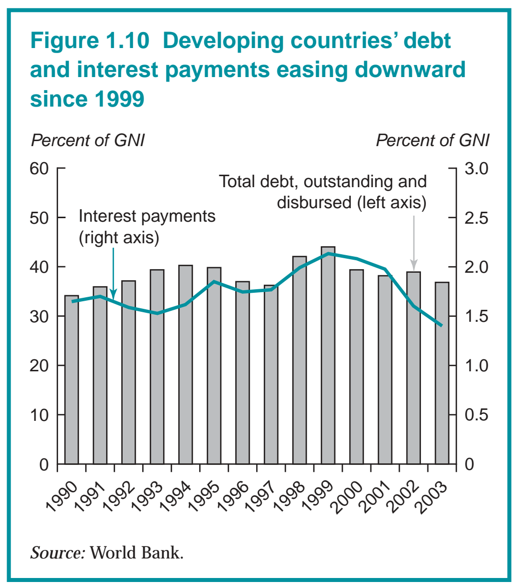
The U.S. trade deficit is largely a homegrown problem. While bilateral trade deficits with specific countries are large, notably with respect to China, the fact that these countries have only small overall surpluses supports the view that the deficit with the United States is more a reflection of U.S. trade patterns than an indication of unfair trading practices. For example, China's large bilateral surplus with the United States (but very small global surplus) reflects its specialization in the production of final consumption goods (sold to the United States) based on intermediate and primary imports from other developing countries with whom China has a cumulatively large trade deficit (Lau 2003).[4]

Failure to address the twin U.S. deficits could have significant impacts on developing countries, especially if that failure leads to an increase in protectionist behavior. This is especially relevant because the substantial improvements in living standards, wages, and incomes in many upper-lower and middle-income countries have been the result of expanding their world market share in manufactures. An increase in protectionism could halt these countries' progress and deny other poor countries the same avenue to development. Moreover, a retreat from recent efforts to reduce trade barriers or a failure to make further progress—especially concerning agricultural subsidies—could have substantial negative consequences on many of the world's poorest countries.

International Finance

Over the past several years, favorable global conditions, strong growth, rapidly expanding trade, and domestic reforms (including lower fiscal deficits and inflation) have allowed developing countries to substantially improve their financial positions (figure 1.10).

Figure 1.10 Developing countries' debt and interest payments easing downward since 1999



Source: World Bank.

On average, their debt to GNI ratio has fallen from 44 to 37 percent since its peak in 1999. This progress, plus low interest rates and strong growth, has substantially lowered the debt-servicing burden for most countries. While the situation of the most heavily indebted countries remains serious, they have made the greatest gains—debt to GDP ratios for these countries are down from 161 to 86 percent since 1994—partly because of debt-relief programs instituted over this period.

These favorable conditions have also allowed many countries to strengthen their external position. Most countries have succeeded in improving their structural positions so that, even in the face of higher oil prices or a more moderate pace for growth, their current account positions should not deteriorate to the point where financing becomes problematic. As a whole, the current account position of the major groups of developing countries is close to balance or in surplus (table 1.2).

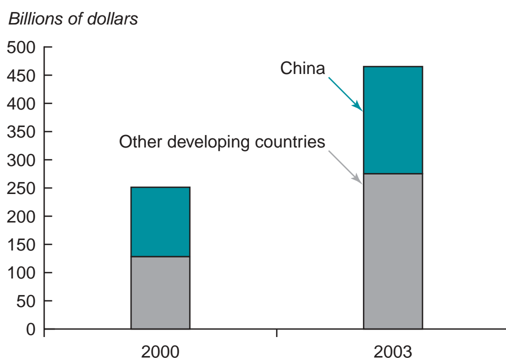
Developing countries have become major sources of international capital. Since 2000, the central banks of some of the largest developing countries have increased their foreign reserves by more than 80 percent. Taken as a group, the reserves of Brazil, China, India, Mexico, Thailand, and Turkey now represent over 45 percent of developing country reserves. Indeed, following private investors' retreat from equity and bond investments in U.S. dollar-denominated assets,[5] the central banks of these countries have become one of the most important sources of financing for the large U.S. current account deficit, absorbing 51 percent of the overall increase in foreign officially-held U.S. treasury bills between March 2000 and January 2003. While this has allowed these countries to increase their reserves by a substantial margin, it has been achieved at the expense of increasing their exposure to the U.S. dollar (figure 1.11). Among these countries, the share of U.S. treasury bills in their official reserves has increased by as much as 20 percentage points and equals almost 70 percent in the case of Mexico, and 58 percent in China. Should these countries decide to rebalance their reserve portfolio by slowing the pace at which they accumulate dollar-denominated reserves, either

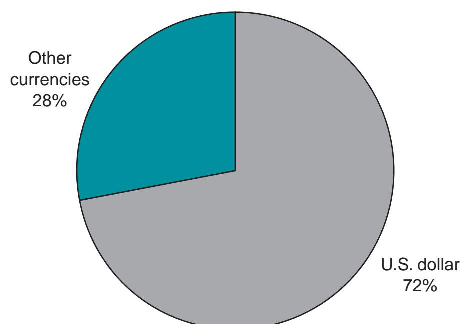
Table 1.2 Current account balances

Percent of GDP in 2004	
East Asia and Pacific	1.5
South Asia	−0.5
Middle East and North Africa	14.4
Sub-Saharan Africa	1.3
Europe and Central Asia	0.1
Latin America and the Caribbean	0.7
High-income countries	−0.8

Source: World Bank estimates.

Figure 1.11 Rising U.S. dollar reserves





Source: World Bank.

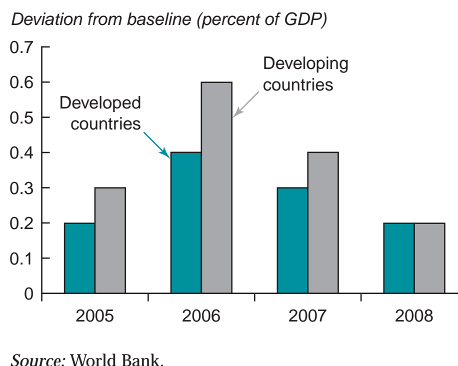
downward pressures on the dollar will accentuate, or interest rates will have to rise in order to attract sufficient private capital inflow.

Notwithstanding robust aggregate performance, many countries have been less successful in reaping the benefits of the last few years of strong economic conditions, and their high current account deficits could imperil their stability—especially in the context of slower growth in trade and world economic activity. More than 50 developing countries have current account deficits that exceed 5 percent of GDP. As a result, even the moderate hikes in interest rates, deterioration in terms of trade, and the slower export demand projected in the baseline will likely require these countries to undergo significant cuts to imports and domestic consumption in order to maintain external stability. If trade growth were to slow more than currently predicted, or if terms of trade were to deteriorate more because of an additional hike in oil prices, the required adjustment could be severe.

Risks and Policy Priorities

Forceful steps are required to reduce the twin deficits in the United States. As the preceding discussion has indicated, over the past few years, private sector equity and direct investment financing of the very large U.S. current account deficit has dried up,[6] having been replaced to a large extent by increased purchases of U.S. bonds by foreign central banks, notably those of developing countries. While these countries' build up of reserves has helped improve their external financial position, the stock of U.S. dollars that they now hold is very high and represents a disproportionate share of their assets. It is not clear that they can or should increase these stocks further by continuing to absorb the lion's share of net new U.S. treasury bills (6 developing countries absorbed more than half of net new issues since 2000).[7] Assuming their appetite for treasuries wanes, downward pressure on the U.S. dollar is likely to re-emerge, and yields will probably have to rise in order to motivate private investors to re-enter the market.[8]

Figure 1.12 Impact of a 200 basis point increase in interest rates



Source: World Bank.

Simulations suggest that a 200 basis point increase in long-term interest rates could reduce world GDP over the short- to medium-term by about 0.5 percent per annum;[9] the impact would be somewhat stronger for developing countries, because higher rates will raise debt servicing burdens, which require additional cuts to spending and demand (figure 1.12). Over the longer term, if the twin deficits in the United States are not addressed (a tightening of fiscal policy would reduce both deficits by increasing U.S. savings[10]), the problem is likely to intensify. Permanently higher long-term interest rates would render a wide range of investment projects uneconomic and slow the pace of potential output for a considerable time[11]— leading, perhaps, to a period of stagflation similar to that observed during the 1970–80s.

While higher U.S. interest rates might maintain investor interest in the dollar, they would have serious disruptive impacts on countries with large U.S. dollar debts. For countries such as Brazil, Indonesia, the Philippines, Poland, and Turkey, a 200 basis point increase in dollar interest rates would significantly increase debt-servicing charges. Increased outflows could provoke large depreciations in their currencies (as much as 9 percent), which would only increase the

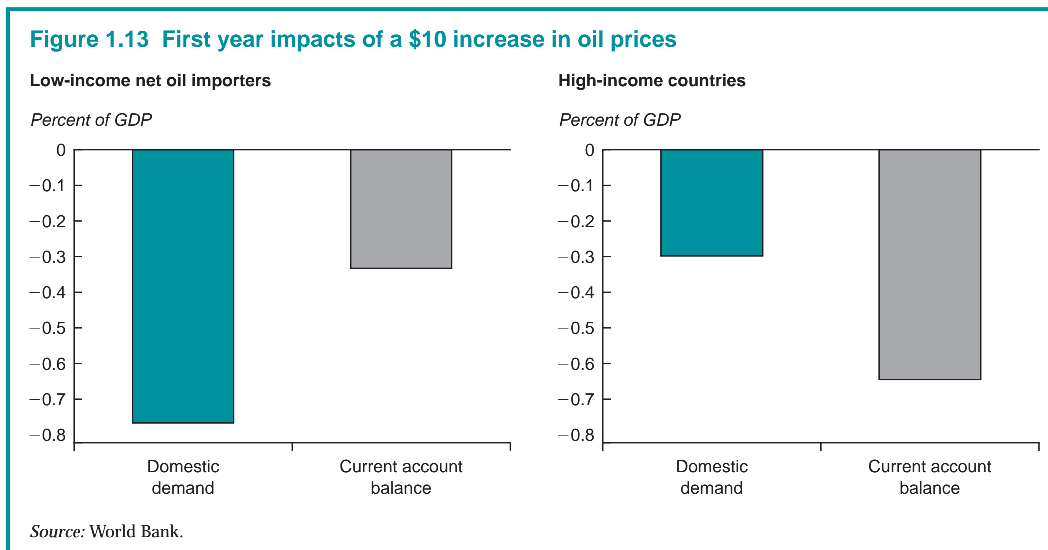
domestic burden of their external debt and generate further downward pressure on their currencies. Maintaining stability would, in all likelihood, require a substantial reduction in imports, consumption, and investment, which would result in slower growth and impede increases in poverty reduction.

The risk of such outcomes makes redressing imbalances all the more pressing. Among developed countries, steps need to be taken to reduce the U.S. government deficit, which would lower overall borrowing requirements and investor's concerns over the long-term financing of the debt. In Europe and other OECD countries, more resolute steps to redress government deficits and to create the fiscal room necessary to deal with the fiscal consequences of aging will be necessary if long-term interest rates are to remain low. For developing countries, a gradual appreciation of some currencies relative to the dollar could help by permitting a further depreciation of the dollar. However, in the absence of fiscal tightening in the United States, such measures are unlikely to have a significant impact. Fiscal consolidation is also required in many developing countries. Recent steps to lower existing government deficits move in the right direction and need to be pursued—as do efforts to reduce trade barriers so that export opportunities can increase. While these actions may well imply hardship and impose real political costs, the human and political consequences of entering into a period of higher interest rates without external and internal finances on a firm footing would be even more dramatic. Finally, funding for initiatives to relieve the debt burden of the poorest countries needs to be increased.

Should oil prices rise even further, the economies of low-income countries are likely to be among the hardest hit. Oil prices are assumed to moderate in the base case, falling from $39 per barrel (for the average of West-Texas Intermediate, Brent, and Dubai oils)[12] in 2004 to $32 in 2006. However, given supply and geopolitical conditions, there is a real risk that prices will either remain at current levels ($46.8 in October 2004 for this average—$49.5 for Brent) or rise even further. Simulations suggest that were events to temporarily disrupt supply by about 1 million barrels per day, oil prices could be expected to increase by about $10 a barrel. In macroeconomic terms, such an increase would slow economic growth by about 0.5 percentage points in the following year.[13] However, the resulting terms of trade shock would be larger in many poorer countries (−2.4 percent of GDP for highly indebted poor oil-importing countries versus −0.2 percent of GDP for high-income countries) because of the relatively high share that energy represents in their imports. And such economies tend to be more sensitive to a given terms of trade shock because of their limited ability to attract capital flows that would offset any resulting increases in their trade deficits. In contrast to high-income countries, which can increase their external borrowing to offset the real-side impact of higher oil prices, low-income countries are obliged to absorb most of the shock immediately. As a result, they undergo a depreciation and substantial reductions in consumption and investment spending—adjustment mechanisms that ultimately reduce spending on imports by almost the entire amount of the increased oil bill (figure 1.13). Their inability to defer adjustment (like high-income countries do) implies significant costs, both to individuals who see their consumption possibilities reduced and to the economy, as lower levels of investment feed through to reduce the capital stock and diminish productive capacity.

Finally, a failure of current efforts to slow the unsustainable pace of growth in China by engineering a soft landing could result in major disruptions. The Chinese authorities have put into place a number of specific—mainly command and control—measures, that restrict additional investment and lending to the construction and heavy production sectors. In the World Bank's forecast, this is projected to succeed in slowing overall growth

Figure 1.13 First year impacts of a $10 increase in oil prices



Source: World Bank.

to some 7.1 percent in 2006, down from an estimated 8.8 percent this year.

So far, these steps have slowed import demand in a number of sectors, notably metals and ores,[14] while credit restrictions have dramatically reduced the pace of money creation. In contrast, private consumption growth shows no sign of easing, and inflation has picked up rapidly. For the moment increased costs have not found their way into wages, but such a possibility cannot be ruled out. Should overheating contribute to further increases in inflation, a stronger policy response may be required. Moreover, investment levels remain very high, leaving open the possibility of a very rapid correction, especially if bad loans in the banking sector reveal themselves to be a serious problem. Either eventuality could provoke a more abrupt slowdown than forecast.

Long-Term Growth, Structural Change, and Poverty

This part of the report, as in years past, presents a long-term growth scenario for the global economy and its implications for meeting one of the MDGs: the halving of the proportion of the population living on $1 or less a day by 2015 (compared to 1990 levels). The strong economic growth in developing countries over the last 2 to 3 years, which is expected to continue through 2006, albeit at a somewhat slower pace, is based on solid fundamentals that are likely to carry forward and contribute to long-term economic prospects. In our base scenario this leads to an annual growth of some 3.5 percent in per capita GDP between 2006 and 2015, and contributes to achieving the MDGs. The poverty MDG will be met on a global basis, but a large number of countries will not meet the goal, particularly those in Sub-Saharan Africa. And though growth is necessary to make progress toward achieving the MDGs, in most countries, growth is insufficient without more targeted policies.

At least four factors are responsible for the recent and prospective improvement in growth prospects. As outlined in the first section of this chapter, among the solid fundamental changes in developing countries is an improvement in macroeconomic conditions (e.g., inflation and indebtedness). The recent *World Development Report* stresses the importance of the investment climate, which

has improved in many countries and has led to an acceleration in growth. A third factor, explored in more detail below, includes significant structural changes—that is, economic diversification and a move away from reliance on agriculture, and integration with the global economy; both of these structural changes involve increased urbanization. A fourth factor, pursued in greater detail in chapter 6, is the reduction in trade barriers.

The special focus of the long-term scenario in this report is on structural changes, particularly as they affect employment. Rapid growth will, in and of itself, lead to structural changes; that is, a relative decline in agriculture and a rise in the demand for services. Countries need to think ahead, allocate scarce public investment in a rational manner, and promote education to better position their work force for a changing environment. While structural changes are likely to be important, many developing countries face an equal challenge in the sheer growth of the labor force. Labor force growth rates are likely to decline over the next decade, but in many regions they will average between 1.5 to 2.5 percent per annum. For the poor, both growth and structural change are likely to be beneficial. Growth, to the extent that it lifts all incomes, will inevitably lead to a fall in poverty. Structural change can accelerate the process of poverty reduction. A decline in the rural population could ease wage pressures. A rising urban population provides easier access to essential health and education services and can lead to a rise in transfers to rural areas.

The focus on structural change also links to the broader theme of the report—the shape and impacts of regional trade agreements (RTAs). The RTAs will undoubtedly lead to additional structural shifts, and with associated transitional costs. How do RTAs compare with growth-induced structural shifts? Do RTAs produce structural shifts that are broadly consistent with those induced by a truly open global economy (which would emerge from a multilateral agreement)? And, if not, would the vested interests protected by an RTA impede progress toward a globally more beneficial agreement? These questions will be addressed in chapter 6. The conclusion from this chapter is that the challenge for most developing countries will be the creation of jobs for a rising work force, rather than how to deal with employment shifts across economic activities.

Long-term growth scenario

The global economy is currently rebounding from the downturn suffered in 2001 and 2002. Not all regions are benefiting equally from the rebound—Japan and the United States are leading the way among industrial economies—but there is fairly solid progress in all the main developing regions on an aggregate basis. This year, 2004, is likely to be the peak in the current upward cycle, with economies drifting toward long-term trend growth in 2005 and beyond. Table 1.3 reflects a plausible long-term scenario for the high-income countries and the World Bank's six aggregate developing regions (see box 1.1 for details concerning aggregation). The scenario reflects current views on potential trend growth over the 2006–15 decade. Better policies, an acceleration in investment, and other factors could improve the prospects, particularly for the slower growing regions. There is still a considerable gap in the productivity levels between developing and industrial economies, and a number of developing countries—particularly in Asia—have demonstrated, over the last 20 to 30 years, a sustained ability for rapid growth.

The focus of this forecast section this year is on anticipated structural changes. These have many dimensions—demographic, rural versus urban, sectoral, employment shifts, openness, and income distribution, among others. While most of these shifts have long-term positive impacts, they can also be associated with short-term transitional costs. Public policies can limit the costs of transition, but they can also be significantly reduced—at least in terms of duration—in a fast growing economy where job growth is robust.

Box 1.1 The aggregation paradox

The per capita growth rate for the world reflects the so-called aggregation paradox. The long-term per capita growth rates for high-income and developing countries are, respectively, 2.4 and 3.5 percent per annum, but the global growth rate is only 2.1 percent and is not the average of the growth rates (weighted or un-weighted). The following table highlights the aggregation paradox. The paradox is explained by the relatively high weight of high-income countries GDP in the world total, but their low weight in world population.

	High-income	Develop-ing	World
Population (million)			
2006	970	5,340	6,320
2015	990	5,900	6,900
Growth rate[a]	0.3	1.1	1.0
GDP ($billion)			
2006	31,200	8,200	39,400
2015	39,500	12,300	51,800
Growth rate[a]	2.7	4.6	3.1
GDP per capita ($)			
2006	32,090	1,530	6,240
2015	39,700	2,080	7,510
Growth rate[a]	2.4	3.5	2.1

a. Growth rates are percent per annum.

Structural Changes over Two Decades

Looking back on the last 20 years of development, many developing regions have already witnessed significant structural shifts. Perhaps foremost is the decline of agriculture as a source of income and employment. In East Asia and the Pacific, agricultural value added has declined from a 28 percent share in 1982 to only 15 percent in 2002, and manufacturing, other industrial, and services have risen (see figure 1.14). Services, according to these figures, still represented less than 40 percent of GDP in 2002, well below the nearly 65 percent share in the high-income countries of East Asia. Thus there is still significant scope for further structural shifts.

The value added shares also belie the relative employment share in agriculture, which tends to be much higher. Take, for example, Thailand, where agriculture's share of value added is below 10 percent, but still employs around 50 percent of the total labor force. In the high-income countries, the relevant shares are around 2 percent of value added and less than 4 percent of employment.[15] Higher agricultural productivity and relative wage differentials will continue to drive an exodus from agriculture into other sectors. And the change can come rapidly. In the Republic of Korea, the percent of employment in agriculture dropped from 32 percent in 1982 to 10 percent in 2001. The agricultural transformation is present in some of the other developing regions as well; for example, in South Asia the percent of employment in agriculture dropped from 40 percent in 1982 down to 27.2 percent in 2002, and in Latin America and the Caribbean, the percent of employment in agriculture dropped from 14.4 percent down to 10.6 percent over the same two-decade period. There has been no significant shift in either the Middle East and North Africa or Sub-Saharan Africa regions. At the same time, neither of those two regions witnessed much economic growth, with only 0.4 percent per capita growth per annum in the former, and a loss of 0.3 percent per annum in the latter.

In all regions, save East Asia, one can see a climb in the share of services. This is not surprising because services are assumed to be income elastic and a relative rise in the consumption share of services is understood. This effect is reinforced by the relatively high rate of productivity growth in manufacturing. All else being equal, this reduces the price of manufactures relative to services and hence enhances the value share of services. Perhaps what is more surprising is the variation across regions.

Table 1.3 Long-term prospects: Forecast growth of world GDP per capita

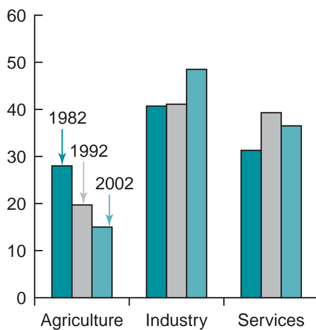
Real GDP per capita, annual average percentage change

	1980s	1990s	2000–06	2006–15
World total	1.3	1.1	1.6	2.1
High-income countries	2.5	1.8	1.7	2.4
OECD	2.5	1.7	1.7	2.3
United States	2.2	1.9	1.8	2.5
Japan	3.5	1.1	1.7	1.9
European Union	2.1	1.8	1.5	2.3
Non-OECD countries	3.5	4.1	1.6	3.5
Developing countries	0.6	1.5	3.4	3.5
East Asia and the Pacific	5.8	6.3	6.0	5.3
Europe and Central Asia	1.0	−1.8	5.2	3.5
Latin America & the Caribbean	−0.9	1.5	0.8	2.4
Middle East North Africa	−1.6	1.1	2.4	2.6
South Asia	3.3	3.2	4.2	4.1
Sub-Saharan Africa	−1.2	−0.5	1.2	1.6

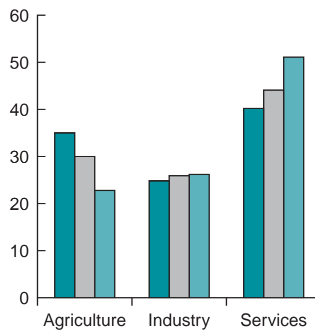
Note: Aggregations are moving averages, reweighted annually after calculations of growth in constant prices.
Source: World Bank.

Figure 1.14 A rise in services

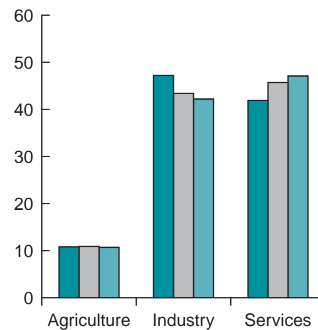
East Asia and Pacific



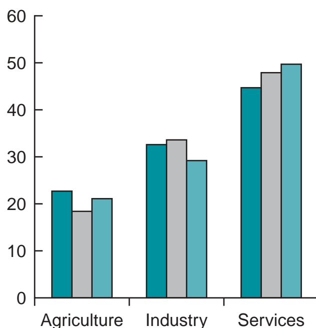
South Asia



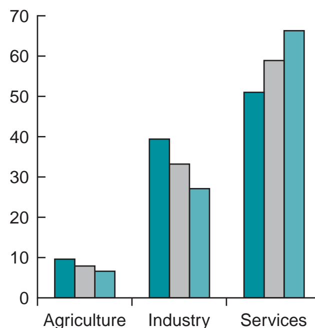
Middle East and North Africa



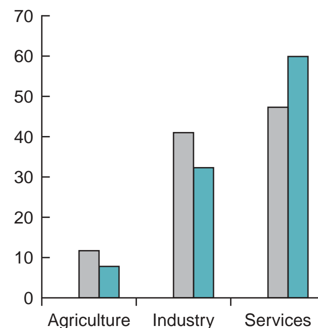
Sub-Saharan Africa



Latin America and the Caribbean



Europe and Central Asia

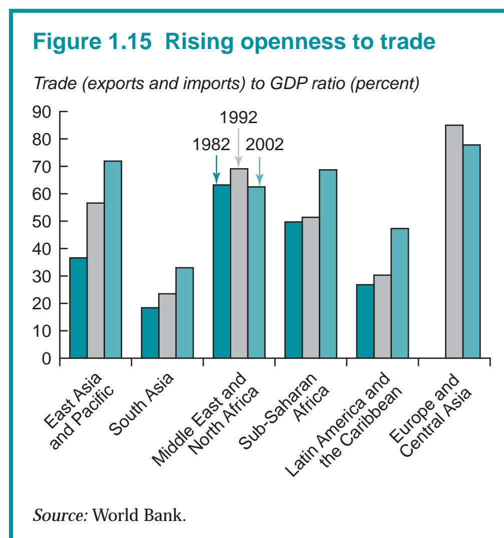


Source: World Bank.

In the high growth regions—East Asia and South Asia—there are two contrasting patterns. In South Asia the employment in agriculture shifted mostly to services, with a small increase in industrial output. In East Asia, employment in agriculture shifted more evenly between industry and services. And there appears to have been a structural break in the 1990s with an acceleration of industrial output. This is consistent with the sharp rise in the trade to GDP ratio doubling from 36 percent in 1982 to 72 percent in 2002, and with East Asia as a hub of assembly and manufacturing activities (see figure 1.15). There are, of course, exceptions in each region. The Philippines, for example, has a sharp rise in services and a decline in manufacturing—perhaps as a result of its regional comparative advantage in back office operations, call centers, and other services requiring specialized language skills. In South Asia, India's services dominate, but growth is much lower in Bangladesh and Pakistan, where textile and clothing exporters may be taking advantage of their relatively generous quotas to the main importing markets.

Three of the other regions—Latin America and the Caribbean, the Middle East and North Africa, and Sub-Saharan Africa—show less growth overall, but are also more dependent on natural resource production, and those relative prices have been declining over most of the period. Natural resources appear under industrial production, so even if volume growth has been positive, with declining relative prices the natural resources share in output could be declining. And apart from Latin America and the Caribbean, these regions have also not really benefited from global production sharing in the more integrated global economy. The Middle East and North Africa Region has barely seen any shift in its trade to GDP ratio. For both Sub-Saharan Africa and Latin America and the Caribbean, however, the ratio has increased markedly, particularly in the 1990s—from 50 percent to 69 percent for Sub-Saharan Africa, and from 27 to 47 percent for Latin America and the Caribbean. The more recent rise in Latin America can be partly explained by the implementation of a raft of regional agreements, including NAFTA and MERCOSUR. At the same time Latin America's degree of openness is lower than that of East Asia, and in general it has been less coopted into global production networks.

Figure 1.15 Rising openness to trade

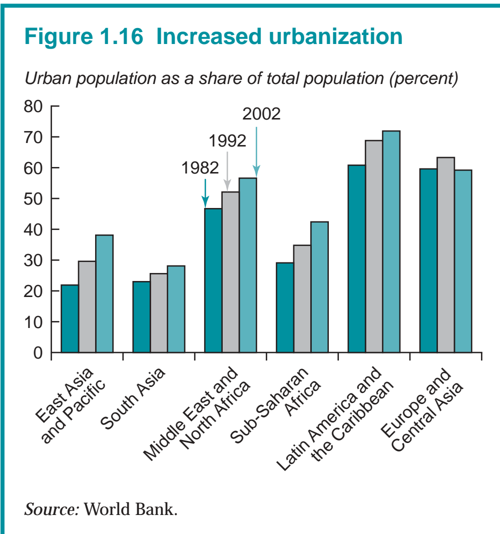


Source: World Bank.

The transformation in the economies of Europe and Central Asia over the last 15 years is a result of an abrupt structural shift. The dominance of industry as part of an economic strategy of planned economies was eliminated. Services in the transition economies quickly filled the gap, which led to significant dislocation for a period, but is now forming the basis of more rational and sustained growth.

Looking ahead it is clear that there is the potential for significant change. While the rate of urbanization has been persistent over the last two decades, there is a long way to go, particularly in Asia and Africa, before attaining the 80 percent level of the industrial countries (figure 1.16). The income gap is also huge, even if incomes are measured in purchasing power parity (PPP) terms. In East Asia, per capita incomes averaged just over $1,000 (1995 dollars) in 2002, compared with nearly $31,000 in the industrial countries—roughly a 30 to 1 differential. Even assuming

Figure 1.16 Increased urbanization



Source: World Bank.

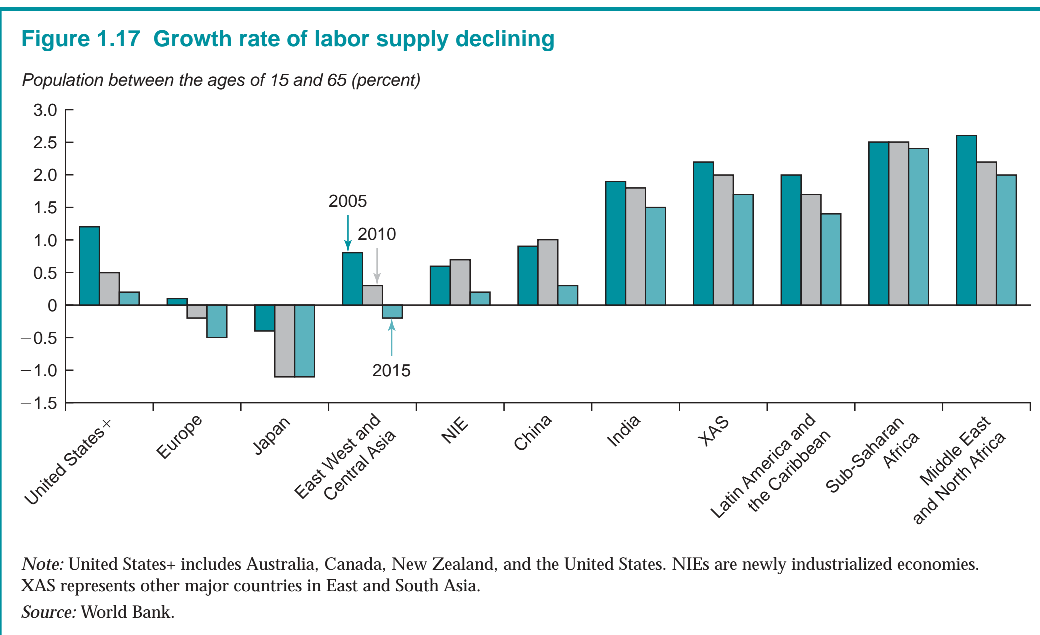
a PPP exchange rate of 5 would still lead to a significant 6 to 1 ratio in per capita incomes. In Latin America, the richest developing region with a per capita average income of $3,700, would have a ratio similar to East Asia using a PPP exchange rate of around 2.

Structural Change in the Future

Table 1.3 presents the long-term growth rates. This section focuses on some of the consequences of growth and other underlying assumptions of the long-term scenario on structural changes, particularly regarding labor shifts—both in volume terms and across sectors.[16]

In the aggregate, and assuming no change in labor force participation rates, labor supply growth will slow down sharply in most regions after 2010—with the exception of the Middle East and North Africa and Sub-Saharan Africa regions (figure 1.17).[17] In Western and Eastern Europe, Russia, and Japan, the labor supply would most likely shrink (even before 2010), putting additional pressure on underfinanced pension schemes. Additionally, it is the regions with the highest labor force growth rates that also tend to have the lowest per capita growth rates, so these regions are on a knife-edge in terms of their capacity to absorb high rates of new workers. These same regions typically have relatively low labor force participation rates, particularly of females; thus increases in

Figure 1.17 Growth rate of labor supply declining



Note: United States+ includes Australia, Canada, New Zealand, and the United States. NIEs are newly industrialized economies. XAS represents other major countries in East and South Asia.
Source: World Bank.

Table 1.4 Labor market structure, 2005–15

	Growth between 2005–15: percent per annum				Growth decomposition		
	Agric	Manuf	Services	Total	Structure	Expansion	Total
Australia, Canada & New Zealand	−0.7	−0.8	0.7	0.4	3.45	3.90	6.88
United States	−1.1	−0.6	0.8	0.5	2.95	5.62	8.34
Japan	−3.0	−2.2	−0.6	−1.0	3.62	9.35	8.70
Korea and Taiwan	−1.9	−0.6	1.0	0.5	4.18	5.65	9.17
Hong Kong (China) and Singapore	0.0	−0.5	1.0	0.7	4.80	7.28	11.65
EU with EFTA	−2.6	−1.5	0.2	−0.2	4.92	2.28	3.12
Brazil	0.8	0.5	1.4	1.2	3.52	13.09	16.28
China	0.5	0.4	1.3	0.8	5.12	8.44	12.02
India	0.1	1.6	2.4	1.7	9.27	19.89	28.02
Indonesia	1.1	1.8	1.6	1.5	8.32	17.18	22.73
Mexico	−0.2	1.6	2.5	2.0	7.00	22.78	28.84
Russia	−1.0	−1.1	0.0	−0.4	4.97	4.35	2.43
SACU	−0.7	−0.2	0.9	0.6	3.82	6.87	10.36
Vietnam	1.7	1.9	2.0	2.0	5.69	22.23	26.20
Rest of East Asia	0.7	1.2	2.1	1.7	4.72	19.36	23.09
Rest of South Asia	1.8	1.3	2.7	2.4	4.60	27.22	31.38
EU accession countries	−0.8	−1.1	0.2	−0.2	6.51	2.41	4.67
Rest of ECA	−0.3	0.3	1.1	0.8	6.15	8.88	14.43
Middle East	2.3	1.6	2.5	2.3	5.26	26.43	30.79
North Africa	0.8	2.0	2.5	2.0	7.27	23.74	29.83
Rest of Sub-Saharan Africa	2.0	2.2	3.0	2.6	4.50	30.19	34.08
Rest of LAC	2.1	0.9	2.2	1.8	5.36	20.74	25.41
Rest of the world	0.8	1.2	2.1	1.7	4.15	19.45	23.12

Source: World Bank simulations.

participation rates will lead to additional labot market weakness.

With high-income demand elasticity for services and relatively higher labor productivity in manufacturing, labor demand growth will tend to be higher in services than in manufacturing and/or agriculture (see table in endnote 17). This effect is quite pronounced in the industrial countries, where labor demand growth between 2005 and 2015 will be negative, on average, in agriculture and manufacturing in all high-income regions, with all of the net growth occurring in services (with the exception of Japan, where labor force growth could potentially decline by 1 percent per annum on average). The shift toward services also occurs in developing countries, but with continued high growth in manufacturing and less growth in agriculture.

Table 1.4 also shows a summary measure of the structural changes. It decomposes the total change in the structure of the labor force into two components. The first is the "structural" component, which measures the quantity of labor force movement across sectors, assuming no change in the volume of labor. The second is an "expansion" component, measuring the overall growth in the labor force. In the case of India, for example, the numbers suggest that the labor force will grow by about 20 percent between 2005 and 2015, or about 1.8 percent per annum. And in each year, about 0.9 percent of the initial labor force will move across sectors. Thus the total annual movement of 2.5 percent per annum is composed roughly of 2/3 expansion and 1/3 by intersectoral movements. It should be clear from the decomposition that for most of the developing regions, there will be more labor movement from the expansion of the labor force than from structural change, with the notable exceptions of Russia and the other countries in Europe and Central Asia—and, perhaps somewhat more surprisingly, China. For the industrial regions with low or declining labor growth, clearly the structural

shifts will be relatively the same order of magnitude as the expansion component. But the shifts are relatively small on an annual basis, perhaps 0.3 to 0.5 percent of the labor force.

Chapter 6 of this report will re-address one issue related to structural shifts in the context of RTAs. Do RTAs lead to structural changes that are inconsistent with the structural changes from a broad multilateral agreement? For example, a country signing an RTA may have a local comparative advantage in a given sector, but not a global comparative advantage. In this case, would the country need to undergo two potentially costly adjustments, should a multilateral agreement be signed subsequent to an RTA? And would the vested interests that benefit from the RTA hamper the ability to achieve a broader multilateral agreement, with positive aggregate benefits, but hurt the sectors that thrived under the preferential arrangement?

Poverty Forecast

Developing country economic performance has been strong since 2002, and this is projected to continue over the next two years and beyond (tables 1.1 and 1.3). This pattern of high growth would in all likelihood lead to a halving of the number of poor (i.e., the percentage of poor living on $1 or less a day) in developing countries between 1990 and 2015 (table 1.5)—one of the key MDGs. At the global level, the target to be achieved in 2015 is around 14 percent (one-half of 27.9), and the forecast is for a headcount index of 10.2 percent. This translates into a forecast of

Table 1.5 Regional breakdown of poverty in developing countries

	Number of people living on less than $1 per day (millions)					
	GEP2004			GEP2005		
Region	1990	2000	2015	1990	2001	2015
East Asia and Pacific	470	261	44	472	271	19
China	361	204	41	375	212	16
Rest of East Asia and Pacific	110	57	3	97	60	2
Europe and Central Asia	6	20	6	2	17	2
Latin America and the Caribbean	48	56	46	49	50	43
Middle East and North Africa	5	8	4	6	7	4
South Asia	467	432	268	462	431	216
Sub-Saharan Africa	241	323	366	227	313	340
Total	1,237	1,100	734	1,218	1,089	622
Excluding China	877	896	692	844	877	606
	$1 per day head count index (percent)					
	GEP2004			GEP2005		
Region	1990	2000	2015	1990	2001	2015
East Asia and Pacific	29.4	14.5	2.3	29.6	14.9	0.9
China	31.5	16.1	3.0	33.0	16.6	1.2
Rest of East Asia and Pacific	24.1	10.6	0.5	21.1	10.8	0.4
Europe and Central Asia	1.4	4.2	1.3	0.5	3.6	0.4
Latin America and the Caribbean	11.0	10.8	7.6	11.3	9.5	6.9
Middle East and North Africa	2.1	2.8	1.2	2.3	2.4	0.9
South Asia	41.5	31.9	16.4	41.3	31.3	12.8
Sub-Saharan Africa	47.4	49.0	42.3	44.6	46.4	38.4
Total	28.3	21.6	12.5	27.9	21.1	10.2
Excluding China	27.2	23.3	15.4	26.1	22.5	12.9

Table 1.5 Regional breakdown of poverty in developing countries (continued)

	Number of people living on less than $2 per day (millions)					
	GEP2004			GEP2005		
Region	**1990**	**2000**	**2015**	**1990**	**2001**	**2015**
East Asia and Pacific	1,094	873	354	1,116	864	230
China	800	600	256	825	594	134
Rest of East Asia and Pacific	295	273	98	292	271	95
Europe and Central Asia	31	101	48	23	93	25
Latin America and the Caribbean	121	136	124	125	128	122
Middle East and North Africa	50	72	38	51	70	46
South Asia	971	1,052	968	958	1,064	912
Sub-Saharan Africa	386	504	612	382	516	612
Total	2,653	2,737	2,144	2,654	2,735	1,946
Excluding China	1,854	2,138	1,888	1,829	2,142	1,812
	$2 per day head count index (percent)					
	GEP2004			GEP2005		
Region	**1990**	**2000**	**2015**	**1990**	**2001**	**2015**
East Asia and Pacific	68.5	48.3	18.2	69.9	47.4	11.3
China	69.9	47.3	18.4	72.6	46.7	9.7
Rest of East Asia and Pacific	64.9	50.8	17.6	63.2	49.2	14.7
Europe and Central Asia	6.8	21.3	10.3	4.9	19.7	5.2
Latin America and the Caribbean	27.6	26.3	20.5	28.4	24.5	19.6
Middle East and North Africa	21.0	24.4	10.2	21.4	23.2	11.9
South Asia	86.3	77.7	59.2	85.5	77.2	54.2
Sub-Saharan Africa	76.0	76.5	70.7	75.0	76.6	69.2
Total	60.8	53.6	36.4	60.8	52.9	32.0
Excluding China	57.5	55.7	42.0	56.6	54.9	38.6

Source: World Bank.

622 million persons living $1 or less a day in 2015, compared with 1.2 billion in 1990 and an estimated 1.1 billion in 2001.[18] With respect to the somewhat higher poverty line of $2 a day, the headcount should improve to 32 percent in 2015—not quite a halving of the estimated 61 percent headcount index in 1990—and corresponding to almost 2 billion poor.

However, progress is highly uneven across and within countries. The global target will largely be achieved because of the significant progress on poverty reduction in China and India. Sub-Saharan Africa lags far behind, and though poverty rates are much lower in some of the other regions, for example Latin America and the Caribbean, progress over the last 15 years has been insufficient to be on track to achieve the income poverty target in 2015 without more rapid growth or policies that are better targeted to the poor. Within regions, progress has also been uneven. Despite the huge overall reduction in East Asia, several countries, for example, Cambodia, Lao PDR, and Papua New Guinea, are off track to meet the goal. In Sub-Saharan Africa, there are only eight countries—representing 15 percent of the subcontinent's population—that will potentially make significant progress toward achieving the income poverty target. Within countries, such as China, there are large pockets of poor people, and reducing poverty in these pockets is difficult because they are often concentrated in remote, hard-to-reach locations. Links to the

national and/or global economy are weak, and provision of public services—education, health, water and sanitation—is difficult and expensive.

This year's poverty forecast, as in years past, reflects changes in two key dimensions. First, new country surveys lead to a re-evaluation of the level of poverty in 1990 and in the most recent base year, 2001. At the global level, the $1/day headcount index for 1990 has been shaved slightly from 28.3 percent in last year's report, to 27.9 percent in this year's report. There is also a very modest decline in the estimated level of poverty for 2001. The new surveys also force a re-evaluation of the link between income growth and poverty reduction. Using the latest survey information and last year's economic forecast, the forecasted decline in poverty is somewhat more rapid, with the headcount index declining to 10.4 percent (from 21.1 percent in 2001), instead of 12.5 percent (from 21.6 percent in 2000).[19] The second key dimension is the change in the long-term economic forecast. The changes overall are relatively modest. However, the somewhat improved performance anticipated between 2003 and 2006 generates better average growth for the forecast period 2001–15 and drops the headcount index for 2015 from 10.4 percent to 10.2 percent.

While progress on income poverty in parts of the world, particularly East and South Asia, has been spectacular if not historic, there is no room for complacency. As mentioned earlier, there are significant pockets of poverty even within the more successful countries. Moreover, there are other dimensions of poverty in which progress has been more limited, and almost all developing countries are off track. In East Asia, for example, the region scores relatively well for achieving 100 percent primary school completion rates, with China and Vietnam already having achieved the target and the Philippines on track.[20] But Thailand and Indonesia are off track, as are some of the poorer countries in the region. For the child mortality MDG, the situation is more worrying. Four countries are on track to achieve the target—Indonesia, Lao PDR, Malaysia, and the Philippines. All other countries are off track, and two—Cambodia and Papua New Guinea—are seriously off track. The situation is also dire for births attended (linked to maternal mortality) and access to safe water. These examples also illustrate that the other MDG targets are less directly correlated to income levels.[21] For example, Lao PDR and Indonesia are on track for the child mortality target, but Thailand is not.

Concluding Remarks

The rapid growth of developing economies, mostly concentrated in East and South Asia, has produced a spectacular, if not historic, fall in poverty that will enable the achievement of the poverty MDG on a global basis, although many countries will be seriously off-target. The rapid growth has been associated with large structural shifts—greater openness, more urbanized populations, and a sharp fall in agricultural employment. These trends will persist in the future as growth rates remain high, and incomes and productivity levels in developing countries are still well below industrial country averages—even taking into account PPP adjustments. As an example of potential structural shifts, take China's level of urbanization. Its rural population may not approach the 20 percent level of industrial countries, but a 50 percent share in 2015 could lead to a cumulative migration in the range of 140 to 175 million persons between 2005 and 2015. Such large shifts will require considerable public and private resources and their efficient allocation. Chapter 6 addresses a complementary issue—structural changes induced by changes in trade policies, notably the impacts of preferential trade agreements.

Notes

1. The investment to GDP ratio in the United States is currently 21 percent, close to its peak of 21.5 percent during the Internet bubble, and well above historical peaks of less than 18 percent.

2. The weighted average of the dollar's fluctuations relative to world currencies.

3. West-Texas Intermediate was much higher in October 2004 ($56). The overall average was depressed by the price of other oil (notably from Dubai), which was lower because producers increased the supply of lower quality oil.

4. Lau (2003) estimates that because of the re-export nature of its trade, the domestic value-added content of Chinese exports may be as little as 20 percent.

5. Net equity and foreign direct inflows of foreign private investors declined by 73 percent between 2001 and 2003. At the same time, net outflows by American private investors increased by 10 percent. As a result, total flows have reversed, from a significant inflow of $35 billion in 2001 to a $195 billion outflow in 2003. Since then, these trends have continued, with total outflows representing $267 billion in the second quarter of 2004.

6. See endnote 5.

7. Calculated as the change in U.S. t-bills held by the central banks of these countries divided by the net increase in t-bills held by official lenders (see http://www.treas.gov/tic/mfhhis01.txt).

8. Mussa (2004) suggests that a further 20 percent depreciation might be required to bring the U.S. economy into external balance.

9. These results are consistent with those published by the OECD for developing countries (see Dalsgaard and others 2001).

10. Even after Ricardian equivalence-based changes to private saving. Nevertheless, Brooks and others (2003) show that, taken alone, neither a 2 percentage point cut in fiscal spending, nor a 10 percent effective depreciation would be sufficient to restore external balance in the United States. They argue that a combination of depreciation, stronger world demand, and a larger fiscal contraction would be required.

11. Under higher interest rates, the desired stock of capital declines, which requires a prolonged period of slower growth before the economy adjusts to the new lower levels of output and capital.

12. In October 2004, this average price was $46.8 comprised of $53 for West-Texas Intermediate, $49.5 for Brent, and $37.7 for Dubai oil.

13. Dalsgaard and others (2001) estimate similar impacts for OECD countries.

14. Growth in steel demand fell 36 percent during the 3-month period ending in July, while copper imports were flat.

15. World Bank 2003b.

16. Unlike the previous section, which focused on the structure of value added, this section focuses on labor. The focus on labor provides a better perspective on the poverty dimension of structural shift. The historical analysis focused on output because of the greater availability and reliability of the data. Historical data on employment patterns has many gaps, and the data that does exist is often not compatible across countries.

17. The baseline scenario and the induced structural changes are predicated on a number of assumptions. First, growth in the labor supply is equated with growth of the working age population. For all regions, this implies a slowing of labor force growth, albeit with high growth in some developing regions. At the same time, the labor force is assumed to be flexible and thus will reinforce anticipated structural shifts. Second, savings are similarly influenced by demographics. In many developing countries this will translate into a slight acceleration in savings as the ratio of youth to workers declines, and a decline in industrial countries as the ratio of elderly to workers rise (explored in more detail in World Bank 2003a). Investment growth will largely be driven by domestic savings, as it has in the past; however, with modest increases in net capital flows toward developing countries, with the exception of East Asia, which has been a major source of international capital over the last five years.

Third are the assumptions regarding productivity growth; based on previously observed trends, these are divided into three broad economic sectors. In agriculture, it is assumed that the past growth of roughly 2.5 percent per annum is maintained through 2015 (see, for example, Martin and Devashish 1999). Maintaining this high rate of agricultural productivity will require continued and perhaps increasing investment in agricultural research and extension, combined with rising investment in agricultural infrastructure, particularly for water resource management. This rate of productivity growth in agriculture is consistent with a modest secular decline in agricultural prices, relative to the general price trend, as observed in the past. The other two broad sectors are manufacturing and services. Again, based on past trends, it is assumed that productivity growth in manufacturing will be higher than in services. This has two impacts: (1) it reduces the price of manufactures relative to services, all else being equal, and thus enhances the share of services in value terms; and (2) for the same level of output, it reduces the

Income elasticities in the Linkage model

	Ag. and food	Energy	Industrial goods	Services
United States	0.01	0.58	0.78	1.14
Japan	0.04	0.64	0.68	1.24
Europe	0.08	0.72	0.71	1.29
Rest of high-income	0.16	0.86	0.80	1.26
Low-income	0.52	1.40	1.08	1.41

demand for employment in the manufacturing sectors, and thus allows for a shift of labor toward services.

Fourth are the demand assumptions—the other side of the coin regarding structural changes. High-income countries have already witnessed a large decline in the demand for agriculture and food relative to income. Demand for services has increased relative to income and the demand for other goods. And there is no reason for these trends not to continue in the future. Thus the forward-looking scenarios assume that income elasticities over the next 10 years will largely reflect their current levels, though highly differentiated across commodities and regions (see table).

18. The absolute number of poor won't necessarily be halved due to population growth.

19. A more subtle change in the methodology has also been incorporated in this year's poverty forecast. The poverty forecast is based on the growth of the survey-based per capita consumption, assuming distribution neutrality (with some exceptions). However, it has been observed in the past that survey-based consumption growth deviates from consumption growth as measured in the national accounts. A conversion factor has been used to adjust for this deviation, which for most countries implied an elasticity of 0.9. In other words, if national income consumption grows at 10 percent, the assumed growth in survey-based consumption is 9 percent. More recent econometric evidence suggests that the long-run elasticity is 1, but that there are short-term deviations from the long-run elasticity. Because of the robustness of the long-run relationship, the new forecast assumes an elasticity of 1. Thus, all else being equal, this year's forecast will be lower than in the past because of higher implied consumption growth.

20. See World Bank 2004.

21. The World Bank, in its effort to improve its ability to monitor and forecast the other dimensions of the Millennium Development Goals, is developing and testing a new tool to forecast some of the MDGs. The tool will link economic growth with expenditures on health, education, and infrastructure. It will also capture some of the complementarities across targets, for example the degree to which improvements in access to safe water can improve health outcomes. A pilot study is currently being undertaken for Ethiopia and first results will be described in the *Global Monitoring Report 2005.*

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Appendix
Regional Economic Prospects

East Asia and Pacific

GDP in the East Asia and Pacific Region is estimated to have increased by almost 8 percent in 2004 (for a second year), the strongest performance since the 1997–98 financial crisis. The regional boom has been led by extremely strong domestic demand and trade growth in China.

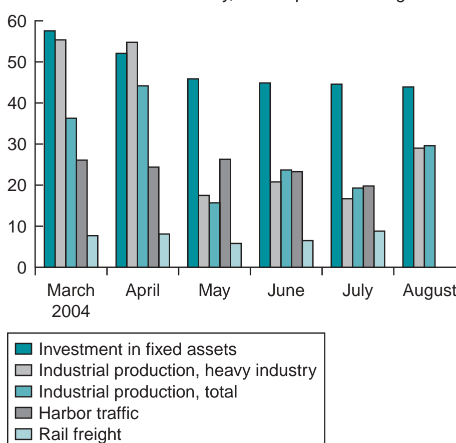
Chinese GDP is estimated to have increased by 8.8 percent, somewhat slower than in 2003. This slowdown reflects China's efforts to stave off an overheating of the economy and prevent an inflationary spiral that could derail long-term growth if recent hikes in food prices are passed through to wages and other consumer prices. Administrative controls on investments and restrictions placed on the issuance of new credits appear to be bringing expansion down to a more sustainable level. Investment growth slowed from over 40 percent to still high 20–30 percent rates between the first and third quarters (figure A1). In addition, the recent moderation in freight rates and the precipitous fall in October of the prices of copper, nickel, zinc, lead, and other commodities that are the building blocks of the Chinese boom appear to reflect perceptions that Chinese demand has been slowing (increases in Chinese demand represented 90 percent of the growth in global steel demand during 2003, and 66 percent of the increased demand for iron ore).

However, the effectiveness of these measures in slowing overall demand is less clear. Investment levels continue to exceed 50 percent of GDP, and retail sales volumes and the dollar value of imports are still expanding very rapidly.

Elsewhere in the region, GDP in 2004 is estimated to have increased by about 7 percent in Malaysia, by between 5.5 and 6.5 percent in the Philippines and Thailand, and by somewhat less than 5 percent in Indonesia. Buoyant consumer spending continues to make an important contribution in all these economies, while fixed investment spending, which has been subdued in the years since the financial crisis, has mounted a substantial recovery since late 2003.

Figure A1 A gradual slowing of China's growth

Selected indicators of activity, annual percent change



Source: National authorities.

Table A1 East Asia and Pacific forecast summary

Annual percent change unless otherwise indicated

	1990–2000[a]	2002	Est. 2003	2004	Forecast 2005	2006	2006–15[a]
GDP at market prices (1995 dollars)[b]	7.7	6.7	7.9	7.8	7.1	6.6	6.1
GDP per capita (dollars)	6.3	5.8	7.0	6.9	6.2	5.7	5.3
PPP GDP[c]	8.4	7.1	8.4	8.1	7.3	6.8	. . .
Private consumption	6.8	5.5	6.5	8.2	7.3	7.0	. . .
Public consumption	7.7	6.8	6.7	5.8	5.4	5.4	. . .
Fixed investment	9.0	13.1	18.6	16.4	9.5	8.1	. . .
Exports, GNFS[d]	11.6	14.8	20.8	20.9	13.2	11.0	. . .
Imports, GNFS[d]	11.6	15.1	23.3	24.4	15.6	12.1	. . .
Net exports, contribution to growth	0.3	0.5	−0.1	−0.7	−0.8	−0.4	. . .
Current account balance (% of GDP)	0.4	3.5	3.1	1.5	1.6	1.6	. . .
GDP deflator (median)	6.8	3.9	3.6	3.9	3.0	3.5	. . .
Fiscal balance (% of GDP)	−1.2	−3.4	−2.8	−2.4	−2.3	−2.2	. . .
Memo items: GDP							
East Asia excluding China	4.6	4.4	5.2	5.8	5.6	5.4	5.0

a. Growth rates over intervals are compound average; growth contributions, ratios, and the GDP deflator are averages.
b. GDP measured in constant 1995 dollars.
c. GDP measured at PPP exchange rates.
d. Exports and imports of goods and nonfactor services.
Source: World Bank.

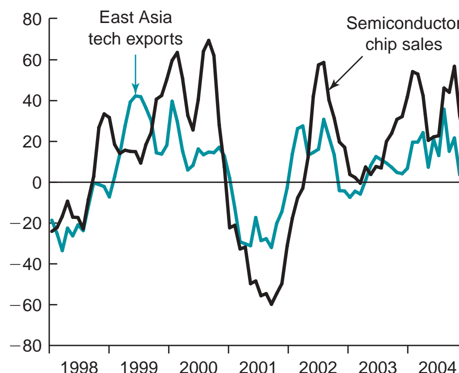
Output in the region is expected to slow through 2006, when it is projected to increase by 6.6 percent. By then Chinese GDP growth is forecast to ease to a more manageable 7 percent pace. It is assumed that administrative controls on investment and credit restrictions are calming the torrid pace of investment. As a result, the overall contribution of investment to GDP growth is projected to decline by more than 3 percentage points, with slower consumer demand also making a contribution as the pace of economic activity moderates.

Excluding China, GDP growth in the region is projected to remain robust, easing somewhat to around 5.5 percent by 2006 (table A1). This mainly reflects the slowing in economic activity among the region's major trading partners (China, Japan, and the United States) and, at the sectoral level, a weakening in world demand for high-tech products (G-3 orders for semiconductors fell 8.5 percent in the three months ending August 2004, as compared with the still robust growth of the second quarter) (figure A2).

This relatively benign outlook is subject to downside risks. In particular, overinvestment and excess capacity in China could lead to a sharp downswing in new investment, which would result in a much more abrupt slowdown than forecast. This slowdown would, in turn, have a significant impact on China's major trading partners in the region. In addition, should rapidly rising headline inflation

Figure A2 The global high-tech cycle may be easing

Selected high-tech indicators, rolling quarterly annualized rates, three month moving average, seasonally adjusted, percent



Sources: Semiconductor Industry Association, National sources, and World Bank.

feed through to core inflation, and the economy overheat, a much sharper policy response may be required. Finally, should oil prices not decline as projected in the baseline, the resulting adverse terms of trade consequences would act as a drag on growth within the region, because most of the larger economies in the region are significant net energy importers.

Over the long term, the East Asia and Pacific region is projected to continue generating strong growth. Since the 1997 financial crisis, GDP growth in the region has averaged 6.8 percent, and real per capita incomes have risen by almost 6 percent a year. While much of this strength reflects China's very rapid growth (8.1 percent on average), the rest of the region still enjoyed robust growth of 4.4 percent. Over the period 2006–15, regional per capita incomes are projected to continue rising rapidly, by about 5.3 percent a year in real terms.

Past reforms auger well for the future. Initiatives such as joining the WTO, the adoption of a much more welcoming attitude toward foreign capital, and efforts to recapitalize and restructure the financial sector in those countries most seriously affected by the 1997 financial crisis have underpinned growth in the recent period. They have done so by expanding markets and increasing the capital stock, which have allowed vast numbers of hitherto underemployed agricultural workers to be productively employed in the manufacturing sector, which increased both demand and output. At the same time, measures to consolidate public finances and reduce debt, including contingent liabilities, have also contributed to improved economic performance.

If real per capita incomes are to continue rising by the projected 5.3 percent a year, the reform agenda will have to be retained and expanded. Given the increased importance of financial markets and external investment, the region's growth prospects could be enhanced through further improvements to financial sector supervision and prudential rules, and by strengthening accounting and auditing standards. By raising investor confidence in regional markets, the domestic repercussions of higher world interest rates as well as the risk of contagion from financial turmoil elsewhere would be limited. Investment levels and growth would be further supported by strengthened insolvency laws, while public-sector governance reforms could significantly improve the state's ability to deliver key public goods and services. In China, clarifying the relations between the largely state-owned banking system and other state-owned enterprises would help reduce the likelihood of accumulating more bad loans.

Europe and Central Asia

Real GDP in Europe and Central Asia is estimated to have increased by 7 percent in 2004, a sharp acceleration from the 5.9 percent outturn in 2003. This strong performance outstrips the 2000 peak in growth of 6.7 percent. It marks a new record since the beginning of the transition period, with the commonwealth of independent states (CIS) showing the most rapid growth (table A2). The acceleration reflects several factors. Domestic consumption and investment in Russia and other CIS oil exporters were boosted by a surge in oil revenues, while the accession of a number of the region's countries to the European Union (EU) provided a further boost to investment demand and foreign direct investment inflows. Industrial production for the region as a whole was up an estimated 8.4 percent (figure A3). Strong domestic demand in Russia spurred increased imports from neighboring countries, mainly in the CIS, and the new EU members continued to increase their share of EU trade, reflecting past foreign direct investment from the EU. Overall, the region increased market share, and its exports grew almost 35 percent faster than world trade (figure A4).

Notwithstanding rapidly expanding production, fiscal deficits remain unsustainably high in a number of countries in central Europe. These deficits along with strong private-sector demand and higher oil prices have

Table A2 Europe and Central Asia forecast summary

Annual percent change unless indicated otherwise

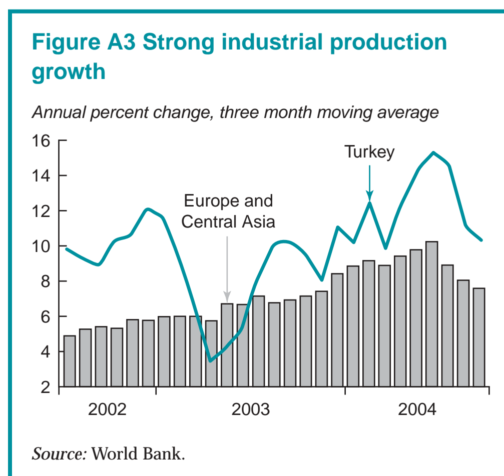
	1990–2000[a]	2002	Est. 2003	2004	Forecast 2005	2006	2006–15[a]
GDP at market prices (1995 dollars)[b]	−1.4	4.6	5.9	7.0	5.6	5.0	3.5
GDP per capita (dollars)	−1.6	4.6	5.9	7.0	5.6	5.0	3.5
PPP GDP[c]	−2.1	4.7	6.3	7.4	5.8	5.1	. . .
Private consumption	0.8	5.5	7.2	6.5	5.5	5.0	. . .
Public consumption	−0.8	2.9	2.4	2.8	2.6	2.3	. . .
Fixed investment	−6.7	1.9	9.3	12.0	7.8	7.4	. . .
Exports, GNFS[d]	2.0	7.7	11.9	13.7	9.8	9.1	. . .
Imports, GNFS[d]	−1.0	8.6	13.5	12.4	10.2	9.4	. . .
Net exports, contribution to growth	1.1	−0.2	−0.5	0.8	0.0	0.0	. . .
Current account balance (% of GDP)	−0.6	0.7	0.1	0.1	−0.5	−0.6	. . .
GDP deflator (median)	. . .	4.2	4.4	4.8	4.2	4.2	. . .
Fiscal balance (% of GDP)	. . .	−3.4	−2.8	−2.4	−1.8	−1.7	. . .
Memo items: GDP							
Transition countries	−2.2	4.0	5.9	6.9	5.7	5.0	. . .
Central and Eastern Europe	1.0	2.8	4.0	5.0	4.6	4.7	. . .
Commonwealth of Independent States	−4.2	5.0	7.5	8.3	6.6	5.2	. . .

a. Growth rates over intervals are compound average; growth contributions, ratios, and the GDP deflator are averages.
b. GDP measured in constant 1995 U.S. dollars.
c. GDP measured at PPP exchange rates.
d. Exports and imports of goods and nonfactor services.
Source: World Bank.

contributed to rising current account deficits and inflation. A notable exception to increasing inflationary pressures is Turkey, where fiscal consolidation and a tightening of monetary policy has helped bring inflation down from 68 percent in 2001 (18 percent in 2003) to only 9 percent in the fall of 2004. While it is still too early to tell, this may herald a new beginning for Turkey whereby economic decision making and growth are no longer constrained by price uncertainty.

Figure A3 Strong industrial production growth

Annual percent change, three month moving average



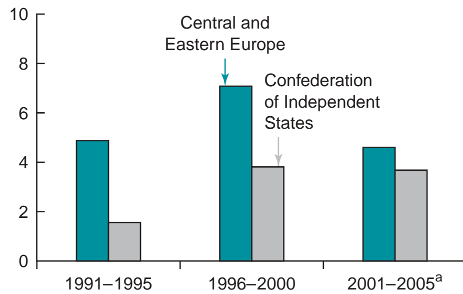
Source: World Bank.

Regional growth is forecast to moderate over the near-term, with output rising by 5.6 and 5 percent in 2005 and 2006, respectively. This aggregate performance masks relatively stable growth in the central European region, where slower growth in trade volumes elsewhere in the world is expected to offset an acceleration in western European demand for products of the region. The slowdown in the CIS is projected to be much sharper, and mainly reflects slower growth in Russia, as energy production tops out at very high levels. For the region as a whole, still high oil revenues should boost domestic demand and employment growth, helping to create a virtuous circle that can maintain growth at high levels. Lower oil prices will lead to a shift in the regional current account balance from surplus to deficit.

Progress in fiscal consolidation, diversification of production, and advancing reforms will influence regional growth outturns. A re-

Figure A4 Growth of goods-and-services exports minus GDP growth

Constant prices, period annual averages



a. 2004 and 2005 data are forecasts.
Source: World Bank.

duction in public expenditure by the governments of new EU members and South Eastern European states, achieved by cutting back on poorly targeted spending and improving public expenditure management would help spur investment in this region and accelerate convergence to EU income levels. Moreover, such steps would prevent a substantial deterioration of public finances when these economies return to slower growth. By slowing the now rapid debt accumulation, a more prudent fiscal policy would also reduce the domestic impact of higher international interest rates and reduce the possibility of disruptive spikes in short-term debt flows. For Turkey, further success in tightening fiscal policy, paying down debt, and controlling inflation would contribute to both improved growth prospects and greater macroeconomic stability.

In the next 10 years, Europe and Central Asian growth is forecast to average 3.5 percent. GDP in the Central and Eastern European countries over the next 15 years is projected to expand much more quickly than it did during the first 10 years of transition. Growth should continue to be led by high investment rates (both foreign and domestic), rising intraregional trade, and expansion in world market share, as these countries continue to reap the benefits of the extensive structural reforms they have implemented and from EU membership. If implemented, further improvements in the policy environment, including greater macroeconomic stability, would help to underpin these higher growth rates.

In general, the structural reform process in many of the CIS is less advanced than in the Central and Eastern European countries, although it is progressing. As a result, long-term growth prospects for the subregion are lower. Indeed, some countries have demonstrated significant resistance to the kinds of reforms that have served their western neighbors so well. High oil prices have provided an impetus to growth, which has facilitated the introduction of a number of reforms in oil-exporting countries and contributed to an increase in investment outlays (particularly in the energy sector). However, as energy prices retreat from their recent highs, countries in the region will need to rely on productivity improvements and product- and labor-market reforms to spur much needed investment.

Prospects in Turkey should be bolstered by the implementation of significant reforms, which could ultimately reduce inflation to historically low levels and bring the fiscal deficit down to a more manageable rate. The European Commission's recommendation that the EU begin accession talks with Turkey should help strengthen public support for further reforms. As these reforms progress, higher investment and improved productivity can be expected. Nevertheless, the process has only begun and underlying fundamentals remain difficult, pointing to significant downside risks and underscoring the importance of maintaining recent reform momentum.

Latin America and the Caribbean

Regional GDP in Latin America and the Caribbean is estimated to have increased by 4.7 percent in 2004, bringing to an end a three-year period of stagnation. Most countries in the region have had a solid year, and growth has accelerated

sharply in several of the larger economies. Output in Brazil is estimated to have increased 3.9 percent for the year as a whole. Mexico has also performed well; its economy expanded by an estimated 4 percent this year. New investments from large U.S. and European firms (Motorola, General Electric, and Electrolux) plus strong export growth among the maquiladora helped allay fears that Mexico was losing market share to Chinese competition. Other countries are also experiencing strong growth. Second quarter GDP increased 13.6 percent in the República Bolivariana de Venezuela, 11.5 percent in Uruguay, 6.7 percent in Argentina, 3.6 percent in Peru, and 3.5 percent in Colombia. Extensive hurricane damage has derailed developments in several Caribbean countries, and it may take several quarters before these countries start growing again—and even longer before economic activity returns to normal (table A3).

Commodity prices played an important role in these developments. Higher oil prices have benefited major oil exporters in the region, such as Colombia, Ecuador, Mexico, and the República Bolivariana de Venezuela, and have increased regional incomes by 0.7 percent of GDP, on average, since 2001. Oil importers, especially countries in Central America, the Dominican Republic, and Uruguay have been hurt, but their losses were attenuated by increases in other commodity prices. This was especially true for large exporters of agricultural products (Argentina, Bolivia, Brazil, Ecuador, and Paraguay) and metals (Chile, Jamaica, and Peru).

Increased international liquidity, fiscal tightening, and prudent monetary policy have improved the financial position of most countries in the region and have contributed to the upgrading of their debt and reductions in debt-servicing burdens. Overall, risk premia on the region's sovereign debt are low and have recovered from the surge observed in the spring. Countries in the region have taken advantage of low interest rates to restructure debt, and rating agencies have recently upgraded the sovereign debt of 15 Latin American countries (figure A5).

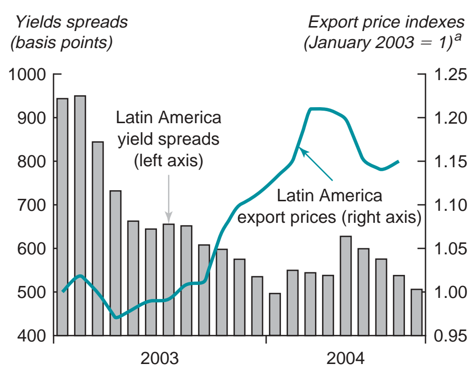
Table A3 Latin America and the Caribbean forecast summary

Annual percent change unless indicated otherwise

	1990–2000[a]	2002	Est. 2003	Forecast 2004	2005	2006	2006–15[a]
GDP at market prices (1995 dollars)[b]	3.3	−0.6	1.6	4.7	3.7	3.7	3.6
GDP per capita (dollars)	1.6	−2.1	0.2	3.2	2.3	2.3	2.4
PPP GDP[c]	3.4	0.0	1.6	4.5	3.7	3.6	. . .
Private consumption	4.0	−1.8	0.6	4.0	3.4	3.4	. . .
Public consumption	2.1	−0.3	1.2	1.9	3.0	2.7	. . .
Fixed investment	4.0	−7.0	−0.4	10.6	5.2	5.5	. . .
Exports, GNFS[d]	8.7	2.2	5.0	9.6	7.0	7.2	. . .
Imports, GNFS[d]	10.8	−6.1	0.5	10.3	9.6	8.1	. . .
Net exports, contribution to growth	−0.3	1.8	1.0	0.0	−0.5	−0.1	. . .
Current account balance (% of GDP)	−2.8	−0.9	0.1	0.7	−0.3	−0.9	. . .
GDP deflator (median)	12.3	6.6	4.2	4.0	4.0	4.0	. . .
Fiscal balance (% of GDP)	−2.4	−3.0	−2.7	−1.4	−1.3	−1.3	. . .
Memo items: GDP							
LAC excluding Argentina	3.1	1.1	0.6	4.3	3.7	3.7	. . .
Central America	4.5	2.1	3.3	3.2	3.3	2.9	. . .
Caribbean	4.1	3.2	1.1	0.9	2.7	3.0	. . .

a. Growth rates over intervals are compound average; growth contributions, ratios, and the GDP deflator are averages.
b. GDP measured in constant 1995 U.S. dollars.
c. GDP measured at PPP exchange rates.
d. Exports and imports of goods and nonfactor services.
Source: World Bank.

Figure A5 Latin America & the Caribbean benefits from a favorable external environment



a. Each country's aggregate export price reflects the commodity composition of its exports.

Source: World Bank.

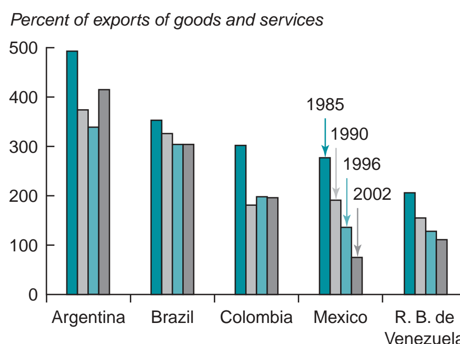
Regional growth is forecast to moderate, with GDP growth slowing to a still robust 3.7 percent by 2006. A number of factors are expected to contribute to this cooling. The projected slowing of world trade growth, and the consequent moderation in both oil and other commodity prices will reduce the pace of income growth and restrain domestic demand. At the same time, the combination of rising world interest rates, lackluster business confidence indicators, and emerging domestic inflationary pressures are expected to slow investment growth (notably in Brazil)—even though investment levels have yet to regain past peaks, and capacity utilization is close to all-time highs in many countries in the region. Capacity constraints in the oil sector are also likely to slow growth in oil-exporting countries.

In Argentina, growth is expected to moderate over the next two years. The boost to growth that was generated by its 2001 devaluation is waning, and the rise in commodity prices is leveling off or declining. At the same time, the recovery is beginning to bump up against capacity constraints in the energy sector, where price controls have discouraged new investment. Moreover, lingering uncertainty surrounding its defaulted bonds are likely to limit the country's access to external financing, constraining much needed capital accumulation.

The most significant downside risk for the region is still its vulnerability to higher interest rates and financial turmoil. Prudent budgetary policies in recent years, a general shift toward more flexible exchange rate regimes, and market opening initiatives have improved the financial position of many countries in the region. External debt of the region as a share of exports (a common indicator of external vulnerability) has fallen from 241 to 164 percent between 1990 and 2002, while inflation and both current account and fiscal balances have improved (figure A6).

However, some of this improvement has been cyclical in nature. Even the moderate downturn and higher interest rates incorporated into the projection will reverse some of this progress. Were the slowdown to be more pronounced or world interest rates higher than forecast, the impact would be large for some countries. Restraining government spending and implementing an efficient tax structure now, when economic growth and government revenues are strong, would help prevent an excessive deterioration in public finances as growth slows. Failure to do so would likely force governments to once again cut spending during the next downturn, exacerbating rather than smoothing the cycle.

Figure A6 Latin American external debt



Source: World Bank.

Long-term prospects for the region are improving. During the period 2006–15, growth is projected to average 3.6 percent and real per capita incomes to rise by 2.4 percent on average. Prospects for achieving this kind of healthy expansion have been improved by the substantial reduction of the fiscal imbalances and the perverse price incentives that have held back growth in the past. As a result of these efforts, debt-to-GDP ratios are falling. Consolidating these gains over the longer term, principally by restraining government spending during upturns, will be critical to ensuring future growth.

Increased reliance on medium-term expenditure frameworks would help increase stability in program financing and tax policy by eliminating the too frequent episodes where fiscal consolidation is undone by rapid increases in spending during periods of strong economic expansion. Keeping expenditure growth on an even keel, even when revenues are high, for cyclical or temporary reasons, will obviate the need for subsequent destabilizing cuts to program spending in order to reestablish internal balance. Establishing a more stable revenue base by reducing reliance on transitory nontax revenues or distortionary tax handles (e.g., oil royalties or other natural resource taxes, taxes on exports, taxes on bank checks, privatization, and so forth) would also help. More cost-effective public spending and a reallocation of resources toward growth-enhancing projects, such as infrastructure development, poverty eradication, education, and health enhancement programs, would further improve economic efficiency and growth.

Middle East and North Africa

GDP in the Middle East and North Africa Region increased by 4.7 percent in 2004, easing from a near-record 5.7 percent advance during 2003. For oil-exporting countries in the region, high and rising oil prices are boosting incomes and contributing to robust growth in domestic demand (figure A7). However, the very large increases in oil production that underlay the strong growth outturns for 2003 have largely run their course. As a result, GDP growth among oil exporters eased from 6.6 percent in 2003 to a still very high 5.0 percent in 2004. Buoyant oil revenues have pushed the overall region's current account balance to a surplus of some $92 billion or 14.4 percent of GDP (table A4). And if high-income countries such as the United Arab Emirates and Kuwait are included as part of the broader geographic region, the surplus rises to $120 billion or 15.5 percent of GDP—unprecedented since the first oil shock of the early 1970s.[1]

Oil importers of the region, though suffering rising import bills, have also benefited indirectly from higher oil prices, and GDP is estimated to have accelerated somewhat in 2004, expanding 4.2 percent. Increased regional demand for their exports and stronger remittance flows have contributed to incomes and production levels—although the labor-scarce oil exporters do not appear to have increased the number of guest workers to the same extent as during past oil price hikes.

The conflict in Iraq has also influenced economic activity across the region. Perceived increases in risk have reduced foreign direct investment inflows and disadvantaged regional investment projects, while heightened security concerns in the developed world have boosted transport costs for regional exports. Terrorist threats, both in Iraq and those potentially targeting the region's oil infrastructure, are an important element underlying the substantial "premium" on oil prices. However, the war has also stimulated demand for logistics and related functions, thereby boosting activity in several economies of the region. Revenues from the Suez Canal have skyrocketed with increased transits; and tourism nights in Egypt have increased by 35 percent as of mid-2004, reflecting an increased propensity among Middle East and North African residents to restrict travel to within the region.

Regional growth is forecast to remain strong in 2005 before easing to 4.5 percent

Table A4 Middle East and North Africa forecast summary

Annual percent change unless indicated otherwise

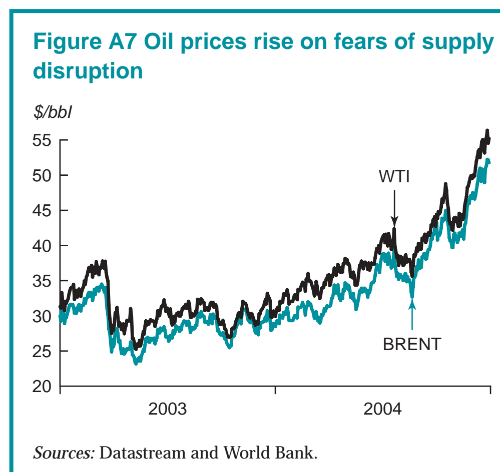
	1990–2000[a]	2002	Est. 2003	Forecast 2004	2005	2006	2006–15[a]
GDP at market prices (1995 dollars)[b]	3.4	3.2	5.7	4.7	4.7	4.5	4.4
GDP per capita (dollars)	1.2	1.4	3.8	2.8	2.8	2.5	2.6
PPP GDP[c]	3.6	4.0	5.6	5.0	5.0	4.7	. . .
Private consumption	2.0	3.0	3.9	4.1	4.2	4.5	. . .
Public consumption	1.7	0.2	4.7	6.0	5.7	4.0	. . .
Fixed investment	3.5	5.2	5.6	8.0	7.2	6.8	. . .
Exports, GNFS[d]	4.8	1.6	10.1	5.1	3.9	4.4	. . .
Imports, GNFS[d]	1.9	3.0	4.6	5.9	5.1	4.5	. . .
Net exports, contribution to growth	0.9	−0.3	2.0	0.1	−0.1	0.2	. . .
Current account balance (% of GDP)	−1.9	4.6	8.1	14.4	11.2	6.7	. . .
GDP deflator (median)	6.8	2.1	3.5	3.9	4.0	4.0	. . .
Fiscal balance (% of GDP)	−1.0	−3.8	−1.7	−2.2	−2.1	−2.1	. . .
Memo items: GDP							
MENA Geographic Region[e]	3.7	2.9	6.0	4.8	4.7	4.4	. . .
Resource poor- Labor abundant[f]	3.8	3.0	4.1	4.2	4.5	5.2	. . .
Resource rich- Labor abundant[g]	3.5	5.9	6.2	6.1	5.7	5.0	. . .
Resource rich- Labor importing[h]	3.7	0.6	7.0	4.2	4.0	3.3	. . .

a. Growth rates over intervals are compound average; growth contributions, ratios, and the GDP deflator are averages.
b. GDP measured in constant 1995 dollars.
c. GDP measured at PPP exchange rates.
d. Exports and imports of goods and nonfactor services.
e. Geographic region includes high-income countries: Kuwait and UAE.
f. Egypt, Jordan, Morocco, and Tunisia.
g. Algeria, Iran, Syria, and Yemen.
h. Bahrain, Kuwait, Oman, Saudi Arabia, and UAE.
Source: World Bank.

in 2006; shifts in the sources of growth are likely. Growth in oil exporting countries is projected to moderate to a respectable 4.1 percent by 2006. The current medium-term view that oil prices will be sustained above $30 per barrel beyond 2006,[2] suggests that the region will continue accumulating large surplus positions, and high oil-related incomes should keep domestic demand robust. The current account surplus for the broader Middle East and North Africa Region is projected to ease from $120 billion in 2004 to $100 billion in 2005, before dropping more substantially to $60 billion or 6.5 percent of GDP by 2006 (figure A8).

In contrast, growth is expected to accelerate among regional oil importers, supported by still high levels of demand from oil exporters and stronger European export demand, as the long-awaited recovery takes hold there. The Maghreb economies should be particularly sensitive to this increase because the European Union (EU) accounts for some 70 percent of their exports. Robust activity in Europe will also likely benefit several resource-poor and labor–abundant economies in the region—among them Egypt, Jordan, and Lebanon.

Figure A7 Oil prices rise on fears of supply disruption



Sources: Datastream and World Bank.

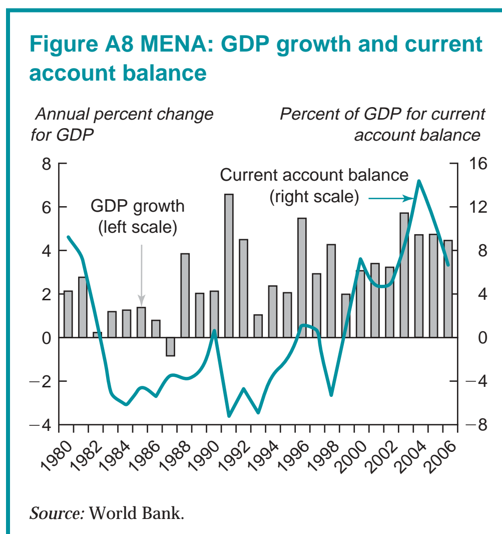


Figure A8 MENA: GDP growth and current account balance

Source: World Bank.

These countries, having signed EU-Mediterranean trade agreements, will benefit from preferential access to that market and can be expected to increase their market shares. However, countries in the region will also likely face increased competition from the new members of the EU, who are now benefiting from almost full market access and strong capital inflows. Meeting this challenge will require reinforced efforts to improve productivity and enhance the quality of regional export products.

In the longer-term, a return to lower oil prices and the need for enhanced reforms across the region will offer substantial challenges. How policymakers manage today's revenue windfalls will have an important long-run impact on the region. Current efforts to allocate surplus revenues to "Oil Funds" and to debt repayment should reduce upward pressure on regional currencies and protect the competitiveness of domestic non-oil firms (the "Dutch disease"). At the same time, such measures should help restrict the expansion of the domestic money supply and help insulate regional economies from overheating.

Longer-term prospects for the region will depend, to a large degree, on the success with which non-oil sectors can develop and flourish. It is important that continuing oil windfalls not delay needed reforms to the "investment climate" across the region, including economic structures and institutions that can promote more balanced growth, employment creation, and the achievement of longer-run poverty reduction goals.[3] Demographic pressures are mounting, and the need for job creation is urgent. At the same time, progress in these areas is complicated by the uncertainties regarding outcomes in the Iraqi conflict, which add an overlay of tension that is a concern for policymakers worldwide.

South Asia

GDP in South Asia is estimated to have slowed considerably in 2004, increasing by 6 percent, down from 7.5 percent in 2003. Much of the slowdown reflects a deceleration in agricultural output (up 3.4 percent) due to poor rainfall, while elsewhere, services, manufacturing, and export demand showed considerable strength. The brunt of the slowdown was felt in India, where the most serious impacts of the delayed onset of the monsoon were felt. In addition to the direct effect on agricultural output, the poor crop had important feed-through effects on rural private consumption, which in India accounts for about a quarter of GDP (over half of the population is dependent on the agricultural sector) (figure A9). India's services sector made strong advances, supported by productivity gains and greater market penetration, and the manufacturing sector continued to post high growth. Overall Indian GDP is estimated to have slowed from an increase of more than 8 percent in 2003 to one of about 6 percent in 2004.

Excluding India, growth in the region is projected to rise to 6 percent in 2004 from 5.6 percent in 2003, supported by robust manufacturing sectors in Bangladesh and Pakistan, and by strengthening services and agricultural sector growth in Nepal and Sri Lanka (table A5). For the subregion as a whole, strong external demand (exports were up 11 percent) and a general rise in remittances from abroad helped boost incomes and

Table A5 South Asia forecast summary

Annual percent change unless indicated otherwise

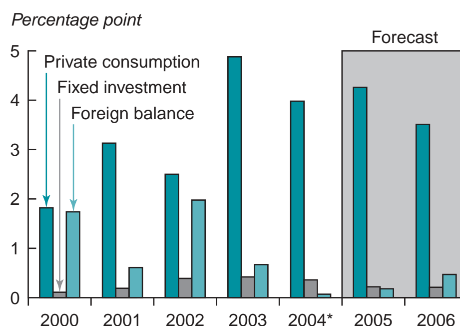
	1990-2000[a]	2002	Est. 2003	2004	Forecast 2005	2006	2006–15[a]
GDP at market prices (1995 dollars)[b]	5.2	4.6	7.5	6.0	6.3	6.0	5.5
GDP per capita (dollars)	3.3	2.8	5.8	4.3	4.7	4.4	4.1
PPP GDP[c]	5.3	4.6	7.6	6.0	6.3	6.0	. . .
Private consumption	4.2	3.9	7.6	6.2	6.6	5.4	. . .
Public consumption	5.2	3.5	3.8	3.4	2.2	2.1	. . .
Fixed investment	6.0	8.4	8.7	7.1	8.5	8.2	. . .
Exports, GNFS[d]	11.1	18.2	11.4	9.8	14.9	10.9	. . .
Imports, GNFS[d]	10.0	5.5	8.4	10.8	15.7	9.6	. . .
Net exports, contribution to growth	0.0	2.0	0.7	0.1	0.2	0.5	. . .
Current account balance (% of GDP)	−1.5	1.1	1.2	−0.5	−0.5	−0.1	. . .
GDP deflator (median)	7.9	3.6	5.2	3.7	5.3	4.7	. . .
Fiscal balance (% of GDP)	−11.0	−9.6	−8.2	−8.4	−7.8	−7.5	. . .
Memo items: GDP							
South Asia excluding India	4.4	4.5	5.6	6.0	5.6	5.8	5.3

a. Growth rates over intervals are compound average; growth contributions, ratios, and the GDP deflator are averages.
b. GDP measured in constant 1995 dollars.
c. GDP measured at PPP exchange rates.
d. Exports and imports of goods and nonfactor services.
Source: World Bank.

domestic demand, with private consumption accounting for virtually all of the increment to demand. In Pakistan, consumer demand was supported by robust increases in consumer credit and worker remittances. Rising investment rates reflected progress in structural reform and improved investor sentiment. Bangladesh's GDP growth is estimated to have been broadly stable between 2003 and 2004, although a sectoral breakdown indicates that this result reflects a combination of stronger manufacturing production (export-led growth) with some moderation of agricultural output (flooding and lower harvests). Growth in Nepal and Sri Lanka was held back by political tensions, which have cut into both tourism revenues and investor confidence. Meanwhile, donor assistance and relative peace, combined with a recovery in the agricultural sector after a prolonged drought, helped boost real GDP growth in Afghanistan by an estimated 16 percent, excluding the opium sector (which accounts for roughly a third of output).

There has been some building of inflationary pressures in the region. In India, producer prices were up 7.9 percent in September 2004 compared with 5.0 percent a year before, while in Pakistan producer inflation in the same period increased from 3.7 to 8.0 percent. Rising inflationary pressures mainly reflect higher food prices and some transmission of the rapid escalation of oil prices. The region's net current account surplus is expected to slip into a small deficit in 2004, due to the high energy import bill. However, robust external demand and continued market penetration are providing a substantial counterbalance.

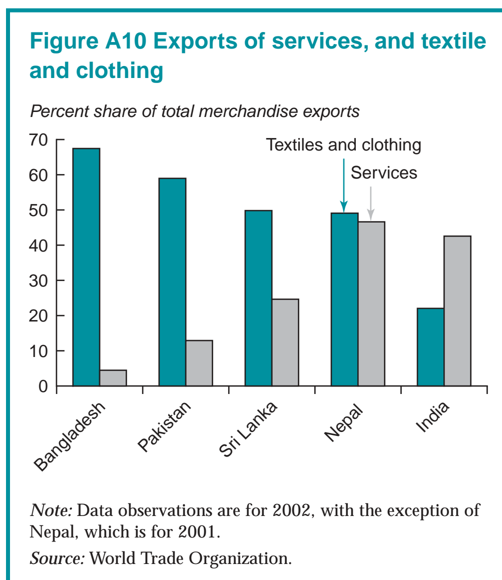
Figure A9 Contributions to growth



Source: World Bank.

Figure A10 Exports of services, and textile and clothing

Percent share of total merchandise exports



Note: Data observations are for 2002, with the exception of Nepal, which is for 2001.

Source: World Trade Organization.

Regional GDP is forecast to accelerate, expanding by 6.3 percent in 2005, before moderating somewhat in 2006. The acceleration is largely driven by an anticipated recovery of agricultural sector growth in 2005; it is forecast despite slower GDP and trade growth elsewhere in the world. The subsequent slowdown in 2006 is connected to a return to trend growth rates in the agricultural sector, which will moderate income and private consumption growth. Nonagricultural sectors are projected to continue expanding at a fast pace. Lower oil prices and better crops (assuming no further weather-related disruptions) should result in an easing of inflationary pressures in the near-term.

The slowdown in world trade growth should be reflected in regional exports, although South Asia is projected to continue increasing its share in both world goods and services markets. The entry of 10 new member countries into the EU should provide a fillip to regional exports. Many of these countries have large textile sectors, which now benefit from a more preferential trading regime and are likely therefore to increase their demand for inputs from South Asia. However, prospects for the South Asian textile sector remain clouded by the impending final phase-out of the Agreement on Textile and Clothing in 2005, which could have significant impacts on the balance of payments, production levels, and employment in a number of smaller countries in the region (figure A10).

Long-term growth in South Asia is forecast to average about 5.5 percent during 2006–15 as the contribution to growth from the private sector continues to rise. Buoyed by an ongoing consolidation of fiscal deficits (diminishing crowding out) and by rising private savings as dependency ratios decline, private investment is expected to play an increasingly large role in the region. The pursuit of trade reforms, banking-sector liberalization and re-regulation, privatization, and infrastructure development should all contribute to improving the investment climate, productivity growth, and ultimately, incomes. These product market reforms are being complemented by progress in raising education and skill levels and reducing infant mortality rates—factors that should further boost productivity. Moreover, demographics should help boost incomes, because despite declining infant mortality rates, falling birth rates mean that South Asian population growth is projected to decelerate and dependency ratios to decline over the forecast horizon. All of these factors suggest that per capita incomes will advance significantly in the coming decades, expanding by an average of 4.1 percent per year for the period 2006–15.

Policymakers in the region face a number of challenges to realize these high rates of growth. Substantial segments of the region's population remain vulnerable to weather patterns and natural disasters. Building capacity to mitigate their impacts without distorting economic incentives should be a priority. Recent peace agreements have eased regional tensions and are contributing to enhanced regional stability, which improves business confidence and increases intraregional trade. However, some international and domestic

tensions remain, and the possibility of a deterioration in relations continues to present downside risks to growth outcomes and poverty reduction.

Sub-Saharan Africa

GDP in Sub-Saharan Africa grew by an estimated 3.2 percent in 2004, much faster than in the 1990s, but slower than almost everywhere else in the world. As a result, per capita incomes increased by only 1.1 percent in real terms, and rather than catching up, the region fell further behind both developed and other developing economies (table A6). Performance within the region was varied. Growth in oil-exporting countries was strong at 4.4 percent but was down substantially from the 7.9 percent pace recorded in 2003 as spare oilproduction capacity dried up. Nevertheless, high oil revenues helped fuel a 6 percent increase in personal consumption and investment demand in oil-exporting countries, factors that contributed to strong import demand and an overall negative contribution to growth from the external sector.

In South Africa, which accounts for almost 50 percent of area GDP, but only 11 percent of the population, growth continued to be dampened by the 40 percent effective appreciation of the rand (since 2002). As a result, exports were weak and imports strong so that despite robust domestic demand (up some 5 percent), GDP increased by only an estimated 2.7 percent. Most of the remaining countries in the region are oil-importers and are impoverished. These poor countries represent more than two-thirds of the population of the subcontinent but less than one-third of GDP; their output rose by an estimated 3 percent, up sharply from 1.7 percent in 2003. Strong agricultural and metal prices helped boost incomes in several countries and are reflected in a surge in consumption, investment activity, and imports. Overall, however, oil-importing Sub-Saharan countries suffered a 0.5 percent of

Table A6 Sub-Saharan Africa forecast summary

Annual percent change unless indicated otherwise

	1990–2000[a]	2002	Est. 2003	2004	Forecast 2005	2006	2006–15[a]
GDP at market prices (1995 dollars)[b]	2.3	3.1	3.0	3.2	3.6	3.7	3.5
GDP per capita (dollars)	−0.4	0.9	0.9	1.1	1.6	1.7	1.6
PPP GDP[c]	2.6	3.6	3.9	3.6	3.8	3.7	. . .
Private consumption	2.1	2.6	3.3	4.0	3.8	4.0	. . .
Public consumption	3.5	4.6	3.5	4.1	2.9	2.9	. . .
Fixed investment	3.4	5.3	7.3	7.2	5.0	5.0	. . .
Exports, GNFS[d]	5.1	0.0	2.3	2.0	6.5	6.4	. . .
Imports, GNFS[d]	5.8	3.5	5.3	6.9	6.6	6.4	. . .
Net exports, contribution to growth	−0.3	−1.3	−1.2	−1.9	−0.4	−0.4	. . .
Current account balance (% of GDP)	−1.6	0.4	−0.2	1.3	0.9	−0.3	. . .
GDP deflator (median)	12.8	5.9	4.2	4.1	4.0	4.0	. . .
Fiscal balance (% of GDP)	−4.4	−2.6	−2.7	−3.0	−2.9	−2.7	. . .
Memo items: GDP							
SSA excluding South Africa	2.9	2.7	4.3	3.6	4.0	4.0	. . .
Oil exporters	2.6	4.2	7.9	4.4	3.9	3.7	. . .
CFA countries	2.2	1.4	1.8	2.7	3.2	3.5	. . .

a. Growth rates over intervals are compound average; growth contributions, ratios, and the GDP deflator are averages.
b. GDP measured in constant 1995 dollars.
c. GDP measured at PPP exchange rates.
d. Exports and imports of goods and nonfactor services.
Source: World Bank.

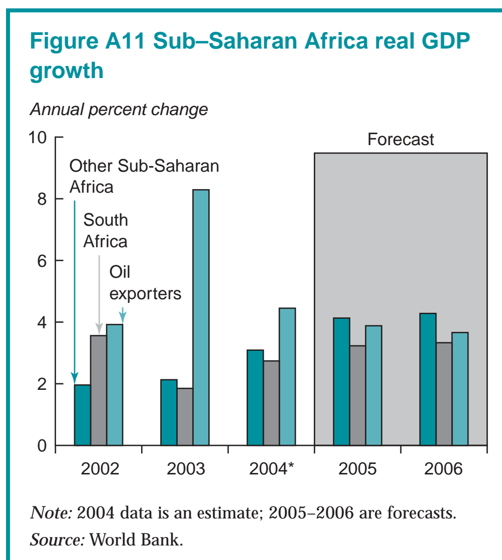


Figure A11 Sub–Saharan Africa real GDP growth

Note: 2004 data is an estimate; 2005–2006 are forecasts.
Source: World Bank.

GDP terms of trade loss, as the negative income effect of elevated oil prices more than offset the positive effect of higher agricultural and metal prices (figure A11).

Political and natural developments continue to play a large role in the region. The strong increase in growth in Ethiopia (to 6.2 percent in 2004) owes much to improved weather conditions, although structural reforms have also played a role. Similarly, an end to the drought reinforced the upswing in Malawi and Rwanda. More stable political conditions in Burundi, the Central African Republic, and Madagascar have improved investment prospects and consumer confidence, allowing normal economic activity and growth to resume. Reduced tensions in the Democratic Republic of Congo have contributed to a better economic performance there, although in some parts of the country, insecurity continues to prevent economic development. Insecurity and political uncertainty are also impeding economic progress in Côte d'Ivoire and Zimbabwe.

Sub-Saharan Africa GDP growth is projected to accelerate in 2005 and 2006, rising to 3.7 percent by 2006. The easing of oil prices and tight capacity constraints are expected to force a slowing in the pace of output among oil exporters. Nevertheless, given still high incomes and robust domestic demand, their annual growth should exceed 3.5 percent. As the effects of the depreciation wane, growth in South Africa should accelerate, reaching 3.3 percent in 2006. Partly in response to stronger South African growth, activity in other oil-importing countries is also projected to accelerate somewhat, reaching 4.3 percent in 2006. While the difference in growth rates from 2004 is small (1.3 percentage points), it represents a doubling in the rate of increase of real per capita incomes, or a doubling in the speed of poverty reduction (figure A12). Overall inflation is expected to remain broadly stable. The easing of oil prices should improve the current account position of oil importers and reduce the surplus among exporters.

The pace and fragility of growth in the region remains a serious challenge. While potential growth rates in the Sub-Saharan Region have increased markedly since the 1980s and 1990s, the economies of the region remain vulnerable to bad weather, disease, and political turmoil. Such disruptions form an important and regular feature in the economic life of countries in the region. In such an environment, especially given the highly indebted nature of some of these countries, budgetary

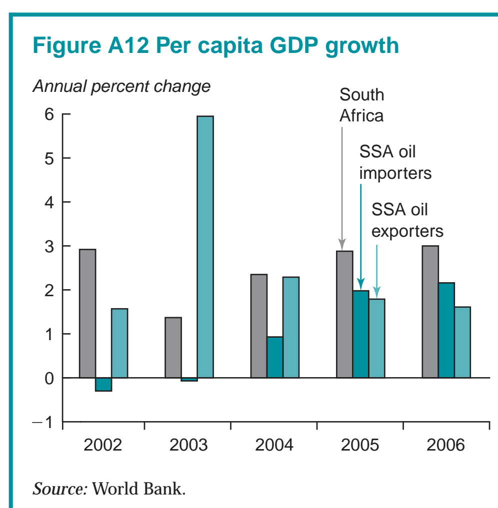


Figure A12 Per capita GDP growth

Source: World Bank.

policy should be based on prudent macroeconomic assumptions. Allowing for such contingencies in budgetary plans would not only help prevent disruptive swings in program spending, it would also help prevent spending from following a pro-cyclical path.

In the long run, per capita GDP is projected to grow by about 1.6 percent per annum, in contrast to the falling incomes that characterized the 1980s and 1990s. Sadly, even such sustained and historically strong growth represents barely half of what is needed to meet the region's Millennium Development Goals by 2015. Moreover, the rest of the developing world is projected to grow more quickly. As a result, notwithstanding an expectation of significant improvements in living standards, Sub-Saharan Africa can be expected to continue falling behind rather than catching up.

Recent improvements in economic performance reflect significant progress in terms of macroeconomic management and development of social and physical infrastructure within the region. In this regard, the highly indebted poor country initiative should help free up resources, which, if directed toward such policies, could help improve prospects for these countries. However, further progress in implementing reforms will be essential if the region is to reach or exceed this projected growth performance, especially given the formidable obstacles faced by the region: a pattern of disruptive civil strife, repeated natural disasters, the limited quantity and quality of infrastructure and human capital, and especially the HIV/AIDS epidemic. In the past, these have been major factors underlying poor performance. Per capita income levels fell substantially in conflict zones during the 1980s and 1990s, while HIV/AIDS has ravaged the population of many African countries. And high mortality and invalidity rates among working-age adults are important factors holding back growth.

Notes

1. A $10/bbl rise in crude oil price is estimated to increase net oil revenues in the geographic region by $60 billion. For oil exporters this amounts to 8.7 percent of 2004 GDP; for the region's net oil importers, the same price hike increases their oil import bill by $1.1 billion or 1.2 percent of GDP.

2. This price refers to an unweighted average of the prices of West Texas Intermediate, Brent, and Dubai crude oils.

3. See the MENA Development Report series, which examines topics of importance to the region: trade and investment, governance, gender, and employment (World Bank 2003).