Global Economic Prospects

Less volatile, but slower growth
Less volatile, but slower growth
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Cynthia Case-McMahon, Indira Chand, and Merrell Tuck-Primidahl managed media relations and the dissemination. Kristina Cathrine Mercado managed the publication process.

**ACRONYMS**

<table>
<thead>
<tr>
<th>Acronym</th>
<th>Description</th>
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<tr>
<td>ASEAN</td>
<td>Association of South East Asian Nations</td>
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<tr>
<td>BRICS</td>
<td>Brazil, Russian Federation, India, China, and South Africa</td>
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<tr>
<td>CDS</td>
<td>Credit Default Swap</td>
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<td>ECB</td>
<td>European Central Bank</td>
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<td>FDI</td>
<td>Foreign Direct Investment</td>
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<td>GDP</td>
<td>Gross Domestic Product</td>
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<td>IMF</td>
<td>International Monetary Fund</td>
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<td>Official Development Assistance</td>
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<td>OECD</td>
<td>Organization for Economic Cooperation and Development</td>
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<td>OMT</td>
<td>Outright Monetary Transactions</td>
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<td>OPEC</td>
<td>Organization of Petroleum Exporting Countries</td>
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<td>PMI</td>
<td>Purchasing Manager’s Index</td>
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<td>QE</td>
<td>Quantitative Easing</td>
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<tr>
<td>SAAR</td>
<td>Seasonally adjusted annualized rate</td>
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<td>TFP</td>
<td>Total Factor Productivity</td>
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Overview and main messages

The global economy appears to be transitioning toward a period of more stable, but slower growth. Global gross domestic product (GDP), which slowed in mid-2012 is recovering, and a modest acceleration in quarterly GDP is expected during the course of 2013. That progress will be masked in the annual data, however, with whole-year growth for 2013 projected at 2.2 percent, a touch slower than in 2012. The strengthening of quarterly growth will show up in whole-year global GDP growth of 3.0 percent for 2014 and 3.3 percent in 2015 (table 1).

Financial conditions in high-income countries have improved and risks are down, but growth remains subdued, especially in Europe

High-income countries continue to face challenges to restore financial sector health, reform institutions, and get fiscal policy onto a sustainable path. However, the likelihood that these challenges provoke a major crisis has declined.

Although acute risks have diminished, real-side activity remains sluggish. Among high-income countries, the challenges are especially difficult in high-income Europe, where growth is being held back by weak confidence and continued banking-sector and fiscal restructuring. The recovery is on more solid ground in the United States, where a fairly robust private sector recovery is being held back, but not extinguished, by fiscal tightening. Meanwhile, in Japan, a dramatic relaxation of macroeconomic policy has sparked an uptick in activity, at least over the short term. Overall, growth in high-income countries is projected to accelerate slowly, with GDP expanding a modest 1.2 percent this year, but firming to 2.0 and 2.3 percent in 2014 and 2015, respectively.

Growth is firming in developing countries, but conditions vary widely across economies

In developing countries, GDP is expected to firm somewhat. Less volatile external conditions, a recovery of capital flows to levels that support growth, the relaxation of capacity constraints in some middle-income countries, and stronger growth in high-income countries are expected to yield a gradual acceleration of developing-country growth to 5.1 percent this year, and to 5.6 and 5.7 percent in 2014 and 2015, respectively.

Most developing countries have recovered from the crisis, so room for additional acceleration is limited

The overall acceleration is not stronger because the majority of developing countries have more-or-less fully recovered from the 2008 financial crisis. For many of these countries, current and projected growth is broadly in line with underlying potential growth—leaving little room for acceleration. Thus, GDP in the East Asia & Pacific region is projected to increase 7.3 percent in 2013, but then expand at a broadly stable 7½ percent rate in each of 2014, and 2015. In Latin America, growth is expected to pick up in 2013 to about 3.3 percent, but then to stabilize at just below 4 percent in each of 2014 and 2015. Already, growth in several countries in both regions is being held back by supply-side constraints that are manifesting themselves in inflation, asset-price bubbles, and deteriorating current account balances.

Many countries in Sub-Saharan Africa are also running at, close to, or above potential output, and risk building up inflationary pressures. Growth in the region is projected to firm over the projection period to 4.9, 5.2, and 5.4 percent in 2013, 2014, and 2015, respectively. Growth in South Asia is projected to pick up to 5.2 percent this year, following a very weak 2012 and then to firm only gradually to 6.0 and 6.4 percent in 2014 and 2015 as spare capacity is reabsorbed.

In developing Europe and the Middle East & North Africa, output gaps remain and growth is projected to strengthen

Many countries in developing Europe have still not recovered from the crisis. Unemployment and spare capacity remain high, because activity has been weighed down by banking-sector, household, and fiscal restructuring (much like high-income Europe). As adjustments are completed, growth in the region is projected to strengthen progressively from 2.7 percent last year to 4.2 percent by 2015. Growth in the Middle East & North Africa has
### The global outlook in summary

(percentage change from previous year, except interest rates and oil price)

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Notes: PPP = purchasing power parity; e = estimate; f = forecast.
1. Canada, France, Germany, Italy, Japan, the United Kingdom, and the United States.
4. Unit value index of manufactured exports from major economies, expressed in USD.
5. Aggregate growth rates calculated using constant 2005 dollars GDP weights.
6. In keeping with national practice, data for Bangladesh, Egypt, India, and Pakistan are reported on a fiscal year basis in table 1.1. Aggregates that depend on these countries are calculated using data compiled on a calendar year basis.
7. Real GDP at factor cost, consistent with reporting practice in Pakistan and India. See Table SAR.2, South Asia Regional Annex for details.
been disrupted by political and social tensions and Euro Area weakness. Assuming that tensions in the region gradually ease, growth is projected to slowly strengthen from 2.5 percent in 2013 to 3.5 percent in 2014 and 4.2 percent in 2015.

**Risks are less pronounced and more balanced than a year ago, with new risks gaining prominence**

Although acute risks in high-income countries are down, more modest downside risks linger as these economies continue to adjust. Importantly, downside risks are now balanced by the possibility of stronger growth should confidence improve more quickly than anticipated in the baseline.

For developing countries that have already recovered from the crisis, or that are expected to in 2013, macroeconomic policy may need to be tightened to contain or prevent inflation, asset-price bubbles, and deteriorating current accounts. Tightening would have the further advantage of restoring depleted policy buffers. In countries where unemployment remains high and spare capacity is ample, notably in developing Europe, a loosening of policy may be in order where policy space exists. The rebalancing effort in China, and its unsustainably high investment rate are ongoing challenges.

**Most countries need to prioritize structural reforms to expand their growth potential**

While projected growth rates are satisfactory and well above the growth rates of the 1990s, they are 1–2 percentage points slower than in the pre-crisis boom period. To achieve higher growth on a sustained basis, developing countries will need to focus on domestic challenges. These differ across countries, but share common themes. In general, policymakers will need to redouble efforts to restore and preserve macroeconomic stability and reduce bottlenecks by streamlining regulations; improving their enforcement; and investing in infrastructure, education, and health.

**New risks include a faster decline in commodity prices, ...**

Over the past year, energy and metals prices have been easing in response to supply and demand-side substitution induced by high prices (metal prices are down 30 percent since their February 2011 peak). If prices decline to their longer-term equilibrium more quickly than assumed in the baseline, GDP growth among Sub-Saharan African metal exporters could decline by as much as 0.7 percentage points, while current account and fiscal balances could deteriorate by 1.2 and 0.9 percent of GDP, respectively. Lower oil prices would have similar impacts for oil exporters (−0.4 percent of GDP), but would tend to benefit developing countries as a whole (+0.3 percent of GDP).

**... and the potential impacts of a withdrawal of quantitative easing**

Quantitative easing has benefited developing countries by stimulating high-income-country GDP, lowering borrowing costs, and avoiding a financial-sector meltdown. On balance, the increased liquidity has not generated excessive capital flows to developing countries. Net capital flows to developing countries have recovered to 4.2 percent of developing-country GDP, but remain well below the 2007 level of 7.2 percent of GDP. However, flows have been more volatile. Based on this experience, the recent intensification of monetary easing in Japan should not prove too disruptive for developing countries over the medium term, but it could generate large fluctuations in flows over the short run that are difficult to manage.

Once high-income countries begin to pursue quantitative easing less actively or begin to unwind long-term positions, interest rates are likely to rise. Higher interest rates will increase debt-servicing costs, and could increase default rates on existing loans. Banks in countries that have enjoyed very strong growth and asset-price inflation, together with high levels of government or private sector debt, may be at particular risk. In the longer term, higher interest rates will raise the cost of capital in developing countries and can be expected to reduce the level of investment that firms wish to maintain. As investment rates adjust to these higher capital costs, developing-country investment spending and growth can be expected to decline by as much as 0.6 percentage points per annum after three years.
Recent Developments

The global economy is transitioning into what is likely to be a smoother and less volatile period. Financial market risk indicators, such as credit default swap rates, sovereign debt spreads, and stock market volatility indicators have all improved significantly since June 2012 (figure 1).

Financial market conditions have improved over the past year

The improvement reflects progress toward fiscal sustainability in the Euro Area, reinforced assurances that the European Central Bank (ECB) will do whatever it takes to save the Euro Area, and concrete steps toward reinforcing those aspects of institutional weakness that contributed to Euro Area difficulties (box 1).

These improved financial market conditions have persisted for almost a whole year, despite being subjected to stresses, including elections in several economies, concerns about a potential banking crisis in Slovenia, the Cyprus rescue package, and an extended period of very slow or negative growth. The durability of the improved indicators attests to the improvement in conditions. Nevertheless, concerns remain, particularly among banks in high-spread countries, which continue to be burdened by relatively large quantities of underperforming loans and relatively weak levels of capitalization (IMF 2013b).

The better financial conditions in the Euro Area, in tandem with the extraordinary monetary policy steps undertaken by the Federal Reserve Bank in the United States, the Bank of England, the ECB, and most recently the Bank of Japan, have flooded markets with liquidity. This in turn has reduced yields on long-term debt and the price of riskier assets—including developing-country equities, bonds, and bank loans. As a result, by May gross capital flows to developing countries, which were weak for most of the post-crisis period, have recovered to close-to-peak levels. Bank lending and equity issuance has doubled relative to the same period a year ago (figure 2). Nevertheless, as a percent of developing-country GDP, capital flows remain well below pre-crisis levels.

The recovery in bank flows is especially important, because it suggests that the most acute effects on developing countries of the deleveraging among high-income banks have passed. Most of the recent recovery in banking flows has benefitted developing Europe and Central Asia, which was the developing region hardest-hit by the crisis and by the Euro Area deleveraging process. Flows in most regions, except the Middle East & North AfricaFN1, were significantly higher than in 2012, with Europe & Central Asia (mainly banking and bond), and East Asia & Pacific (mainly bond and equity) recording the biggest increases.

Despite the improvement in gross flows and in financial indicators among high-income countries, developing-country financial-market prices have been weak. Thus, while stock markets in high-income countries surged in the post–June 2012 period (the
Stoxx Europe 600, Standard & Poor’s 500 Index, and Nikkei 225 are up 17.5, 18.1, and 44.5 percent, respectively), overall indexes for developing countries have declined. This said, some developing-country stock markets have shown strong gains, raising concerns about overvaluation. Equity market indexes in Indonesia, Malaysia, the Philippines, and Thailand all recorded highs in 2013, partly reflecting strong inflows of foreign private capital. Indeed, stock markets in these countries have declined lately as concerns about high valuations and prospects of scaling back of the U.S. stimulus program weighed in on investor sentiment.

The generally better performance of high-income stock markets in the recent period reflects both a difference in timing (developing-country stocks recovered earlier in the cycle), and the relatively high valuations that developing-country stock markets had at the start of the crisis. Currently price-earnings ratios of major developing-country firms remain much lower (between 12 and 18) than in high-income countries (where they are between 16 and 24).

Overall, net capital flows (inflows + outflows) to developing countries fell by about 7 percent in 2012, reflecting broadly stable net inflows (1.5 percent) and a 28.4 percent increase in outflows,
roughly proportionately distributed across foreign direct investment (FDI), equity, debt, and other outflows (table 2). Both net inflows and outflows are projected to rise. Overall net capital inflows should rise by about 5.7 percent in 2013, with much of the increase reflecting the stronger flows toward the end of 2012. They are expected to rise by 2.9 percent in 2014 and 7.5 percent in 2015, reaching $1.4 trillion or about 4.3 percent of developing-country GDP in 2015.

Capital costs are rising, reflecting reduced high-income country risks

Not only have developing-country stock markets underperformed high-income stock markets, developing country sovereign credit default swap (CDS) rates and yields (figure 3) have been rising, despite the improved ratings of developing countries, and strong investor appetite for developing-country bonds. FN2

Rising spreads, even as demand is strong and growing, may reflect a welcome and ultimately healthy improvement in market perceptions of the riskiness of investing in high-income countries. Part of the decline in developing-country risk premiums over the past five years was due to the increased riskiness of high-income country debt. FN3

Now that those risks have receded, investors may be shifting their portfolios back into high-income country assets, resulting in an increase in developing-country yields and spreads and better stock-market performance in high-income countries.

### Table 2. Net financial flows to developing countries ($ billions)

<table>
<thead>
<tr>
<th></th>
<th>2008</th>
<th>2009</th>
<th>2010</th>
<th>2011</th>
<th>2012e</th>
<th>2013f</th>
<th>2014f</th>
<th>2015f</th>
</tr>
</thead>
<tbody>
<tr>
<td>Current account balance</td>
<td>409.4</td>
<td>233.0</td>
<td>173.3</td>
<td>129.6</td>
<td>-16.7</td>
<td>-74.9</td>
<td>-108.2</td>
<td>-126.3</td>
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<tr>
<td><strong>Capital Inflows</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Private inflows, net</td>
<td>782.3</td>
<td>620.0</td>
<td>1,145.6</td>
<td>1,145.1</td>
<td>1,178.3</td>
<td>1,250.2</td>
<td>1,290.7</td>
<td>1,391.7</td>
</tr>
<tr>
<td>Equity Inflows, net</td>
<td>583.4</td>
<td>541.3</td>
<td>710.5</td>
<td>710.4</td>
<td>758.1</td>
<td>791.1</td>
<td>803.5</td>
<td>863.5</td>
</tr>
<tr>
<td>Net FDI inflows</td>
<td>637.0</td>
<td>427.1</td>
<td>582.3</td>
<td>701.5</td>
<td>670.0</td>
<td>719.3</td>
<td>715.7</td>
<td>758.2</td>
</tr>
<tr>
<td>Net portfolio equity inflows</td>
<td>-53.6</td>
<td>114.2</td>
<td>128.2</td>
<td>8.9</td>
<td>88.1</td>
<td>71.8</td>
<td>87.8</td>
<td>105.3</td>
</tr>
<tr>
<td>Private creditors, Net</td>
<td>198.8</td>
<td>78.7</td>
<td>435.1</td>
<td>434.6</td>
<td>420.2</td>
<td>459.1</td>
<td>487.2</td>
<td>528.2</td>
</tr>
<tr>
<td>Bonds</td>
<td>-8.6</td>
<td>61.0</td>
<td>129.7</td>
<td>123.8</td>
<td>190.3</td>
<td>187.3</td>
<td>164.4</td>
<td>151.9</td>
</tr>
<tr>
<td>Banks</td>
<td>223.3</td>
<td>-11.9</td>
<td>37.2</td>
<td>108.2</td>
<td>82.0</td>
<td>104.7</td>
<td>125.3</td>
<td>146.9</td>
</tr>
<tr>
<td>Short-term debt flows</td>
<td>-17.1</td>
<td>17.8</td>
<td>257.6</td>
<td>189.3</td>
<td>141.0</td>
<td>158.5</td>
<td>188.2</td>
<td>221.1</td>
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<tr>
<td>Other private</td>
<td>1.3</td>
<td>11.7</td>
<td>10.7</td>
<td>13.3</td>
<td>7.1</td>
<td>9.2</td>
<td>10.4</td>
<td>9.8</td>
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<tr>
<td><strong>Official inflows, net</strong></td>
<td>30.4</td>
<td>81.0</td>
<td>73.2</td>
<td>30.0</td>
<td>14.1</td>
<td>10.7</td>
<td>6.7</td>
<td>3.1</td>
</tr>
<tr>
<td>World Bank</td>
<td>7.2</td>
<td>18.3</td>
<td>22.4</td>
<td>6.6</td>
<td>4.6</td>
<td></td>
<td></td>
<td></td>
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<tr>
<td>IMF</td>
<td>10.8</td>
<td>28.8</td>
<td>13.8</td>
<td>0.5</td>
<td>-3.9</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Other official</td>
<td>12.4</td>
<td>35.9</td>
<td>36.9</td>
<td>22.8</td>
<td>13.4</td>
<td></td>
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<tr>
<td><strong>Capital outflows</strong></td>
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<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>FDI outflows</td>
<td>-211.8</td>
<td>-144.3</td>
<td>-213.9</td>
<td>-198.0</td>
<td>-238.0</td>
<td>-275.0</td>
<td>-325.0</td>
<td>-370.0</td>
</tr>
<tr>
<td>Portfolio equity outflows</td>
<td>-32.1</td>
<td>-75.9</td>
<td>-50.6</td>
<td>4.3</td>
<td>-12.4</td>
<td>-17.3</td>
<td>-24.3</td>
<td>-29.4</td>
</tr>
<tr>
<td>Private debt outflows</td>
<td>-78.3</td>
<td>50.7</td>
<td>-57.3</td>
<td>-81.0</td>
<td>-103.0</td>
<td>-72.0</td>
<td>-61.0</td>
<td>-56.0</td>
</tr>
<tr>
<td>Other outflows</td>
<td>1.0</td>
<td>-5.6</td>
<td>7.7</td>
<td>-10.0</td>
<td>-12.0</td>
<td>-7.0</td>
<td>-6.0</td>
<td>-9.0</td>
</tr>
<tr>
<td><strong>Net capital flows (inflows + outflows)</strong></td>
<td>491.5</td>
<td>525.8</td>
<td>904.7</td>
<td>890.4</td>
<td>827.1</td>
<td>889.6</td>
<td>881.1</td>
<td>930.4</td>
</tr>
<tr>
<td><strong>Net unidentified Flows/a</strong></td>
<td>-82.1</td>
<td>-292.8</td>
<td>-731.3</td>
<td>-760.8</td>
<td>-843.8</td>
<td>-964.5</td>
<td>-989.3</td>
<td>-1,056.7</td>
</tr>
</tbody>
</table>

Source: The World Bank

Note: e = estimate, f = forecast

/a Combination of errors and omissions, unidentified capital inflows to and outflows from developing countries
These developments may also reflect concern on the part of investors about inflation of asset prices in some developing countries (such as Brazil, Indonesia, Lao PDR, Philippines, Thailand, and Turkey) and the recent easing of commodity prices. Risk premia could have risen because high asset prices have been interpreted as a harbinger of sharp future correction; or if an expectation of lower commodity prices had raise concerns about future government revenues and governments’ capacity to repay existing debt and spending programs.

Improved financial conditions are yielding stronger economic activity

Global economic activity has strengthened over the past several months (figure 4). The turn around, which began in the East Asia & Pacific region, has spread more widely. Developing-country industrial production grew at a 5.1 percent annualized pace during the first quarter of 2013 (0.6 percent if China is excluded), and high-income-country industrial production expanded at a 2.9 percent annualized pace.

Despite Euro Area weakness, high-income-country GDP growth strengthened in the first quarter of 2013.

- In the United States, GDP rose 2.4 percent in the first quarter of 2013, despite sharp payroll tax increases that have cut into consumer incomes. The strength was supported by a recovering housing market (house prices are at a two-year high) and an increase in payroll jobs (more than ½ a million jobs were added in the first quarter). Investment demand, which was unusually weak in the second half of 2012, has also contributed (durable goods orders increased at a 20 percent annualized pace through March, although order growth has since eased).
- In Japan, the move toward a much more relaxed monetary and fiscal policy (first announced in November 2012 but made more concrete during the first quarter of 2013) prompted a sharp acceleration in GDP, which grew at a 4.1 percent annualized pace in the first quarter of 2013.
- In the Euro Area, GDP contracted once again in the first quarter, declining at a 0.8 percent (saar, -0.2% q/q sa), with growth in Germany turning marginally positive. For the region as a whole, industrial production expanded at a 0.7 percent annualized rate in the first quarter, and the annualized pace of decline among high-spread economies eased to only 0.3 percent.

Developing-country growth eased in 2013Q1 but remains solid

Among those developing countries that report quarterly GDP, data suggest an acceleration in activity during the fourth quarter of 2012—notably in East Asia & Pacific, where quarterly GDP expanded by 8.3 percent in the fourth quarter (for more regional detail, see box 2 and the regional annexes). In South Asia, however, growth continued to be weak, with GDP growing at only a
4.7 percent annualized pace in the final quarter of 2012. Industrial production data, which are available for a wider range of countries, display a clearer acceleration trend toward the end of 2012.

During the first several months of 2013, however, the pace of growth in developing countries appears to have slowed, particularly in East Asia, where quarterly growth in China, and Indonesia has eased, and actually turned negative in Malaysia and Thailand. Elsewhere signs are more mixed. Growth has slowed in Chile, Mexico, and South Africa, but strengthened in Philippines, Lithuania, Peru, Turkey, and Ukraine. First quarter GDP in India also disappointed, expanding only 4.8 percent y-o-y or about 5 percent q/q saar.

Available industrial production data confirm this mixed picture (figure 5), with activity rates slowing in East Asia & Pacific (to 8.6 percent saar), firming in Europe & Central Asia (at 2.4 percent), returning to positive territory in Latin America & the Caribbean (0.5 percent), and easing somewhat in South Asia at a robust 7.7 percent. Available data show that activity was contracting in Sub-Saharan Africa and rapidly in the Middle East & North Africa during the three months ending February 2013.

Although there are some signs of acceleration, output in several large middle-income countries remains weak, compared with the pre-crisis boom period. Growth rates in Brazil, India, the Russian Federation, Turkey, and South Africa are all well below post-crisis rates, despite relatively easy policy stances and amid indications of overheating in some (see discussion beginning on page 17).

The sharp recovery in trade appears to be losing momentum

After contracting for several months, global trade is expanding once again (figure 6), with the total volume of exports and imports rising at a 5.0 percent annualized pace in the first quarter of 2013. The upturn in trade was driven by developing country imports, which rose at an 18.0 percent annualized pace in 2013Q1. This helped stir a 2.9 percent annualized increase in high-income country exports in 2012Q4 (figure 6).

The pick-up in import demand among developing countries was broadly-based, with import volumes rising in East Asia & Pacific, Latin America & the Caribbean, and South Asia. Data for the Middle East lag and, as of February 2013, do not show signs of acceleration. The pick-up in global demand, including in high-income countries, is also supporting faster export growth in developing countries (box 3). Developing countries exports were expanding at a 15.5 percent annualized pace during the first quarter of 2013.

Most recently, there are signs of an easing in the pace of global trade. Developing-country import demand slowed to an annualized pace of 10.8 percent in April, and both export (-5.4 percent) and import demand (-3.6 percent) from high-income

![Figure 5](image-url)
Box 2. Recent Regional Economic Developments

(The regional annexes to this volume contain more detail on recent economic developments and outlook, including country-specific forecasts.

The East Asia & Pacific region led the rebound in global economic activity during the fourth quarter of 2012. The landscape for trade and industrial production is changing, however, reflecting China’s rebalancing efforts, the yen depreciation, lower commodity prices, capacity constraints (in Indonesia, Malaysia, the Philippines, and Thailand), and a gradual tightening of macroeconomic policies. These factors have combined to reverse earlier output gains in China, Indonesia, Malaysia, Thailand, and Vietnam contributing to easing of industrial production growth from double digit rates to just 6 percent annualized pace during the first quarter of 2013. Growth rates of both exports and imports are also moderating but regional trade continues to expand at double-digit rates. Industrial activity in the Philippines, which relied less on domestic stimulus measures, continues to expand by a double-digit rate in early 2013, partly because of the country’s strong trade linkages to a rebounding Japan. A relatively loose policy stance in the region, excluding China, during 2012 has contributed to a buildup of debt and has fueled goods and asset price inflation.

Output in the developing Europe & Central Asia region also improved considerably, growing at a 2.4 percent annualized pace in the three months ending March 2013. With the exceptions of Ukraine and Latvia, all countries had positive industrial production growth, and the rebound was particularly strong in Serbia. The US dollar value of imports also accelerated during the first quarter, suggesting firming of domestic demand. However, US dollar value of regional exports have slowed with weak growth in Russia and Latvia, despite the strong import demand from developing countries and strengthening import demand from high-income Europe. Inflation has eased slightly since food price hikes and administrative tariffs caused it to gain momentum in the second half of 2012.

Economic activity in Latin America & the Caribbean softened in the first quarter of 2013, with industrial production remaining relatively flat, after a slight contraction in the fourth quarter. Slower domestic consumption in conjunction with weak external demand caused economic activity to slow in many countries in the region, with annualized quarterly growth easing in Brazil, Mexico, Chile, and contracting in Venezuela. As elsewhere, regional import demand bounced back in 2012Q4 but has eased to a more sustainable pace of 8.7 percent annualized pace in 2013Q1. Meanwhile, lower commodity prices contributed to significant declines in export revenues. Despite slower growth than during the pre-crisis period, several countries in the region continue to struggle with high and even rising inflation, suggesting structural bottlenecks. Price controls in Argentina have partially contained inflation but could lead to shortages of certain goods, while in Venezuela the recent currency devaluation has exacerbated local price pressures. In Brazil, inflation continues to surprise on the upside on higher food and service prices.

Economic outturns in the Middle East & North Africa continue to be dominated by political and social developments. Among oil exporters, hydrocarbon output resumed its downward trend in the second half of 2012 as the boost from Libyan oil production to prewar levels faded. Output among oil importers rebounded at an annualized 10.4 percent pace in Q1, reflecting a recovery in Egypt from sharp declines in 2012, but momentum has slowed reflecting rising political tensions in Egypt and Tunisia, spillovers from the Syrian conflict to Jordan and Lebanon, and weak external demand that have dampened activity among oil importers. With the exception of Iraq and Morocco, inflation remains persistently high across the region, rising over 40 percent in the Islamic Republic of Iran because of a tightening of international sanctions. But there has been a slight easing in some economies as global food prices have moderated. Declining foreign exchange reserves, widening external and fiscal financing gaps (only partly reflecting weak demand from Euro Area trading partners) pose challenges to macroeconomic stability and management in the region. Aid from the wealthier economies in the region has helped bridge financing gaps in Egypt, Jordan, Morocco, and Tunisia.

Economic activity in South Asia picked up in the second half of 2012, supported by strengthening external demand and fiscal and policy reforms. By the first quarter of 2013, industrial production was rising at different paces in Bangladesh, India, Pakistan, while in Sri Lanka, it stabilized in 2012Q4. After slowing sharply in 2012, regional export volume growth accelerated to a 15.7 percent annualized pace in the three months ending in April 2013. Year-on-year inflation rates are moderating across the region, helped in part by an easing of international commodity prices. As inflation moderated, monetary policy eased in Pakistan (in late 2012), in Bangladesh and India (in the first half of 2013), and in Sri Lanka (2012H2 and 2013H1) to support growth. However, inflation momentum remains strong, particularly in Bangladesh and India, mainly reflecting supply-side constraints and entrenched inflationary expectations.

Exports from Sub-Saharan Africa were not exempt from the decline in global trade during 2012 (the exception being agricultural exporters whose trade held up during the second half of the year). Industrial production slowed sharply in the second half of 2012 among oil exporting economies (Angola, Gabon, and Nigeria), partly because of domestic challenges in Nigeria. Similarly, labor unrest was partly responsible for the flat growth in South Africa’s industrial production in 2012Q2 and Q3. South Africa GDP rebounded to 2.1 percent annualized pace in 2012Q4, before slumping once again in Q1 2013 to 0.9 percent (q/q saar). Although more recent data for the rest of the region is not available, a similar mixed result is expected, with stronger global industrial production supporting growth in some, but weaker commodity prices cutting into incomes in others. Earlier policy tightening (particularly in East Africa) and improved harvests in 2012 have contributed to slow regional inflation, with prices rising at a 6.8 percent annualized pace during the first quarter. Rwanda took advantage of low interest rates and investor appetite for higher-yielding assets to issue its inaugural Eurobond in April 2013, while other countries in the region (including Ghana, Kenya, and Nigeria) have plans to follow suit.
countries turned negative in April. Also, China’s economic growth appears to be losing momentum as export growth slowed from 12.7 percent (y/y) in April to one percent (y/y) in May - its slowest expansion in 15 months. With China being an important trading partner in many developing countries, weaker growth there will weigh down on the imports of other developing countries.

Commodity prices have weakened in response to new capacity

Despite the strengthening of the global economy, the prices of most industrial commodities have been declining (figure 7). While it is still too early to be certain, the declines appear to result from both increased supply and increased substitution on the demand side induced by the high prices of the past several years.

Since 2000, capital expenditures by major firms in oil and metals markets have quintupled (figure 8). Overall, they increased an average of 15 percent annually since 2005 in the case of oil and 20 percent in the case of metals. The impact of increased supply is most visible in energy markets (figure 9), where higher prices have made technologies economically viable and spurred large increases in North American oil and natural gas production and large increases in African oil production (see the Commodity Annex for a more complete discussion). Recent developments have also been influenced by the recovery of production in Middle East countries such as Libya and Iraq.

Similarly, the coming on stream of new projects in Latin America (Chile, Peru), Africa (Zambia, Democratic Republic of Congo), and Asia (China, Mongolia) have placed substantial downward pressure on metals prices even as sales have strengthened. But demand suppression has also been at work. Global demand for refined metals increased 4.5 percent in 2012 (9.9 percent in China), but metal demand by Organization For Economic Cooperation and Development (OECD) member countries fell by 3.9 percent in 2012.

The combination of increased supply and weak demand has yielded a buildup in global stocks. For example, combined copper stocks at the major metals exchanges are up 46 percent since 2012. Aluminum stocks, which have been rising since end-2010, increased 8 during the past 12 months.
Box 3. South-South Trade

As reported in the January 2013 edition of Global Economic Prospects (World Bank 2013a), more than half of developing-country trade is now with other developing countries, up from 37 percent in 2001. China has played a big role in this process (26 percent of total exports from all developing countries are going to China, up from 14 percent in 2001). But even excluding China’s trade with other developing countries, and not withstanding rhetoric suggesting that developing-country growth has come on the back of high-income imports, growth of trade between the remaining developing countries has also outpaced trade with high-income countries by a wide margin throughout the first decade of this century (box figures 3.1 and 3.2).

The U.S. dollar value of trade between developing countries has grown annually by an average of 19.3 percent over the past decade (17.5 percent if trade with China is excluded) versus about 11 percent for developing-country exports to high-income countries. Importantly, every developing region shows the same basic trend, with intra-developing-country trade outstripping developing-developed trade, and by a large margin—except for Europe and Central Asia, where EU integration helped increase trade between the region and high-income countries.

Interestingly, the rapid expansion of intra-developing-country trade reflects more than just commodity trade, with the value of developing-country exports of manufactures rising at about the same rate as the value of commodities as a whole. The result is all the more surprising because commodity prices more than doubled over the sample period, suggesting that the volume of manufacturing trade between developing countries was expanding particularly rapidly. The one broad commodity grouping that exceeded manufacturing trade growth was metals and ores, mainly reflecting the very strong demand in China for these products. Excluding China from developing-country trade, the intra-developing country value of metals and ores trade grew somewhat less quickly than manufactures.

Expectations are that prices will continue to ease over the medium term. The World Bank forecast, which calls for the price of a barrel of oil to ease to $102 in 2013, and to $101 in 2015, reflects a technical assumption that oil prices will slowly decline between now and 2025 to a level consistent with the real cost of producing a barrel of oil from the Canadian tar sands using today’s technology (the Canadian tar sands are among the most abundant and most expensive to produce sources of crude oil). Metals prices are expected to decline in real terms by 3.7 and 1.4 percent in 2013 and 2014, respectively, reflecting increased supply and a gradual reduction in the metals intensity of developing-country (especially Chinese) growth (see Commodity Annex for more details). Food prices are also projected to decline (7.7, 6.0, and 5.5 percent over 2013–15), reflecting a gradual improvement in supply conditions and reduced production costs due to lower energy and fertilizer prices.

Inflationary pressures remain subdued

Despite the monetary stimulus in high-income countries and an acceleration in developing-country growth in 2012Q4, inflationary pressures remain relatively subdued, although East Asia & Pacific, the Middle East & North Africa and South Asia are showing signs of rising inflation (figure 10).
Inflation in high-income countries remains low. Inflationary pressures in China appear to have eased but may be intensifying in Indonesia and Lao PDR following years of rapid growth and relatively loose macroeconomic policy, and core inflation remains high in Vietnam. In the Middle East & North Africa, high prices reflect both efforts to reduce the fiscal burden of price subsidization by raising some regulated prices, as well as supply disruptions caused by civil and armed strife. In South Asia, increases in regulated prices have also played a role, as have tight market conditions despite the relatively slow pace of growth.

In contrast, inflation rates in developing Europe and Central Asia have declined to close to 7 percent, down somewhat from the 8½ to 9 percent average during the pre-crisis period. The easing partly reflects still-large output gaps, but structural reforms have also contributed.

Monetary policy in developing countries continues to ease. Since January, the Reserve Bank of India has cut interest rates by a cumulative 75 basis points despite strong inflationary pressures. In Mexico, the central bank has cut rates by 50 basis points—its first interest rate cut since July 2009. Other policy easing included a 100-basis-point cut implemented by the Bank of Colombia in three consecutive actions. Interest rates were also lowered in Albania, Azerbaijan, Belarus, Georgia, Kenya, Mongolia, Sri Lanka, Thailand, Turkey, Uganda, and Vietnam. Only five developing countries (Brazil, the Arab Republic of Egypt, Gambia, Ghana, and Tunisia) have raised interest rates in 2013; Serbia raised and then cut rates.

Although global inflationary pressures remain benign, given the lags in monetary policy transmission, this additional easing may add to a strengthening activity already under way, resulting in additional inflationary pressures in countries operating close to full capacity, without much payoff in additional output.

Economic weakness in high-income countries has cut into aid flows

Ongoing fiscal adjustments and budgetary problems among high-income countries have led to a decline in aid for two consecutive years for the first time since 1997. According OECD (2013) data, net official development assistance (ODA) flows in 2012 fell 4 percent in real terms to $125.6 billion, bringing the total decline since 2010 to 6 percent. As a share of Gross National Income in donor countries, ODA for developing countries fell to 0.29 percent in 2012 from 0.31 percent in 2011. Cuts to aid budgets were steepest among high-spread Euro-area economies, with Spain having cuts its aid budget by 50 percent, Italy by 35 percent, Greece by 17 percent, and Portugal by 13 percent. ODA increased among only nine reporting economies, with Korea (18 percent), Luxembourg (10 percent), and Australia (9 percent) reporting the largest increases. Turkey almost doubled its assistance to North African countries after the Arab spring.

The outlook for aid remains gloomy for poor countries. The OECD expects aid flows to recover only modestly in 2013 and to remain stable during
2014 to 2016. The bulk of the increase in flows is expected to benefit middle-income Asian economies, with flows to countries with the largest Millennium Development Goals gaps declining. Bilateral aid to Sub-Saharan economies declined 7.9 percent in 2012 in real-terms.

Outside Europe, remittance flows to developing countries are largely unaffected

The European debt crisis and rise in unemployment rates in high-income countries (which account for the bulk of remittance flows to developing countries) has negatively affected incomes of migrants and, in turn, their ability to send money home (for a more detailed discussion, see World Bank 2013a). Nevertheless, migrants appear to have absorbed these shocks to some extent and continue sending remittances to their family and friends in need. As a result, the value of remittances to developing countries rose to $401 billion in 2012, up 5.3 percent, or about half the 11.5 percent increase recorded in 2011. As a share of recipient-country GDP, remittances rose only 0.2 percentage point.

This aggregate story masks important differences across countries. For instance, the large number of migrants in the Arabian Gulf generated significant increases in remittance flows from the Gulf Cooperation Council countries—with the U.S. dollar value of remittances to South Asia and the Middle East & North Africa rising 12.3 and 14.3 percent, respectively. By contrast, developing regions that are more closely tied to high-income Europe (figure 11), where the protracted debt crisis has taken a severe toll on economic activity, experienced much weaker increases in remittances. Remittance flows to the developing Europe & Central Asia region fell 3.9 percent and increased 1.6 percent in Sub-Saharan Africa in U.S. dollar terms in 2012, following increases of 13.5 and 4.9 percent, respectively, in 2011. Flows to Latin America were hit especially hard by the continuing downturn in Spain, where the unemployment rate rose above 26 percent, forcing many Latin American migrants to return home. The dollar value of remittance flows to Latin America rose 0.9 percent in 2012, with absolute declines in some countries like Colombia (-2.3 percent) that have significant numbers of migrants in Spain.

The U.S. dollar value of remittance flows to developing countries is projected to increase 6.7 percent in 2013 and to gradually firm to a 10.2 percent rate of increase in 2015, reflecting a modest easing in oil prices and a gradual strengthening of growth in high-income countries. Despite the increases in nominal terms, flows are projected to remain broadly stable when expressed as a share of developing countries’ GDP.

Global outlook: less volatility, somewhat stronger growth

Hard data so far this year point to a global economy that is slowly getting back on its feet. However, the recovery remains hesitant and uneven. Several times since the onset of the crisis in 2008, expectations of a firming of growth have ended in disappointment. And the current conjuncture is no different. Forward-looking indicators, including business surveys, have strengthened over the past six months only to weaken again recently (figure 12).

While an important clue as to current and future developments, a pessimistic bias has crept into the
relationship between Purchasing Manager’s Indexes (PMI) and actual output. Based on the historical relationship between industrial activity and the World Bank’s global PMI indicator (a weighted average of national and Markit PMI indicators), PMIs between 2010 and 2013 have been systematically about 3.0 points lower than they should have been.

While this pessimistic bias could be just a statistical artifact, it could also be an indicator of increased caution on the part of firms. Under this interpretation, firms having been disappointed by poor growth outcomes in the past may be skeptical of stronger growth now, and could be holding back on investment until they are sure that another slowing is not in the offing. Such behavior, may be self-fulfilling and could explain why despite improved conditions in financial markets, and the gradual accumulation of pent-up demand for consumer and investment durables, the recovery (especially in Europe) remains modest.

**A gradual recovery in high-income countries**

Activity in high-income countries has been under considerable pressure from fiscal and banking sector consolidation and associated uncertainties. These pressures are expected to remain over the forecast period, although the drag they are exerting on growth is projected to diminish, in part because much of the necessary adjustment has already been accomplished.

In the United States, the private sector recovery appears to be relatively robust. By some measures, growth in the first quarter of 2013 was stronger than expected with industrial production expanding at a 4.4 percent annualized pace, and retail sales at a 2.9 percent pace. First quarter GDP growth was relatively weak at 2.4 percent, in part because of a decline in government spending. The gathering momentum in the U.S. economy is both reflected in and prompted by an improving labor market (unemployment has fallen to 7.6 percent) and recovery in the housing market.

Progress toward agreeing on a credible plan to bring the deficit down to sustainable levels has been slow. However, policy makers have extended both the debt ceiling and spending authorizations well into the future, thereby reducing the likelihood of a debt-ceiling confrontation and the threat of default. On the downside, both the tax increases agreed at the beginning of the year and the spending sequester will be a drag on growth in coming quarters, continuing to offset some of the strength from the private sector recovery. Overall, GDP growth for the year is projected to slow somewhat, compared with 2012, to about 2.0 percent in 2013, before strengthening to 2.8 percent in 2014 and 3.0 in 2015.

The economy of the Euro Area remains very weak despite improved financial conditions and some signs of strengthening. On the positive side, funding costs in core Euro Area countries have declined, and lending has started to grow again. Imports, exports, and industrial production have all returned to positive (albeit modest) growth.

However, borrowing costs in high-spread economies remain very high; unemployment continues to rise (including in so-called core economies); and weak growth is compromising progress on the fiscal front. Moreover, although important structural and fiscal consolidation reforms have been undertaken (see box 1), the pace of progress has eased, leading to concerns of reform fatigue, while several elections have highlighted popular discontent with austerity. Finally, unemployment is crushingly high in periphery economies (27 percent in Spain and Greece, 18 percent in Portugal, 14 percent in Ireland, and 12 percent in Italy).
Growth in the Euro Area is expected to pick up slowly during the course of 2013, in part because the drag from fiscal consolidation and banking sector restructuring in the core countries is expected to become less intense. As a result, quarterly growth for the Euro Area as a whole is expected to return to positive territory in the middle of 2013 and then gradually gain strength. Nevertheless, whole year GDP is projected to contract by 0.6 percent in 2013, with annual growth slowly strengthening to 0.9 percent in 2014 and to about 1.5 percent by 2015. Despite the return to positive growth, little progress is expected to be made in reducing unemployment. Weakness in high-spread economies where the deepest adjustments are occurring will continue, with growth not turning positive until 2014 and then only to a soft 0.3 percent.

Growth in Japan rebounded in the fourth quarter of 2012 and into the first quarter of 2013, expanding at a 4.1 percent annualized pace, with consumer demand rather than investment a major driver—although industrial production expanded rapidly (8.9 percent in 2013Q1). Trade denominated in U.S. dollars has dropped off precipitously (as of April 2013, it was 8.0 percent lower than in June 2012), in part because of the 18 percent depreciation of the Yen vis-à-vis the dollar since March 2012. The decline also reflects bilateral weakness in Japan’s exports and imports to and from China, apparently linked to tensions over disputed territories.

The strength in the Japanese economy partly reflects the effects of announcements of a shift toward looser monetary policy made in November and confirmed with announcements of a large quantitative easing, fiscal stimulus and structural reform policy in January. Growth is projected to come in at 1.4 percent this year and in 2014 and at 1.3 percent in 2015. For growth to remain strong through 2015, however, Japan will have to implement a robust set of productivity enhancing policy changes. Measures announced to date, include deregulation of the agriculture and electricity sectors, a relaxation of rules in health care, investment tax incentives, (including FDI); some corporate governance reforms; and a partial relaxation of restrictions on the investment behavior of pension funds.

Prospects for developing countries vary widely, reflecting local economic and policy conditions

Overall, developing-country GDP is expected to firm somewhat in 2013, growing by 5.1 percent and gradually rising to 5.6 percent in 2014 and 5.7 percent in 2015 (Box 4 provides a regional breakdown of prospects, while the regional annexes provide additional detail). That aggregate story, however, hides considerable regional and country-level variation (figure 13). At least four classes of developing countries can be identified:

- countries (including many in East Asia and Sub-Saharan Africa) that are growing rapidly and already close to or above potential, and therefore at risk of overheating;
Growth in the East Asia & the Pacific region slowed to 7.5 percent in 2012 largely due to weakening of growth in China (relative to the recent path). The regional growth is projected to slow further to 7.3 percent in 2013 with still weak 7.7 percent growth in China and easing of growth in the region excluding China from 6.2 percent in 2012 to 5.7 reflecting weak global demand and domestic policy tightening. The regional growth is projected to pick up to 7.5 percent in 2014 and 2015 as China's growth firms up and growth in the region excluding China accelerates to 5.9 percent in 2014 and then 6 percent in 2015 supported by strengthening global trade flows. The main risks to the region are internal, associated with a sharp reduction in Chinese investment, quantitative easing in Japan and rapidly rising debt and asset prices pose risks for Indonesia, Malaysia, Thailand and the Philippines. Efforts to enhance productivity gains through market reforms should deepen, especially in Cambodia, the Lao PDR, Myanmar, and Vietnam, while building buffers against future shocks remains a policy priority in Lao PDR, and small Pacific islands.

GDP growth in Europe & Central Asia is estimated to have sharply slowed to 2.7 percent in 2012 from 5.6 percent in 2011 as the region faced significant headwinds including weak external demand, deleveraging by European banks, a poor harvest, and inflationary pressures. While GDP growth in 2013 in the region will be supported by improved agricultural performance and reduced deleveraging pressures, the rebound will nevertheless be constrained by the weak carryover growth caused by low economic activity in 2012Q4; ongoing fiscal adjustments by the region’s economies, and high unemployment. The recovery in export demand is expected to be gradual. The region’s growth is expected to reach 2.8 percent in 2013 and 4.2 percent by 2015. Medium-term prospects for the region will critically depend on progress in addressing structural constraints to economic growth including capacity constraints, high unemployment, and lack of competitiveness.

Growth in Latin America & the Caribbean is expected to strengthen to 3.3 percent in 2013, from 3.0 percent in 2012, supported by stronger demand domestically and abroad. Growth should converge toward potential after very weak growth in 2012 in Brazil (0.9 percent) and Argentina (1.9 percent). Growth in most other countries is expected to ease slightly or decelerate this year. Growth is expected to decelerate markedly in Venezuela (to 1.4 percent), as highly expansionary policies are reversed. Over the medium term, the regional economy is expected to grow just under 4 percent annually, supported by stronger capital flows (notably FDI), recovering external demand, and structural reforms in some of the larger economies. Such improvements will be essential if the region is to sustain stronger growth over the medium term in the context of slow growth among major trading partners. Risks facing the region include the possibility of overheating in some of the faster-growing economies and the potential impacts of even weaker-than-expected commodity prices.

Growth in the Middle East & North Africa region is projected to slow to 2.5 percent in 2013, from 3.5 percent in 2012, reflecting a second year of recession in the Islamic Republic of Iran, subdued growth in the Arab Republic of Egypt, and a modest pickup in Algeria. Political tensions remain high in advance of scheduled elections and referendums, and security risks are dragging down activity and investment. In the wake of lower private capital inflows since 2010, fiscal and external account imbalances among oil importers are increasing, in turn exacerbating funding pressures and undermining fiscal sustainability particularly in Egypt. However, a gradual strengthening of demand in key Euro Area trading partners and the moderation in global food prices could provide some respite in the near term. Among oil exporters, surging government spending has increased vulnerability to a sustained fall in oil prices. Medium-term prospects hinge on the resolution of political tensions and security risks, and on the implementation of reforms to place the region’s economies on a more sustainable footing and to boost investment, jobs, and growth.

GDP growth in South Asia slipped to 4.8 percent in 2012, mainly reflecting a continued deceleration in India, and slower growth in Sri Lanka and Bangladesh. Growth in Pakistan and Nepal remains sluggish, below regional peers. Regional GDP growth is projected to pick up to 5.2 percent in 2013, before accelerating to 6.1 percent and 6.4 percent in 2014 and 2015, in line with strengthening external demand, normal monsoons (after poor rains in 2012), and a gradual pickup in investment spending. Continued progress in fiscal consolidation and implementation of reforms that reduce structural constraints and lower inflationary expectations will determine the pace of recovery. Domestic risks that have gained in importance include a possible derailing of reforms, a resurgence of inflation, and weaker-than-expected monsoon rains.

Growth in Sub-Saharan Africa has remained robust at an estimated 4.4 percent in 2012 (5.4 percent if South Africa is excluded), supported by resilient domestic demand and still relatively high commodity prices. Strengthening external and resilient domestic demand, an accommodative policy environment, increasing investment, still high commodity prices, and increased export volumes in countries with new mineral discoveries (Sierra Leone, Niger, and Mozambique) are expected to underpin a return to the region’s pre-crisis growth rate of around 5.2 percent over the forecast horizon (2013–15). Nonetheless, risks remain tilted to the downside. A weaker-than-expected recovery in high-income countries and sharper-than-expected decline in commodity prices will slow growth in the region and lead to deterioration in fiscal and current account balances, which remain strained in a number of economies in the region. Other domestic risks include overheating in economies operating close to capacity, adverse weather conditions, and political instability.
countries that appear to be running up against capacity constraints at growth rates well below the growth rates of the pre-crisis period, including several large and economically important middle-income countries;

countries with considerable slack in their economies, whether because of the severity of the post-crisis downturn (developing Europe), or because of social and political disruptions to economic activity (Middle East & North Africa); and finally

developing countries where recovery from the crisis appears complete, and there are no outward signs of overheating—this is the largest group of the four.

**Strong growth and capacity constraints are issues for many countries in East Asia, Sub-Saharan Africa, and Latin America**

Policy makers in fast-growing economies that are close to (or above) full capacity should be focusing on avoiding overheating, rebuilding fiscal and monetary conditions, and implementing structural reforms to allow their economies to sustain the fast growth. Managing macroeconomic policy is difficult at the best of times. For fast-growing economies—especially those that are having success in exploiting previously untapped potential—the challenge is particularly difficult because judging where an economy is relative to potential is daunting when domestic economic structures are rapidly changing and both foreign and domestic investors are expressing strong confidence in an economy’s future (box 5). While there are clear costs associated with overheating, especially when fast growth has been accompanied by rapid credit expansion, there are equally clear opportunity costs associated with prematurely slowing an economy and potentially forgoing fast growth and rising incomes.

For countries that combine rapid growth and already tight capacity conditions, the risks of overheating are higher; these risks include high or rising inflation or both (figure 14); growing current account deficits (as domestic supply is unable to meet rapidly rising demand); and asset price bubbles. In these economies, a tightening of either or both fiscal and monetary policy might be in order. That would be especially desirable in countries where monetary conditions have been relaxed in recent years, or where structural deficits are relatively high and the economy could therefore benefit from restoring some of the fiscal cushions that were expended in responding to the crisis.

In China, ongoing rebalancing efforts remain a priority as does engineering a gradual decline in its unsustainably high investment rate. Should investments prove unprofitable, the servicing of existing loans could be come problematic — potentially sparking a sharp uptick in non-performing loans that could require state intervention (see World Bank 2013a, for more).

**In still other countries, growth in the post-crisis period has been weaker than during the boom because of underlying supply-side constraints**

Growth in Brazil, India, Russia, and South Africa has been 2–3½ percentage points slower since 2010 than it was during the pre-crisis boom period of 2003–07 (table 3). While different factors are at play in each of these middle-income countries, there are several common factors. First, growth during the boom period was much stronger than during the preceding four years or even 10 years. Many began to think that these higher pre-crisis growth rates might be consistent with potential output growth, a view that the strong bounce-back of growth in the period immediately following the crisis seemed to confirm. However, countries have had difficulty sustaining such rapid growth without generating goods or asset price pressures.
This, plus increasing current account deficits, suggest that underlying potential output growth was slower than pre-crisis growth rates might have suggested. Indeed, World Bank estimates of potential output indicate that, in each of these countries, pre-crisis growth was well in excess of potential growth. Weak post-crisis growth in several of these countries has not generated significant spare capacity. Rather it has eliminated what were in some cases large positive output gaps in 2007.

To the extent that current output gaps are relatively small (or positive), efforts to increase growth through monetary and fiscal stimulus risk being (or may have been) ineffective and might add to debt or inflationary pressures without any sustained progress in increasing output or reducing unemployment.

According to the World Bank estimates in table 3, the 2012 output gap in Brazil, India, and Turkey is either positive or close to zero (less than 1 percent), suggesting limited scope for growth to accelerate in the short run (growth in 2012 was slower than potential growth in most of these countries). Moreover, growth rates in the future are likely to be constrained by the rate of growth of potential, which although higher than post-crisis averages for these countries, remains well below pre-crisis growth rates.

Of course, there is considerable uncertainty surrounding these (or any) estimates of potential output. However, inflation increased over the past year in two of the five countries in table 3, and current account balances deteriorated in all but one. These developments suggest that supply constrains rather than deficient demand may be at the root of the slower growth during recent years (table 4).

For all of these countries, if growth is to return to pre-crisis growth rates on a sustainable basis, much more attention will need to be paid to policies that tackle supply-side bottlenecks, whether they stem from weak or poorly enforced regulations, corruption, inadequate or irregular provision of electricity, or inadequate investments to improve educational and health outcomes.

### Table 3. Growth post-crisis has been much weaker than during the pre-crisis period in several middle-income countries

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<tbody>
<tr>
<td>Brazil</td>
<td>1.4</td>
<td>2.3</td>
<td>4.7</td>
<td>1.8</td>
<td>1.7</td>
<td>2.4</td>
<td>-0.8</td>
<td>0.9</td>
<td>3.2</td>
</tr>
<tr>
<td>India</td>
<td>6.6</td>
<td>5.4</td>
<td>8.8</td>
<td>6.1</td>
<td>2.5</td>
<td>2.2</td>
<td>0.9</td>
<td>5.3</td>
<td>6.8</td>
</tr>
<tr>
<td>Russia</td>
<td>-0.4</td>
<td>6.8</td>
<td>7.6</td>
<td>3.9</td>
<td>9.7</td>
<td>-1.9</td>
<td>-1.3</td>
<td>3.4</td>
<td>3.7</td>
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<tr>
<td>Turkey</td>
<td>3.4</td>
<td>3.0</td>
<td>7.3</td>
<td>5.4</td>
<td>4.3</td>
<td>-2.4</td>
<td>-0.2</td>
<td>2.2</td>
<td>4.0</td>
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<tr>
<td>South Africa</td>
<td>2.4</td>
<td>3.4</td>
<td>5.2</td>
<td>2.8</td>
<td>5.0</td>
<td>-0.7</td>
<td>-1.0</td>
<td>2.5</td>
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Note 1: Average annual compound growth rate
Note 2: Calendar year average of fiscal year GDP measured at factor cost for India

### Table 4. Inflation is rising or current account deteriorating in countries with tight output gaps

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<tbody>
<tr>
<td>Brazil</td>
<td>Inflation (y/y)</td>
<td>Current account percentage points (y/y)</td>
<td></td>
</tr>
<tr>
<td>India</td>
<td>6.5</td>
<td>-2.3</td>
<td>1.4</td>
</tr>
<tr>
<td>Russia</td>
<td>9.4</td>
<td>-5.4</td>
<td>-0.9</td>
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<tr>
<td>Turkey</td>
<td>7.4</td>
<td>3.9</td>
<td>3.6</td>
</tr>
<tr>
<td>South Africa</td>
<td>6.5</td>
<td>-6.0</td>
<td>-5.0</td>
</tr>
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</table>

Several countries in developing Europe participated in the excesses of the pre-crisis boom period, with both households and firms taking on high levels of debt often denominated in foreign currency and often used to finance consumption rather than...
Box 5. Slower growth in the post-crisis period mainly reflects a return to underlying potential growth rates after above-potential growth during the boom period

Defining potential growth and why it is important
Forecasting is always a challenging exercise—even more so when the global economy is going through a large adjustment. To provide some anchor to the forecasting process, the World Bank relies on potential GDP (growth).

Potential output is defined as the trend growth in the productive capacity of the economy, that is, it is the estimated level of output attained when the entirety of the capital stock and effective labor supply is employed. It is thus a measure of the maximum sustainable output (growth)—the level of real GDP (growth) in a given year that is consistent with a stable inflation and the way in which the factors of production, capital and labor, are optimally combined in the production process.

In calculating the total GDP, working-age data comes from the United Nations, while the capital stock is estimated using the perpetual inventory method from investment data and assuming a depreciation rate of 7 percent (IMF 2005). TFP was calculated using a Hodrick-Prescott filter through spot estimates of total factor productivity (TFP) (i.e. the Solow residual).

In the pre-crisis period, developing-country GDP grew 2 percentage points faster on average than potential GDP. Developing-country GDP grew on average by 8.3 percent each year between 2005 and 2007, approximately 2.0 percentage points faster than the annual growth of potential output during that period. As a result, World Bank estimates suggest that develop­ing-country demand was fully 3.5 percentage points higher than supply in 2007 (output was broadly in balance in 2005).

The crisis erased excess demand, with most countries returning to absorbing spare capacity relatively quickly.
With the crisis, developing-country growth slowed sharply from 8.5 percent to 1.9 percent between 2007 and 2009, broadly the same slowdown observed in high-income countries in percentage point terms (6.8 points for developing countries, 6.3 points for high-income countries). As a result, the excess demand of the end of boom period was erased and a negative output gap of 0.9 percent of potential GDP was opened up by 2009. The rebound in activity in 2010 more than absorbed the gap, with positive or close to zero output gaps in all developing regions except Europe and Central Asia. Slower-than-potential growth in East Asia & Pacific, and South Asia, closed output gaps from above, while growth broadly in line with potential in Latin America has kept the gap closed in that region. In Sub-Saharan Africa, where estimates of potential are particularly difficult, GDP has grown less quickly than potential in the post-crisis period, opening up a small negative output gap.

Growth since the crisis has been constrained by domestic bottlenecks and productivity, stymieing efforts to use expansionary macroeconomic policy to boost growth.
While growth during the post-crisis period has been slower than during the pre-crisis period, it has, on average, been in line with underlying potential growth. Potential growth for all developing regions has slowed relative to the boom period by an estimated 0.5 percentage point. Slower population and TFP growth have contributed to the slower growth. The rate of growth of the capital stock for all developing regions increased, but declined if China is excluded from the calculation. In terms of contributions to potential growth, about 1/4 of the slowdown is attributable to slower population growth for the world excluding China and ½ due to slower TFP growth. The major contributor to slower potential growth in South Asia was slower capital stock accumulation. Weaker TFP growth was the largest driver of slower growth among BRICS, while in Latin America & the Caribbean, weaker population growth was a major factor.

To achieve faster growth, developing countries will have to focus on supply-side reforms.
There is obviously significant uncertainty surrounding measures of output gaps and potential output, particularly among developing countries where the structure of economies is changing so quickly. Nevertheless, these results serve as a reminder that developing countries will need to continue with structural policy reforms that eliminate bottlenecks, enhance productivity, and stimulate capital accumulation if they are to achieve sustainably faster growth rates over the medium term.

1. The data reproduced in this box derive from the World Bank’s macroeconomic model and its estimates of total factor productivity (TFP) and potential output. These estimates are derived following a production-function technique similar to that used by the OECD and the European Commission, as described in (Burns, Janse van Rensburg, and Bui 2013). Future TFP growth, which influences current TFP growth through the employed smoothing algorithm, is assumed to be equal to the average observed in the pre-boom period 1995-2005.
investments in new productive capacity. In addition, the banking sectors in many of these countries had close relations with European banks. As a result, their own difficulties in dealing with rising quantities of nonperforming loans were magnified by a drying up of external funding sources upon which many banks had relied. As in high-income Europe, the adjustment that ensued following the crisis was brutal. Unemployment soared to record levels, as banks deleveraged and households and firms cut into spending in an effort to repair damaged balance sheets. Fiscal conditions deteriorated throughout the region, with severe consequences in a few countries where public debt levels had risen even during the boom years.

The good news is that growth rates for many of the hardest-hit countries have recovered to levels close to their underlying potential output. However, growth has not been strong enough to make significant inroads into existing unemployment and spare capacity.\textsuperscript{FN7} Arguably, these economies have been caught in a high unemployment equilibrium. Traditional policy advice in situations like this would be to use fiscal and monetary policy to stimulate growth and help close output gaps, but for many countries already high fiscal deficits and the necessity of restoring bank balance sheets limit the scope for such actions (figure 15). For these countries, policy may have to focus on increasing economic flexibility (including labor retraining) to promote improved competitiveness and take advantage of faster growth elsewhere.

\textbf{Output gaps are small and appear to be closing for the majority of developing countries}

The bulk of developing countries are in a relatively positive place, with modest output gaps (countries close to the center of the figure 16), that are closing (countries in the green-shaded portions of the graph), either because output growth has slowed below potential and is therefore easing inflationary pressures, or because output is growing somewhat faster than potential. In these economies, policy appears to be broadly on track, although authorities may need to examine the overall stance of fiscal policy to evaluate whether there is scope for a gradual tightening to regenerate buffers consumed during the crisis period or to tighten monetary policy and in some cases rebuild reserves to provide room for a monetary policy easing should the global economy weaken sharply.

\textbf{Post-crisis risks have receded, with domestic challenges gaining prominence}

The cumulative steps taken by Euro Area countries over the past several years have greatly reduced the fiscal sustainability problems on the continent. The
International Monetary Fund (IMF) estimates that ⅔ of Euro Area countries have already done enough fiscal adjustment (through end of 2013) to achieve debt sustainability and debt reduction (IMF 2013b, 8). This fiscal consolidation although enormously painful has, in conjunction with reassurances offered by the European Central Bank (ECB), helped restore confidence in the Euro Area even as concerns about individual countries and banks remain. Indeed, as the uncertainty evoked by the Cyprus rescue effort illustrated, continued careful management of conditions at both the country level and the regional level is required.

Much of the uncertainty that surrounded U.S. fiscal policy toward the end of 2012 has dissipated. Congress has twice extended the debt ceiling well in advance of reaching it, reducing the likelihood that a return of brinkmanship will cause the debt to go unpaid. The decision to allow payroll taxes to expire and increase tax rates on some wealthier individuals, together with the spending cuts associated with the sequester have reduced the U.S. general government deficit by an estimated 1½ percent of GDP.

Nevertheless, little progress has been made toward setting U.S. fiscal policy on a sustainable medium-term path. At 7.0 percent of GDP in 2012, the general government deficit remains very high, and gross general government debt is projected to reach 107 percent of GDP in 2013. As a result, the IMF (2013b) estimates that an additional deficit reduction of some 8.2 percent of GDP will be required before fiscal policy in the United States returns to a sustainable path (almost twice the estimated cuts required in the Euro Area). In Japan, the same number is more than twice as high again, even when seeking the less ambitious objective of reducing general government gross debt to 173 percent of GDP.

**Traditional risks have receded, but other risks and challenges have emerged or grown in stature**

Even as the post-crisis risks from the high-income world have declined in importance, a new set of uncertainties and risks are emerging or gaining in stature. For instance, developing countries are increasingly concerned about:

- the potential effects of the radical relaxation of both fiscal and monetary policy in Japan;
- the potential impacts on revenues, government balances, and growth among commodity exporters, if the increased supply and demand suppression that high commodity prices have evoked begins to generate strong downward pressures on commodity prices;
- domestic challenges, including inflationary pressures and asset price bubbles, and weaker than pre-crisis growth rates.
- The challenges that the eventual withdrawal of quantitative easing may bring.

**Dealing with sharply relaxed fiscal and monetary policy in Japan**

After several months of signaling that they would be loosening fiscal and monetary policy, Japanese authorities announced at the beginning of 2013 a three-pronged macroeconomic growth strategy, comprising new public works spending of ¥10 trillion, a new monetary policy aimed at reaching a 2 percent inflation target in the medium term, and structural policies aimed at increasing total factor productivity growth. For the moment, the precise nature of the programs is not entirely clear—for example, only about half of the announced new spending appears to be net new spending. Similarly, the impact and details of announced to incite firms to invest, reduce protection in the service and agricultural sectors and stimulate female labor participation is unclear. The monetary easing, which, as announced, would about the same size as the third round of quantitative easing (QE3) in the United States, has only just begun.

Japanese quantitative easing can be expected to affect developing countries in three ways:

- The yen’s depreciation is likely to dampen developing-country exports (figure 17). However, income elasticities are typically larger than price sensitivities and in this particular instance, developing countries gain from increased import demand from Japan might outweigh the losses associated with the Yen’s (real) depreciation;
By adding to the looseness of global monetary conditions, through lower global interest rates and perhaps increased capital inflows, potentially adding to overheating pressures, especially in developing East Asia & Pacific;

Through increased demand for final goods and intermediate products used in Japanese exports, mainly benefiting countries involved in the supply chains of Japanese exporters.

Longer-term unless the structural component of the reform agenda is successful in boosting productivity and GDP growth, the fiscal and monetary stimulus elements are unlikely to have a lasting positive effect for developing country GDP, while increased liquidity and indebtedness could prove destabilizing.

Ultimately the overall impact on individual developing countries will depend in part on the importance of Japan as a trading partner, the size of liquidity leakage from the Japanese economy, the extent that individual developing countries attract additional capital flows, and the extent to which the quantitative easing boosts Japanese final and intermediate demand for the exports of developing countries (box 6 and the Exchange Rate Annex cover different channels and likely impacts in more detail).

Finally, the financial impact of Japanese quantitative easing could be attenuated by the scaling back or even withdrawal of U.S. quantitative measures (see the following discussion for more on this point).

**Past investments are boosting the supply of industrial commodities, potentially ending the supercycle**

Since early 2011, industrial commodity prices have been weakening, a process that appears to be intensifying in 2013, despite signs that the global economy is gaining strength (figure 18). Indeed, since their peak in early 2011, the price of metals and minerals is down 30 percent and that of energy is down 14 percent, with prices off 12 and 5 percent, respectively, between January 2013 and the end of May 2013. This price weakness has sparked discussion about whether a supercycle in commodity prices is coming to an end—particularly within the metals industry, where large increases in supply are coming on stream in response to investments spurred by the high prices of the past several years. \(^{\text{FN8}}\)

While the baseline assumption of a gradual easing in prices over the projection period remains the most likely outcome, a steeper decline cannot be ruled out. Table 5 reports the results of two simulations. The first scenario examines the impacts on developing-country GDP, current accounts, and fiscal balances of a scenario where oil prices, reach the real long-term supply cost of $80 per barrel (industry experts’ current estimate of the cost of profitably extracting oil from the
Potential impacts of Japanese quantitative easing on developing countries

The yen’s depreciation caused developing-country exchange rates to appreciate 1.7 to 3.7 percentage points more than would have been the case otherwise.

Since September 2012, the yen has depreciated in real effective terms by 21 percent. So far, the impact on developing economies is measurable, if relatively muted. Developing-country real-effective exchange rates appreciated by 4.7 percent over the same period, which was 3.5 percentage points more than their average appreciation over any six-month period between 2005 and 2012. Countries in East Asia & Pacific have closer direct trade ties with Japan and their currencies were hit harder, rising by 6.1 percent versus an earlier average appreciation of 2.4 percent. Thailand experienced a sharp 12.5 percent real-effective appreciation of its currency. Simulations suggest that in the absence of the yen’s depreciation, currencies in developing countries generally and in East Asian developing countries specifically would have appreciated 1.7 and 3.7 percentage points less quickly.

The yen’s depreciation likely to dampen developing-country exports.

The yen’s depreciation will tend to make imports more expensive for Japanese consumers and will, therefore, initially reduce Japanese demand for developing-country imports. However, typically income elasticities are larger than price sensitivities and in this particular instance, developing country exporters’ gains from increased import demand from Japan might outweigh the losses associated with the Yen’s (real) depreciation.

Effects are not larger because few developing countries compete directly with Japan.

Impacts on developing-country exports to the rest of the world would be limited because few compete directly with Japan. Only four developing countries have an export similarity index with Japan in excess of 50 (100 implies an identical export structure), and even for those where similarities are relatively high, impacts may be limited given differences in markets served (Mexico competes in the auto sector, but is focused in the U.S. market, which represents only 22 percent of Japanese auto exports).

Countries like Thailand and Philippines that are in Japan’s supply chain may benefit from increased Japanese exports.

Suppliers of parts and components to Japan in regional production networks, particularly Thailand and the Philippines, could benefit from gains by Japanese exporters in global markets and even derive additional benefits through increased potential FDI from Japan. Firms in trade partner countries (including those in East Asia & Pacific) would also benefit from Japanese technology, machinery, and equipment at competitive costs. In the area of service trade, tourists from developing East Asia to Japan would have increased purchasing power that would contribute to further narrowing Japan’s trade deficit with the region. Trade partners in the region and globally would benefit from an increase in Japan’s demand for global imports.

Quantitative easing will help keep interest rates low and may contribute to the volatility of capital flows.

The announced quantitative easing component of the Japanese stimulus package is roughly twice the size of QE3 in the United States. However, financial leakages to developing countries are unlikely to be twice those associated with the U.S. QE3 because capital outflows from the United States tend to flow more directly to developing countries than do Japanese outflows (only 3 percent of Japanese portfolio outflows are directed to developing countries, versus 8.3 percent for the United States). However, Japanese capital markets are thinner than U.S. capital markets and, therefore, may be less able to absorb the additional capital flows, forcing a larger share to leak out. Finally, IMF (2013d) found that the impacts of QE3 on developing countries was much less marked than earlier episodes because markets were much calmer then (as they are now).

Evaluations of the effect of U.S. QE on developing countries offer unclear guidance about the potential impact of Japanese QE.

Finally, it is not all that clear what the impact of the leakages (however large they may be) will be on developing countries. Research by the Asian Development Bank (2013) suggests that the main impact on developing countries of the U.S. quantitative easing was globally positive, mainly because it lowered borrowing costs and boosted demand. Similarly IMF (2013d) suggests that flows to developing countries have not been excessive and have been broadly manageable, although volatility associated with changed sentiment in high-income countries has generated temporary strains and monetary policy challenges. While lower interest rates may be contributing to asset bubbles and excess risk taking, they have also permitted the relatively inexpensive financing of a great deal of capacity enhancing investment.

By extending periods of low interest rates and boosting capital flows, Japanese QE could exacerbate regional bubbles.

Japanese QE will undoubtedly serve to keep borrowing costs down for an even longer period than would have occurred otherwise. That may contribute to asset price bubbles and volatile capital flows, although to what extent is difficult to evaluate, just as the evidence concerning the impact of the U.S. policy in this regard is mixed.
### Table 5: Impact of a more rapid supply-induced decline in industrial commodity prices

**Scenario 1:** Oil price gradually declines to $80/bbl real by June 2014, other commodity prices react endogenously

<table>
<thead>
<tr>
<th>Scenario 1</th>
<th>Real GDP</th>
<th>Current Account (% of GDP)</th>
<th>Fiscal Balance (% of GDP)</th>
</tr>
</thead>
<tbody>
<tr>
<td>World</td>
<td>0.1</td>
<td>0.4</td>
<td>0.3</td>
</tr>
<tr>
<td>High income countries</td>
<td>0.1</td>
<td>0.5</td>
<td>0.4</td>
</tr>
<tr>
<td>Developing countries</td>
<td>0.1</td>
<td>0.3</td>
<td>0.1</td>
</tr>
</tbody>
</table>

**Oil exporters**

| Developing countries | -0.1 | -0.4 | 0.1 | -0.3 | -1.4 | -1.4 | -0.2 | -1.1 | -1.1 |
| East Asia and Pacific | 0.1 | 0.4 | 0.4 | 0.0 | 0.0 | 0.1 | 0.0 | -0.2 | -0.3 |
| Europe and Central Asia | -0.2 | -0.8 | -0.3 | -0.5 | -2.3 | -2.3 | -0.4 | -1.8 | -1.8 |
| Latin America and Caribbean | -0.1 | -0.3 | 0.4 | -0.2 | -0.8 | -0.7 | -0.1 | -0.6 | -0.5 |
| Middle East and N. Africa | -0.4 | -1.4 | 0.1 | -0.8 | -3.5 | -2.2 | -0.4 | -2.1 | -2.3 |
| South Asia | n.a. | n.a. | n.a. | n.a. | n.a. | n.a. | n.a. | n.a. | n.a. |
| Sub-Saharan Africa | -0.3 | -1.4 | -0.8 | -0.9 | -4.5 | -4.4 | -0.6 | -2.9 | -3.3 |

**Oil importers**

| Developing countries | 0.2 | 0.6 | 0.1 | 0.2 | 0.7 | 0.5 | 0.1 | 0.2 | 0.1 |
| East Asia and Pacific | 0.2 | 0.8 | -0.1 | 0.2 | 0.8 | 0.4 | 0.1 | 0.2 | 0.1 |
| Europe and Central Asia | 0.1 | 0.4 | 0.3 | 0.2 | 0.8 | 0.9 | 0.1 | 0.2 | 0.1 |
| Latin America and Caribbean | 0.0 | 0.2 | 0.1 | 0.0 | 0.2 | 0.2 | 0.0 | -0.1 | -0.2 |
| Middle East and N. Africa | 0.1 | 0.5 | 0.4 | 0.1 | 0.5 | 0.6 | 0.0 | 0.2 | 0.1 |
| South Asia | 0.2 | 0.9 | 0.8 | 0.3 | 1.4 | 1.5 | 0.1 | 0.7 | 0.7 |
| Sub-Saharan Africa | 0.0 | 0.2 | 0.2 | 0.0 | 0.2 | 0.2 | 0.0 | 0.0 | 0.0 |

**Scenario 2:** Metal prices gradually decline by a cumulative 20% by June 2014

<table>
<thead>
<tr>
<th></th>
<th>Real GDP</th>
<th>Current Account (% of GDP)</th>
<th>Fiscal Balance (% of GDP)</th>
</tr>
</thead>
<tbody>
<tr>
<td>World</td>
<td>0.0</td>
<td>0.0</td>
<td>0.0</td>
</tr>
<tr>
<td>High income countries</td>
<td>0.0</td>
<td>0.0</td>
<td>0.1</td>
</tr>
<tr>
<td>Developing countries</td>
<td>0.0</td>
<td>0.0</td>
<td>0.0</td>
</tr>
</tbody>
</table>

**Metal exporters**

| Developing countries | 0.0 | -0.2 | -0.1 | -0.1 | -0.3 | -0.3 | 0.0 | -0.2 | -0.3 |
| East Asia and Pacific | n.a. | n.a. | n.a. | n.a. | n.a. | n.a. | 0.0 | 0.0 | 0.0 |
| Europe and Central Asia | 0.0 | -0.2 | -0.1 | -0.1 | -0.3 | -0.3 | 0.0 | -0.3 | -0.3 |
| Latin America and Caribbean | 0.0 | -0.1 | -0.1 | 0.0 | -0.2 | -0.2 | 0.0 | -0.2 | -0.2 |
| Middle East and N. Africa | n.a. | n.a. | n.a. | n.a. | n.a. | n.a. | 0.0 | 0.0 | 0.0 |
| South Asia | n.a. | n.a. | n.a. | n.a. | n.a. | n.a. | n.a. | n.a. | n.a. |
| Sub-Saharan Africa | -0.1 | -0.7 | -0.5 | -0.2 | -1.2 | -1.2 | -0.1 | -0.8 | -0.9 |

**Metal importers**

| Developing countries | 0.0 | 0.1 | 0.0 | 0.0 | 0.2 | 0.1 | 0.0 | 0.0 | 0.0 |
| East Asia and Pacific | 0.0 | 0.1 | -0.1 | 0.0 | 0.2 | 0.1 | 0.0 | 0.1 | 0.0 |
| Europe and Central Asia | 0.0 | 0.2 | 0.1 | 0.1 | 0.3 | 0.3 | 0.0 | 0.0 | -0.1 |
| Latin America and Caribbean | 0.0 | -0.2 | -0.1 | -0.1 | -0.3 | -0.4 | 0.0 | -0.3 | -0.3 |
| Middle East and N. Africa | 0.0 | 0.1 | 0.1 | 0.0 | 0.2 | 0.2 | 0.0 | 0.1 | 0.1 |
| South Asia | 0.0 | 0.2 | 0.2 | 0.1 | 0.4 | 0.4 | 0.0 | 0.2 | 0.2 |
| Sub-Saharan Africa | 0.0 | 0.0 | 0.0 | 0.0 | 0.1 | 0.1 | 0.0 | 0.0 | 0.0 |

In this scenario, global GDP is positively affected (up 0.4 percentage point in 2014 relative to baseline), because the positive effects on oil-importing economies outweigh the negative impact on oil-exporting countries. The GDP of developing-country oil exporters is projected to decline by a relative modest 0.4 percent in this scenario in 2014, but the effects on current account and fiscal balances are larger—1.4 and -1.1 percent of GDP, respectively. The simulation assumes that exporters are able to finance the deterioration in these balances. If they were unable to do so, GDP impacts would be substantially larger. For the most part, developing-country oil exporters are still running current account surpluses, but fiscal deficits exceed 3 percent of GDP in 6 of 16 countries for which data exist. If countries could not finance additional deficit, they could be forced into a procyclical tightening of policy that would exacerbate the cycle.

The second simulation analyzes the impact of a more rapid decline in metals prices, which are assumed to fall by a further 20 percent by June 2014 relative to the baseline, in response to additional capacity coming onstream following past investments (see earlier discussion). In this scenario, the effects on global and oil-importing country GDP are broadly unchanged, in part because, unlike oil, the share of metal and minerals in the imports of most countries is small (even in China, which consumes a disproportionate share of the world’s metals, metals and minerals represent only 16 percent of total imports). The impact on metals exporters is more severe. Among Sub-Saharan African metal exporters, GDP could fall by as much as -0.7 percent in Sub-Saharan Africa, balance of payments declining by 1.2 percent of GDP, and the fiscal balance by nearly 1 percent.

Unlike oil exporters, these impacts are more likely to be binding for developing metals exporters whose average government and current account deficits are equal to 2.7 and 6.3 percent of GDP. Assuming that increases in government deficits above the 3 percent level cannot be financed, GDP impacts would increase to -0.5 percent for the metal exporting countries facing financing constraints, versus -0.2 percent for countries where there are no financing constraints.

Notwithstanding the 16 percent decline in oil prices between their March 2012 peak and May 2013, commodity prices are much higher than they were at the turn of the century. For example, between their 2001 record lows and 2012, nominal oil prices are up more than 300 percent, while metals and agricultural prices are up 225 and 157 percent, respectively.

The eventual tightening of monetary policy in high-income countries may slow growth in developing countries

Although much of the current debate in developing countries concerns the potential impacts of Japanese quantitative easing (see earlier discussion), the implication for developing countries of backing away from current levels of stimulus and even the withdrawal of stimulus are at least equally important. Although Japan has embarked on a new stimulus policy, there are increasing signs that the United States will soon either reduce the size of or stop its QE efforts. If that happens, not only will the net effect of Japanese easing likely be offset (at least partially) by tighter policies in the United States, but over the medium term, developing countries are likely to face tighter financial conditions, with potentially important real-side implications.††9

As monetary policy in high-income countries begins to be less accommodative, long-term interest rates can be expected to rise. Currently, U.S. long-term interest rates are some 110 basis points below their pre-crisis level and 140 basis points lower than their long-term average in real terms. Assuming that a relaxation of quantitative...
Easing leads U.S. long-term interest rates to rise to their long-term average in real terms, and that developing-country interest rate spreads remain constant, developing-country borrowing costs would rise by the same amount as long-term U.S. rates.

Econometric evidence suggests, however, that developing-country spreads tend to rise when base rates increase. Work done for the 2010 edition of Global Economic Prospects suggests that a 100-basis-point increase in high-income-country base rates is associated with a 110 to 157 basis point increase in developing-country yields (World Bank 2010; Kennedy and Palerm 2010, 2013 and IMF 2013a).

If real base rates return to their long-term averages, they would rise from about 188 basis points today to around 322 basis points (the mean level between 1990 and 2007). Based on historical experience, that could cause developing-country yields to rise by between 150 and 270 basis points, with countries with relatively good credit histories and low spreads at the bottom end of the range and those with less good records toward the upper end of the range. This is broadly in line with recent IMF (2013a, 38–39) estimates that suggest that three-fourths of the 465 basis point decline in developing-country yields since December 2008 has been caused by external rather than domestic factors. FN10

Simulations suggest that the associated increase in the cost of capital would cause desired capital-to-output ratios in developing countries to decline, resulting in slower investment growth for an extended period as well as a slower rate of growth of potential output of around 0.6 percentage points per annum after three years during the transition period to a lower capital-output ratio. Longer term, potential output could be lower by between 7 and 12 percent unless measures are undertaken to reduce domestic factors that contribute to the high cost of capital in developing countries. Efforts in this regard could more than completely offset the impact of tighter global conditions.

Higher interest rates could also expose risks in countries with high debt levels

In addition to the longer-term effects that a return to higher capital costs would have, there is also the risk that the transition to higher rates occurs in an abrupt and disruptive fashion (IMF 2013d). In such a scenario, rather than a gradual increase in long-term rates as monetary stimulus eases, markets react preemptively, causing rates to jump quickly, potentially trapping some participants in vulnerable positions that appeared manageable under low interest rates but proved not to be under suddenly higher interest rates.

Developing countries that have run up private and public sector debt during the low-interest period could be particularly vulnerable. So too would be countries with relatively weak domestic financial sectors and elevated current account or government deficits that might make them vulnerable to either a sharp increase in capital costs or a reduction in flows.

Although the majority of developing countries appear to be in good condition in this regard, public debt levels are high and proving difficult to manage in countries such as Cape Verde, Egypt, Eritrea, Jamaica, Jordan, Lebanon, Pakistan, and Sudan. IMF statistics suggest that gross general government debt exceeds 50 percent of GDP in 36 low- and middle-income countries and increased in 12 of these by 10 or more percentage points of GDP between 2007 and 2012 (figure 19).
Individual country exposure is not limited to general government debt. In several economies, private sector debt has been increasing rapidly as well. And private debt can rapidly become a public-sector problem as the recent financial crisis illustrated for high-income countries and the East Asia crisis for developing countries. In this respect, 18 developing countries have private external debt exposures in excess of 30 percent of GDP. Three-quarters of these are in developing Europe and Central Asia reflecting strong banking and intercompany linkages with high-income Europe. In the case of Seychelles and Papua New Guinea, the gross private sector debt reflects a thriving offshore-banking system (figure 20). While that changes the nature of the associated risk, it does not eliminate it, as the recent experiences of Cyprus, Iceland, and Ireland illustrate.

While external debt is sometimes more problematic, because exchange rate movements can affect domestic agents’ ability to service loans, local currency debt can also problematic — especially if problems with domestic debt provoke a local banking crisis.

Data on domestic banking claims on the private sector (such data exclude debt associated with local bond markets) suggest a number of countries where debt levels are especially high (second panel of figure 20.) However, interpreting the data is difficult, because while debt to GDP levels can reflect vulnerability, they also reflect the extent of intermediation — which is generally associated with stronger growth and higher incomes.

Countries where debt levels are high, and have been rising rapidly, may represent the greatest risk. In East Asia for example, combined nonfinancial corporate and household debt has increased in several countries, reaching 130 percent of GDP in China and Malaysia in 2012. For the East Asia region as a whole, private debt has increased by 19 percentage points of GDP since 2007, while in Latin America it has increased by 9 percentage points. Household debt (only by deposit-taking corporations) in Thailand has risen 15 percentage points since 2007 and now stands at 63.4 percent of GDP (see World Bank 2013 for more). Total household debt is estimated to be about 77 percent of GDP in Thailand and almost 80 percent of GDP in Malaysia.
Concluding remarks

Overall, the global economy is moving into a new and hopefully less volatile phase. The extreme risks and swings in perceptions that have driven global capital and output markets have eased significantly, even as new risks and challenges have gained in prominence.

The majority of developing countries have navigated the crisis and immediate post-crisis period very well. With the exception of some countries in developing Europe and the Middle East & North Africa, they recovered relatively quickly from the crisis and have enjoyed solid, if less rapid than boom period, growth rates. With the demand gaps opened up by the crisis largely filled, future growth will increasingly be determined by the success with which countries succeed in addressing supply-side bottlenecks, including gaps in physical, social, and regulatory infrastructure:

- In many countries, policy attention is appropriately returning to simplifying regulations, opening up to trade and foreign investment, investing in infrastructure and human capital. These are the policies that have underpinned the acceleration in developing country growth over the past 20 years, and it is only through continued reform and progress in these policies that the strong productivity growth of the past 20 years can be maintained.

- For the many countries operating at close to or even above full capacity, macroeconomic policy may need to be tightened—both to reestablish fiscal space that was used up in response to the crisis and to prevent inflationary pressures and asset bubbles from building up.

The external risks facing developing countries have also evolved:

- The recent decline in industrial commodity prices is, perhaps, signaling an end to the upward phase of the commodity cycle. Policy makers in commodity-exporting countries need to take a close look at the potential consequences of a sharper-than-anticipated decline in commodity prices for growth, government finances, and their external financing needs.

- For countries in East Asia, the recent intensification of monetary easing in Japan could prompt strong and disruptive capital inflows, adding to already existing inflation and currency pressures.

- Longer term, as high-income monetary policy becomes less accommodative, interest rates in developing countries will rise. Higher rates may generate difficult adjustments and possibly domestic crises, especially in countries where public and private sector indebtedness has been on the upswing.

- Over the longer term, higher interest rates will translate into increased capital costs, potentially slowing developing-country growth by as much as 0.6 percentage points per annum after three years as firms reduce debt levels to more manageable levels.
1. Equity flows to the Middle-East & North Africa completely dried up in the first four months of 2013, with just one bond issue from Lebanon ($1.1 billion) and two syndicated bank deals worth about $643 million.

2. Traditionally, risk premiums are measured as the difference between developing-country yields or CDS rates and those of similar U.S. assets, with the idea that the U.S. assets proxy for the risk-free rate of return. As the crisis hit, the riskiness of U.S. financial assets clearly went up, even if yields did not, either in the short run because of flight-to-quality effects or later because of quantitative easing. At the same time, spreads on developing-country financial assets declined. Only part of that decline can be explained by improved credit quality (IMF 2013b), the rest being explained by the increased riskiness of the base rate and the reduced cost of credit.

3. Since January 2013, 10 developing-country borrowers have been upgraded and only six downgraded. In addition, over the past 18 months, eight developing countries (or developing-country governments)—Angola, Bolivia, Honduras, Mongolia, Paraguay, Rwanda, Tanzania, and Zambia—have issued bonds for the first time (in Bolivia’s case, for the first time in more than 90 years). Since 2010, 14 countries have entered international bond markets for the first time.

4. The IMF (2013a) estimates an overall fiscal contraction for the Euro Area of 0.7 percent of GDP, compared with 0.5 percent in 2012 and 2.1 percentage points in 2011.

5. The measures of potential used here are based on a production function method and rely on estimates of trend total factor productivity growth as well as assumptions that the full capacity rate of employment (employment divided by working-age population) are constant over time and that all of the services of the capital stock are available—where the capital stock is estimated as equal to the sum of all past investments depreciated at a 7 percent rate.

6. For instance, the South African Reserve Bank’s latest estimate of annual long-run potential output growth is 3.5 percent. However the bank also notes that “our estimates for South Africa over the same period as the ECB study reflect a decline from an average of 3.9 per cent (2000–07) to 2.8 per cent (2008–10); more or less similar to the estimated magnitude of decline in the euro area and the United States” (Ehlers and others 2013, 10).

7. For negative output gaps to close, growth must temporarily exceed the rate of growth of potential and vice versa.

8. Heap (2005) argues that industrial commodities go through a super-cycle where prices are likely to stay high for an extended period of time. Jerrett and Cuddington 2008 have empirically visualized the hypothesis for a number of metals. Erten and Ocampo (2012) identify four super-cycles in real commodity prices during the period 1865-2009, ranging between 30-40 years with amplitudes 20-40 percent higher or lower than the long run trend (similar cycles have been identified by Cuddington and Zellou (2013) for metals).

9. See World Bank 2010, chapter, 3 for a more detailed discussion of the impact of higher borrowing costs.

10. The IMF work differs from the World Bank work in citing high-income-country stock market volatility as the main external factor underpinning the decline in spreads. The World Bank (2010) includes high-income stock-market volatility with a much wider range of risk appetite indicators to derive a synthetic price-of-risk indicator that simultaneously determines developing country and high-income country risk premiums.
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Overview

Growth in industrial sectors in the post 2008-2009 period has been unimpressive globally, with the exception of East Asia and Pacific, and China in particular. After bouncing back in the immediate aftermath of the crisis global industrial production growth weakened again in the second half of 2010, and after a short-lived acceleration dipped again in mid-2011 and in the second half of 2012. Financial turmoil in high-income countries, and uncertainties surrounding the course of policy actions in high-income countries combined in some cases with policy-induced slowdowns in some of the larger developing countries and/or capacity constraints have restrained the pace of activity.

Overall, more than four years after the financial crisis began, global industrial output is only 5.3 percent higher than its pre-crisis peak. Output in high-income countries is still 6.5 below pre-crisis levels, with output in the Euro area and Japan sharply lower and output in the United States having almost regained pre-crisis levels. Output in developing countries outside China is 2.6 percent higher than its pre-crisis peak.

Growth in developing countries has been most dynamic in East Asia and Pacific mainly reflecting double-digit IP growth in China, where output is 67.9 percent higher than the pre-crisis high, versus 12 percent in the remaining countries in the region. Industrial output in South Asia and Europe and Central Asia are 19.6 and 2 percent higher respectively than their pre-crisis peaks. Industrial output in Latin America and the Caribbean and Sub-Saharan Africa is more or less in line with the pre-crisis levels. Middle East and North Africa is the only developing region where industrial output is lower than four years ago, largely due to the fall in production associated with the socio-political unrest during the Arab Spring.

Recent economic developments

Industrial production growth strengthened to an above trend pace in early 2013

Output strengthened in much of the world toward the end of 2012 and into the first quarter of 2013, with global output expanding at a close to 3.4 percent annualized pace in the three month leading to March, supported by strengthening final demand and rising inventories (figure IP.1).

Developing countries industrial output expanded at about a 5.1 percent annualized pace during the first quarter of 2013, with East Asia and Pacific’s industrial production growing at a 8.6 percent annualized pace and China’s industrial output expanding at a 9.7 percent annualized pace in the first quarter of 2013 (figure IP.2). Industrial output growth in other developing regions has varied markedly, but has been generally much softer. Growth has remained unimpressive in Latin America and the Caribbean as performance in Mexico has been softening and despite a modest improvement in growth in Brazil (figure IP.3). Output growth remained relatively flat in Europe & Central at 2.4 percent annualized pace in the first quarter of 2013, on account of relatively weak..
performance in Russia and Turkey. Growth remained strong in the South Asian subcontinent despite a deceleration of growth in India expanding at an 7.7 percent annualized pace in the first quarter of 2013. Data for the Middle-East and North Africa and Sub Saharan Africa lags, but was still declining in both regions in the three months to February.

Among high-income countries outside of the Euro Area industrial output also accelerated – reaching 3.5 percent up from 0.7 percent in the fourth quarter of 2012, mostly on rapid expansion in the United States and Japan. A recovering housing market and the creation of more than half a million payroll jobs in the first quarter of 2013 have supported the acceleration in activity, boosting consumer demand. Investment demand has also recovered with capital goods orders rising at a 20 percent annualized pace in the first quarter of 2013. As a result industrial production in the U.S. expanded at a 4.4 percent annualized pace in the first quarter of 2013, up from the 2.6 percent annualized pace recorded in the final quarter of 2012, despite a significant fiscal drag. In Japan, the relaxation of both monetary and fiscal policies, have prompted a sharp rebound in activity, with industrial production growth rebounding to 9 percent annualized pace in the first quarter of 2013.

In the Euro area industrial production stabilized, expanding 0.7 percent annualized in the first quarter of 2013 compared to a 8.1 percent annualized pace of decline in the fourth quarter of 2012. An increase in energy and capital goods production was behind the improved outturns. Excluding Germany, where output performance has been more robust (up 1.2 percent annualized pace in the first quarter of 2013), the improvement in industrial sector performance is less dramatic as output declined most rapidly among the high-spread economies that are enduring the harshest fiscal consolidations.

Capital-goods orders point to increased global capital spending in early 2013, but momentum may be weakening. After a sharp decline in mid-2012, G3 capital goods orders recovered briskly in the latter part of 2012, with shipments following a similar path (figure IP.4). Capital- goods orders

![Image](Fig IP.2) Strong industrial production growth in East Asia in Q1 2013

![Image](Fig IP.3) Industrial production growth recovers in Europe and Central Asia in Q1 2013

![Image](Fig IP.4) Capital goods orders are picking up in both high income and developing countries
rose at a rapid pace in the first quarter of 2013, with US capital goods orders rising at a 21.4 percent annualized pace, up from a 13.8 percent expansion in the fourth quarter of 2012. In Japan, after a robust recovery in the last quarter of 2012 (15.5 percent) capital goods orders growth accelerated markedly to 31.8 percent in the first quarter of 2013, while in Germany capital goods orders rose 3 percent over the same period, almost half the pace recorded in fourth quarter of 2012 (8.3 percent). In developing countries, capital goods orders eased only slightly, rising at an 22 percent annualized pace in the first quarter of 2013, down marginally from the 19 percent pace recorded in fourth quarter of 2012, pointing to sustained investment growth in these economies.

Data for April suggest however that the pace of expansion of capital goods orders might be easing in the US in the second quarter of the year. Similarly capital import orders by developing countries are also showing signs of moderating.

...but there are signs of moderation in the pace of expansion into the second quarter

Forward-looking indicators like purchasing manager's indexes suggest a slower pace of activity for the second quarter, as fiscal tightening in the US cuts into activity there and capacity constraints in many developing economies moderate growth – which should nevertheless continue to expand broadly in line with underlying potential. Indeed the step down in the global manufacturing Markit PMI in April to the lowest level since December (but still above the 50 mark that indicates expansion) followed by a marginal increase in May suggest that global manufacturing output growth is moderating into the second quarter of 2013. Sentiment regarding leading indicators components such as new orders and finished goods inventories improved only modestly.

Notably high-income and developing countries PMIs moved in opposite directions in May, with sentiment improving in most high-income countries surveyed and deteriorating in three quarters of developing countries.

Business sentiment in the U.S. is weighed down by the fiscal drag, with higher taxes likely to weigh on consumer spending, and budget sequestration further limiting domestic demand growth. The US manufacturing ISM index softened at the end of the first quarter and dropped below the 50 growth mark in May, on softer domestic demand and notwithstanding a boost in external demand. Meanwhile the business sentiment as gauged by the Markit PMI deteriorated to a six-month low in April, before inching up to 52.2 in May, remaining in growth territory.

PMIs in major developing countries such as Brazil, China, India, Russia and Turkey all declined for two or more consecutive months.

The moderation in output in East Asia is expected to be relatively broad, as suggested by PMI indexes. The May PMI has been weaker than expected in China, where the PMI retreated 1.2 points to 49.2. In China industrial output growth has decelerated further to 7.4 percent annualized pace in the three months leading to April. Interpreting the trade and industrial output data for East Asia is made more difficult by the timing of the Lunar New Year which fell in February this year.

Although PMIs improved in the Euro area in May, to the highest level since 2012, they continue to indicate contraction albeit at a slower pace. Sentiment improved in Germany, France, Italy, and Spain (albeit from depressed levels). Meanwhile sentiment in Japan improved for a fifth consecutive month, to its highest level in more than a year, as inventories are relatively low while orders are rising.

Noteworthy is the fact that despite stabilizing at a higher level than the one recorded in the fourth quarter of 2012, business sentiment remains at historically low levels globally, suggesting business confidence remains fragile and is yet to return to pre-crisis levels.

...nevertheless growth is expected to remain solid at a trend like pace

Industrial production growth in developing countries is expected to moderate to a more sustainable pace over the short term, with growth
in China remaining in the low double-digit range, while output elsewhere in East Asia moderates. The continuation of supportive fiscal policy with a front-loading of infrastructure spending is expected to benefit China’s industrial production. In addition, according to recent surveys labor demand continues to outpace labor supply, especially in the service sector, and might lead to increased labor income in the months ahead, which should be supportive of private consumption.

Some of the manufacturers in the region may be challenged by the large depreciation in the Japanese yen, induced by monetary easing, and may lose market share over the short-term, although other than China and Thailand, most countries in the region do not compete directly with Japan (see Main Text). Japanese output is expected to continue to post a robust recovery, following an 8 percent annualized bounce back in the first quarter of 2013.

Growth in industrial output is also expected to remain soft in countries with capacity constraints, including some of the larger developing economies. Industrial output performance will remain weak in Brazil, despite significant stimulus from the government, as high production costs, and capacity constraints continue to weigh on growth. Furthermore retail sales growth has decelerated markedly, as rising inflation has caused real wage growth to slow. Quarterly industrial production growth in South Asia is projected to moderate, as growth in India slows from unsustainable levels.

In Latin America, the weakness in the Mexican industrial sector should be reversed in mid-2013, as the Mexican manufacturing sector growth will re-link with the better performing U.S. manufacturing. However, performance in Argentina’s industrial sector is likely to be weak as a result of recent policies that restrict access to foreign currency for essential capital imports.

Growth in industrial production is expected to strengthen in the second half of 2013 in Europe and Central Asia, supported by modestly stronger domestic and high-income European demand, which should help narrow the still wide output gap in the region. Still weak private credit growth will continue to weigh on industrial sector activity this year.

Growth in Middle East and North Africa will recover but remain subdued despite large excess capacities, in part due to weak domestic demand.

In the Euro Area output is projected to strengthen modestly in the second half of the year, as the pace of fiscal consolidation eases and pent-up demand forces should support growth.

The recent declines in commodity prices, including oil and metals prices appear to mainly reflect higher supply (see commodity annex and main text). Lower input prices rather than suggesting slower demand going forward, should provide a fillip to activity, both by increasing real incomes and reducing production costs.

In order for growth in global industrial production to return to its long time trend over the medium term the pace of growth in high-income economies needs to accelerate as they still account for a significant share of global industrial output, and lead in global innovation for local markets, which is expected to support growth in industries such as automobile, chemicals, machinery and pharmaceutical (McKinsey 2012).

In terms of growth rates industrial sectors were much more dynamic in developing countries, expanding at an annual pace of 8.5 percent over the 2002-2007 period compared to 2.6 percent in high-income countries (figure IP.5). Among developing countries East Asia and Pacific was the most dynamic region (11.2 percent average annual pace), followed by South Asia (9.4 percent) and Europe.
and Central Asia (8.1 percent). Latin America and the Caribbean’s performance was less impressive (5.1 percent), expanding at the same pace as that of Sub-Saharan Africa. Middle East and North Africa expanded at a slowest pace among developing regions (4.1 percent).

During the boom years (2002-2007) global industrial production expanded at an average pace of 4.1 percent a year, with developing countries accounting for about 54 percent of growth in global industrial production (figure IP.6). East Asia and Pacific contributed more than 36 percent to global growth, with China alone accounting for almost a third. Among developing regions the second largest contributor to growth in global industrial production was Latin America and the Caribbean (8.7 percent), followed by Europe and Central Asia (6.4 percent) and South Asia (5.4 percent) (figure IP.7).

A significant part of the expansion in the global industrial production came from rapid growth in the construction, mining, and utilities sectors in developing countries. These sectors together accounted for close to 30 percent of overall global growth during the 2000-2010 period, with China accounting for more than half of that contribution (17 percent). The expected slowdown in investment in China over the coming years, partly as the property market cools down, may subtract from the global industrial production trend growth if not supplemented by stronger growth in other major emerging economies with large infrastructure gaps such as India and Brazil, whose infrastructures are perceived as inadequate given their level of economic development (WEF 2012-2013).

Overall growth in the industrial sector, and manufacturing in particular, stands to gain from the shift in demand towards developing economies. Output in industries that need to be close to consumers due to cost structures (high transportation costs) and that produce products that are not heavily traded (food processing) is likely to expand rapidly as income in developing countries continue to rise.

**Risks and vulnerabilities**

The downside risks of a further deterioration in performance in the Euro area, of steeper fiscal consolidation in the United States and Japan, persist although the probability associated with these risks has declined since our January 2013 edition. An additional risk is that of an abrupt slowdown in investment in China which would have significant consequences for exporters of capital goods in particular in East Asia but also Germany and the United States.
If commodity prices decline markedly capital expenditures, which have risen sharply during the boom years especially in oil and metals markets, could slow significantly, affecting capital goods producing countries. Lower commodity prices and lower fuel prices in particular could boost real disposable incomes and bolster demand for other manufactures.

There is also an upside risk associated with the performance of the U.S. economy and its resilience in the face of the fiscal drag. Similarly the performance in the Euro Area could be stronger than in our baseline.

As policies in high-income countries become less accommodative the cost of capital is likely to rise over the medium term and costlier capital could limit investment and growth in industrial production. (GEP 2010).
References


INFLATION
Global inflation is subdued as cost pressures related to commodity prices continue to ease and demand factors in high income countries remain weak

Despite loose global monetary conditions and an acceleration in economic activity, global consumer prices rose at a modest 2.7 percent annualized rate in the three months ending April of 2013 (figure INF.1).

This was the slowest first quarter increase in global consumer prices since 2009, reflecting subdued high-income country growth and a moderation of global commodity prices (figure INF. 2).

Core inflation\(^{FN1}\) eased insignificantly in the majority of countries for which consistent data series are available. For the OECD country group as a whole, quarterly core inflation declined to 1.6 percent in 1Q2013 compared to 1.9 percent in 1Q2012.

**Developing country inflation ticked down in April 2013 on declining commodity prices**

Developing country prices\(^{FN2}\) rose at a 6.9 percent annualized rate in the three months to April of 2013 showing some moderation from more accelerated growth over the past two quarters.

The recent down tick in developing country inflation is notable, presumably signaling an end to the gradual rise that began in the summer of 2012 — prompted by the upturn in international grain prices related to droughts in the US, Eastern Europe and Central Asia and shortage of grain supplies.

Among developing countries, inflation in low income economies has shown the fastest declining trend throughout 2012, both on a year-over-year and a quarterly annualized basis.

The year-over-year inflation in these economies is now about half of the 14 percent rate recorded a year ago (figure INF.2 and 3).

Quarterly inflation on an annualized basis bottomed out in August of 2012 after slowing to a 5.5 percent rate with price acceleration partly reflecting the temporary increase in international food prices in Q42012 (see above).

More recently, as commodity prices have eased and growth has weakened, quarterly inflation has also moderated falling back to a 5.5 percent annualized rate in the three months ending April of 2013.
High-income country inflation remains weak

Year-over-year inflation in high-income countries has remained under 2 percent since April 2012, while quarterly inflation has displayed more volatility partly reflecting changes in energy prices (figure INF. 4).

Quarterly core inflation on an annualized basis for the G-7 country group declined to 1.4 percent in 2013Q1 compared to 1.7 percent in 1Q2012. The low trend rate of inflation in high-income countries reflects still ample spare capacity, and the weakness of the recovery especially in the Euro Zone and Japan.

In Japan, the sharp depreciation of the yen since September 2013 (see main text and exchange rate annex) has pushed quarterly inflation into a positive territory in January and February.

More recently however, price pressures in Japan eased again reflecting moderating global commodity prices. Quarterly inflation on an annual basis dropped to a negative 0.6 percent in the three months to April and the year-over-year inflation stood at a negative 0.7 percent — well below the authorities new 2 percent annual inflation target.

Global monetary conditions continue to be loose with Japan implementing aggressive monetary easing

In high-income countries low interest rates are combined with the Federal Reserve’s Federal Open Market Committee’s continued monthly purchases of $85 billion of housing-market debt and Treasuries and quantitative easing in the UK and Japan and further policy easing in the Euro Area with the interest rate cut by another 25 basis points to 0.50 percent implemented in May.

Developing country monetary policy has loosening bias in general

The majority of the developing country central banks continue to keep their interest rates on hold at historical low levels in their effort to stimulate domestic demand as global economic activity
remains weak and inflation pressures generally subdued. Some developing countries implemented additional rate cuts most recently following quite disappointing Q1 2013 growth outcomes in the overall context of moderating global price pressures.

About twenty developing and seven high-income countries and economic unions implemented policy rate cuts in the first months of 2013. This included a cumulative 75 basis point rate cut implemented by the Reserve Bank of India and a 50 basis point rate cut in Mexico—first easing since July 2009. Other policy easing measures in LAC included a 100 basis point rate cut (to 3.25 percent) by the Bank of Colombia in three monthly consecutive rate cuts and a 50 basis points rate cut by the Bank of Jamaica.

In Sub-Saharan Africa Angola, Kenya, Sierra Leone and Uganda continued to ease policy and Botswana and the West African States implemented their first rate cuts in few years. In ECA—where growth has weakened and price pressures have generally moderated—policies have been eased in a number of developing countries, including Albania, Azerbaijan, Belarus, Georgia, Macedonia and Turkey.

In the EAP Mongolia cut its policy rate by 175 basis points, Vietnam implemented a 100 basis point cut this year and Thailand implemented a rate cut in May following a sharp output contraction in the first quarter of 2013.

Monetary policy was tightened by about six developing central banks in 2013, including Brazil, Ghana, Gambia, Serbia, Tunisia and Egypt in an attempt to curtail inflationary pressures fueled by domestic factors, including rapid credit expansion and currency depreciation, particularly in Egypt.

**Monetary policy globally and in developing countries is increasingly embracing inflation targeting**

The Central Banks in most of the major countries are now following some type of inflation targeting regime. For the most part, inflation remains within inflation target (figure INF. 5) — with the notable exception of some large middle income countries, including Indonesia, Brazil, Russia, Turkey and South Africa, where headline inflation has tended to exceed targets due to recurring price pressures related to supply constraints.

**Loose policy stance in developing countries may be counterproductive in countries operating at full capacity**

In general, the central banks worldwide are keeping rates low with major focus still on downside risks in the global economy. Accommodative policy
stance may be adequate in the economies with remaining output gaps and subdued demand.

Some developing regions continue to experience price pressures reflecting local conditions despite benign global inflationary pressures (figure INF.6).

In the economies that are operating at full capacity the loose policy stance may be counterproductive contributing to domestic price pressures without much payoff in additional output.

Moreover, a loose policy stance and low rates are encouraging risk taking attitude, fueling asset bubbles and pushing domestic debt to risky levels in the economies that are operating above their full capacity.\(^5\)

### Headline inflation in East Asia and the Pacific region accelerated in early 2013 reflecting a strong rebound in economic activity and accommodative policies

Inflation has ticked up in a number of countries in the East Asia and the Pacific region in the first quarter of 2013 after declining through much of 2012. Annualized quarterly inflation in the East Asia and the Pacific region accelerated to 3.5 percent rate in the three months to March 2013 compared with 2 percent a year earlier (figure INF. 7) reflecting price acceleration in China, Indonesia and Lao, PDR.

In China, although the headline inflation rate remains under the central bank target of 3.5 percent, price pressures are present. Quarterly inflation accelerated to a 3.7 percent annualized rate in the three months to February, the highest since October 2011, but eased in March in response to tightening of monetary conditions and administrative measures addressed toward curbing property prices.

In Indonesia, inflation has been building up rapidly, with the quarterly inflation accelerating to a 9.5 percent annualized rate in the three months to April reflecting currency depreciation and hikes in food prices due to trade restrictions. Core inflation in Indonesia eased to 4.21 percent (year-over-year) in March from February’s 4.29 percent but remains high.

In Malaysia and Thailand currency appreciation combined with broadly stable commodity prices has helped curb inflationary pressures. Inflation also eased in Mongolia to 10.4 percent (year-on-year) in April which was the lowest rate observed since July 2011 reflecting a slow-down in economic activity.

Overall, the headline inflation remains within the central bank targeted range in the majority of the EAP countries, with the exception of Indonesia. Given limited spare capacity in the region, the generally loose stance of macroeconomic policy could stoke inflationary pressures and amplify the credit and asset price risks, especially in case of the volatile capital inflows including from Japan in relation to the latest quantitative easing.

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\(^5\) FN5

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**Fig INF.7** Price pressures are building up in EAP

**Fig INF 8** Inflation eased in ECA

Source: World Bank; Datastream.
**Inflation has moderated in Europe and Central Asia but price pressures are high in large middle income countries**

In Europe and Central Asia, inflation has eased recently due to declines in food prices following last summer’s poor crop (figure INF. 8). Besides, in most economies, ample spare capacity and high unemployment is keeping inflationary pressures at bay.

Azerbaijan, Bulgaria, Georgia and Macedonia have been experiencing considerable easing in consumer price inflation since the end of 2012 reflecting weak domestic demand and easing commodity prices with Georgia experiencing deflation since October 2012.

The year-over-year inflation remains high in some large economies (notably Turkey and Russia), reflecting limited spare capacity. Quarterly inflation in those economies eased most recently reflecting slowing growth and declining commodity prices, but the timing and the pace of easing price pressures diverge and reflect domestic policies.

Quarterly inflation has slowed to 3.8 percent annualize rate in the three months to April in Russia where monetary policy remained tight despite slowing growth. The headline inflation at 7.2 percent in April was nevertheless above the central bank’s 5-6 percent targeted rate. FN6

Policy easing in Turkey contributed to accelerating inflation to 9.7 percent annualized rate in the three months to March 2013. Turkey’s quarterly core inflation eased to 6.5 percent in 1Q2013 compared to 9.6 percent in 1Q2012. The headline inflation also dropped to 6.1 percent in April reflecting global decline in commodity prices, but remains above the central bank’s 5 percent annual inflation target.

In Kazakhstan, adjustments in regulated prices put a temporary upward pressure on inflation with quarterly inflation increasing to 7.9 percent annualized rate in the three months to November 2012. Tight policy and easing commodity prices contributed to moderating price pressures in 2013. Quarterly inflation slowed to 5.3 percent (q/q saar) and year-over-year at 6.4 percent (saar) in April 2013 was at the lower point of the 6-8 percent annual inflation target band.

In Belarus, quarterly inflation remains high at 35.8 percent (saar) in the three months to April 2013. Price pressures increased in the first quarter of 2013 following a significant decline to 10.3 percent annualized rate in the three months to November from the earlier hikes in response to stabilization measures. Belarus has been experiencing high level of inflation since 2011 following almost a threefold devaluation of the national currency against the US dollar implemented to correct external macroeconomic imbalances.

Although inflation remains sticky in the largest countries of the region, price pressures moderated across the rest of the Latin America and the Caribbean

Quarterly inflation in Latin America and the Caribbean (excluding Venezuela) eased to 5 percent in 1Q2013 from 5.9 percent in 4Q2012 indicating easing of price pressures, partly reflecting moderating commodity (notably food) prices (figure INF.9).

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**Fig INF.9** Diverging inflation trends across LAC

CPI, % change, 3m/3m, saar

Source: World Bank; Datastream.

FN6
Inflation outcomes across countries mirror diverging policy stances, with Colombia, Chile, Peru and Mexico seeing strong growth combined with moderate consumer price inflation.

Brazil has been on the other hand trapped in slow growth and high inflation equilibrium. Headline inflation was 6.5 percent in April 2013—just at the upper limit of the central bank’s 4.5 percent +/-2 inflation targeting band.

Till very recently monetary policy had been easing contributing to a cumulative 525 basis point cut between August 2011 and end of 2012. Brazil was however one of the few developing countries that starts to tighten its policies in 2013 by implementing two consecutive rate cuts in April and May (cumulative 75 basis point rate increase).

Currency devaluation has exacerbated local price pressures in Venezuela, where the year-over-year inflation reached 35.2 percent in May—12.6 percentage points higher than last year.

In Argentina, quarterly inflation on an annualized basis, which has accelerated in Q42012 eased most recently partly reflecting moderating commodity prices. However, the year-over-year inflation remains stubbornly high partly reflecting import restrictions combined with loose policies.

In the Middle-East & North Africa high prices reflect both supply disruptions caused by civil and armed strife as well as the measures addressed at adjusting large macro-economic imbalances

Average inflation in the Middle-East & North Africa exceeds 22 percent with quarterly inflation even higher. Prices pressures emanate from variety of sources, including high costs associated with importing food and fuel (Jordan and Tunisia) due to the region’s high dependence on internationally traded food commodities, supply shortages caused by political and armed conflict in some countries and international sanctions in others (Iran and Syria), and currency deprecation and administered price increases adding to pressures in some countries (e.g. Egypt) (figure INF.10).

In South Asia consumer price based index remains high but the wholesale price index-based inflation moderated significantly, especially in India

Year-over-year inflation ticked down in South Asia region in April on moderating commodity prices, but quarterly inflation still
shows some acceleration. This mainly reflects an upward adjustments to domestic fuel prices (figure INF. 11) implemented over the past months.

On a country level, in India, year-over-year consumer-based inflation declined below 10 percent in April, and the wholesale price index-based inflation declined below 6 percent for the first time in more than three years. However quarter-over-quarter consumer-price based inflation continued to rise and stood at 11.3 percent annualized rate in the three months to April.

Other countries in the region, including Bangladesh and Pakistan, and Sri-Lanka until most recently, have been experiencing moderating price pressures recently reflecting decline in commodity prices with both quarterly and annual inflations easing during the first quarter of 2013 in line with the global trends.

Several countries in the region eased monetary policy between mid-2012 and 1Q 2013 as they saw core inflation coming down. Those countries include Pakistan, which cut its key policy rate by a cumulative 250 basis points between August and December 2012, and Sri-Lanka and India where policy rates have been eased more recently.

Price pressures in South Asia continue to stem from growing demand for food and energy reflecting raising household incomes combined with tight supplies related to bottlenecks and structural constraints in the production and distribution of food and utilities.

**Inflation experienced a steep decline in Sub-Saharan Africa, but price pressures prevail in a number of large countries reflecting capacity constraints and loose policies**

In Sub-Saharan Africa (excluding South African republic) quarterly inflation eased by about 6 percentage points since last year reflecting commodity price moderation and tight monetary conditions (see main text).

But with many countries operating at little or no spare capacity, loose policies directly contribute to consumer price inflation. Ghana and Kenya, for example have seen their quarterly inflations accelerating in April to 15.4 percent annualized rate and 8.5 percent respectively reflecting easing policies.

In South Africa, year-over-year inflation has been around the upper limit of the Central Bank targeted rate since some time despite slow growth due to weakening of the rand and wage hikes. Core inflation also accelerated to 5 percent (y/y) in 1Q2013.

In some countries of East Africa, notably Uganda and Tanzania, inflation remains contained following a massive decline in 2012 (figure INF.12). In West Africa, moderating commodity prices and tight policies contributed to easing price pressures. In Nigeria, for example, the year-over-year inflation eased to 8.6 in March 2013—the lowest level in five years. Inflation also remained low in the countries of West African Economic and Monetary Union (WAEMU) (Benin, Burkina Faso, Cote d’Ivoire, Guinea Bissau, Mali, Niger, Senegal, and Togo).
Some developing countries continue to experience high inflation rates or severe disinflation due to country specific conditions

Year-over-year inflation exceeded 15 percent in only seven developing countries in the first quarter of 2013 including Belarus (>20%), Iran (>40%), Malawi (>35%), South Sudan (>24%), Sudan (>40%), Syria (>49%), and Venezuela (>35%).

Burundi, Eritrea, Ethiopia and Guinea all experienced sharp inflationary peaks in 2012, but managed to reduce price pressures containing inflation rate below 15 percent as of April of 2013.

Outlook and risks

The inflation outlook mirrors the growth outlook and remains uncertain. Under the baseline scenario, which assumes global economic recovery and moderating commodity prices, inflation is projected to pick up only gradually with strengthening global demand as it remains to be predominantly anchored around the targeted rates. Moreover, the impact of accelerating inflation in developing countries will be counterbalanced by subdued price pressures in the high-income economies, reflecting a continued low consumer confidence and slow economic activity. Price pressures are likely to persist in a selected number of economies such as Brazil, India, Russia, Turkey, South Africa with supply bottlenecks, especially in case of demand stimulating policies.

In addition, many developing countries remain vulnerable to medium-term price pressures through excessive credit and debt build-up, feeding into asset prices. Moreover, with international reserves declining and/or deficit countries relying on foreign capital inflows, there is not only limited scope for monetary easing, but there is a medium-term risk that a “normalization” of monetary policy in developed countries may encourage capital flight and put "unwanted pressure" on foreign exchange markets and potentially (future) erode reserves, while destabilizing currencies and exerting upward pressure on inflation. This risk is however unlikely to unfold over a short term period given the weak pace of recovery in high-income countries and in the context of the latest (May 2, 2013) interest rate cuts in Euro Area.

In the near term, global inflation is likely to remain at around 3 percent (year-on-year) largely due to depressed price pressures in the high-income countries. Developing country inflation is projected to accelerate to 7 percent in the case of a continued loose monetary policy environment.

The inflation outlook is subject to any supply-side shock related risk. Upside risks may entail a moderate acceleration – but even with this increase inflation is likely to remain below its 2011 levels. Global oil supply risk is related to a possible deterioration in political conditions in the Middle East but can also stem from the technical problems. A major supply cutoff could limit supplies and result in prices spiking well above US$ 150/bbl depending on the severity, duration and response from OPEC, emergency reserves, and demand curtailment.

Downside risks include further easing in inflation in high-income countries in case of continued low confidence and weak economic activity. There is also a downside risk related to slower economic growth, especially by emerging economies, including China.

While the Fed and ECB’s interventions have helped to avoid the worst potential effects of banking-sector de-leveraging and liquidity constraints in high-income Europe, the ultra-loose monetary policy in high-income countries, including in Japan, could once again be sowing the seeds for the kinds of disruptive, inflationary, and asset-bubble creating capital inflows that characterized the second half of 2010.

Moreover, in some developing countries monetary policy has also been very loose, while debt burdens have risen rapidly. Although global inflationary pressures remain benign, given the lags in monetary policy transmission, additional easing may add to a strengthening activity already underway resulting in additional inflationary pressures in countries operating close to full capacity, without much payoff in additional output.
Notes:

1. Consumer prices, all items non-food, non-energy. OECD data and classification.

2. Developing country inflation is calculated on a GDP weighted basis.

3. Following earlier tightening Serbia has recently cut its policy rate by 25 basis points.

4. The UK has a 2 per cent inflation target with no explicit upper bound. If inflation rises more than 1 percentage point above the target the Governor of the Bank must write an open letter to the Chancellor explaining the reasons for the deviation.

5. EAP Update, April 2013, WB, Philippine Economic Update, April 2013, WB, Global Financial Stability report, April 2013, IMF.

6. Formally the Bank of Russia will finalize its move to inflation targeting by 2015. Currently, it is still using the currency corridor and uses interventions, although recently the Central Bank of Russia has largely refrained from using currency interventions allowing the ruble to float.
FINANCIAL MARKETS
Recent developments in financial markets

The “risk-off” phase in global financial markets has continued since the beginning of the year.

Global financial markets have been mostly calm since the beginning of the year following the substantial improvements during the second half of 2012 (GEP 2012 January). Investor confidence, as proxied by risk premia and credit default swap (CDS) rates, has remained relatively strong despite negative developments in Euro Area (box FIN.1), including continued economic weakness, political gridlock in Italy that has stalled reforms, and the Cyprus crisis that culminated in the imposition of capital controls—a first in the Euro Area. Developing-country CDS rates have in general remained at low levels (figure FIN.1). Increases in Egyptian and Argentinian CDS rates were the main exceptions (figure FIN.2). Egyptian spreads rose due to the rising deficit and debt tied to the economic consequences of political turmoil, while Argentinian rates increased due to the uncertainty generated by a US court decision concerning the repayment to creditors that did not participate in the 2005 and 2010 restructuring of Argentinean debt.1

Developed country stock markets have outperformed developing countries so far in 2013

The developed country equity stock market indices gained value during the five months of 2013 but have declined since late May as the concerns about possible tapering of United States quantitative easing have increased. The total year to date gain was 11.1 percent (figure FIN.3). The benchmark S&P 500 index for the United States reached a new record level on May 19th as improving economic data reports seemed to confirm that the U.S. economy was gaining momentum (figure FIN.4).

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Fig FIN.1 CDS rates for most developing regions remained stable despite the events in March

Fig FIN.2 Argentina’s CDS rates surged in March from already very high levels

Fig FIN.3 Developed country equities are outperforming developing country
Similarly, the Japanese Nikkei stock market index gained almost 50 percent in value between January and May reflecting the expectations related to the monetary easing program announced by the Bank of Japan (box FIN.2). Nevertheless, the year to date gain for the index was only 23 percent after the sharp decline since late May. Investor appetite in Europe has been also positive but less robust due to the region’s weak economic outlook. After a similar adjustment since May, the year to date gain for European stock market index was only 5.4 percent.
Overall, equity markets in Europe and Japan have recovered more than 80 percent of their 2007 value, versus a more than full recovery in the United States.

In contrast with the strong performance in high-income markets earlier in the year, the developing country stock market performance has been relatively weak since the beginning of the year. Stock market indexes declined in Brazil (−13.4 percent) and Russia (−10 percent), whereas they remained more or less stable in China (0.1 percent) and India (0.7 percent). The weakness in developing country stock markets partly reflects weak corporate earnings and country-specific factors. Recent curbs on property markets in China, for example, have contributed to the weakness in share values, while easing in commodity prices have affected stock market performances in Brazil and Russia. Equity markets in several East Asian countries—Indonesia, the Philippines, and Thailand—reached record highs earlier in the year, helped by strong foreign private capital inflows.

The earlier decoupling in the equity market performance of developed and developing countries also likely reflects a decline in the investors’ perceptions of the riskiness of high-income country financial assets, and growing concerns about asset prices bubbles and growth prospects in some middle-income countries. Such a revaluation would likely induce investors to shift their portfolios away from developing to developed markets, and may help explain why yields on developing country debt are rising (see below).

**Developing country bond yields have risen since January despite the general “risk-off” phase in global financial markets...**

Indeed, the cost of international bond financing—proxied by 10-year U.S. Treasury bond yield + EMBIG cash bond spread—has gone up this year after reaching a record low level in early January (figure FIN.5). Unlike previous episodes, the recent rise in the yields did not occur during a period of heightened global risk-aversion. Moreover, the widening in secondary-market bond spreads was not associated with a decline in benchmark US yields. US treasury yields tend to fall during the periods of heightened risk-aversion in global financial markets as they are considered safe assets. Over the past few years, developing country bond yields have tended to remain relatively constant, even as benchmark yields (US 10 year treasury yield) fluctuated—implying that spreads have risen as benchmark yields fell. During the first half of 2013, however, developing-country spreads have increased amid rising benchmark US 10-year Treasury yields (figure FIN.6)—and despite the continued trend toward upgrading of developing country debt by rating agencies.FN2

These developments could be consistent with the beginning of a new trend where the price of risk
returns to levels that are more normal. The trend decline in spreads for developing countries over the last five years has been partly explained by their improved credit quality. Much of the improvement however reflects the very low policy rates and quantitative easing in high-income countries (World Bank, 2010; IMF, 2013), with easy monetary conditions having suppressed the price of risk in both developed and developing countries. Recent increases possibly reflect market expectations that the pace of quantitative easing in the United States may ease soon even though Fed policymakers have reassured the markets that they will remain accommodative.

Despite the weak performance of the stock markets, gross capital flows to developing countries remained robust during the early months of 2013

During the first five months of 2013, gross capital flows (international bond issuance, cross-border syndicated bank loans and equity placements) to developing countries rose by 63 percent year-on-year and reached a historic high at $306 billion (figure FIN.7). All types of flows posted around 60 percent increase, with record levels of international bond issuance by developing countries. Flows strengthened in every region except North Africa and Middle East (box FIN.2). The sharpest increase was in Europe and Central Asia, where the flows more than doubled.

Syndicated bank lending to developing countries totaled $91 billion during the first five months of 2013, 69 percent higher compared with a year ago. Despite the relative weakness in April, bank lending has been on a rebound since the second quarter of 2012 (figure FIN.8). While many factors were at play, an easing in the deleveraging process by European banks has been the key. As early as June 2012, three quarters of European banks had complied with the ECB’s capital ratio requirements. Moreover, according to the April ECB Bank Lending Survey, Euro Area banks have eased the pace of tightening of their credit standards.\textsuperscript{FN3} Euro Area banks have begun repaying ECB crisis loans and have already started to repay some of the loans well in advance (box FIN.1).
Almost 70 percent of the bank lending during the first five months of 2013 went to resource-related companies, mostly for acquisition and trade finance purposes. The average cost of bank financing declined by 18 bps to 3.3 percent as the benchmark 6 month US Libor rate has eased in 2013, while average bank spreads have remained stable (figure FIN.9). The average maturity of the bank loans declined slightly to 5.4 years, with the share of long-term syndicated bank lending (at least five years of maturity) falling to 35 percent from 55 percent in 2012. Syndicated lending for trade finance declined by 11 percent during the first five months of 2013 compared with the same period last year, while the average maturity of the loans increased for one year.

The increase in equity flows—initial public offering (IPO) and follow-on issuance—was due to the strong follow-on issuance from East Asia, Europe and Central Asia, and Latin America and the recovery of the overall IPO activity from last year’s low level. While China still dominates overall equity volume, equity issuance also...
increased in other countries, including Indonesia, Malaysia, Philippines, Thailand, Brazil, Russia, Chile, and Mexico.

International bond flows to developing countries have been particularly robust, reaching a historically high level at $158 billion for the first five months of the year with the record monthly issuance of $45 billion in April. Developing countries have issued more than 20 billion per month since September 2012 with the exceptions of seasonally low December and February when the Chinese Lunar New Year was this year (figure FIN.10). The heavy issuance has been supported by investors’ robust risk appetite and low borrowing cost.

The strong appetite for higher-yield developing-country debt has been driven by low yields in high-income countries because of quantitative easing. This has created an opportunity for several non-investment-grade (non-IG) companies to tap into international bond markets. In fact, the share of non-investment grade corporate issuance rose to 31 percent of the value of bonds issued by developing countries (compared with 18 percent in 2012) and 46 percent of the number of bonds (34 percent in 2012) (figure FIN.10). In addition, there has been a long line of first-time sovereign bond issuers including Honduras ($500 million) and Rwanda ($400 million). Even Papua New Guinea is planning to tap the international debt market soon.

Foreign direct investment inflows to developing countries remained robust in 2012 after the increased uncertainty in global financial markets earlier in the year.

After slowing down during the first half of 2012, foreign direct investment (FDI) inflows to developing countries picked up strongly in the final quarter of the year. Nevertheless, flows totaled $670 billion, 5 percent lower than $701 billion in 2011 (figure FIN.11). The weakness in the flows earlier in the year was mostly the result of increased uncertainty in global financial markets due to Euro Area problems. The impact of the uncertainty was much more profound for high-income economies where FDI inflows declined by 32 percent (figure FIN.12). Most developed countries experienced
declines compared to 2011. While Finland, Netherlands and Belgium experienced net disinvestments in 2012, FDI inflows declined by almost 90 percent in Denmark and Germany. The relative resilience of FDI in developing countries mostly reflects stable re-invested earnings and intra-company loans. The share of developing countries in global FDI inflows reached its highest level at 45 percent in 2012.

FDI inflows were weak in most of the developing regions. The largest contraction was in South Asia where flows declined around 20 percent due to slow growth and regulatory uncertainties in India and Pakistan. FDI inflows to the East Asia region also declined with China, Malaysia, and Thailand all experiencing contractions. Despite the 8 percent drop in FDI inflows due to the ongoing structural changes in its economy, China was the top FDI recipient in the world in 2012. Similarly, FDI inflows declined in most Eastern European economies, reflecting economic weakness in high-income Europe with largest drops in Latvia, Lithuania, and Serbia.

In contrast, FDI inflows to Latin American economies rose by 10 percent supported by still high (if weakening) commodity prices and increased investment from the United States, especially to Argentina, Chile and Colombia.

Limited high frequency data indicate a mixed picture so far in 2013: robust flows to Chile, India and Russia and easing in other developing countries. Flows to other developing countries will likely rebound in the second half of the year.

Several countries in emerging Europe, including Russia and Serbia, have announced plans to accelerate privatization efforts this year. FDI flows are expected to increase by 7 percent reaching $719 billion in 2013.

**Hot money flows: a new heat wave from the East?**

The loose monetary policy run by high-income countries since the 2008/09 crisis has prompted investors to borrow cheaply and invest in high-yielding markets. Investors have been attracted to developing country local currency assets (equity and bonds) because of their stronger growth potential, and interest rate differentials. This has led to significant levels of the flows to equity and local currency debt securities (also referred as hot money flows). Flows to a few large middle-income countries were particularly strong in 2010 (See GEP January 2011). Managing the fluctuations in these flows, which tend to be quite volatile, can be quite challenging and some countries have introduced special measures including capital controls.

The data for these flows—portfolio investment with a breakdown of issuance in the country—are only available for few countries and exhibit a mixed picture for 2013 (figure FIN.13). Despite the current relatively low risk environment and high liquidity in the market, flows to local stock and bond markets have moderated for Turkey but have picked up in Brazil. While flows to Mexico surged in the last quarter of 2012 and were at record high levels in 2012, the data for 2013 are not available.

![Mixed picture for hot money flows](chart1.png)

**Mixed picture for hot money flows**

**The flows to EM Mutual Funds declined sharply after January**

![The flows to EM Mutual Funds declined sharply after January](chart2.png)

**The flows to EM Mutual Funds declined sharply after January**

*Source: World Bank; Haver.*
Box FIN.3  Japan’s monetary easing and developing countries

In November 2012, the Bank of Japan (BoJ) signaled that it would undertake monetary easing measures to fight against deflation. The BoJ announced the actual quantitative and qualitative easing measures on April 4th this year. These measures include the monthly purchase of ¥7.5 trillion ($75 billion) of the Japanese government bonds aiming to double its monetary base in two years. It will also expand the average maturity of bonds that it purchases from three to seven years. More importantly, the BoJ will continue these “as long as necessary”.

The BoJ’s quantitative easing (QE) program is similar to the QE3 program in the US. The $75 billion monthly purchase of government bonds is similar in size to the Fed’s monthly $85 billion purchase under QE3. Both programs seek to depress the return on low-risk assets, in order to push investors into riskier assets.

While the immediate beneficiary of the program is domestic assets, spillover into international capital markets is inevitable. In the case of the Japanese program, the size of the outflows may be larger, in part because at $8.8 trillion for bonds and $3.3 trillion for equities, the Japanese market is only 22 and 8 percent the size of U.S. markets. The bulk of these flows are likely to go to other high-income countries, only 2.4 percent of Japanese external holdings are in developing countries. However, Japanese investors have been actively investing in local currency bond and equity markets in some developing countries (box table).

There are already indications that Japanese institutional investors have been recently increasing their exposure to developing countries via Uridashi funds (typically foreign currency bonds) and larger Toshin investment trust funds (predominantly equity). According to the Investment Trusts Association of Japan, Japanese portfolio investment in local debt securities increased in Mexico (by 34 percent), Turkey (28 percent) and Thailand (17 percent) during the first two months of 2013. The increase was less pronounced in Philippines (5.9 percent) and South Africa (4.4 percent).

Although the depreciation of yen will make the assets abroad relatively more expensive, the Japanese QE program might also increase direct investment by lowering the cost of capital for Japanese multinationals. Developing countries receive a larger 20 percent share of these outflows. Asian developing countries in turn receive two thirds of these flows. Rising outward FDI flows from Japan in recent years have been particularly important for Thailand, accounting for 40 percent of that country’s FDI inflows in 2012, up from 28 percent in 2009.

Box table FIN 3.1  Japanese outward investment position by destination, 2011 ($ billion)

<table>
<thead>
<tr>
<th></th>
<th>FDI</th>
<th>Portfolio Investment</th>
<th></th>
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<td></td>
<td>Total</td>
<td></td>
<td>Total</td>
<td>PI: Equity</td>
<td>PI: Debt</td>
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<td>Developed</td>
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<td>647</td>
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<td>Developing</td>
<td>742.5</td>
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<td>Thailand</td>
<td>31.0</td>
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<td>1.5</td>
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<tr>
<td>Indonesia</td>
<td>13.9</td>
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<td>2.6</td>
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<td>1.6</td>
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<td>0.9</td>
<td>2.3</td>
<td></td>
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<td>27.2</td>
<td>13.3</td>
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<td></td>
<td></td>
</tr>
</tbody>
</table>

Source: Bank of Japan.
As an alternative measure, high-frequency data on flows to Emerging Market (EM) Mutual Funds—which only represent a portion of such flows—indicate a decline in recent months (figure FIN.14). The fall has been particularly sharp for EM equity funds with net outflows in March and May. The fall partly reflects weak corporate earnings and country specific factors (discussed earlier). In addition, downside risks for the returns on these assets have also risen, in particular if US Treasuries were to rise earlier and higher than expected.

Looking forward, Japan’s decision to begin a quantitative easing program may reverse the trend in these flows (box FIN.3). The Bank of Japan’s (BoJ) commitment to purchase $75 billion of government bonds a month (just short of the Fed’s monthly purchase of $85 billion) is likely to weaken returns in Japanese markets, and make developing-country assets more attractive than otherwise. While Japanese investors’ tend to have a stronger home-bias than US investors, the Japanese domestic market is smaller than the U.S. and as a result the impact on domestic asset prices is likely to be larger, and the incentive to invest abroad larger. How large of an impact on developing country assets will depend on whether investors turn to high-income country or developing assets. Here, Japanese investors tend to allocate a smaller share of their external assets to developing countries than American investors do, although they have been active in many developing country local currency debt markets. Their portfolio investment tends to be geographically diverse with a significant presence in Brazil, Mexico and Turkey.

Expectations of policy actions have already bolstered portfolio outflows with an increase in flows to developing countries. For example, the flows to Toshin funds (investing in local and international equity and bond markets) and Uridashi funds (typically foreign currency bonds) have been very robust since the beginning of the year. According to the Investment Trusts Association of Japan, Japanese portfolio investment in local debt securities increased in Mexico (by 34 percent), Turkey (28 percent) and Thailand (17 percent) during the first two months of 2013. The increase was less pronounced in Philippines (5.9 percent) and South Africa (4.4 percent).

If the current trend gains momentum in coming months, some developing countries might face challenges in managing the impact of these flows on their economy.

**Prospects**

The level of net private capital inflows going to developing countries is set to rise in nominal terms but as a percent of total developing country GDP, net inflows are forecast to ease by 2015. After the 1.4 percent increase in 2012 reaching $1.2 trillion (4.9 percent of developing countries’ aggregate GDP), net capital inflows to the developing world had a strong start in 2013 (figure FIN.15 and table FIN.1). They are expected to increase to $1.3 trillion (4.7 percent of GDP) with another record level of bond flows, rebounding bank lending and robust FDI inflows.

While the prospects for capital flows to developing countries remain positive in the medium-term, some of the factors that have been in play over the last few years are expected to weaken. For example, while developing countries will continue to grow relatively faster than developed countries and their credit quality has improved, the growth differential is expected to narrow as growth in high-income countries picks up. Perceptions of the riskiness of high-income country investments have also declined, which should lead to a portfolio shift in their favor over the medium term.

**Fig FIN.15** Net private capital flows are set to rise in nominal terms

![Net private capital flows are set to rise in nominal terms](image)
In addition, the uniformly accommodative stance of monetary policy in high-income countries may become more diverse as the United States reduces the extent of quantitative easing and Japan expands it. A gradual transition toward monetary policy tightening in the US is likely to increase the cost of capital for developing countries and expectations of such a move may lead to an easing in flows even earlier. This may be partially offset by the quantitative easing in Japan, if investors there substantially increase their appetite for developing country assets. The overall effect is likely to tighten external financial conditions for developing countries.

The impact of tighter external financial conditions will be evident for bond flows to developing countries—both international issuance and foreign investment into local currency bond markets. After reaching record highs in 2012 and 2013 bond flows are expected to fall gradually in 2014 and 2015.

Bank lending on the other hand is expected to rise gradually particularly now that intense deleveraging pressures have eased—although the extent of the bounce back may be limited by a stricter regulatory environment.
FDI inflows to developing countries are projected to increase through the forecast period, reaching $758 billion (2.4 percent of GDP) by 2015. Despite considerable real-side uncertainties in the short term, multinational corporations continue to be attracted to developing countries’ medium-term growth prospects, large and growing consumer base, natural resources, and still low labor costs. In addition, many developing countries are removing barriers to foreign investment. For example, following its recent World Trade Organization accession, Russia has committed to reducing restrictions on foreign investors in a number of service industries. Other countries in Eastern Europe have been pursuing privatization in their services sector. Similarly, India may attract an influx of investment in the coming years now that the cap on foreign ownership in multi-brand retail and aviation businesses has been raised. As long as Japanese monetary easing reduces the cost of capital for its multinationals, it should also support FDI flows to Asian economies, particularly Thailand and Vietnam in the short-term.

While remaining the main FDI destination among developing countries, FDI inflows to China are expected to ease over the medium term. The Chinese economy has been going through structural adjustments with rising wages and production costs, which will continue to limit the efficiency-seeking FDI. The fall will be partly compensated, however, by the market-seeking FDI flows as multinationals would like to serve its growing middle-income population.

Despite the expectation that private capital flows to developing countries will increase, the outlook is subject to significant downside risks. First, despite the recent progress towards a resolution for Euro Area debt crisis, considerable uncertainties remain and as highlighted by the Cyprus bailout, event risk persists. Any major setback could lead to a renewed crisis of confidence. Similarly, lack of progress in dealing with fiscal challenges in the United States has a similar potential to generate confidence issues.

Another factor that might generate volatility in the global financial markets is the process of unwinding of monetary easing in the United States. As discussed earlier, the expectations related to a possible ease in the pace of quantitative easing have already led to the recent increase in US 10-year Treasury yields accompanied widening in spreads. Hence, any rapid shift in the expectations related to the process might generate sharp adjustments in the financial markets and capital flows to developing countries.
Notes

1. Argentina defaulted a record $95 billion in sovereign debt in 2001. The country managed to restructure 92 percent of the debt in 2005 and 2010. Since then, Argentina has been in a long legal fight with bondholders who did not enter debt swaps. In the fall of 2012, a U.S. court ruled that Argentina had to repay the unrestructured debt, which prompted fears that the country would have to default once again on its unrestructured debt. As of yet the issue remains unresolved. According to a recent report published by the International Monetary Fund, ongoing litigation against Argentina could have pervasive implications for future sovereign debt restructurings by increasing leverage of holdout creditors. (http://www.imf.org/external/np/pp/eng/2013/042613.pdf)

2. Since January 2013, the sovereign ratings of 11 developing country borrowers have been upgraded versus 5 downgrades.

3. According to the April ECB report, net tightening of credit standards declined for loans to businesses in the Euro area. Net tightening for firms is now below its historical average. Credit standards also declined for households, although they remain higher than the historical average.

4. Historical FDI data have been revised as several countries have started to report under Balance of Payments and International Investment Position Manual (BPM6).
TRADE
Recent Developments

After a cyclical rebound in global trade, the pace of trade expansion is decelerating once again

Following the slump in Q2 2012, global trade began a cyclical rebound in Q3, led by an acceleration in developing country imports, which sparked an uptick in both high-income country and developing-country exports. As high-income country activity picked up, so too did their import demand helping to further boost overall trade in the fourth quarter and into the first quarter of 2013. However, reflecting ongoing fragility in the global economic recovery, particularly in high-income countries, the pace of trade expansion has slowed in recent months. Indeed, in the three months leading to April 2013, global trade expansion had decelerated to a below trend pace of 0.8 percent (3m/3m saar) compared with 10.9 percent in March (figure TRADE.1).

The deceleration in import demand has been broad-based, impacting both developing and high-income countries

The rebound in developing country import demand began almost as soon as the Euro Area financial market tensions of May-June 2012 began to ease. In both Q4 2012 and Q1 2013, this import rebound gained strength in part because of the firming derived demand it generated in high-income and other developing countries. However, weaker growth momentum in some large developing countries (including Brazil, China, India, Russia and South Africa) is reflected in the slowing down of the aggregate developing country import demand, even if still remaining robust. Indeed, in the three months to April 2013, developing country import demand was expanding at a 10.9 percent pace (down from the 18.0 percent pace registered in March). Nonetheless, developments differ across developing regions (see box TRADE.1).

Similar to the slowdown observed in developing countries, high-income country import demand also weakened in recent months. However, unlike the still positive import demand growth in developing countries (reflecting stronger domestic demand conditions there), high-income countries import demand growth contracted in the three months leading to April (-3.7%, 3m/3m saar). Although on aggregate import demand among high-income countries decelerated in April, developments have not been uniform across individual economies (figure TRADE.2).

US import demand growth decelerates, after earlier cyclical rebound.

The ongoing steady strengthening of US private sector economic activity, (GDP grew at 2.4 percent in Q1 2013, q/q saar compared with 0.4 percent in Q4 2012) was supportive of the rebound in its import demand. After contracting for four consecutive months between August 2012 and November 2012, US import demand growth started expanding once again in December, peaking at 5.9 percent (3m/3m saar) in January. Nonetheless, by March, business sentiment indicators for the US began declining. This decline in sentiment was reflected in real-side activity as both US industrial production and trade expansion slowed. Indeed, in March, US import demand growth contracted at a 2.5 percent (3m/3m saar) pace. And although there was an uptick in April (0.3 percent, 3m/3m saar), import demand is still expanding below trend. A strengthening US
Regional import developments

Import demand in East Asia & the Pacific registered a solid rebound in both Q4 2012 and Q1 2013 (Box fig TRADE 1.1). The robustness of trade in the region also reflects increasing trade and financial integration, although concerns have been raised about the potential impact on regional trade of the decline in Sino-Japanese trade and from the sharp depreciation of the yen (see main text). Indeed, declining business sentiment for some of the larger economies in the region suggest a weakening of this expansion in Q2 2013. Available data for April shows that the pace of import momentum decelerated to 13.4 percent (3m/3m saar) from 25.4 percent in March.

In Europe and Central Asia, import demand in the two largest economies in the region, Russia and Turkey, has rebounded rapidly — rising at a 19.7 percent pace in Russia and at 12.1 percent in Turkey in Q1 2013—partly reflecting the advanced stage of recovery in these economies. In those developing European countries with closer ties to the Euro Area, output gaps remain elevated and the recovery in import demand has lagged, the expansion in import demand has been weaker. On aggregate import demand in the region expanded at 16.8 percent rate in the three months ending March 2013.

Strong domestic demand in Latin America’s largest economy (Brazil), supported by loose monetary policy and household tax incentives, contributed to solid import demand in the region. Indeed in Q1 2013, import demand in Brazil grew at an above trend 21.3 percent pace. However, for the region as an aggregate import demand was 5.9 percent in Q1 2013. The weaker aggregate regional expansion in Q1 2013 reflects recent deceleration in import demand in both Argentina and Mexico. In April Brazil’s import growth contracted, but strengthening import demand from other countries in the region supported the acceleration of the region’s import demand to 6.1 percent (3m/3m saar).

In South Asia where India, dominates trade activity, the replenishing of depleted stocks and earlier monetary policy easing, contributed to the robust expansion in South Asia’s imports. However, India’s export growth has not kept pace with its import demand, thus contributing to a growing trade balance and current account deficit.

The latest available region wide data for Sub Saharan Africa and the Middle East and North Africa is February 2013 (Box fig Trade 1.2). Fortunes for both regions however, diverge. As was the case for other developing regions, import demand in Sub Saharan Africa strengthened through February to a robust 17.5 percent pace (slightly higher than the developing country average of 16.6 percent at the time) from 13.1 percent in the previous month. However, in the Middle East and North Africa, the contraction in import demand which commenced in August 2012 was sustained through February 2013 (-4.8 percent, 3m/3m saar), even if at a weaker pace. The weakness in import demand in the region in part reflects the effects of political challenges on demand conditions in some countries in the region.

Source: World Bank; Datastream.
economy should be supportive of global trade as the US still remains the world’s largest importer, accounting for some 12.5 percent of global imports in 2011.

After contracting for several months, import demand in high-income Europe begins expanding once again.

Notwithstanding a steady trend decline in its market share, the European Union still remains the world’s largest trading bloc and customs union, hence developments in Europe are of significant importance in global trade. Euro Area import demand began expanding once again in February 2013 (3.5 percent, 3m/3m saar) – the first expansion in ten months—and has continued expanding through March (3.4 percent, 3m/3m saar). The pick-up in Euro Area imports has occurred not with standing the weak domestic demand conditions there: rising and record high unemployment, tight lending conditions, ongoing fiscal uncertainty, and lingering uncertainty weighing down on investor confidence. The strengthening of import demand could reflect the rebuilding of inventories after several months of contracting imports demand, rather than strengthening of domestic demand conditions in the bloc.

Overall, net exports demand in the Euro Area is contributing to mitigating the weakness in Euro Area demand. For instance, in 2012, net exports contributed 1.6 percentage points to Euro Area GDP growth, notwithstanding the overall contraction of 0.6 percent in output (figure TRADE.3). Since exports tend to have a large import component, the acceleration in imports in 2013 Q1 likely reflects better exports as well as modest strengthening in the Euro Area economy.

Japanese imports demand has rebounded in recent months.

Japan accounts for 6.5 percent of global trade, hence developments there remain important, particularly so in the East Asia region where it is an important final market for several economies.

After several months of contracting import demand (between August 2012 and February 2013), import demand in Japan has begun accelerating once again, consistent with the strengthening of economic activity recorded in Q1 2013 (3.5 percent, q/q saar up from 0.3 percent in Q4 2012) as the effects of strong government stimulus measures begin to impact real side activity. Indeed, in the three months to April import demand accelerated to 6.3 percent compared with a 12.9 percent pace of contraction that occurred in December 2012.

Exports have lagged imports but are growing rapidly — with all regions participating in the trade rebound

Supported by the rebound in global economic activity (as observed by the pick-up in import
demand), developing country exports strengthened in Q4 2012 (14.8 percent, q/q saar), and this pick-up was sustained through Q1 2013 (15.5 percent, q/q saar), albeit at a different pace across individual developing regions (table Trade.1). Nonetheless, along with the deceleration in global import demand, the pace of export growth is showing signs of deceleration, with developing country export growth expanding at an annualized pace of 7.8 percent in the three months to April 2013 compared with the 15.4 percent recorded in the previous month.

During Q1 2013 the pace of export expansion was strongest in East Asia (26.1 percent, q/q saar) led by China and also in South Asia (23.2 percent, q/q saar) led by India. Central and Eastern European countries are benefitting from the strengthening import demand in the Euro Area with exports from the region expanding by a solid 14.5 percent (3m/3m saar) annualized pace in Q1 2013. However stagnant export growth from Russia and the sharp decline in Turkey’s export growth weighed down on the overall Europe and Central Asia exports. Hence in Q1 2013 overall exports in the region expanded by only 1.5 percent—as below the developing country growth of 15.4 percent. Latin America and the Caribbean region was the only developing region where export growth contracted in Q1 2013, mainly due to contracting export growth in Mexico (-7.4 percent, q/q saar) and Brazil (-4.4 percent, q/q saar). However, a pick-up in Brazil’s export volumes in supported the rebound observed for the region in April (5.0 percent, 3m/3m saar).

Data for both Sub Saharan Africa and the Middle East lags behind other developing regions. Latest available for the region is February 2013. In both regions, export growth had rebounded from the contracting activity in the months prior to November 2012. Indeed, in the three months to February export growth was accelerating at 19.7 percent in Sub Saharan Africa and 12.8 percent in the Middle East and North Africa.

### Medium Term Prospects for Global Trade

After its slump in 2012 (2.8 percent growth), global trade growth is projected to pick-up in 2013 and gradually strengthen through 2015. Underlying this pick-up in activity is the expected strengthening of the Euro Area economy (largest trading bloc) by Q3 2013, and the ongoing steady recovery in the US and robust developing country growth expected to continue through 2015.

Global trade in goods and services is projected to increase by 4.0 percent in 2013, before strengthening to 5.0 percent in 2014 and reaching 5.4 percent in 2015. Despite this relatively strong growth projection, global trade volumes will remain below their pre-crisis trend — potentially suggesting a slowing in the long-term trend for

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<td></td>
<td>Q2</td>
<td>Q3</td>
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<td>Sub Saharan Africa</td>
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Source: World Bank; Datastream.

Table TRADE.1
Export growth in developing regions

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<th>2012 (q/q, saar)</th>
<th>2013 (3m/3m, saar)</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Q2</td>
<td>Q3</td>
</tr>
<tr>
<td>East Asia &amp; Pacific</td>
<td>23.2</td>
<td>-12.2</td>
</tr>
<tr>
<td>Europe &amp; Central Asia</td>
<td>8.3</td>
<td>-10.5</td>
</tr>
<tr>
<td>Latin America &amp; Caribbean</td>
<td>-6.1</td>
<td>-4.1</td>
</tr>
<tr>
<td>Middle East &amp; North Africa</td>
<td>-21.5</td>
<td>-42.9</td>
</tr>
<tr>
<td>South Asia</td>
<td>-6.4</td>
<td>-11.8</td>
</tr>
<tr>
<td>Sub Saharan Africa</td>
<td>48.4</td>
<td>-34.2</td>
</tr>
</tbody>
</table>

Source: World Bank; Datastream.
The Re-orientation of South-South Trading Partners in Recent Years

Though accounting for about a third of global trade, the faster projected trade growth for developing countries (between 6.4 percent to 8.4 percent annual growth over forecast horizon) compared to high-income countries (2.8 percent to 4.3 percent over forecast horizon) between 2013 and 2015 is expected to be a key driver in the expansion of global trade. As documented in GEP 2013A, over the past decade, the most dynamic segment of global trade is trade among developing countries – so called “South-South” trade. Indeed, over the past decade the USD value of trade between developing countries has grown annually by an average of 19.3 percent (17.5 percent if trade with China is excluded) versus about 11 percent for developing country exports to high-income countries.

This trend is expected to continue over the forecast horizon. One significant element that has driven this South-South trade has been the growing role of East Asia as a major global trading bloc. Together this region, accounts for about half of the re-orientation towards South-South trade, with China, being the most dynamic trading partner. Indeed, without exception, every single developing region has increased its trade with China, while contemporaneously reducing their trade dependency on high-income markets (Box Figure Trade 2.1). The developing regions to have most re-oriented and increased their trade with China over the past decade have been those with a comparative advantage in natural resources. Between 1999 to 2011 Sub Saharan Africa increased their exports to China from 2.23 percent of their total exports to 22.73 percent, Latin America increased theirs from 1.0 percent to 11.5 percent and the Middle East and North Africa from 2.21 percent to 15.29 percent. Reflecting the strong integration of production networks in East Asia, the share of exports from other East Asian economies to China has increased from 4.5 percent in 1999 to 18.6 percent in 2011.

The rapidly growing South-South trade has however not been driven by only China but also other developing regions, in particular the rest of the East Asia region. However, outside of China and East Asia Pacific region, in general, the diversification of trading partners towards other developing regions, though occurring, has been less dynamic compared to that with the East Asia region (see Box Table TRADE 2.1).

Indeed, outside of trade with the East Asia region, the most significant re-orientation has been increasing exports from both the Middle East and North Africa. Excluding this, the re-orientation of trade with other developing regions has been somewhat less dynamic (see Box Table TRADE 2.1). More surprising however is the relatively slow progress towards increased integration among developing countries in the same region, with the exception of East Asia where regional trade integration (share of intra-regional imports) almost tripled since 1999. Indeed, excluding China which tends to export a greater share to high-income countries, the share of the other East Asian countries exports to the East Asia region increased by 20 percentage points (from 7.1 percent to 30.3 percent of their total exports). This is not the case in other developing regions. Although Europe and Central Asia remains the second most trade-integrated developing region (thanks to many countries benefitting from multiple trade agreements in the region, especially those associated with the European Union) part of the progress made in regional integration appears to have been eroded by the weak demand post crisis, as intra-regional trade having risen to 27.8 percent by 2008 (from 19.2 percent in 1999), has since declined to 25.5 percent in 2011 (see Box Fig TRADE
2.2. For both Latin America and Sub-Saharan Africa, regional trade integration has steadied around 16 percent over the past decade. And in Sub-Saharan Africa, after increasing by some 5 percentage points between 1999 and 2002, the share of regional trade has also steadied at around 12 percent of total trade, reflecting significant cross border barriers as well as increased external competition due in part to unilateral tariff liberalization. Among developing regions, the Middle East and North Africa and in South Asia remain regions with the least intra-regional trade, about 3 and 4 percent of their total trade is carried among regional neighbors. Not surprising several analytical studies (including those using gravity models) continue to point to the underperformance of intra-regional trade in the Middle East and North Africa (Dennis, 2006; Devlin and Yee, 2005; Zarrouk, 2003 Al-Atrash and Yousef, 2000), as well as in South Asia (Kumar et al. 2009) and in Sub-Saharan Africa (Buys et al. 2010).

While trade in natural resources, in particular ores and metals has been the fastest growing commodity category of imports among developing countries, the growth in trade in manufactured goods among developing countries has also been solid - growing as fast as petroleum imports and faster than agricultural raw material imports. The strength of importance of ores and metals is however accentuated by the inclusion of China. Excluding China, manufactured goods has been the fastest component of south-south trade, reflecting increased production chain interlinkages among developing countries, particularly in the East Asian region.

Box table TRADE 2.1 The diversification of trading partners between developing regions has been most dynamic between all developing regions and the East Asia region

<table>
<thead>
<tr>
<th>EXPORT MARKET</th>
<th>IMPORT MARKET</th>
</tr>
</thead>
<tbody>
<tr>
<td>[additional increase in exports share going to import market, in percentage points]</td>
<td></td>
</tr>
<tr>
<td>(e.g. an additional 18.0% of SSA share of its total exports was re-orientated towards the EAP region)</td>
<td></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>IMPORT MARKET</th>
<th>EAO</th>
<th>EAP</th>
<th>ECA</th>
<th>LAC</th>
<th>MENA</th>
<th>SAS</th>
<th>SSA</th>
</tr>
</thead>
<tbody>
<tr>
<td>East Asia excl. China (EAO)</td>
<td>6.3</td>
<td>4.2</td>
<td>0.5</td>
<td>1.0</td>
<td>-0.2</td>
<td>2.2</td>
<td>0.5</td>
</tr>
<tr>
<td>East Asia &amp; Pacific (EAP)</td>
<td>20.4</td>
<td>8.0</td>
<td>3.6</td>
<td>10.8</td>
<td>11.1</td>
<td>8.5</td>
<td>18.0</td>
</tr>
<tr>
<td>Europe Central Asia (ECA)</td>
<td>1.4</td>
<td>3.1</td>
<td>6.2</td>
<td>1.0</td>
<td>1.3</td>
<td>2.9</td>
<td>0.8</td>
</tr>
<tr>
<td>Latin America &amp; Carribean (LAC)</td>
<td>1.3</td>
<td>4.1</td>
<td>0.0</td>
<td>1.3</td>
<td>-0.6</td>
<td>2.7</td>
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<tr>
<td>Middle East &amp; North Africa (MENA)</td>
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<td>0.4</td>
<td>1.4</td>
<td>-0.7</td>
</tr>
<tr>
<td>South Asia (SAS)</td>
<td>2.5</td>
<td>2.5</td>
<td>0.5</td>
<td>1.2</td>
<td>6.6</td>
<td>1.5</td>
<td>0.5</td>
</tr>
<tr>
<td>Sub Saharan Africa (SSA)</td>
<td>0.4</td>
<td>1.0</td>
<td>0.2</td>
<td>0.7</td>
<td>0.4</td>
<td>2.5</td>
<td>5.2</td>
</tr>
</tbody>
</table>

Source: UN COMTRADE.

Box table TRADE 2.1

Fragile global economy. Downside risks to the forecasted uptick in global trade activity have not changed over the past six months. Nonetheless, unlike earlier periods where the balance of risks were weighted on the downside, these are now more balanced (see main text). Downside risks continue to include a worsening of conditions in the Euro Area, the possibility that markets react badly to a failure of either the United States or Japan to map out a credible medium-term deficit reduction strategy, a rapid decline in Chinese growth and geopolitical concerns. To these may be added the possibility that high commodity prices, which have supported the value of global trade — if not the volume — could decline rapidly with deleterious consequences for incomes and imports of commodity exporting countries, but benefits for importers.
However, outturns in the global economy, particularly from high-income countries could surprise on the upside, compared to the subdued uptick embedded in our current forecasts (high-income growth of 1.2 percent in 2013 strengthening to 2.3 percent by 2015 – see main text for details). This could arise from another of reasons including the pent-up demand in high-income countries, low levels of inventories, and improved credit flows to real economy in high-income countries. If this were to occur, this would lead to a rapid rise in not only high-income trade but also that of developing country trade than currently embedded in our forecasts.

A rise in protectionism. With unemployment remaining at elevated levels, weak global demand and little progress in multilateral trade talks, the incidence of new restrictive trade measures, while slowing down compared to a year ago, still reveals some worrisome trends. The World Trade Organization reports that in the five months leading to mid-October 2012, an additional 71 new trade restricting or potentially distorting measures were introduced. The most frequent measure used was the initiation of anti-dumping investigations, followed by stringent customs procedures. This represents a decline from the 108 new measures introduced a year ago. Nonetheless, although the pace of imposition of new restrictions dropped, recent experience suggest that, once imposed it is difficult to remove such restrictions, inevitably due to the political constituencies that they build. For instance, only 21 percent of new trade-restricting measures introduced since October 2008 by G-20 countries have been removed, thereby leading to a cumulative increase in the stock of trade restrictions. Indeed on a net basis (i.e. accounting from removal of restrictions), current existing measures imposed by G-20 countries since October 2008, is estimated to affect some 3.5 percent of global trade (as of October 2012), up from 2.9 percent in May 2012.

The resurgence in announced bilateral and regional trade agreements among high-income countries could mitigate the acceleration of developing country trade.

Notable among these are the US-EU free trade agreement and the Trans Pacific Partnership (US and nine other economies, including high-income countries such as Japan, Australia, New Zealand, Singapore and Chile). While bilateral and regional preferential trade agreements have proliferated in past decades, these new accords (if agreed to) are much larger in scope. A trade agreement between the US and the EU alone would be unprecedented in size - accounting for some 40 percent of global trade! Hence were the preferences included in a potential deal between the US and the EU, not extended to other developing countries within the multilateral trading system this could disadvantage developing countries.

A principle concern with agreements is the extent to which non-participant third parties will be affected by trade diversion, potentially leading to a decline in global welfare, even if the agreement benefits the parties to it. Given the size of high-income countries, these potential trade-diverting impacts from preferential trade agreements are further magnified and developing countries are likely to be the losers from such an agreement, were it to be trade-diverting. Hence, efforts to clinch a multilateral deal (Doha Round) will over the long-term maximize global welfare.
Notes

1. The null hypothesis that developing country import volumes do not granger cause high-income export volumes is rejected at 1 percent level, after 3 lags. Similarly the null hypothesis that high-income import volumes do not granger cause developing country export volumes is rejected at 1 percent level, after 4 lags.

References


Kumar, R., and M. Singh (2009). India’s Role in South Asia Trade and Investment Integration.


EXCHANGE RATES
Recent developments

Real exchange rates in high income countries since mid-2012 have been driven mainly by accommodative monetary policies

Policy measures in high income countries designed to restore financial market confidence and support economic growth have played a significant role in movements of trade-weighted real effective exchange rates (REER) of both high income and developing countries in recent months. Among the major high income currencies, the Japanese yen depreciated by a steep 21 percent in real effective terms between September 2012 and April 2013 (figure ExR.1). This depreciation came about as markets reacted to initial announcements of macroeconomic policy changes to raise inflationary expectations and support Japan’s growth. These announcements were followed up by the introduction of an explicit 2 percent inflation target in January 2013, and by a commitment in early April to aggressive monetary easing—including near-zero interest rates and an asset purchase program that would double Japan’s monetary base by the end of two years—in pursuit of that target. Although Japan’s expansionary policies were undertaken primarily for domestic goals, they have contributed to the abovementioned sharp depreciation of its currency. Some possible implications of the large yen depreciation are discussed in box ExR.1.

The appreciation of the euro in trade-weighted real effective terms since mid-2012 (discussed in the January 2013 edition of the Global Economic Prospects report) continued into the first half of 2013, partly because of the Japanese depreciation and partly because financial market tensions remained subdued. By February 2013, the euro had appreciated 9 percent in REER terms from its trough in July 2012. Since February, the continued economic weakness in the Euro Area and uncertainties surrounding Italian elections (February) and Cyprus’ banking sector problems (March) tempered the euro’s earlier appreciation, bringing the total rise since July 2012 to 7.1 percent in REER terms by April 2013.

Despite these large fluctuations, the US dollar has remained broadly stable in real-effective terms — holding approximately the same level in April as in July 2012. In between times, it first depreciated during the second half of 2012, and then rebounded in early 2013 as the yen declined. Since January, the US dollar is up by 2.5 percent in real effective terms.

But recent swings in G3 currencies mask important medium term trends

Notwithstanding its steep depreciation since September 2012, the yen was only 2.3 percent lower in REER terms in April compared with its level in mid-2008 prior to the global financial crisis. And despite its strong appreciation since mid-2012, the euro is 12.7 percent lower (REER terms) than its pre-financial crisis level. By contrast, the US dollar has appreciated 3.1 percent in REER terms since mid-2008. In addition to the effect of the recent yen depreciation, the relative strength of the dollar over the longer period partly reflects the status of the US dollar as a “safe haven” during times of market turmoil and heightened risk aversion, when investors sought the safety of US government bonds and other financial assets.
The yen weakened to a four-year low of 103 against the US dollar in May 2013, depreciating 25 percent from its level in September 2012, mainly in response to announcements of expansionary monetary policies. In trade-weighted real effective (REER) terms, the yen depreciated 21 percent between September and April. Together with gradually strengthening global demand, the weaker yen appears to have halted an earlier slide in Japan’s exports (Japanese exports fell by 24 percent in US dollar terms between June 2012 and January 2013 due to weak global growth and a territorial dispute with China, its largest trade partner). Between January and April, Japanese exports rose 9.5 percent in US dollar terms, while imports contracted 5.8 percent. Japanese GDP accelerated to a 4.1 percent annualized pace in Q1 2013, from 1.2 percent in Q4 2012. Sentiment improved among Japanese automobile manufacturers in the first quarter, in part due to improved prospects for exports.

The above trends are broadly consistent with empirical studies which find that large real exchange rate depreciations tend to stimulate exports, and in turn, economic growth (see, for instance, Hausmann, Pritchett and Rodrik (2005) and Freund and Piterlola (2012) for cross-country evidence, and Thorbecke and Kato (2012) for evidence from Japanese consumption exports). Conversely, Kappler et al. (2012) using a cross-country dataset find that large exchange rate appreciations result in a reduction in real exports and a deterioration of current account balances.

The implications of the large yen depreciation for Japan's trade-partner countries need to be considered with some caveats. The unprecedented monetary easing in the current episode together with fiscal stimulus may raise Japan’s aggregate demand substantially. As income elasticities are typically larger than price sensitivities, in this particular instance, developing-country exporters’ gains from increased import demand from Japan might eventually outweigh the losses associated with the Yen’s (real) depreciation. The effect of the yen depreciation on exports of trade partner countries would also vary depending on the extent of their complementarities and competition with Japanese exports in world markets. For instance, using industry-level data, Li, Liu and Song (2010) find that Japan and China’s export structure tends to be complementary, while Japan and South Korea compete in exports of technology-intensive products. The study found that a real depreciation of the yen had a positive impact on China’s (relatively more labor-intensive) exports, but a negative impact on South Korea’s (relatively more high tech and capital intensive) exports. Moreover, countries that import capital goods or intermediate products from Japan or those that are part of Japanese firms’ regional production chains (e.g., Thailand, Philippines, India) could benefit from a weaker yen through reduced costs of imported inputs. Outward investment flows resulting from Japanese monetary easing may also benefit developing countries (see GEP Finance Annex). Larger and higher productivity firms in trade-partner countries may be able to absorb some of the exchange rate changes in their markups, reducing the sensitivity of their exports to exchange rate movements (see Berman, Martin and Mayer (2012) for evidence from French firm-level data).

Over the longer term, however, the benefits for developing countries are contingent on Japan raising its longer-term potential growth through structural and policy reforms. In the short-term, Japanese quantitative easing could add to the looseness of global monetary condition, through lower global interest rates and potentially strong and disruptive capital flows to developing countries, and could raise overheating pressures, particularly in East Asian countries.

For Japan itself, studies suggest that competitiveness gains from REER depreciation may be temporary and difficult to sustain over time, and may even introduce costly distortions in the real and financial sectors of the economy (Haddad and Pancaro (2010)). Indeed, despite a rise in exports following depreciation episodes in the past, Japan’s share in global trade has declined almost steadily during the last two decades, from over 9 percent in 1991 to 4.6 percent by 2012. Moreover, the eventual adjustment of prices of non-traded goods over time implies that a shift in the monetary policy stance alone cannot be used to sustain a particular real exchange rate that is misaligned with fundamentals (Eichengreen 2008). Overall, the evidence indicates that a real exchange rate depreciation may provide a temporary boost to exports, but structural reforms that bring about sustained improvements in productivity and reduce barriers to trade, investment and labor mobility are likely to play a larger role in a longer-term growth strategy.
Given the protracted debt crisis in the Euro Area during this period and financial market uncertainties, unconventional monetary policies undertaken by the US Federal Reserve in the form of several rounds of quantitative easing may have possibly prevented an even stronger appreciation of the US dollar in REER terms compared with its pre-financial crisis level.FN4

The trend appreciation of developing country currencies has picked up pace since mid-2012

Together with easing of financial market tensions since mid-2012 and the large yen depreciation, the appreciation of developing country currencies picked pace in the second half of 2012 and early 2013. The GDP-weighted average of trade-weighted real effective exchange rates (REER) for developing countries rose by 4.7 percent between September 2012 and April 2013—a significantly faster pace compared with the almost flat trend (0.7 percent annual appreciation) during the previous 24 months (figure ExR.2). The steep appreciation during this recent 7-month period was also faster than the 5.4 percent annual REER appreciation of developing-country currencies observed prior to the financial crisis, between January 2005 and August 2008. The earlier strong appreciation had occurred during a boom in international commodity prices, sustained inflows of foreign capital into developing countries, and a faster pace of growth and higher rate of productivity increases in developing countries compared with high income countries (see Global Economic Prospects July 2012 edition). And prior to that, the average REER for developing-country currencies was broadly unchanged in 2004 compared with its level in 1995.

Notwithstanding the overall REER appreciation in the group of developing countries since the second half of 2012, there was significant variation in the magnitude of, and factors contributing to, currency movements in individual countries. The internationally-traded currencies of typically middle-income emerging market economies were influenced by: movements in high income currencies (in particular, the large yen depreciation); a rebound in private capital inflows to developing countries; elevated international commodity prices; strengthening economic activity and exports in the group of developing countries; and country-specific differences in policies and performance.

The 21 percent REER depreciation of the yen since September 2012 appears to have resulted in significant appreciation pressures in Japan’s trade partners, particularly among countries in the East Asia region. Simulations suggest that in the absence of the steep yen depreciation, on average trade-weighted real effective exchange rates in the East Asia and Pacific region would have appreciated 3.7 percentage points less quickly during this seven-month period (compared to the actual 6.1 percent appreciation), and the average REER for the group of developing-countries would have appreciated 1.7 percentage points less than that observed.

In addition to the yen depreciation, a rebound in private capital flows since the third quarter of 2012 and elevated commodity prices appear to have contributed to

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**Fig ExR.2** A faster appreciation of developing-country real effective exchange rates (REERs) since mid-2012

Real effective exchange rates (January 2005=100)

- Developing Countries
- Europe & Central Asia
- South Asia
- China
- Latin America & Caribbean
- East Asia excl. China

Note: The four developing regions shown in the chart account for close to 90 percent of GDP of developing countries. Sub-Saharan Africa (SSA) and the Middle East and North Africa (MENA) regions are not shown in the chart, but are included in the overall Developing Country aggregate.

appreciation pressures in several emerging market countries. Private capital flows to countries in Europe and Central Asia, East Asia and Pacific, and South Asia have risen robustly since mid-2012 (see GEP Finance Annex). Some studies suggest that surges in capital inflows are likely to be associated with appreciation of real effective exchange rates of recipient countries (see Magud and Sosa (2010) for developing countries, and Jongwanich and Kohpaiboon (2013) for emerging Asia). The average REER appreciation of large emerging economies appears to be positively related with a decline in their sovereign credit default swap (CDS) rates, an indicator of financial risk (figure ExR.3).

International commodity prices strengthened in early 2013 on an improving global outlook, but have eased in more recent months following an improvement in supply conditions (see GEP Commodity Annex). Notwithstanding these shorter-term movements, industrial commodity prices in 2012 and early 2013 were elevated compared to both the immediate post-financial crisis period and the period prior to 2007. Real effective exchange rates of commodity exporters have typically moved together with international commodity prices (figure ExR.4). But they have diverged in the most recent period, with real effective exchange rates appreciating despite the recent easing of commodity prices, suggesting that other factors may be playing a role in buoying these currencies in recent months.

Strengthening global trade since the third quarter of 2012 and a recovery in developing-country exports have also contributed to increased foreign currency revenues in developing countries. However, in a few countries, country-specific factors seem to have been more significant contributors to movements in real effective exchange rates. The factors relevant for different developing countries and regions are discussed below.

Both yen devaluation and robust capital inflows contributed to appreciation pressures in East Asia

East Asian currencies faced significant appreciation pressures from both the large depreciation of the yen as well as from a surge in private capital inflows since the second half of 2012. In inflation-adjusted terms, between September 2012 and April 2013, bilateral real exchange rates of several countries in East Asia appreciated 25-30 percent relative to the Japanese yen, while Thailand’s currency appreciated a larger 34 percent (figure ExR.5). FN5

Because of the relatively large weight (compared with other developing regions) of Japan in their trade, the average GDP-

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Notes: GDP-weighted averages of CDS spreads and REERs for Brazil, Chile, Colombia, Indonesia, Mexico, Malaysia, Peru, Russia, Thailand and Turkey. China is excluded from the chart due its managed exchange rate regime. Source: World Bank; IFS; JP Morgan.
weighted REER for developing countries in the East Asia & Pacific region has appreciated strongly by 6.1 percent since September 2012, versus 3.7 percent for other developing regions. The Thai baht appreciated 12.5 percent in REER terms in this period—as strong capital inflows added to upward pressures from the yen depreciation—while currencies of China and Indonesia appreciated 5.9 and 5.4 percent, respectively. By contrast, the South Korean won appreciated a smaller 3.9 percent in REER terms, in part due to political tensions.

Currencies in Latin America & Caribbean and Eastern Europe & Central Asia were influenced by capital inflows and international commodity prices

In the Latin America & Caribbean region, despite an easing of commodity prices in recent months (although prices remain elevated relative to recent years—see GEP Commodity Annex), several Latin American currencies have appreciated in REER terms since early or mid-2012 (figure ExR.6).\textsuperscript{FN6} The Mexican peso rose 8.3 percent since September 2012 together with an upturn in the United States (Mexico’s largest trading partner) and rising demand for Mexican exports, and strong portfolio inflows into government bonds.

Chile’s currency has risen 6 percent in REER terms since early 2012 as a result of robust commodity revenues and private capital inflows. The Brazilian real rose 7.4 percent in real effective terms since September 2012—after depreciating 12 percent during the previous 1½ years following imposition of capital control measures. The financial transactions tax (IOF) on foreign currency inflows into Brazil’s domestic debt markets was reduced to zero in early June 2013. The challenges that developing-country policymakers face when confronted with surges in capital inflows that result in appreciation of real effective exchange rates, and some of the measures that have been used to alleviate their impacts are discussed in box ExR.2.
How should developing countries react to capital flows-induced real exchange rate appreciation?

The shifts in monetary policy stances in high income countries since the global financial crisis—although designed primarily to support their domestic goals of reviving domestic growth and raising inflationary expectations, rather than facilitate depreciation of their currencies or engage in “competitive devaluation”—have still raised concerns among developing country policymakers about their unintended consequences in the form of surges in private capital flows, real exchange rate appreciation and possible loss of export competitiveness (Eichengreen (2013) and Kappler et al. (2012)). Recent research finds that the direct contribution of quantitative easing measures in the United States on capital flows into emerging market economies was relatively modest (see Fratzscher, Lo Duca, and Straub (2012) and Morgan (2011)). However, other studies suggest that the indirect impact of the extended period of unconventional monetary policies in high income countries in terms of reducing global risk aversion and lowering the cost of capital, together with stronger economic performance of emerging economies, may have been important factors behind surges in capital flows into developing countries in recent years (see, for instance, Ghosh et al. (2012) and Forbes and Warnock (2012)). Cross-country and country-specific studies indicate that these inflows have often been associated with appreciation of realized effective exchange rates in recipient countries (see, for instance, Magud and Sosa (2010), Combes, Kinda and Plane (2011), Jongwanich and Kohpaiboon (2013), and Ibarra (2011)).

The interrelated goals of maintaining exchange rate stability and financial stability and open capital accounts in a situation of unconventional monetary policies in high income countries and abundant global liquidity complicates the task of developing country authorities. For instance, lowering interest rates to discourage foreign inflows may exacerbate existing domestic credit and asset price bubbles and cause overheating in certain sectors. But raising interest rates to curb credit growth can risk attracting even more capital inflows and further appreciate the exchange rate (which, in turn, can attract even more short-term speculative inflows)—with potentially destabilizing consequences for sovereign and firm balance sheets if these flows were to reverse suddenly. Moreover, for countries that have relatively less flexible exchange rate regimes, this lack of exchange rate flexibility can create incentives for taking on foreign debt and thereby increase the share of foreign currency credit in overall credit (Magud, Reinhart, and Vesperoni (2012)). The “impossible trinity” of not being able to achieve all three policy objectives of exchange rate stability, free capital mobility, and an independent monetary policy - and a fourth related objective of financial stability - has sometimes been cited as a reason for developing countries to impose some form of controls on capital flows (see Eizenman (2010)).

Emerging economies faced with disruptive short-term foreign capital inflows (“hot money”) have resorted to various measures to correct the resulting temporary deviation of exchange rates from underlying fundamentals, and to alleviate the impact of these flows on credit markets. These include direct foreign exchange interventions, interest rate policies, prudential regulations (e.g., restrictions on banks’ borrowing from abroad, limits on domestic lending to certain sectors), and various forms of capital controls—such as taxes and fees on capital inflows, minimum holding periods for government bonds, withholding taxes on capital gains, and minimum waiting periods to repatriate capital, among others (see Ostry et al. (2012)). Brazil’s earlier financial transactions tax (IOF) on foreign currency inflows into domestic debt markets is a well-known example (This tax was reduced to zero in early June). Earlier, Thailand had imposed withholding taxes on foreign holdings of government bonds in 2010, while Indonesia had imposed a six-month holding period for central bank bonds and limits on short-term foreign borrowing by banks in 2011 (IMF 2012). Peru’s central bank raised reserve requirements on dollar-denominated deposits several times in 2012 and in the first half of 2013, citing the need to moderate inflows of foreign capital and control credit growth; and intervened in foreign exchange markets in the first half of 2013 to stem appreciation of the sol. Turkey has also used prudential measures, including allowing banks to hold part of their required reserves in foreign exchange, which can alleviate pressures from the foreign exchange market when capital inflows are strong. Colombia intervened periodically in foreign exchange markets during 2012 to moderate the rise of its currency against the US dollar.

The evidence on the effectiveness of controls on volumes of capital flows is however mixed (Magud, Reinhart and Rogoff (2011)), although these measures may alter the composition of inflows (Ostry et al. (2012)). Fratzscher (2012) finds that rather than being motivated by capital flows volatility, capital controls have typically been associated with significantly undervalued exchange rates, in addition to concerns about signs of overheating, such as high credit growth and rising inflation. Nevertheless, when faced with a surge of capital inflows that threaten to overwhelm domestic financial markets and result in asset price volatility and bubbles, credit booms, and real exchange rate appreciation, capital flow management (CFM) measures such as temporary controls on foreign capital, domestic prudential measures, and interventions in foreign exchange markets may reduce exchange rate volatility and provide space for the domestic economy to adjust to the changed external circumstances (IMF (2012)). But if these result in real exchange rates that are persistently out of line with underlying macroeconomic fundamentals in the medium-term, capital controls can cause distortions and suboptimal investment and production decisions across tradable and non-tradable sectors, and impose unnecessary economic costs.
Among developing countries in the Europe & Central Asia region, the Russian ruble appreciated 3.8 percent in REER terms since September 2012 on the back of a surge in syndicated bank lending and buoyant crude oil revenues (figure ExR.6). Notwithstanding weakening GDP growth, the Turkish lira rose 7.1 percent in REER terms in the same period, partly reflecting robust capital inflows and an improvement in its export performance, as robust exports to the Middle East offset weakening demand from the Euro Area. The Turkish lira has exhibited one of the largest appreciation among regional currencies, strengthening by 17 percent in REER terms since January 2012, although it still remains 3 percent below its level in early 2008 prior to the global financial crisis. The Romanian leu appreciated by a strong 10.4 percent in REER terms between September 2012 and April 2013, also reflecting robust inflows into local currency bond markets (see GEP Finance Annex).

Commodity exporting developing countries in the Europe & Central Asia region and in Latin America & Caribbean typically have weaker trade linkages with Japan compared to that of East Asian countries, and were therefore less affected by the yen depreciation.

**Domestic developments played a more significant role in South Africa and India**

Some notable exceptions to the general appreciation trend among developing countries include countries with growth concerns, in particular, South Africa and India (figure ExR.7). Until recently, movements of the rand tended to track closely South Africa’s terms of trade, adjusting flexibly to international commodity price movements (see Global Economic Prospects June 2012 edition), and in turn, facilitating internal economic adjustment. This historical link appears to have been broken in the most recent period, as the rand weakened in REER terms in the second half of 2012 despite a rally in international commodity prices. The rand’s performance was adversely affected by mining sector tensions, a downgrade of South Africa’s sovereign rating, and weak growth in 2012; and by further weakening of activity in the first quarter of 2013. The Indian rupee has also been weak due to slower growth and a widening current account deficit, but stabilized somewhat in REER terms in the second half of 2012 and early 2013, mostly due to robust portfolio inflows after announcement of a number of reforms, including raising limits on foreign direct investment in the retail, broadcasting and aviation sectors.

### Current account balances of developing countries deteriorated and international reserves as a share of imports have fallen

The weak global economy and decline in the pace of expansion in international trade in 2012, together with rebalancing of China towards domestic sources of growth in recent years, have sharply reduced the overall current account balance of developing countries (figure ExR.8). Oil exporters among developing countries gained from...
sustained high international oil prices during 2011-2012 and in early 2013, although a modest 2.5 percent decline in crude prices is projected for the whole year (see GEP Commodity Annex). By contrast, robust domestic demand and high crude oil prices in recent years (up until early 2013) contributed to strains on oil importers’ trade and current accounts balances.

At the same time, developing countries’ holdings of international reserves have declined as a share of imports since 2010 (figure ExR.9). Reserves have fallen the most among oil importers in the Middle East and North Africa region (a decline equivalent to 3.5 months of imports) and in South Asia (decline equivalent to 3.9 months of imports). Reserves in Europe and Central Asia declined to 2.3 months of imports as regional trade and investment was adversely affected by the weakness in Western Europe. The decline in average reserve coverage of imports in other regions is smaller: by 1 month in East Asia and Pacific excluding China, and by 0.3 month in Sub-Saharan Africa. By contrast, international reserves in months of imports remained broadly stable in the Latin America and Caribbean region in this period (rising by 1 month of imports), mainly on the back of strong commodity revenues and robust capital inflows.

Notwithstanding declining import cover across developing regions, reserves still stand well above the critical 3 months of imports in the vast majority of developing countries, with a few exceptions. However, the number of developing countries with reserves equivalent to less than 3 months of imports rose to 17 countries as of April 2013 from 11 in January 2010 (figure ExR.10). For instance, in Egypt and Pakistan, international reserves have fallen below 3 months of imports.

Smaller reserves relative to imports may increase the risk of sudden depreciation of real exchange rates due to shifts in investor sentiment or other external shocks. It should be noted, however, that reserves in months of import cover are a relatively crude measure of reserve adequacy and may need to be complemented with other measures that take into account a country’s overall external financing needs. Moreover, reserve adequacy depends, among other factors, on the exchange rate regime: countries with flexible exchange rates and without the need to defend a particular exchange rate may require a lower reserve coverage of imports.
Conclusions

The weaker current account and reserve position of developing countries can imply increased vulnerability to shifts in investor sentiment. The trade balances and reserve positions of developing countries have started to improve in line with a pickup in exports and easing of international commodity prices. But as discussed, these indicators remain significantly weaker compared with the levels in 2010. Although buoyant private capital flows have helped to finance the larger current account deficits of the group of developing countries excluding China and crude oil exporters, they also render their balance of payments and real exchange rates vulnerable to sudden shifts in investor sentiment and reversal of capital inflows. This can happen, for instance, in response to domestic problems (e.g., weaker than expected growth, recognition of asset price bubbles); increased risk aversion resulting from renewed fiscal and debt tensions in high income countries; or from an unanticipated move towards a tighter monetary policy stance in some high income countries.

Increased coordination on policies affecting currencies can help to mitigate the spillovers of domestic policies across borders. Given that domestic policies of large countries aimed at boosting their own growth can have significant unintended spillovers on currencies of other countries, greater international coordination on policies that affect currencies may prove mutually beneficial (Eichengreen (2013), IMF (2012), Ostry, Ghosh and Korinek (2012), Hoekman (2013); see also the G-7 Statement (2013) and G-20 Communiqué (2013)). For instance, coordination in monetary policies across large economies can ensure that spillovers of domestic policies on other countries and effects on exchange rates are minimized (Basu (2013)).

Developing countries should try to adjust to persistent foreign currency inflows and maintain real exchange rates that are consistent with macroeconomic fundamentals. Maintaining flexible market-determined exchange rates can facilitate adjustment of the domestic economy to changes in capital inflows, commodity revenues, and other external shocks. However, in the shorter term, as discussed earlier, developing countries (including those with sound macroeconomic fundamentals) may face destabilizing currency pressures resulting from surges in capital inflows. In specific circumstances, temporary controls on capital flows and macro-prudential measures may help in reducing exchange rate volatility caused by external events (IMF 2012). But over the longer-term, such controls can cause unnecessary distortions and suboptimal investment and production decisions, especially if they result in real exchange rates that are persistently out of line with underlying macroeconomic fundamentals. Therefore, exchange rate policies and related capital flow management measures should not be seen as a substitute for structural and labor market reforms, and investments in infrastructure and human capital that are necessary to raise productivity and growth over the longer term.
Notes

1. Since the global financial crisis of 2008-09, central banks in the G3 economies (United States, Euro Area, and Japan) have maintained a highly accommodative policy stance—reducing short-term policy interest rates to below 1 percent and implementing unconventional monetary policies, including large-scale financial asset purchases—in order to restore financial market confidence and support economic growth (see GEP Finance and Inflation Annexes).

2. In late July 2012, the head of the European Central Bank Mario Draghi promised to stand behind the currency union after financial market tensions intensified during mid-year. Subsequent measures taken by Euro Area authorities to restore financial market confidence—including, among others, the Outright Monetary Transactions bond purchase program announced in September 2012 and extension of Greek debt in November 2012—resulted in an easing of financial market tensions and reduced the tail risk of exit of periphery countries from the Eurozone. Despite fiscal contraction, accommodative monetary policies in general appear to have contributed to increased market confidence in the ability of the Euro Area currency union to weather negative shocks (see GEP Finance Annex for more details).

3. The extent of complementarity, however, may have declined since the 1997-2004 period covered by the study as China has moved towards production of higher value-added products in recent years. See also Auboin and Ruta (2013) on other studies on the relationship between exchange rates and trade.

4. The US Federal Reserve has undertaken three rounds of quantitative easing (QE) since November 2008. Recent research finds that the dollar weakened significantly in real trade-weighted terms following QE announcements (Glick and Leduc 2013). An unanticipated QE announcement equivalent to a 1 percentage point reduction in federal funds interest rate futures resulted in a 0.5 percentage point depreciation of the dollar in REER terms following the announcement. Fratzscher, Lo Duca, and Straub (2012), however, find that QE1 and QE2 had opposite effects on the US dollar. QE1 measures undertaken in the immediate aftermath of the global financial crisis in late 2008 were associated with inflows into US financial assets, which, in turn, appreciated the US dollar. But QE2 measures implemented from August 2010 onwards triggered a portfolio rebalancing from US financial assets toward emerging market equities, resulting in a marked depreciation of the US dollar.

5. South Korea, Singapore, and Hong Kong SAR, China which are part of geographic East Asia, are considered high income countries according to the World Bank’s income classification, and are therefore not included in the East Asia and Pacific (EAP) regional aggregates.

6. The evidence suggests that the effect of capital flows and commodity revenues on real effective exchange rates of commodity-exporters tends to be larger in countries that are relatively more integrated with international financial markets (see January 2013 edition of the Global Economic Prospects).

References


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COMMODITY MARKETS
Overview

After strengthening in early 2013 due to improved economic outlook, most industrial commodity prices retreated below their end-2012 levels (figure COMM.1). Food prices have been declining as well, mainly a reflection of improved supply conditions (figure COMM.2). The price of crude oil (World Bank average) dropped to US$ 99/bbl in April, 8 percent below its February peak. The metal price index is down 13 percent since its February 2013 peak. Precious metals are down as well, 15 percent since February and more than 25 percent since the all time high of August 2011.

In the baseline scenario, which assumes no major macroeconomic shocks or supply disruptions, oil prices are expected to average US$ 102/bbl in 2013, down from US$ 105/bbl in 2012 (table COMM.1). Agricultural prices are projected to decline almost 6 percent in 2013 (food, beverages, and raw materials down by 5.5, 8.9, and 5.8 percent, respectively), under the assumption of average crops. Metal prices will to decline marginally (a little more than 1 percent) and therefore will remain 17 percent lower than their 2011 average. Fertilizer prices are expected to decline more than 7 percent, mainly reflecting low natural gas prices in the United States. Precious metals prices are expected to decline more than 10 percent as institutional investors are increasingly considering them less attractive “safe haven” alternatives, which comes on top of weak physical demand.

There are a number of risks to the baseline forecasts. Downside risks include weak oil demand if growth prospects deteriorate sharply, especially in emerging economies where most of the demand growth is taking place. Over the longer term, oil demand could be dampened further if the substitution between crude oil and other types of energy accelerates. On the upside, a major oil supply disruption due to political turmoil in the Middle-East could result in prices spiking by $50 or more. The severity of the outcome would depend on numerous factors, including the severity and duration of the cutoff, policy actions regarding emergency oil reserves, demand curtailment, and OPEC’s response.

A key uncertainty in the outlook is how OPEC (notably, Saudi Arabia) reacts to changing global demand and non-OPEC supply conditions. Since 2004 when crude oil prices started rising, OPEC has responded to subsequent price weakness by cutting supply, but has not been as willing to intervene when prices increase. However, as non-OPEC supplies continue to come on stream and demand moderates in response to higher prices, the sustainability of this approach may come under pressure.

OPEC’s spare capacity has averaged 4.6 mb/d during the first four months of 2013, almost 30 percent higher than a year ago but only marginally higher than average of the past decade—it had dropped below 2 mb/d in the middle of 2008 when oil prices reached US$ 140/bbl. OECD in-
ventories averaged 2.7 mbd during the first five months of 2013, remarkably similar to the corresponding period in 2012.

Price risks on raw materials, especially metals, depend both on the speed at which new supply comes on stream and on China’s growth prospects. Metal prices have declined 30 percent since their early 2011 highs, and by 8 percent between February and May 2013. The price weakness reflects both moderate demand growth and strong supply response, in turn a result of increased investments of the past few years, induced by high prices. For some metals, stocks have increased considerably as well. For example, combined copper stocks at the major metals exchanges are up 46 percent since 2012. Aluminum stocks, which have been rising since end-2010, increased 8 during the past 12 months.

The prospects for the metal market depend importantly on Chinese demand, as the country accounts for almost 45 percent of global metal consumption. However, if robust supply trends continue and weaker than anticipated demand growth materializes, metal prices could follow a path considerably lower than our baseline, with significant consequences for metal exporters (see simulations in main text).

In agricultural commodity markets, the key risk is weather. According to the global crop outlook assessment released by the US Department of Agriculture in May 2013, the global maize market will be better supplied in the coming, 2013/14, season. However, because stocks are still low by historical standards, any adverse weather event could induce sharp increases in maize prices—as it did in the summer of 2012 when maize prices rallied almost 40 percent in less than two months. The wheat market, which is currently better supplied than maize, could also come under pressure either due to a bad crop or in sympathy with higher maize prices—as the crops are competing for the same land. In contrast, price risks for rice are on the downside, especially in view of the large public stocks held by Thailand. Edible oil and oilseed markets have limited upside price risks as well due to well supplied oilseed (mostly soybeans in South America) and edible oil (primarily palm oil in East Asia) markets. Global supplies of the major 8 edible oils are expected to reach a record 155 million tons this season, up from last season’s 152 million tons. Global oilseed supplies will experience similar growth.

Trade policy risks (similar to 2008 and 2010) appear to be low as evidenced by the virtual absence of export restrictions since the summer of 2012, despite sharp increases in grain prices. Finally, growth in the production of biofuels is slowing as policymakers increasingly realize that the environmental and energy independence benefits from biofuels are not as large as initially believed.
Crude oil

Oil prices have fluctuated within a remarkably tight band around US$ 105/bbl (figure COMM.3) over the past 18 months. Fluctuations have been driven mainly by the geopolitical concerns in the Middle East on the supply side and European debt issues along with changing developing-country growth prospects on the demand side. Price increases earlier in 2013 reflected some geopolitical tensions in the Middle East and improving global outlook prospects. However, as supply conditions improved and market concerns over the Euro Area eased once again, crude prices began weakening. And they are now 5 percent lower than at the beginning of the year.

Recent Developments

Large supplies of Canadian crude oil (especially from tar sands) to the United States, combined with rapidly rising U.S. shale liquids production have contributed to a build-up of stocks at a time when U.S. oil consumption is dropping and natural gas supplies are increasing rapidly.

Although the price of Brent crude (the international marker) topped US$ 117/bbl in February, West Texas Intermediate (WTI, the U.S. mid-continent price) averaged US$ 21/bbl less due to the large built up of stocks at Cushing, Oklahoma, the delivery point of WTI. The Brent-WTI price differential declined to less than 10 percent in May, nine percentage points lower compared to the January 2011-May 2013 average of 17.7 percent and the lowest since January 2011 (figure COMM. 4).

Downward pressures on mid-continental prices have eased, partly in response to some 760 thousand barrels a day in rail shipments in 2013Q1 from oil producing regions to refineries—an 8-fold increase from 90,000 barrels per day in 2011Q1—according to the June 2013 assessment by the Association of American Railroads. Downward pressures on West-Texas crude will abate further when the new pipelines to the U.S. Gulf become operational or reversal of existing pipelines that carry oil from the East Coast to Mid-Continent U.S. are completed—currently expected some time in late 2014 or early 2015.

The decline in non-OPEC output growth in 2011 appears to have reversed. Non-OPEC producers added 0.7 mb/d to global supplies in 2012 and an additional 0.5 mb/d in 2013Q1, mainly reflecting earlier large-scale investments. In the United States horizontal drilling and hydraulic fracturing have contributed almost 1.5 mb/d of crude oil production during the two years since 2011Q1 (figure COMM.5). Currently, the U.S. States of Texas and North Dakota, where most of shale oil production takes place account for almost 45 percent of total U.S. crude oil supplies, up from 33 percent a year earlier. Indeed, the IEA projects that global crude oil supply will increase by 8.4 mb/d by 2018 up 5 percent from the 91 mb/d in 2012. The increase mainly reflects surging North American crude
output (2.3 mb/d from US “light tight oil”, which includes production from shale, and 1.3 mb/d from Canada’s oil sands).

Although shale liquid (also referred to as tight oil) and shale gas techniques have great potential to be applied worldwide, there are public concerns regarding the ecological impacts of such technologies. In addition, several countries that are believed to have similar reserves to those in the United States may be slow to utilize that potential due to difficulties in accessing drilling rights, poor regulatory frameworks, and limited “know-how” in exploring and developing the resources.

Oil production among OPEC member countries averaged 36.9 mb/d in 2013Q1, down from previous quarter’s 37.2 mb/d. Yet, this is 10 mb/d higher than 2002Q2, the lowest of the Organization’s recent history but still higher than the official 30 mb/d quota. Iraq—still outside OPEC’s quota—has reached pre-war levels of production, currently standing slightly over 3 mb/d. Libya’s oil output is about 80 percent of pre-war levels of 1.4 mb/d. Iran’s oil exports were 0.8 mb/d in April, a decline of 60 percent since June 2011 when sanctions took effect, and may tumble even further as new sanctions take effect from July 2013.

The post-2010 net growth in OPEC oil production reduced spare capacity among its member countries from 6.3 mb/d in 2009Q4 to 3.1 mb/d in 2012Q2, a 50 percent decline (figure COMM.6). However, OPEC’s spare capacity reversed the downward trend, standing at 4.6 mb/d during the first 4 months of 2013, of which nearly two thirds is in Saudi Arabia. The Saudi government has promised to keep the global market well supplied (and has the ability to do so), but also deems US$ 100/bbl to be a fair price.

According to IEA, spare capacity in the global oil market is expected to rise to more than 7 mb/d in 2014, almost three times higher than the 1.5-3.0 mb/d range between 2004 and 2008. It should then begin to decline by 2016 as growth in the United States will slow while demand growth remains firm.

World oil demand increased modestly, a little more than 1 percent, or 0.9 mb/d in 2012 (figure COMM.7). Japan is the only OECD economy for which crude oil consumption increased (by 1 mb/d) in 2012. Most of that
increase was to fill the loss of nuclear power generation capacity as a result of the Tohoku earthquake. Oil consumption among OECD countries has fallen by almost 5 mb/d, or 10 percent, from its 2005 peak. Non-OECD demand remains robust. In fact, non-OECD economies are expected to consume more oil than OECD economies during 2013Q2, for the first time in history (44.5 mb/d the former versus 45 mb/d the latter). IEA expects non-OECD demand to reach 54 percent of global demand by 2018.

**Outlook and Risks in the Oil Market**

Nominal oil prices are expected to average US$ 102/bbl during 2013 and decline to US$ 101/bbl in 2014. Over the longer term, oil prices are projected to fall in real terms, due to growing supplies of conventional and (especially) unconventional oil, efficiency gains, and substitution away from oil (box COMM.1 discusses the substitution possibilities between oil and other types of energy). The assumptions underpinning these projections reflect the upper-end cost of developing additional oil capacity, notably from oil sands in Canada, currently assessed by the industry at about US$ 80/bbl in constant 2013 dollars. While it is expected that OPEC will continue to limit production to keep prices relatively high, the Organization is also sensitive to letting prices rise too high, for fear of inducing innovations that would alter fundamentally the long term path of oil prices.

World demand is expected to grow at less than 1.5 percent annually over the projection period, with all the growth coming from non-OECD countries as has been the case in recent years (figure COMM.8). Growth in oil consumption among OECD countries is expected to continue to be subdued due to low growth, and efficiency improvements in vehicle transport induced by high prices—including a gradual switch to hybrid, natural gas and electrically powered transport. Pressures to reduce emissions due to environmental concerns are expected to further dampen oil growth demand at global level.

Growth in oil consumption in developing countries, on the other hand, is expected to remain relatively strong in the near and medium term. In the longer-term, however, it is expected to moderate as the share of low-energy using services in these economies grow, subsidies are phased out, and (as noted above) other fuels become incorporated into the energy mix.

On the supply side, non-OPEC oil production is expected to continue its upward climb, as high prices have prompted higher levels of exploration (including deep water offshore and shale liquids) and the implementation of new extractive technologies to increase the output from existing wells (figure COMM.9). Significant production increases are expected in Brazil, the Caspian, and West Africa, which together with the United States and Canada are likely to more than offset declines in mature areas such as the North Sea.
Until the mid-2000s, the prices of the world’s key natural gas markets (U.S., Europe, and Japan) had been tied to oil prices. Thus, in addition to moving in a synchronous manner with each other and with oil, both natural gas and oil were priced the similar levels in terms of energy content. In other words, natural gas and crude oil markets were integrated—though due to administered pricing mechanisms, not market forces. Coal, which has been priced independently, was traded about one third the price of oil, in energy equivalent terms (figure Box COMM. 1.1).

The energy price boom of the early 2000s changed all that. First, it delinked U.S. natural gas prices from oil prices and from European and Japanese natural gas prices. Second, it generated a gap between WTI (the mid-Continent US price) and Brent (the international marker). Third, it linked US natural gas and coal prices. This box elaborates on the reasons behind such changing patterns and concludes the following. The WTI-Brent gap will close soon, perhaps as early as 2014 or 2015 at the latest. The coupling of U.S. natural gas and coal prices is likely to remain (and, perhaps, strengthen). Natural gas price convergence will depend on various investment and policy factors, thus it may take some time before it materializes. Yet, the future relationship between natural gas and oil prices is more complex to analyze. It will depend on whether induced innovation takes place—something that cannot be evaluated or projected.

Induced innovation in the extraction of natural gas through fracking and horizontal drilling techniques (often referred to as “unconventional” gas), primarily in the U.S. was followed by supply increases in turn lowering US natural gas prices. Low gas prices made it an attractive alternative to some U.S. energy intensive industries, especially electricity generation, which are gradually switching from coal to natural gas. Indeed, the US has experienced a marked reduction in coal use, 10.5 percent down from 2006-08 to 2009-11, when global consumption increased 9 percent. As a result, beginning in 2009 US natural gas and coal have been traded at similar price levels in energy equivalent terms but they diverged from European natural gas and Japanese liquefied natural gas (LNG) prices (figure Box COMM 1.2).

Will natural gas prices converge? There are numerous market (both demand and supply) and policy constraints, the removal of which is likely to induce coupling of natural gas prices in the longer term.

- **Supply**—Increased unconventional gas supplies outside the U.S. Unconventional gas production has taken place almost exclusively in the United States. Yet, unconventional natural gas reserves, are plentiful in many regions, including North America, Latin America, and most importantly Asia Pacific. Industry estimates show that more than 40 percent of known global natural gas reserves are recoverable at current prices and technology are unconventional. Reasons for the slow technology adoption include poor property rights, limited know-how, and environmental concerns.

- **Trade**—Construction of LNG facilities and gas pipelines. Currently, 31 percent of natural gas crosses international borders—21 percent through pipelines and 10 percent in LNG form (by comparison, nearly two thirds of crude oil is traded internationally, 46 percent as oil and 20 percent as products.) As more LNG facilities come on board and new gas pipelines are constructed, trade of natural gas will increase, thus exerting upward (downward) price pressure in producing (consuming) regions. Nevertheless, it should be noted that regardless of how much natural gas trade increases, LNG will be traded at much higher prices than gas through pipelines because of the high costs of liquefying and transporting.

- **Demand**—Relocation of energy intensive industries. In addition to the substitution from coal to natural gas by the energy intensive industries in the U.S., there is evidence that industries are moving to the United States to take advantage of the “natural gas dividend”, in a way reversing the long standing trend of U.S. industries moving to Asia (and elsewhere) in response to the “labor cost dividend.” Four energy-intensive industries that are taking (or

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**Box figure COMM. 1.1 Energy prices**


**Box figure COMM. 1.2 Natural gas prices**

will take) advantage of lower energy prices in the U.S. are paper, aluminum, steel, and chemicals, whose energy costs as a share of total material costs ranges between 5 and 9 percent (the share for total US manufacturing is 3 percent, 4-5 times more energy intensive than agriculture, see box COMM.3).

- **Substitute product—Coal.** More trade in coal is likely to take place, thus further facilitating convergence of natural gas prices and also strengthening the convergence of coal and natural gas prices, already underway. Indeed, between 2005 and 2012 global coal exports almost tripled (from 258 to 758 million tons) pushing coal traded as a share of production to almost 15 percent. Furthermore, anecdotal evidence points to even further increases. For example, a recent article (“Tata Eyes Coal Assets Freed by Global Fracking Boom”, Bloomberg, April 30, 2013) noted that Tata Power, India’s second largest electricity producer, is seeking coal supplies from the U.S., Colombia, and Canada (they account for 13.9, 1.5, and 0.9 percent of global coal production; China’s share is 50 percent).

- **Policies—US energy exports, nuclear energy, property rights.** Three types of policies are expected to increase trade in natural gas and, consequently, price convergence. First, the U.S. is gradually removing restrictions on energy exports, most of which were introduced after the oil crisis of the 1970s in response to energy security concerns. Second, several countries are reconsidering nuclear energy policies, especially after the Tohoku accident; some plan not to replace aging nuclear power units while others contemplate early decommissioning. Thus, nuclear power’s diminishing contribution to global energy consumption—which has already declined from its 2001 peak of 6.4 percent to 4.9 percent in 2011—will be substituted by coal, natural gas, and to a lesser extent renewables (see table COMM 1.1 for historical and current energy consumption shares). Third, countries with large unconventional reserves are likely to introduce policies to strengthen property rights, a key reason for not developing them.

Subsequent to the natural gas boom, fracking and horizontal drilling were applied to the US oil sector, which, as expected, induced similar supply response. These oil supplies along with increasing crude inflows from Canadian oil sands caused decoupling of WTI from Brent with the latter being traded 18 percent above the former after January 2011 (figure Box COMM.1.3). Historically (1983-2005), WTI was traded with a 6 percent premium over Brent, because the mid- Continent US was a “deficit” region. Following increased imports from Canadian oil sands during 2006-10, WTI and Brent were traded in par. After January 2011, however, Brent has been traded with a premium over WTI following increased domestic shale oil supplies—it averaged 18 percent between January 2011 and May 2013. The premium may persist for another two years, until a new pipeline begins transferring surplus oil from Cushing, Oklahoma to the US Gulf (some oil is currently moving by truck and rail). The WTI discount is likely to stabilize around 5 percent, (a mirror image of the pre-2006 premium) when the market reaches equilibrium—oil supply in the mid- Continent US exceeds demand and the surplus moves to the Gulf at the lowest possible cost.

What about convergence of natural gas and oil prices? Because more than half of global crude oil supplies go to the transportation industry, the prospects of substitutability between crude oil and other types of energy will depend on the degree to which vehicles can switch from crude oil-base fuels to natural gas or electricity. As discussed in the January 2013 edition of Global Economic Prospects: Commodity Market Outlook (p. 7, box 1), contrary to natural gas, crude oil products have convenient distribution networks and refueling stations that can be reached by cars virtually everywhere in the world. Thus, in order for the transport industry to utilize natural gas at a scale large enough to make a dent in the crude oil market, innovations must take place such that the distribution and refueling costs of natural gas become comparable to those of crude oil. The second alternative, electricity, has its own drawbacks, namely, storage capacity and refueling time. Consider that a truck with a net weight capacity of 40,000 pounds were to be powered by lithium-sulphur batteries for a 500-mile range, the batteries would occupy almost 85 percent of the truck’s net capacity, leaving only 6,000 pounds of commercial space. Hence, as was the case in natural gas, for large scale electricity use by vehicles, innovation in battery technology must take place.

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**Box figure COMM. 1.3 Brent and WTI prices**

**Box table COMM 1.1 Shares of global primary energy consumption (percent)**

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<tr>
<th>Year</th>
<th>Oil</th>
<th>Gas</th>
<th>Coal</th>
<th>Nuclear</th>
<th>Hydro</th>
<th>Other</th>
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<td>1965-69</td>
<td>42.6</td>
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<td>2.1</td>
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<td>3.7</td>
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<td>1985-89</td>
<td>39.0</td>
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<td>28.2</td>
<td>3.5</td>
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<td>6.4</td>
<td>1.6</td>
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</table>

Source: BP Statistical Review.

Note (1): “Other” includes biofuels, solar, wind, geothermal, and biomass.

Note (2): The shares were calculated in oil equivalent terms.
Metals

Following the post-2008 financial crisis collapse, metal prices regained strength and increased almost continuously to reach new highs in February 2011 when the World Bank price index reached 229 (2005 = 100), up 164 percent since its December 2008 low (figure COMM.10). This increase (along with the sustained increases prior to the financial crisis) generated large new investments inducing a strong supply response.

Most of the additional metal supply went to meet demand from China, whose consumption share of world refined metals reached 44.2 percent at the end of 2012, up from 42 percent in the previous year (figure COMM.11). Metal prices, however, have been weakening since 2011. This decline along with the drop in energy prices and (an even sharper) decline in precious metal prices has prompted economists and analysts to argue that the so-called commodity super cycle may be coming to an end (see box COMM.2 for a discussion on super cycle and how it relates to global metals reserves).

Recent Developments

**Aluminum** demand increased by 6.8 percent in 2012 according to World Bureau of Metal Statistics (WBMS), led for the second year by double digit demand growth in China (15 percent) and a 7.5 percent increase in Indian demand. Consumption contracted in European Union (7.7 percent) and Brazil (5.2 percent) on the back of continued economic weakness. Aluminum consumption continues to benefit from substitution away from copper, mainly in the wiring and cable sectors (copper prices are now more than four times higher than aluminum prices, whereas the two were similar prior to the 2005 boom). Substitution is expected to continue for as long as the aluminum prices remain twice as high as copper prices, according to industry analysts.

Aluminum supply was up marginally by 3.2 percent, down from 7.5 percent growth in 2011. Output was constrained by high energy costs, which account for nearly 40 percent of total production costs. Supply growth is coming from countries with abundant (or, often, subsidized) energy, including China (up 12 percent), United States (up 4.4 percent), and United Arab Emirates (up 6.2 percent). Nevertheless, aluminum production has declined sharply in the European Union (down 19 percent) on environmental pressures and adverse economic developments, Canada (down 6.9 percent) due to labor disputes. Brazil and Russia have experienced marginal declines as well. Aluminum stocks at the London and Shanghai exchanges (combined) are up 8 percent for the year (end-May 2013/end-May 2012). Stocks have been rising for some time, and are currently (May 2013) 20 percent higher than their end-2010 levels. However, significant amount of aluminum inventories are tied up in warehouse financing deals and unavailable to the market.

**Copper** demand expanded by 4.7 percent in 2012, up from 1.4 percent the year before, according to WMBS data with China’s apparent demand...
increasing 11.7 percent, up from 7.2 in 2011. However, it is unclear how much of this demand increase was due to stock build-up and how much was actually consumed. Estimates of stock build-up in Chinese bonded warehouses indicate an increase of more than 160 percent in 2012 to some 850,000 tons. Elsewhere, demand for copper has recovered, including Brazil (up 8.6 percent) after declining the previous year, Mexico (up 20 percent), and the United States (up 3.3 percent). Demand was especially weak in the European Union (down 7.7 percent) and Japan (down 1.3 percent).

Supply of refined copper continued to expand at a modest 2.9 percent pace in 2012, down from 3.2 percent increase in 2011. However, output of mined copper rose 4.4 percent in 2012, up from 1.2 percent growth during 2009-2011. High copper prices have induced a wave of new mines and expansions of existing ones that are expected to come on-stream soon. For example, Escondida in Chile, the world’s largest copper mine, is on track to increase its production by 20 percent in 2013. Mined copper output rose 7.1 percent in Africa in 2012, with several mines coming on stream in Zambia and the Democratic Republic of Congo. The Oyu Tolgoi mine in Mongolia began production in 2013 and is expected to be one of the top five producing copper mines in the World and increase that country’s production capacity four-fold. Copper stocks at the London, New York and Shanghai exchanges (combined) are up 95 percent in May 2013 compared to a year ago.

Nickel demand expanded 6.1 percent in 2012, down from 17 percent growth in 2011. The sharpest decline was in China, where apparent demand rose 17.4 percent, versus 46 percent in 2011. China now accounts for 40 percent of global stainless steel production (a major source of nickel demand), up from 4 percent a decade ago. Demand contracted in most high income countries, including the EU (down 8 percent) and Japan (down 8.3 percent) and the US (down 6.2 percent).

Nickel supply grew by 13 percent in 2012, a second year of double digit growth, slightly down from 16 percent growth in 2013. A wave of new nickel mine capacity is likely to keep nickel prices close to marginal production costs. Several new projects will soon ramp up production, including Australia, Brazil, Madagascar, New Caledonia, and Papua New Guinea. Another major global source of nickel is Nickel Pig Iron (NPI) in China, which sources low-grade nickel ore from Indonesia and the Philippines. China’s production capacity may soon be constrained, though, given that Indonesia has announced that it will develop its own NPI industry and has introduced export quotas and may ban nickel ore exports by end-2013. Nickel stock were built up during 2012 as supplies exceeded the consumption—LME stocks were 68 percent in May 2013 compared to a year ago.

Outlook and Risks in Metal Markets

Metal prices are expected to experience a modest decline in 2013, which will come on the top of the 15 percent decline experienced last year. Aluminum prices are expected to decline marginally in 2013 and following and upward trend thereafter in response to rising power costs and the fact that current prices have pushed some producers at or below production costs. Nickel prices are expected to decline 3 percent in 2013, and to follow a slightly upward trend thereafter. Although there are no physical constraints in these metal markets, there are a number of factors that could push prices even higher over the forecast period, including declining ore grades, environmental issues, and rising energy costs. On the contrary, copper prices are expected to decline almost 7 percent in 2013 with more declines in the subsequent years, mostly due to substitution pressures and slowing demand. Over the medium term, stainless steel demand is expected to remain robust, growing by more than 6 percent annually, mainly driven by high-grade consumer applications, as emerging economies are increasingly mimicking consumption patterns of high income countries.

Most of the risks on metal prices are on the downside, especially weakening of China. As discussed in the main text, if metal prices decline sharply (say, 20 percent over the course of next year, relative to the baseline), while it will not have much of an impact of global GDP, the decline will impact metal exporting countries, especially Sub-Saharan African metal exporters, whose GDP and fiscal balance may decline as much as 0.7 and 1 percent, respectively, compared to the baseline.
Box COMM.2  Global reserves, demand growth, and the “super-cycle” hypothesis

In 1990, the world consumed less than 43 million tons of metals. In 2012 it consumed 91 million tons. All this growth was driven by China—in 1990 China accounted for a mere 4 percent of global consumption; today it accounts for almost 45 percent. In 1990, the world consumed 66 million barrels of oil per day (mb/d), 37 percent of which was consumed by OECD economies. In 2012, it exceeded 90 mb/d, half of which is consumed by non-OECD economies. Despite these strong consumption growth patterns, this box shows that the assumed resource depletion that has occupied headlines often is less of an issue now than it used to be. Nevertheless, problems exist, including environmental concerns, concentration of resources, and the high cost of extracting such resources.

Metal consumption by China during the past decade has been so strong that it reversed the downward trend of global metal intensity (that is, metal consumption per unit of GDP), a turnaround that continues today. Thus, metal intensity now is the same as it was the early 1970s—on the contrary, food and energy intensities have continued their long term downward trend. On the other hand, despite the strong demand growth of oil by non-OECD economies, they still consume 2.6 barrels per year on a per capita basis, as opposed to 13.7 by OECD economies.

The strong growth in consumption of industrial commodities by emerging economies along with the likelihood that they will sustain high growth rates, inevitably raises the issue of resource depletion. The issue of non-adequacy of resources to sustain projected population and income growth rates has been debated frequently, especially in periods of high prices. Examples include the peak oil hypothesis for crude oil reserves and the Club of Rome arguments regarding food supplies (Meadows and others 1972).

Based on US Geological Survey data, figure COMM 2.1 reports global reserves for two ores (bauxite, iron ore), five base metals (nickel, copper, zinc, lead, tin), and two precious metals (gold, silver). The reserves are expressed in terms of years of current production (the so-called reserves-to-production ratio, R/P), evaluated at two 2-year periods (2000-01 and 2010-11) spanning the recent price and consumption boom. (According to the U.S. Geological Survey, reserves refer to the part of the reserve base which could be economically extracted or produced at the time of determination but does not imply that extraction facilities are in place and operative).

Numerous stylized facts emerge from the analysis. First, the R/P ratios for various metals paint a mixed picture regarding resource scarcity. Specifically, the ratio increased in three of the nine cases: nickel (from 43 to 46 years), copper (from 26 to 41), and silver (from 16 to 22). It did not experience any appreciable change for gold and zinc but declined marginally for lead (from 21 to 19 years). Yet, three metals exhibited significant declines: Tin (from 34 to 19 years), iron ore (from 136 to 65 years), and bauxite (from 180 to 133). Second, the declines in the R/P ratios reflect increased production, not declining reserves. In fact, with the single exception of tin (whose reserves declined nearly 40 percent during the 10-year period under consideration) and gold (where reserves increased only 4 percent), reserves increased between 16 percent (bauxite) and 94 percent (copper). Third, the two largest declines in the R/P ratio—iron ore, down by 71 years, and bauxite, down by 47 years—took place in markets where the respective metals are relatively abundant, hence less of a need to invest in exploration and development activities. Thus, of the nine metals examined here, tin appears to be the only reserve-constrained commodity.

Box Fig COMM 2.1  Global metal reserves

Box Fig COMM 2.2  Global oil and gas reserves

What about energy? Figure COMM. 2.2 depicts R/P ratios for natural gas and crude oil between 1980 and 2011. In both markets the ratios have been increasing, a significant 3.1 percent per annum for crude oil and a marginal 0.4 percent for natural gas. In fact, the R/P ratio for crude oil exceeded 54 years in 2011 for the first time. (According to BP, “reserves” are generally taken to be those quantities that geological and engineering information indicates with reasonable certainty can be recovered in the future.
from known reservoirs under existing economic and operating conditions.

The increases of crude oil reserves during the 1980s is due to additions by OPEC members. The 1999 uptick reflects the addition of 120 billion barrels from Canada’s oil sands (equivalent to 4 years of current global consumption) while during the mid-2000s global reserves increased due to Venezuela’s Orinoco Belt oil, currently estimated at 220 billion barrels (7 years of global consumption). The R/P ratios for both crude oil and natural gas are likely to increase enormously when the unconventional reserves are added in the economically recoverable resource pool. Indeed, industry experts have noted that when all global recoverable reserves are considered, the world may have as much as 2 centuries worth of natural gas, evaluated at current consumption rates, prices, and technology.

While adequacy of reserves per se does not seem to be a problem, at least in the foreseeable future, there are several issues of concern, including environmental issues, concentration of ownership, further demand strengthening, and increasing extractions costs. First, by their very nature, extraction of these resources may be associated with environmental issues, such as contamination of ground water resources or concerns that excessive fracking may be linked to increasing frequency of earthquake activity.

Second, as we move forward, the reserves will become more concentrated. For example, currently OPEC accounts for more than 72 percent of oil reserves, nearly half of which are located in Saudi Arabia and Venezuela. Natural gas reserves are concentrated as well, with the Russian Federation and Turkmenistan accounting for over one third and Iran and Qatar accounting for nearly 28 percent. (The Herfindahl concentration indices for crude oil and natural gas reserves were 9.8 and 10.7 percent in 2011.)

Third, extracting these resources is becoming increasingly costly. For example, the marginal cost of oil is currently estimated at US$80/bbl for Canadian oil sands (this cost forms the basis for the World Bank’s long term oil price assumptions).

Last, a key issue on resource adequacy and prices will be the strength of demand. The future of metal markets will depend on the metal intensity of Chinese economy. Oil consumption will depend on demand by emerging economies and whether their energy intensities emulate that of high income countries. Consider, for example, that in per capita terms, OECD countries consume 5 times more crude oil than non-OECD countries or more strikingly, the U.S. consumes 23 times more oil than India (figure COMM 2.3).

Many observers (see, for example, Heap 2005) looking at the extremely robust demand for metals, and the rapidly rising metals intensity of the Chinese economy, as well as the strong oil demand by emerging economies, argued that these commodities go through a super cycle where prices are likely to stay high for an extended period of time. The so-called “super cycle hypothesis” has been empirically verified for a number of metals (Jerrett and Cuddington 2008). Super-cycles of this nature, especially for extractive commodities, have taken place in the past rather infrequently (for example, during the industrial revolution in the United Kingdom, and the westward expansion of the late 1800s/early 1900s in the United States). Erten and Ocampo (2012) identified four such super cycles in real prices of agriculture, metals, and crude oil during 1865-2009; the length of the cycles ranged between 30-40 years with amplitudes 20-40 percent higher or lower than the long run trend (similar estimates have been given by Cuddington and Zellou (2013) for metals.) Furthermore, the mean of each super-cycle was lower than for the previous cycle, thus supporting the view that nominal prices of primary commodities grow at a lower rate than nominal prices of manufacturing commodities (Prebisch-Singer hypothesis).

Indeed, energy and metal prices (expressed as ratio to manufacturing prices) experienced the largest and longest boom since WWII (figure COMM 2.4). While most of the conditions behind the post-2004 price boom are still in place, there are signs that some conditions may be easing. Perhaps, the 2008 and 2011 twin peaks of commodity prices marked the beginning of the end of the current super cycle. If so, the current super-cycle will be much shorter than previous ones. But, it is too early to tell.

Box Fig COMM 2.3 Per capita oil consumption

Source: BP Statistical Review; UN; OECD; Eurostat.

Box Fig COMM 2.4 Commodity prices, MUV-deflated

Precious Metals

Following 18 months of relative stability, precious metals prices declined sharply during 2013Q2—the World Bank metal price index declined 20 percent in the past 6 months (figure COMM.12). The decline marked a reversal of eleven straight years of increasing prices precious metal prices. The price drop reflects changing perceptions of global risk, given gold’s status as a “safe-haven” investment asset. Holdings of gold by EFTs are down more than 18 percent for the year. In contrast, holdings of silver and platinum are up, 12 and 32 percent respectively by end-May 2013.

High gold prices have attracted considerable investment in the gold mining industry, for both existing and new mines. China has announced a new production target of 450 tons per year by 2015, up from 400 tons in 2012 when output grew 12 percent. Production in South Africa declined 13 percent in 2012, in what might signal a long-term decline as it was a fourth consecutive annual decline—although it also reflected very serious labor disputes in late 2012, which disrupted production of both gold and platinum.

The precious metal index is expected to decline almost 11 percent in 2013 (gold, silver, and platinum down by 10, 13, and 3 percent). Most risks are on the downside due to supply improvements, even as the pace of global recovery improves, including easing of financial tensions in Europe.

Fertilizers

Fertilizer prices, a key input to the production of most agricultural commodities especially grains and oilseeds, experienced a 5-fold increase between 2003 and 2008, the largest increase among all key commodity groups (figure COMM.13). In addition to strong demand, the price hikes reflected increases in energy prices, especially natural gas—some fertilizers are made directly out of natural gas. Indeed, fertilizer prices are now three time higher than a decade ago, remarkably similar to the 3-fold increase in energy prices.

Most recently fertilizer prices have been easing. The World Bank’s fertilizer index declined 4 percent in 2013Q1 after declining 3 percent in 2012. The declines were more pronounced in potassium and phosphate, each 8 percent down. Other types of fertilizers changed only marginally. Weak demand, especially by India and China has been the key factor behind the weakness (demand by the US and Latina America has been strong).

Fertilizer prices are expected to ease considerably in the medium term; more than 7 percent in 2013 and another 5 percent in the next two years—primarily reflecting lower production costs due to the projected moderation of natural gas prices as well a number of projects coming on-stream, especially in the United Arab Emirates and the Former Soviet Union, both important natural gas producers.
Agriculture

With the exception of grains, most agricultural prices have been declining almost continuously since their early 2011 peaks (figure COMM.14). Beverages and raw materials are down 32 and 35 percent, respectively between their February 2011 peaks and May 2013. Non-grain food prices are down as well—edible oils down 16 percent and other food prices down 17 percent. Initially, grain prices followed a similar (declining) path, but they reversed course sharply after the heat wave in summer of 2012 caused considerable damage in maize-producing areas in the Midwestern United States, while severe drought conditions in Eastern Europe and Central Asia affected wheat production. The World Bank food price index gained almost 11 percent in just one month—from June to July 2012. Since then supply conditions have improved considerably across most food groups. For example, both the edible oil and oilseed markets are well supplied, with the global edible oil production expected to reach new record. Grain supplies are improving as well. In its May 2013 assessment (the first for next season’s crop), the U.S. Department of Agriculture projected a marked improvement in maize conditions for 2013/14, a comfortable wheat crop, and a well-supplied rice market. In response to this outlook most food prices have receded—the food price index has lost most of its summer 2012 gains. Yet, upside risks exists, especially in maize, as any adverse weather event to upset global markets.

Recent developments in agricultural markets

Grain prices have been declining steadily since the spike in the summer of 2012 as news for a better supplied 2013/14 season were gradually emerging (figure COMM.15). Between July 2012 and May 2013, maize and wheat prices have declined 11 and 8 percent, respectively, partly eliminating the gains during July and August of 2012. In its May 2013 update (the first for the 2013/14 crop season), the U.S. Department of Agriculture, placed its global maize production assessment at 966 million tons, up from 2012/13 season’s 857 million tons, in turn increasing the stock-to-use ratio from 14.4 percent to 16.6 percent. Similarly, the global wheat production assessment for 2013/14 stands at slightly over 700 million tons, up from current season’s 655 million tons, inducing a marginal increasing in the stock-to-use ratio as well.

After dropping below the US$ 600/ton mark in November 2011, rice prices have fluctuated within a very tight band around US$ 540/ton. They exceeded US$ 600/ton only twice: towards the end of 2011 when there were some reports of flood damage to the Thai crop and last year when the Thai government introduced its purchase program—a public stock-holding mechanism. According to U.S. Department of Agriculture’s May 2013 assessment, global rice production is expected to reach almost 480 million tons in 2013/14, 9 million tons above the 2012/13 record. The stocks-to-use ratio is expected to reach almost 27 percent, remarkably similar to that of 2012/13 and well within historical
Trade in rice has improved as well reaching a new record of 38.6 million tons during last calendar year, aided in part by a surge in Chinese imports (2.9 million in 2012, up from 0.5 million tons a year earlier). And, early reports indicate that this year may be another record for rice trade, perhaps as high as 40 million tons.

**Edible oil** prices have declined almost 20 percent since their summer 2012 peak, as measured by the World Bank’s edible oil price index, effectively eliminating all the gains during the first half of last year. The decline reflects an improved South American soybean crop as well as a better reassessment of the U.S. soybean crop, for which yields turned out to be higher than originally thought. **Palm oil** supplies from Indonesia and Malaysia have improved as well—these two countries account for 80 percent of global palm oil supplies. Soybean prices have weakened as well during the past 9 months, down almost 28 percent from their September 2012 highs (figure COMM.16). The extended soybean price spike during 2012 also reflects the overall tightness in the animal feed industry. Soybean meal and white maize (the latter produced primarily in the United States) are close substitutes as they both are key inputs to the animal industry.

Edible oils experienced the fastest production (and consumption) growth rates of agricultural commodities during recent decades, and this is likely to be the case for the future. Table COMM.2 reports production growth rates for 8 commodities and shows that in all four sub-periods since 1960, palm oil and soybeans exhibited growth rates that are two to three times higher than food commodities as well as cotton (key raw material) and coffee, whose growth is roughly aligned with population growth. The main exception is maize, which during 2004-12 grew by an annual average of 3.7%, a reflection of biofuel demand. The four periods capture different price regimes, namely, increasing commodity prices up to the first oil crisis (1960-73), declining prices (1974-85), stable and low prices (1986-2003), and high prices during the recent boom (2004-12).

Edible oils are, perhaps, the only commodity group whose income elasticity is high not only for low and middle income countries but also for high income countries. This reflects the fact that as income increases, people tend to eat more in professional establishments and consume more pre-packaged food items, both of which are utilizing more edible oil than otherwise.

**Beverage** prices have declined as well. The World Bank’s beverage price index (comprised of coffee, cocoa, and tea) is down 32 percent since its February 2011 record high. The earlier surge (and recent decline) in beverages reflects mostly coffee prices—specifically arabica—which reached a US$ 6.00/kg during 2011, the highest nominal level ever (figure COMM.17). The increase in arabica reflected a shortfall in Colombia production (the world’s second arabica supplier after Brazil). However, as Colombian production recovered partially, and coffee companies began using more robusta in their blends, arabica prices declined and they are now traded at half their early 2011 highs. Global coffee output reached 145 million bags in 2012, up from

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**Figure COMM.16** Edible oil prices

![Edible oil prices](source: World Bank.)

**Table COMM.2** Production growth of key commodities

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<tbody>
<tr>
<td>Maize</td>
<td>4.1%</td>
<td>3.9%</td>
<td>1.8%</td>
<td>3.7%</td>
</tr>
<tr>
<td>Rice</td>
<td>3.3%</td>
<td>2.9%</td>
<td>1.2%</td>
<td>2.0%</td>
</tr>
<tr>
<td>Wheat</td>
<td>3.9%</td>
<td>2.8%</td>
<td>0.8%</td>
<td>2.1%</td>
</tr>
<tr>
<td>Coffee</td>
<td>3.4%</td>
<td>2.2%</td>
<td>2.5%</td>
<td>1.8%</td>
</tr>
<tr>
<td>Cotton</td>
<td>2.7%</td>
<td>2.8%</td>
<td>1.4%</td>
<td>2.9%</td>
</tr>
<tr>
<td>Sugar</td>
<td>2.2%</td>
<td>2.6%</td>
<td>2.3%</td>
<td>1.9%</td>
</tr>
<tr>
<td>Palm oil</td>
<td>8.6%</td>
<td>10.1%</td>
<td>7.8%</td>
<td>6.8%</td>
</tr>
<tr>
<td>Soybeans</td>
<td>7.5%</td>
<td>6.8%</td>
<td>4.0%</td>
<td>4.7%</td>
</tr>
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Source: U.S. Department of Agriculture.
137 million bags in 2011. Furthermore, Brazil, world’s top coffee supplier, is expected to have a bumper crop in 2013/14 (April-March), currently estimated at almost 47 million bags. Coffee supplies from Vietnam (world’s largest robusta supplier), Colombia, and Indonesia are also expected to be large as well. After declining nearly 35 percent during 2011, cocoa has been traded at around US$ 2.35/kg. The weakness of cocoa prices reflects partly weak demand in Europe, traditionally a key consumer of cocoa for chocolate manufacturing. Global cocoa production is expected to reach 3.96 million tons in 2012/13, down from last season’s 4.06 million tons. Declined by Central and South America will offset increases by West Africa. Last, sugar prices (not part of World Bank’s beverage price index) have been weakening as well, down 22 percent since a year ago and 40 percent lower than their 2011 peak. The sugar market is faced with a large surplus. Global sugar production exceeded 182 million tons in 2012, up from 173 million tons in 2011 while consumption in both years averaged 163 million tons. Good crops in both South America (especially Brazil) and Asia have contributed to the surplus. Brazil, world’s top sugar supplier, in an attempt to boost prices, announced a tax credit to ethanol producers; yet, the announcement failed to support prices.

**Raw material** prices have been relatively stable during the past two quarters after declining sharply from their early 2011 peaks—down 35 percent from February 2011 to August 2012 (figure COMM.18). Cotton prices have found some strength recently—they have gained 8 percent since January 2013. The cotton market is well supplied by historical standards; global production is expected to be 25.1 million tons in 2013/14, and consumption at 24.3 million tons. An estimated 1 million tons will be added to global stocks, pushing the stocks-to-use ratio to 77 percent, the highest since the end of World War II. Approximately 9 million tons of cotton have gone to the state reserves of China during the past two seasons, explaining the relative strength of cotton prices (International Cotton Advisory Committee 2013). Nevertheless, cotton prices increased the least during the post-2004 commodity price boom—up 37 percent between 1997-2004 and 2005-12 as opposed to a 75 percent increase of the overall agricultural price index—primarily because of the increase in yields by China and India following the adoption of biotechnology (Baffes 2011).

**Natural rubber** prices have been remarkably stable during the past two quarters, following their sharp decline from their early 2011 peak (similar to cotton). The decline in rubber prices reflected both increased supplies and fears of demand deterioration, especially from China—most natural rubber goes towards tire production, and China is the fastest-growing market for tires. Crude oil prices play a key role in the price of natural rubber as well, because synthetic rubber, a close substitute to natural rubber, is a crude oil by-product. Global natural rubber production reached 11.3 million tons during the 12-month period ending May 2013, 60 percent of which is supplied by Thailand and Indonesia. Almost 40 percent of global rubber consumption is accounted by China, which has been growing at more than 5 percent during the past few years. That makes the longer term prospects of the rub-
ber market sensitive to China’s growth outlook, as is the case with most metals and mineral commodities. Timber prices have been remarkably stable as well during the past two quarters. Initial expectation for a boom in timber demand (and prices) for post-Tohoku earthquake reconstruction did not materialize while global demand for timber products has weakened considerably.

**Outlook and risks for agricultural commodities**

Agricultural prices are projected to decline 5.9 percent in 2013 with most of the decline to be accounted by beverages (–8.9 percent), followed by raw material (–5.8 percent), and food commodities (–5.5 percent). Within the food group, edible oils are expected to decline the most (–9.0 percent), followed by other food (–5.0 percent), and grains (–1.0 percent). The largest declines among key food commodities will be experienced by soybeans (–8.7 percent), palm oil (–13.9 percent), followed by other edible oils. Grains will change marginally (maize and rice down by about 1 percent and wheat marginally up). The decline in beverages will be led by arabica coffee (–18.5 percent) and less so cocoa (–5.9 percent), while Malaysian longs and rubber will account for most of the weakening in raw materials (–11.2 and –9.7 percent, respectively). A number of assumptions (along with associated risks) underpin the outlook for agricultural commodities, namely, crop conditions, energy prices, biofuels, macroeconomic environment, and trade policies. A detailed assessment of these risks is given below.

**Crop conditions**

It is assumed that crop production in the Southern Hemisphere will not experience any adverse weather conditions, and next season’s outlook will return to normal trends. In its May 2013 outlook assessment (the first for next season), the U.S. Department of Agriculture estimated the 2013/14 crop season’s global grain supplies (production plus starting stocks) at 2.56 billion tons, up 5.7 percent from 2012/13, thus replenishing most of the losses due to the 2012 summer heat wave. If history is any guide, when markets experience negative supply shocks similar to the 2012 drought, production comes back within one (or, perhaps two) seasons through resource shifting, as has been the case in previous episodes (for example, maize in 2004/05,
wheat in 2002/03, and rice in 2001/02, see figure COMM.19a-c). However, it may take up to three seasons before stocks are fully replenished—subjecting the maize and (less so) wheat prices to upside risks. As discussed earlier, the rice market is well supplied also reflected in the remarkable stability of rice prices.

**Oil prices**

The outlook assumes that in 2013 crude oil prices will ease marginally and fertilizer prices will experience a 7 percent (both fertilizer and crude oil are key inputs to agriculture, especially grains and oilseeds). However, because of the energy intensive nature of agriculture—the industry has been estimated to be four to five times more energy intensive than manufacturing—an energy price spike could trigger proportional food price increases. The energy price cross-price elasticity of agriculture goods ranges from 0.2 to 0.3 (depending on the commodity), implying that a 10 percent increase in energy prices will induce a 2-3 percent increase in agricultural prices.

**Biofuels**

Despite an only marginal increase in global biofuel production in 2011 and 2012, the outlook assumes biofuels will continue to play a key role in the behavior of agricultural commodity markets. Currently, biofuels production represents about the equivalent of 1.3 mbd crude oil production and are projected to grow moderately over the projection period. In the longer-term there is much uncertainty about biofuel production. If biofuel production increases at the rates suggested by some forecasts (more than 5 percent annually), as much as 10 percent of global land area allocated to grains and oilseeds could be producing biofuel crops (evaluated at world average yields) within the next two decades. Such assumptions are supported by the baselines of the joint OECD/FAO Agricultural Outlook as well as the IEA Energy Outlook, published in May 2013. However, policy makers are increasingly realizing that the environmental and energy security benefits of biofuels may not outweigh their costs, thus biofuels policies are likely to ease. Indeed, biofuels grew very little during the past two years with similar expectation for this and next year (figure COMM.20).

Yet, the likely long-term impact of biofuels on food prices is complex, as it goes far beyond land diversion, subsidies, and mandates. The impact is likely to depend more on the following factors: (i) the level at which oil prices make biofuels profitable and (ii) whether technological developments of biofuel crops (or even new crops) could increase the energy content of the respective plants, thus, making them more attractive sources of energy. Thus, high energy prices along with likely technological innovations could pose large upside risks for agricultural prices in the longer term (box COMM 3 elaborates further on this issue).

**Macroeconomic environment**

The last assumption is associated with the risk of a sharp reversal to the loose macroeconomic environment, including low policy rates and quantita-
tive easing. There are two channels through which interest rates affect commodity prices—all commodities, not just agriculture. The first operates through physical demand and supply: Low interest rates may affect stock-holding behavior because of the lower cost of capital, they may induce rightward shift in demand because of expansion in current consumption, and they may increase investment lower borrowing costs and hence a rightward shift of future supply. Thus, the effect of interest rates can be either positive, negative, or, even zero, depending on the relative elasticities. The interest rate elasticity for food commodities appears to be near-zero (see Baffes and Dennis (2013) for elasticity estimates and a literature review). Research at the World Bank (currently under way) shows that the interest rate elasticity for metal prices may be positive, implying that the shift of supply schedule due to the lower cost of capital overwhelms shifts in demand (the impact through stockholding is not as important in metals and minerals).

The second channel operates through investment fund activity, the so-called financialization of commodities—a controversial and hotly-debated topic. Investment fund activity which has been increasing over the course of the last ten years, exceeded US$ 330 billion during 2012, according to BarclayHedge, which tracks developments in the hedge fund industry (figure COMM.21). Most of the funds have been invested in energy and agricultural commodity markets. The relationship between investment fund activity and commodity prices is a highly debated topic. Some have argued that these funds have sufficiently large weight to unbalance the market, thus impairing the price discovery mechanism. Others have praised these investment vehicles claiming that they inject liquidity in commodity markets. Despite some contrasting views, the empirical evidence is, at best, weak. While it is unlikely that these investments affect long term price trends, most likely they have affected price variability.

**Trade policies**

Given the 2008 (and less so 2010) experience, the outlook assumes that policy responses will not upset agricultural markets, an assumption that relies on markets remaining well-supplied. If the baseline outlook materializes, policy actions are unlikely and, if they take place, will be isolated with only limited impact. For example, when the market conditions for rice and cotton were tight (in 2008 and 2010, respectively), export bans induced price spikes. However, last year’s Thai rice purchase program and India’s export ban on cotton did not have any discernable impact on the respective prices. Interestingly, cotton prices declined more the day after Indian export ban on cotton was announced (March 2012) than they gained the day of the announcement. In fact, there may be a downside price risk for rice if Thailand releases some (or all) of the stocks it accumulated through the purchase program, not an unlikely scenario given that the costs of the program account for as much as 1 percent of the country’s total GDP (World Bank 2012).

**Recent trends in domestic food prices**

The discussion thus far has focused on price movements in U.S. dollar terms. However, what matters most to consumers is the price they pay for food in their home countries. It is not uncommon for prices paid by consumers in an individual country to differ considerably from international prices, at least in the short run. Reasons for this include exchange rate movements, trade policies intended to insulate domestic markets, the long distance of domestic trading centers from domestic markets (adding considerably to marketing costs), quality differences, and differences in the composition of food baskets across countries.

Table COMM.3 reports changes in domestic wholesale prices of three commodities (maize, wheat, and rice) for a set of low- and middle-income countries—the selection of countries was driven, in part, by data availability. These changes are compared to the corresponding world price changes (reported in the top row of each panel). The periods chosen are 2013Q1 against 2012Q4 (capturing short run responses) and 2013Q1 against 2012Q1 (intended to capture longer term effects). The table also reports price changes between 2006-07 and 2011-12, effectively capturing the entire food price boom period.
World prices of all three grains changed little between 2012Q4 and 2013Q1 (maize and wheat down 3.8 and 9.6 percent, respectively and rice up 0.7 percent); the US dollar did not change much either. The corresponding median domestic price changes were –0.6, 5.8, and 0.2 percent. Focusing at the variability of price changes, however, a different picture emerges. The relative calm in world prices was reflected in the domestic prices of rice, less so in wheat, but not in maize where 5 countries experienced double digit increases despite the moderate decline in world price. A mixed picture emerges as well when 2013Q1 is compared to 2012Q1.

Again, the median domestic price increases are somewhat similar to those of world prices, but there is high variability around these medians for maize and wheat (but not for rice). For example, the world and the domestic median price of maize increased 9.8 and 2.5 percent, respectively. Yet, six of the 17 countries in the sample experienced price declines while seven countries experienced increases exceeding 20 percent.

The last column reports price changes between 2006-07 and 2011-12, periods long enough not be affected by the presence of lags in any significant way. During these two 2-year periods, the world price of maize, wheat, and rice went up by 107, 41, and 75 percent. Not surprisingly, all countries experienced large domestic price increases in all three commodities, with corresponding median increases at 74, 66, and 48 percent. As was the case with the shorter periods, there is considerable variation across countries. For example, rice prices increased by 130 percent in East Africa (average of Tanzania and Uganda) but only 44 percent in West Africa (average of Niger, Mali, and Burkina Faso).

The tentative conclusion from this brief analysis is that in the short term, domestic prices move, for the most part, independently of world prices. A stronger link is present in the longer term but large differences across countries are present, implying that domestic factors play a dominant and persistent role in the food price determination process of local markets.

<table>
<thead>
<tr>
<th>Table COMM.3</th>
<th>Wholesale grain prices in (nominal local currencies, percent changes)</th>
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<tbody>
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<tr>
<td>---------------</td>
<td>----------------</td>
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<tr>
<td><strong>Maize</strong></td>
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<tr>
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</tr>
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<tr>
<td>Mozambique</td>
<td>10.7</td>
</tr>
<tr>
<td>Dominican Republic</td>
<td>8.4</td>
</tr>
<tr>
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<td>7.6</td>
</tr>
<tr>
<td>Ukraine</td>
<td>4.7</td>
</tr>
<tr>
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<tr>
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<td>-0.8</td>
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<tr>
<td><strong>Wheat</strong></td>
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Box COMM.3  The complex interplay among food, fuels, and biofuels

The interaction between food and energy commodities is an important, complex, (sometimes) misunderstood, and hotly debated subject. This box identifies some of the key interaction channels between energy and food markets (figure COMM 3.1). It argues that high energy prices may affect food prices through four channels, namely, higher cost of producing food, biofuel policies, profitable biofuels, and increasing biofuel profitability through induced innovation. The box concludes that, in the longer term, energy could play an even more important role in the determination of food prices.

The Cost Link (A and B/C). The strong relationship between energy and non-energy prices was established long before the post-2004 price boom. Gilbert (1989) estimated transmission elasticity from energy to non-energy commodities of 0.12 and from energy to food commodities of 0.25. Hanson, Robinson, and Schluter (1993) based on a General Equilibrium Model found a significant effect of oil price changes to agricultural producer prices in the United States. Borensztein and Reinhart (1994) estimated transmission elasticity to non-energy commodities of 0.11. A strong relationship between energy and non-energy prices was found by Chaudhuri (2001) as well. Baffes (2007) estimated transmission elasticities of 0.16 and 0.18 for non-energy and food commodities, respectively. Moss, Livanis, and Schmitz (2010) found that U.S. agriculture’s energy demand is more sensitive to price changes than any other input. Pindyck and Rotemberg (1990) concluded that various unrelated primary commodity prices not only co-move, but also co-moved in excess of what the macroeconomic fundamentals could explain. The strong energy-food price link is also evidenced by the input-output values of the GTAP database, which show that the direct energy component of agriculture is four to five times higher than manufacturing sectors (figure COMM 3.2).

The Policy-Driven Biofuel Link (D/F): In addition to being a key cost component, energy plays an important role on the demand side through the diversion of some food commodities to the production of biofuels. The role of biofuels is not new. Kovarick (2012) identified four periods of biofuel use. The first went up to the mid-19th century, when the chief uses of biofuels were cooking and lighting. The second period, the early 20th century, saw the expanded use of biofuels in the internal combustion engines. The third, covering the mid- to late-20th century, includes mainly the oil crises of the 1970s. The fourth period, the 21st century, reflects environmental and energy independence concerns. Indeed, biofuels constituted the largest demand growth component of grains and oilseeds during the past decade. Currently, they account for about 2-3 percent of area allocated to grains and oilseed and represent the equivalent of 1.2 million barrels of crude oil per day. Most of biofuel production comes from maize-based ethanol in the United States (48 percent share), followed by sugarcane-based ethanol from Brazil (22 percent), and edible oil-based biodiesel in Europe (17 percent). Numerous studies have examined the impact of biofuels on food prices, and give a wide range of estimates. Mitchell (2008) found that the expansion of biofuels and the policy reactions that higher prices induced, were responsible for almost three quarters of the food price increases during 2000-08. Gilbert (2010) finds that at most one-quarter to one third of the rise in food prices over 2006–2008 can be directly attributed to biofuels. Roberts and Schlenker (2010) conclude that U.S. biofuel mandates increase maize prices roughly 20 percent.

More recently, the impact of biofuels on food prices has been studied through the link between energy and non-energy prices. Serra (2011) found a long run linkage between ethanol and sugarcane prices in Brazil and also that crude oil and sugarcane prices lead ethanol prices but not vice versa. Saghaian (2010) established strong correlation among oil and other commodity prices (including food) but the evidence for a causal link from oil to other commodities was mixed. Gilbert (2010) found correlation between the oil price and food prices both in terms of levels and changes, but also noted that it is the result of common causation and not a direct causal link. Zhang and others (2010) found no direct long-run relationship between fuel and agricultural commodity prices and only a limited short-run relationship. Rebero (2012) concluded that the pric-
es of maize, wheat, and soybeans are not driven by oil price fluctuations.

Overall, despite a nearly 6-fold increase in biofuel production during the first decade of the millennium, the price link between energy and food commodities is not as clear-cut as some would have expected. This may partly be explained by the non-market influence of mandates, which caused biofuel production to rise (and perhaps influence food prices) independently of what was happening to oil prices. Consider an exogenous shock which pushes crude oil prices up, in turn, lowering fuel consumption. Under a mandated ethanol/gasoline mixture ethanol and maize prices will decline, *ceteris paribus*, leading to a negative food-oil price relationship (de Gorter and Just 2009).

**The Link through Profitable Biofuels (G1):** A more important issue is the level at which energy prices provide a floor to food prices. If biofuels are profitable at current energy prices, the income elasticity of food will rise toward the higher elasticity of the larger (figure COMM 3.3) energy market, a point highlighted by numerous authors, including Lustig (2008), Heady and Fan (2010), and Baффes and Dennis (2013). Various rules of thumb to determine when biofuel production becomes profitable have been posited. One such rule suggests profitability is reached when the US$ barrel price of crude oil is 50 percent or more than the US$ price of a ton of maize. Another places it at US$ 3/gallon of gasoline at the pump (in the U.S.). A World Bank (2009) report argued that because of the strong correlation between the maize and crude oil prices above US$ 50/barrel, crude oil dictate maize prices. The US Government Accountability Office (2009) noted that oil above the $80-$120/barrel range may make biofuels profitable (depending on the circumstances). Babcock (2011) noted that high crude oil prices would have created market-driven investment incentives in the US ethanol industry even in the absence of policies.

**Induced Innovation Link (G2):** Profitable biofuels may induce innovations by increasing the energy content of biofuel crops hence increasing food prices even further. To see the likely impact of biofuels-related induced innovation on food prices consider the following illustrative example. One hectare of land produces 10 tons of maize generating US$ 2,500 in farmgate revenue either by supplying maize to the food and feed industry at US$ 250/ton or selling it to ethanol industry at US$ 0.63/liter (assuming 4,000 liters maize-to-ethanol conversion). If an improved maize variety were to increase the ethanol content by 10 percent, it would generate US$ 2,750/hectare in farmgate revenue, raising the cost of maize to the food and feed industries to $275/ton, since this is how much the ethanol industry would pay. Furthermore, the innovation in the energy content of maize would induce proportional price increases in all crops that could be grown on that land. While the above example is hypothetical, it does illustrate how innovations in the energy content (or in the efficiency of extracting ethanol) of existing or new crops could trigger food price increases, even in the absence of changes in energy prices or demand and supply conditions of food commodities.

The food-fuel-biofuel link can be summarized within two oil price scenarios (figure COMM 3.4). Though less likely, the “Low” oil price scenario could materialize if a sharp slowdown in emerging economy growth takes place. It could also materialize in response to innovation in battery technology and/or large scale utilization of natural gas that could unleash substitution away from crude oil to electricity and natural gas by the transportation industry. Under low oil prices, the energy costs to agriculture will decline leading to lower food prices—scenario I(b). Furthermore, low oil prices may ease biofuel policies, lowering food prices even further—scenario I(a). Interestingly, while scenario I(a) is consistent with a strong link between oil and food prices (through production costs), scenario I(b) weakens the link (because of the mandated nature of biofuels). Now consider the “High” oil price scenario. As noted above, high oil prices are likely to make biofuels profitable, in which case food and oil prices will move in a synchronous manner—scenario II(a). Moreover, profitable biofuels may induce innovation in the energy content of crops, in which case food prices could increase even further—scenario II(b). Under scenario II(b), the oil-food price link may weaken since food prices may increase even if demand and supply conditions for food and energy markets do not change.

**Box Fig COMM 3.3 Global Energy Shares**

| Source: BP Statistical Review and author’s calculations |

| Box Fig COMM 3.4 Oil and Food Price Scenarios |

| Source: World Bank |
References


EAST ASIA and the PACIFIC REGION
Overview

Growth in the East Asia & the Pacific region slowed to 7.5 percent in 2012, which nevertheless represented 40 percent of global growth. The slowdown was due to slower growth in China, which has started to shift away its economy from excessive reliance on investment and net exports.

Growth in the rest of the region accelerated to 6.2 percent, 1.6 percentage points faster than the average of the preceding decade and comparable to growth during the boom and bounce-back years of 2007 and 2010.

With virtually all countries in the region having recovered from the 2008 crisis—largely thanks to domestic stimulus—rising debt levels and asset bubbles are increasingly a source of concern especially in the context of strong capital flows and weak external demand environment.

**Economic outlook:** GDP growth in the region is projected to slow to 7.3 percent in 2013 reflecting weak global conditions and waning effects of stimulus measures. China is projected to slow to 7.7 percent rate in 2013 but accelerate to about 8 percent in 2014 and 2015 as global conditions improve.

Growth in the rest of the region is expected to slow to 5.7 percent in 2013 due to fiscal tightening, capacity constraints and a negative contribution from net exports reflecting exchange rate movements and weak external demand. Growth is projected to firm up to about 6 percent in 2014 and 2015 as external conditions improve.

**Risks and vulnerabilities:** The risk of a serious crisis emanating from high-income countries has declined, but the strength and timing of recovery in Europe remains uncertain.

Developments throughout the region will remain sensitive to outturns in China and Japan. The main risk related to China remains the possibility that high investment rates prove unsustainable, provoking a disorderly unwinding and sharp economic slowdown.

The depreciation of the Japanese yen in response to loose monetary policy is likely to affect some developing-country exports and growth in the short-term. The effects are expected to be balanced overall due to potential gains through supplies of inputs, including parts and components as well as imports of competitive technology, machinery and equipment.

Japanese quantitative easing is likely to exacerbate capital inflows, potentially contributing to demand price pressures, asset price inflation and a further rise in domestic debt encouraged by low borrowing costs. Although net capital flows are not expected to generate sustained pressures on regional exchange rates, low Japanese interest rates could increase capital flows and exchange rate volatility.

The recent decline in global commodity prices may reflect a turning point as past investments came on stream. Should this easing accelerate, fiscal and current accounts, and incomes and growth in commodity exporters like Indonesia, Malaysia, Mongolia, Papua New Guinea (PNG), Timor Leste and Solomon Islands could come under pressure, even as lower prices would benefit importers. The negative impact is expected to be muted in Malaysia and Indonesia where the decline in oil prices will contribute to an improvement of budget balances through a reduction in fuel subsidies.

**Policy recommendations:** With most of the region having fully recovered from the financial crisis, and many countries growing at historically high rates, policies could become less accommodative. Should capital flows make adjusting monetary policy difficult a larger share of the burden may have to be borne by fiscal tightening, while macro-prudential measures would gain in importance to safeguard financial stability. Fiscal consolidation can perhaps be achieved by rationalizing current spending, which would allow structural reforms and growth enhancing infrastructure investment programs to continue.

Rebuilding buffers to absorb future shocks, remains a priority in Cambodia, Lao PDR, Vietnam, the Pacific islands and Mongolia where gradual global and regional integration has benefitted growth, but also made these economies more vulnerable to global and regional business cycles and commodity price fluctuations.
Recent developments

Although growth in the East Asia and the Pacific region slowed to 7.5 percent in 2012, its contribution to global growth was still an impressive 40 percent.

The growth slowdown was largely due to slower growth in China as it started to reduce its reliance on net-exports and investment. China’s growth declined to 7.8 percent in 2012—the weakest rate since 1999.

Outside China, regional growth accelerated from 4.6 percent in 2011 to 6.2 percent in 2012. This was 1.6 percentage points faster than the annual average growth rate attained over the preceding decade and comparable only to the growth rates observed during the boom and bounce-back years of 2007 and 2010.

This acceleration partly reflected Thailand’s recovery from the devastating floods in 2011 (figure EAP.1). GDP grew 6.5 percent in 2012 versus only 0.1 percent in 2011. But the acceleration was more widespread, if less spectacular elsewhere. Sixty percent of countries in the region grew faster in 2012 than in 2011, and more than two thirds grew faster than 6 percent.

This strong annual performance came despite a mid-year slowdown, caused by slower growth in China and the mid-year ramp-up in Euro Area financial market tensions. After slumping sharply mid-year, real-side activity (industrial production, and exports) picked up pace in the fourth quarter (figure EAP.2).

Many countries swiftly reacted to the mid-year slowdown and to the weak external demand by loosening macroeconomic policy.

Monetary policy was relaxed, with the majority of the central banks—Malaysia being a notable exception—cutting policy rates during 2012. Vietnam implemented the most aggressive easing, cutting interest rates by 600 basis points, unwinding a tightening of equal magnitude implemented the year before.

Fiscal policy was broadly accommodative with many countries in the region, including Indonesia, Malaysia and Thailand accelerating public-sector investment programs through budget and state-owned enterprise activity, and local government investments, particularly China. Malaysia stepped-up its cash transfers and civil service bonuses, Thailand enlarged its rice subvention scheme and implemented the significant car buyer incentive programs.

Partly as a result, real credit growth in the region accelerated sharply, reaching 20 percent rate in Indonesia, 14.6 percent in China and 10 percent in Malaysia and Thailand (figure EAP.3).
The stimulus measures coincided with a revival in global capital flows and demand (see capital flow section below), partly because of the lags involved with macro policy, and contributing to a sharp acceleration in economic activity, with regional quarterly GDP rebounding at a 8.4 percent annualized rate in 4Q2012.

Reflecting the stimuli, central budget deficits deteriorated across the region exceeding 3 percent of GDP in all countries except China, Indonesia, PNG and the Philippines. Consolidated budget deficits, including local budget financing had exceed 3 percent of GDP in China.

The combination of the loose macro policy and fast growth has contributed to a significant rise in private and public-sector debt levels in the region

Government debt remains well below high-income levels (it exceed 100 percent of GDP in some European countries, including Greece, Italy and Portugal, the United States and Japan), but have continued to rise despite high rates of GDP growth in Thailand, Malaysia and China.

Non-government debt has also been rising in China, Malaysia and Thailand and now exceeds 150 percent of GDP in China and Malaysia and is above 100 percent of GDP in Thailand (figures EAP. 4 & 5).

Household debt represents the larger share of that total, at around 77 percent of GDP in China and Malaysia and is estimated at around 80 percent of GDP in Malaysia.

Rapid growth of household debt resulted from a combined effect of low interest rates and strong demand. Present levels of household debt are about 2-3 times higher of their pre-1997 crisis levels in China, Malaysia and Thailand.

In China, non-Government sector debt is concentrated in the corporate sector (about 2/3s
of total non-Government sector debt. The composition of non-Government debt is more balanced and corporate debt is lower than its pre-1995-1997 crisis levels in Indonesia, Malaysia and Thailand.

At the same time, the overall external position of the key Asian economies has been significantly strengthened over the past decades through build-up of foreign asset and strengthening of reserve base. The East Asia economies are also better prepared to cope with external headwinds in the context of the flexible exchange rate regimes that they have been increasingly adopting.

While fast growing Asian economies still have fiscal room to counteract a possible financial crisis, the rapid build-up of debt during the low-interest rate period increased the exposure of the major regional developing economies and raises certain concerns. It is recommended that favorable growth period could be used to strengthen buffers to counteract future external shocks and reduce vulnerabilities.

Robust, policy-fueled demand conditions boosted import demand across the region while exports remained weak

This increased demand for imports was primarily driven by high rates of investment, which led to a surge in imports, including for capital goods. At the same time, the terms of trade of commodity exporting countries (Indonesia, Malaysia, Mongolia and Papua New Guinea) deteriorated on weaker commodity prices (figure EAP.6).

Regional exports meanwhile came under pressure from global weakness. A combined effect of those developments put further pressure on net-exports (exports-imports) which have been an increasingly large drag on growth (figure EAP.7).

Net-exports subtracted 4 percentage points from overall GDP growth in Malaysia and about 1.5 percentage points in Indonesia and Thailand in 2012. In the Philippines, on the other hand the net-export contribution to growth was positive partly reflecting the post-Tokohu earthquake reconstruction related exports to Japan.

The bulk of developing countries in East Asia & the Pacific region have completed their recovery from the crisis

The relatively small hit to regional output in the immediate wake of the crisis and the strong growth since, means that the output gaps (the difference between demand levels and underlying supply potential) either only slightly negative or positive in three quarters of countries in the region in 2012. Less than 1/5th of the countries in the region have been operating at or above their potential since 2011.
Strong growth in the last part of 2012 has contributed to some overheating pressures in a number of countries in the region.

The overheating pressures manifested themselves in growing current account deficits (as domestic supply was unable to meet rapidly rising demand), in rising inflation, asset price pressures and high property prices depending on specific country circumstances and policy context.

Strong domestic demand, partly due to high investment rates has contributed to a deterioration in regional current account positions.

This deterioration happened despite falling commodity prices, which should have worked in the other direction for the majority of countries in the region. For the ASEAN-4 countries, the deterioration was particularly marked (2.2 percent of GDP), although the group’s current account remained in surplus.

Most of this decline was due to an $26 billion, or 3.0 percent of GDP adjustment in Indonesia’s current account position reflecting a record trade deficit of $1.7 billion (figure EAP. 8).

In China, the current account surplus seem to have stabilized at around 2.6 percent of GDP, consistent with the earlier sharp adjustments from a peak level of 10.1 percent of GDP in 2007.

Along the region’s smaller economies, Mongolia’s current account deficit expanded further reaching about 1/3rd of the country’s GDP reflecting both weaker commodity prices and increased investment (with high import content) in the mining sector. Lao and Cambodia continued to record large current account deficits (16 percent and 11.5 percent of GDP respectively).

Inflation in the region as a whole picked up in the first quarter of 2013, but at a 3.1 percent annualized pace remains relatively modest.

This aggregate situation masks significant intra-regional variation and mainly reflects relatively modest inflation of 2.7 percent in China (3m/3m saar) versus the rest of the region where it has climbed to 5.1 percent (3m/3m saar) in the three months to April (figure EAP. 9).

In Indonesia, the quarterly inflation rate accelerated to 9 percent (3m/3m saar) rate in the first quarter reflecting capacity constraints, but also currency depreciation and a rise in food prices due to trade restrictions. Inflation has also accelerated strongly in Lao, PDR and core inflation remains high and the headline inflation extremely volatile in Vietnam despite a slowing of growth.

Source: World Bank; Datastream.

Source: World Bank; IMF; IFS; Datastream.
In China, where growth has been slowing, inflation pressures are less of a concern and the headline inflation rate remains anchored around the central bank’s revised 3.5 percent inflation target. However price pressures are present in certain rapidly growing segments of the economy, including real estate.

**Excess demand pressures and loose monetary conditions may also be contributing to asset price bubbles in the region**

Overall, the region’s stock market performance has been mixed. The regional stock market composite, the MSCI EMF Asia Index, up only about 10 percent since June 2012 and dropped by about 2 percent in the first four months of 2013. Nevertheless, it outperformed the global emerging market benchmark indicator which registered an overall 4 percent loss so far this year.

The modest performance of the regional index masks diverging trends i.e. underperformance of Chinese stocks and record highs reached by some ASEAN country stocks. ASEAN markets boomed with some markets (Indonesia, Thailand, Lao, PDR and The Philippines) advancing by 30-50 percent since last May (table EAP. 1).

The rapid increase in stock prices combined with high price-earnings ratios (between 17 and 22 still below those in high-income countries) are raising concerns about overvaluation of stocks. In fact, the top performing East Asian developing market stocks (Indonesia, the Philippines and Thailand) have seen about a 7-8 percent decline in past few weeks from this year — around mid-May—picks.

Property prices continued to increase with the average square meter prime property price about two times more than the average per capita income in Cambodia,\(^1\)

1.3 times—of that in China and about 60 percent of the average per capita income in Indonesia and Thailand (compared with about 10 to 30 percent of the average per capita income in high income and developing countries).

### Table EAP.1 Asian stock performance

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<tr>
<td>Philippines Stock Exchange PSEi Index</td>
<td>6,875.60</td>
<td>7,310.94</td>
</tr>
<tr>
<td>Value</td>
<td>19.95%</td>
<td>27.35%</td>
</tr>
<tr>
<td>Year To Date</td>
<td>38.43%</td>
<td>53.84%</td>
</tr>
<tr>
<td>Vietnam Ho Chi Minh Stock Index / VN-Index</td>
<td>524.56</td>
<td>490.34</td>
</tr>
<tr>
<td>Value</td>
<td>28.92%</td>
<td>20.05%</td>
</tr>
<tr>
<td>Year To Date</td>
<td>25.81%</td>
<td>13.21%</td>
</tr>
<tr>
<td>Jakarta Stock Exchange Composite Index</td>
<td>4,777.37</td>
<td>5,078.68</td>
</tr>
<tr>
<td>Value</td>
<td>12.00%</td>
<td>18.40%</td>
</tr>
<tr>
<td>Year To Date</td>
<td>26.28%</td>
<td>30.62%</td>
</tr>
<tr>
<td>Stock Exchange of Thailand SET Index</td>
<td>1,528.55</td>
<td>1,617.89</td>
</tr>
<tr>
<td>Value</td>
<td>11.81%</td>
<td>18.32%</td>
</tr>
<tr>
<td>Year To Date</td>
<td>36.18%</td>
<td>42.52%</td>
</tr>
<tr>
<td>Laos Securities Exchange Composite Index</td>
<td>1,338.82</td>
<td>1,376.45</td>
</tr>
<tr>
<td>Value</td>
<td>10.21%</td>
<td>13.31%</td>
</tr>
<tr>
<td>Year To Date</td>
<td>31.87%</td>
<td>33.35%</td>
</tr>
<tr>
<td>FTSE Bursa Malaysia KLCI Index</td>
<td>1,787.80</td>
<td>1,766.81</td>
</tr>
<tr>
<td>Value</td>
<td>7.71%</td>
<td>5.94%</td>
</tr>
<tr>
<td>Year To Date</td>
<td>17.43%</td>
<td>19.23%</td>
</tr>
<tr>
<td>Hong Kong Hang Seng Index</td>
<td>21,615.09</td>
<td>23,082.68</td>
</tr>
<tr>
<td>Value</td>
<td>-3.01%</td>
<td>2.43%</td>
</tr>
<tr>
<td>Year To Date</td>
<td>17.67%</td>
<td>24.08%</td>
</tr>
<tr>
<td>Korea Stock Exchange KOSPI Index</td>
<td>1,932.70</td>
<td>1,986.81</td>
</tr>
<tr>
<td>Value</td>
<td>-3.11%</td>
<td>-0.51%</td>
</tr>
<tr>
<td>Year To Date</td>
<td>4.75%</td>
<td>7.97%</td>
</tr>
<tr>
<td>Shanghai Stock Exchange Composite Index</td>
<td>2,210.90</td>
<td>2,251.81</td>
</tr>
<tr>
<td>Value</td>
<td>-2.03%</td>
<td>-0.69%</td>
</tr>
<tr>
<td>Year To Date</td>
<td>-1.83%</td>
<td>-1.57%</td>
</tr>
<tr>
<td>Mongolia Stock Exchange Top 20 Index</td>
<td>14,998.14</td>
<td>13,543.99</td>
</tr>
<tr>
<td>Value</td>
<td>-14.83%</td>
<td>-23.09%</td>
</tr>
<tr>
<td>Year To Date</td>
<td>-20.45%</td>
<td>-33.32%</td>
</tr>
<tr>
<td>Tokyo Stock Exchange Tokyo Price Index TOPIX</td>
<td>1,111.97</td>
<td>1,245.23</td>
</tr>
<tr>
<td>Value</td>
<td>30.64%</td>
<td>46.16%</td>
</tr>
<tr>
<td>Year To Date</td>
<td>55.80%</td>
<td>72.01%</td>
</tr>
<tr>
<td>S&amp;P 500 Index</td>
<td>1,642.81</td>
<td>1,654.90</td>
</tr>
<tr>
<td>Value</td>
<td>16.30%</td>
<td>16.96%</td>
</tr>
<tr>
<td>Year To Date</td>
<td>26.86%</td>
<td>27.73%</td>
</tr>
<tr>
<td>NASDAQ Composite Index</td>
<td>3,473.77</td>
<td>3,479.36</td>
</tr>
<tr>
<td>Value</td>
<td>15.68%</td>
<td>15.84%</td>
</tr>
<tr>
<td>Year To Date</td>
<td>23.49%</td>
<td>23.11%</td>
</tr>
<tr>
<td>Dow Jones Industrial Average</td>
<td>15,238.59</td>
<td>15,260.43</td>
</tr>
<tr>
<td>Value</td>
<td>17.67%</td>
<td>17.71%</td>
</tr>
<tr>
<td>Year To Date</td>
<td>24.69%</td>
<td>24.45%</td>
</tr>
</tbody>
</table>

Source: Bloomberg.
Gross rental yields increased to 9 percent in Indonesia and 6-7 percent in the Philippines and Thailand, which is two-three times higher than high income and developing country average.

The improvement in global financial market conditions during the second half of 2012 (see GEP January 2013) combined with the strong growth in the East Asia and the Pacific region attracted increased capital flows to the region towards year-end. Overall net flows reached $457.8 billion—about 10 percent lower than in 2011 or about 4.6 percent of regional GDP (figure EAP.10). The composition of the net capital flows to the region has changed reflecting local conditions. Equity flows, reached about 74 percent of the total inflows to the region reflecting a US$54.8 billion (about 38 percent y/y reduction) decline of short-term debt flows due to lower trade financing (table EAP.2).

FDI inflows, which represent the bulk (more than 90 percent) of total equity inflows declined by 8.3 percent (by US$ 27.9 billion in nominal terms), while net portfolio equity inflows quadrupled (from US$ 8.4 billion in 2011 to US$31 billion in 2012) recovering to their pre-2011 level in nominal terms. The bond issuance in the region, rose

### Table EAP.2 Net capital flows to East Asia and the Pacific ($ billions)

<table>
<thead>
<tr>
<th></th>
<th>2008</th>
<th>2009</th>
<th>2010</th>
<th>2011</th>
<th>2012e</th>
<th>2013f</th>
<th>2014f</th>
<th>2015f</th>
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<tr>
<td>Private inflows, net</td>
<td>207.3</td>
<td>251.2</td>
<td>513.5</td>
<td>508.7</td>
<td>457.6</td>
<td>471.9</td>
<td>483.2</td>
<td>517.2</td>
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<tr>
<td>Equity Inflows, net</td>
<td>203.8</td>
<td>183.9</td>
<td>329.5</td>
<td>343.2</td>
<td>337.9</td>
<td>325.6</td>
<td>327.7</td>
<td>331.6</td>
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<tr>
<td>Net FDI inflows</td>
<td>211.3</td>
<td>153.7</td>
<td>289.7</td>
<td>334.9</td>
<td>306.9</td>
<td>302.9</td>
<td>300.3</td>
<td>298.2</td>
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<tr>
<td>Net portfolio equity inflows</td>
<td>-7.6</td>
<td>30.2</td>
<td>39.8</td>
<td>8.4</td>
<td>31.0</td>
<td>22.7</td>
<td>27.4</td>
<td>33.4</td>
</tr>
<tr>
<td>Private creditors. Net</td>
<td>3.6</td>
<td>67.3</td>
<td>184.0</td>
<td>165.4</td>
<td>119.7</td>
<td>146.3</td>
<td>155.5</td>
<td>185.6</td>
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<td>Bonds</td>
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<td>8.4</td>
<td>20.8</td>
<td>18.9</td>
<td>35.4</td>
<td>39.6</td>
<td>33.7</td>
<td>29.6</td>
</tr>
<tr>
<td>Banks</td>
<td>17.9</td>
<td>-6.1</td>
<td>13.2</td>
<td>1.8</td>
<td>-2.4</td>
<td>8.1</td>
<td>10.3</td>
<td>12.3</td>
</tr>
<tr>
<td>Short-term debt flows</td>
<td>-13.3</td>
<td>65.0</td>
<td>148.9</td>
<td>144.9</td>
<td>90.1</td>
<td>98.3</td>
<td>111.3</td>
<td>143.2</td>
</tr>
<tr>
<td>Other private</td>
<td>-2.3</td>
<td>0.03</td>
<td>1.1</td>
<td>-0.2</td>
<td>-3.4</td>
<td>0.3</td>
<td>0.2</td>
<td>0.5</td>
</tr>
<tr>
<td>Official inflows, net</td>
<td>-0.4</td>
<td>3.9</td>
<td>3.0</td>
<td>1.4</td>
<td>0.2</td>
<td>-0.1</td>
<td>-1.3</td>
<td>-1.9</td>
</tr>
<tr>
<td>World Bank</td>
<td>1.2</td>
<td>2.2</td>
<td>2.7</td>
<td>0.9</td>
<td>0.3</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>IMF</td>
<td>-0.05</td>
<td>0.1</td>
<td>-0.02</td>
<td>-0.03</td>
<td>-0.2</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Other official</td>
<td>-1.5</td>
<td>1.6</td>
<td>0.3</td>
<td>0.6</td>
<td>0.1</td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Source: The World Bank

Note: e = estimate, f = forecast
insignificantly to $35.4 billion in 2012 (a 16.5 percent increase) from what was a robust pace of issuance ($18.9 billion) in 2011.

**Economic outlook**

While signs of overheating appeared in several economies in 2012, the pace of expansion has eased in 2013Q1 reflecting fiscal tightening, and slow recovery of external demand.

Output growth slowed in China and in the other fast growing ASEAN-4 economies, particularly in Malaysia and Thailand following a sharp acceleration in the second half of 2012. In Malaysia, first quarter GDP growth came at a negative 2.5 percent saar, slowing from 8 percent rate in 2012Q4 mainly reflecting fiscal consolidation but also negative contribution from net-exports. Thailand’s output has contracted sharply in Q12013 following a revised 11.7 percent quarter-on-quarter saar growth in 2012Q4.

In China and Indonesia, the slowing was less pronounced. China’s first quarter GDP growth declined to a 6.6 percent quarter-over-quarter saar, from 8.7 percent in 2012Q4. In Indonesia, GDP expanded at an estimated 5.3 percent (q/q saar) in the first quarter of 2013, after a brisk 6.9 percent increase in 2012Q4 (figure EAP. 11).

Regional industrial production activity also slowed to 6.0 percent (q/q, saar) in the first quarter, reflecting modest slowdown in China and a much sharper correction among ASEAN economies.

Prospects for the region going forward point to a modest acceleration in activity during the rest of 2013, but annual growth is projected to be lower than in 2012.

Forward looking indicators suggest positive and broadly-based, if somewhat weaker, growth going forward. For instance, Purchasing Managers’ Indexes (PMI) for all countries in the region recovered above the 50 threshold in April, but remain volatile showing some recent strengthening for Indonesia and weakening for Vietnam (figure EAP. 12).

The projected pick up in activity will nevertheless deliver somewhat slower growth in the region with China estimated to growth at 7.7 percent in 2013 slightly below a 7.8 percent rate of 2012.

This will be combined with some quite significant easing in ASEAN economies (5.7
percent in 2013 versus 6.2 percent in 2012) (table EAP.3). Output growth pattern in ASEAN reflects a combination of continued strong growth in Indonesia and certain easing in Malaysia, Thailand and the Philippines from record high levels achieved in 2012.

Regional growth is projected to recover to 7.5 percent in 2014 and 2015 on improved external conditions, but the dramatic change in Japanese policy introduces significant uncertainty into the forecast for developing East Asian and the Pacific region.

The projected slowdown of economic growth in these three countries is reflecting capacity constraints and an expected fiscal tightening of policy in response to inflationary and asset price pressures and growing debt levels, but also weak recovery of global demand, including a projected decline in demand for imports from Japan due to yen depreciation.

Monetary conditions remain relatively loose with the majority of the central banks on hold or easing, including recent rate cuts in Mongolia, Vietnam and Thailand.

Cambodia, Lao, Mongolia and Myanmar are projected to continue to deliver strong growth benefiting from a dynamic economic transformation, although the prospects for the region’s small(er) economies are mixed.

Output gains from the completion of a new gold mine in Lao PDR have already been realized and so growth is projected to slow. In Cambodia, a rebound in global trade should support further improvements in garment production and exports.

<table>
<thead>
<tr>
<th>Table EAP.3</th>
<th>East Asia and Pacific forecast summary</th>
</tr>
</thead>
<tbody>
<tr>
<td>(annual percent change unless indicated otherwise)</td>
<td>00-09a</td>
</tr>
<tr>
<td>GDP at market prices b</td>
<td>8.1</td>
</tr>
<tr>
<td>GDP at market prices c</td>
<td>8.1</td>
</tr>
<tr>
<td>GDP per capita (units in US$)</td>
<td>7.3</td>
</tr>
<tr>
<td>PPP GDP</td>
<td>8.0</td>
</tr>
<tr>
<td>Private consumption</td>
<td>6.0</td>
</tr>
<tr>
<td>Public consumption</td>
<td>7.4</td>
</tr>
<tr>
<td>Fixed investment</td>
<td>10.8</td>
</tr>
<tr>
<td>Exports, GNFS d</td>
<td>10.3</td>
</tr>
<tr>
<td>Imports, GNFS d</td>
<td>9.6</td>
</tr>
<tr>
<td>Net exports, contribution to growth</td>
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</tr>
<tr>
<td>Current account bal/GDP (%)</td>
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</tr>
<tr>
<td>GDP deflator (median, LCU)</td>
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</tr>
<tr>
<td>Fiscal balance/GDP (%)</td>
<td>-1.8</td>
</tr>
</tbody>
</table>

Memo items: GDP
- East Asia excluding China | 4.4 | 6.9 | 4.6 | 6.2 | 5.7 | 5.9 | 6.0 |
- China | 9.4 | 10.4 | 9.3 | 7.8 | 7.7 | 8.0 | 7.9 |
- Indonesia | 4.6 | 6.2 | 6.5 | 6.2 | 6.2 | 6.5 | 6.2 |
- Thailand | 3.5 | 7.8 | 0.1 | 6.5 | 5.0 | 5.0 | 5.5 |


a. Growth rates over intervals are compound weighted averages; average growth contributions, ratios and deflators are calculated as simple averages of the annual weighted averages for the region.

b. GDP at market prices and expenditure components are measured in constant 2005 U.S. dollars.

c. Sub-region aggregate excludes Fiji, Myanmar and Timor-Leste, for which data limitations prevent the forecasting of GDP components or Balance of Payments details.
d. Exports and imports of goods and non-factor services (GNFS).
### Table EAP.4  East Asia and Pacific country forecasts

<table>
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<tr>
<th>Country</th>
<th>GDP at market prices (% annual growth)</th>
<th>Est. Forecast</th>
<th>00-09(^a)</th>
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<th>2011</th>
<th>2012</th>
<th>2013</th>
<th>2014</th>
<th>2015</th>
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<td>7.3</td>
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<td>7.0</td>
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</tr>
<tr>
<td></td>
<td>Current account bal/GDP (%)</td>
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<td>-8.7</td>
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<td>-10.1</td>
<td>-9.3</td>
<td>-9.0</td>
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<td>10.4</td>
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<td>7.8</td>
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<td>8.0</td>
<td>7.9</td>
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<td></td>
</tr>
<tr>
<td></td>
<td>Current account bal/GDP (%)</td>
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<td>2.6</td>
<td>2.5</td>
<td>2.4</td>
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<td>2.3</td>
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<td></td>
</tr>
<tr>
<td></td>
<td>Current account bal/GDP (%)</td>
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<td>-7.7</td>
<td>-7.8</td>
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<td>-22.5</td>
<td>-7.8</td>
<td>-7.5</td>
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<td>6.5</td>
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</tr>
<tr>
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<tr>
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<tr>
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<td>Current account bal/GDP (%)</td>
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<td>11.1</td>
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<td>6.4</td>
<td>6.2</td>
<td>5.2</td>
<td>5.3</td>
<td>5.4</td>
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<td>5.6</td>
<td>3.3</td>
<td>1.0</td>
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</table>


World Bank forecasts are frequently updated based on new information and changing (global) circumstances. Consequently, projections presented here may differ from those contained in other Bank documents, even if basic assessments of countries' prospects do not significantly differ at any given moment in time.

Samoa; Tuvalu; Kiribati; Democratic People's Republic of Korea; Marshall Islands; Micronesia, Federated States; N. Mariana Islands; Palau; and Tonga are not forecast owing to data limitations.

a. GDP growth rates over intervals are compound average; current account balance shares are simple averages over the period.
b. GDP measured in constant 2005 U.S. dollars.
c. The start of production at Papua-New-Guinea-Liquefied Natural Gas (PNG-LNG) is expected to boost PNG's GDP growth to 20 percent and shift the current account to a 9 percent surplus in 2015.
Projections for Mongolia have been revised downwards, due to delays in major mining projects and lower commodity prices. In Myanmar, the reform momentum and continued improvements in the international environment are projected to drive growth gradually toward 6.5 percent in 2013/14 and 6.6 percent in 2014/15.

The outlook for the Pacific Islands is positive, but given the small size of many economies, the precise shape of the forecast will depend on the timing with which ongoing and planned investment projects in the extractive sector come on stream (table EAP.4).

Countries in East Asia and the Pacific region which have close direct trade ties with Japan have seen their currencies hit harder by yen’s depreciation than other developing economies

Thailand experienced a sharp 13.4 percent real-effective appreciation of its currency since July 2012 as the yen depreciated in real effective terms by over 22 percent (figure EAP.13). In the short-term, exchange rate depreciation is likely to hurt the exports of countries that compete in the same kinds of markets as Japan (South Korea, Singapore, Taiwan, China) and those linked to those economies through supply chains, especially in generally weak demand environment.

Those negative impacts are expected to be balanced by potential gains through supplies of parts and components. The economies, such as the Philippines, and Thailand that are important suppliers of parts and components to Japan in regional production networks, could benefit from gains by Japanese exporters in global markets. In addition, increased demand for a number of key regional export commodities (e.g. gas from Malaysia) despite the overall deceleration of Japan’s import demand, are also expected to benefit the region. Additional benefits are expected through competitive imports, which would allow the regional firms and businesses to benefit from the ability to import Japanese technology, machinery and equipment at lower costs.

If sustained over time, the depreciation of the yen could eventually alter the dynamics of trade in the region. It would help cut the region's trade deficits even further, especially between the EAP region and Japan, as Japan is EAP’s largest source of imports and fourth largest export destination. In the medium-term and assuming that Japan’s growth accelerates and imports eventually pick-up, trade partners in the region would benefit from an increase in Japan’s demand for regional imports.

In general, Japan’s recovery as well as recovery of its exports will depend on depth of the structural reforms and its ability to boost productivity (figure EAP.14). Overall, as competitive pressures increase, the developing economies in the East Asia and the Pacific region should continue to focus on financial stability and accelerate structural reforms to alter their productivity and competitiveness.

Less certain is the likely impact of Japanese quantitative easing on Japanese capital flows toward regional economies. For countries already operating at close to full capacity, additional capital inflows can be expected to increase upward pressure on currencies, or if monetary authorities intervene upward...
pressure on money supply, credit and inflation. How large these effects may be will depend on the extent to which outward flows increase and the extent to which developing countries are destinations for these flows (see discussion in main text and for more detail in the exchange rate annex).

Risks and vulnerabilities

Uncertainties related to economic recovery in high income countries have subsided, but are still present. Regional risks have gained importance.

The regional outlook remains sensitive to outturns in China, with the main risk stemming from the possibility of an abrupt decline in China’s high investment rates (see World Bank, 2013a for more).

In addition, as discussed above, there are considerable uncertainties surrounding the impact of Japan’s shift in macroeconomic policy. Overall, weak yen could affect the dynamics of trade in manufactures in the region in the short-term. By extending periods of low interest rates and boosting capital flows, Japanese QE could also contribute to further pressures on asset prices and may encourage further risk taking and credit growth. Rising debt levels and asset prices in the emerging East Asia & Pacific economies are already the growing source of vulnerability (see discussion on page 4-5). Should these trends intensify, a disorderly unwinding of these pressures, including perhaps a domestic banking-sector crisis, cannot be ruled out, potentially. In ordered to reduce the likelihood of such an outturn fiscal policy likely needs to be tightened already in 2013 and monetary policy focus should be shifted to financial stability and tail risk considerations. In the medium-term, if Japan manages to escape its deflation and rekindle growth with the measures taken, all developing economies in the region would benefit through various channels, including through an increase in Japan’s demand for imports (see also EAP Economic Update and Main text).

A strong supply increase in extractive commodity markets following a quintupling in capital expenditures globally has already put downward pressure on prices. If these were to intensify, commodity exporting countries, including Indonesia, Malaysia, Mongolia, PNG could see government revenues and current account balances, which are in some cases already very high (e.g. more than 30 percent of GDP in Mongolia) come under significant pressure — even as lower prices would benefit importers. In such a lower price scenario, if investment projects are cancelled and anticipated increases in output not materialized, countries could find themselves in financial difficulty. External debt is especially high in Mongolia (more than 130 percent of GDP), and in Papua New Guinea (about 100 percent of GDP).

Policy recommendations

Ensuring strong and stable consumption through raising household incomes to sustain growth is a priority in China along with the reorientation of investments toward agriculture, human capital and services and increased efficiency of investment. The process of rebalancing also involves a gradual
shift in the structure of China’s debt toward a reduction of corporate sector debt, including through reduction of non-performing assets accumulated during the years of investment-led growth.

Policymakers in fast-growing-close to (or above) full capacity ASEAN economies where policies have been relaxed in recent years, including Indonesia, Malaysia, Thailand and the Philippines should be focusing their actions on avoiding overheating and rebuilding fiscal and monetary buffers which will be challenging in a continued weak external demand environment. Slower growth in conditions of overheating may be desirable.

However, while there are clear costs associated with overheating, especially when fast growth has been accompanied by rapid credit expansion, there are equally clear opportunity costs associated with prematurely slowing an economy and potentially forgoing fast growth and rising incomes. Countries that are too quick to respond to changes in the global environment, risk the of inadvertently running pro-cyclical policies. A balanced approach in implementing policy tightening is recommended. Macroeconomic policy needs to be more closely driven by local economic conditions, including the level of activity, building on the previous efforts toward de-coupling the economies from external demand.

Over the medium-term, the East Asia & Pacific economies will benefit from continued efforts to deepen structural reforms and to keep their global competitive edge in the context of intensifying global and regional competition. Countries need to place greater emphasis on ensuring that market forces are given sway to incite investment flows into the most productive assets, including human capital which will over time boost potential output.

Rebuilding buffers to deal with future shocks, including with commodity shocks remains a priority in Lao PDR, Vietnam, the Pacific islands and Mongolia where gradual global and regional integration has benefitted growth, but also made these economies more vulnerable to global and regional business cycles and commodity price fluctuations. The effectiveness of the on-going economic transformation in Myanmar, establishing a track record of reforms under the WTO accession framework by Lao, and progress in implementing market oriented reforms in Cambodia and Vietnam are also important elements of ensuring sustainable growth.
Notes:

1. Footnote 1 (Price per square meter / GDP per capita)*100

2. The gross annual rental income, expressed as a percentage of property purchase price. This is what a landlord can expect as return on his investment before taxes, maintenance fees and other costs.

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EUROPE and CENTRAL ASIA REGION
Overview

The Europe and Central Asia region suffered a significant economic slowdown in 2012 as the region faced significant headwinds, including weak external demand, deleveraging by European banks, poor harvest and inflationary pressures. As a result, growth fell to 2.7 percent in 2012, compared with 5.6 percent in 2011 with a sharp slowdown in developing Europe and less severe adjustments among Commonwealth of Independent States.

External conditions have significantly improved in 2013 with calmer financial markets and the recovery in global trade. As a result, capital flows to the region have increased with the sharpest improvement in cross-border syndicated bank lending. The pick-up in bank-lending partly reflects the moderation in the pace of Euro Area bank deleveraging and going forward, this should ease the supply-side credit constraints. In addition, several sovereigns and corporates successfully tapped international bond markets. Similarly, following the sharp decline in 2012, FDI in the region is expected to rebound this year. Despite the recovery in global trade, the region’s export performance has been mixed. Export growth has been weak in Russia and Latvia but considerably strong in Romania, Lithuania and Turkey. Several countries have benefited from the increased diversification in terms of export destination in recent years.

Outlook for 2013-2015: GDP growth in Europe and Central Asia is projected to rise only slightly in 2013 to 2.8 percent. While growth in the region will be supported by better harvest and improved external conditions, the rebound will be constrained by the weak carry-over from last year, ongoing fiscal adjustments, and high unemployment in several countries, particularly in developing Europe. Growth in the two biggest economies in the region—Russia and Turkey—has been held back by supply bottlenecks. While growth in Russia is projected to slow to 2.3 percent in 2013, from 3.4 percent in 2012, growth in Turkey is expected to increase to 3.6 percent from 2.2 percent, supported by relatively loose macroeconomic policies. As a result, Turkey’s current account deficit is expected to widen further to 6.9 percent in 2013.

Going forward, growth in the region should firm to 3.8 percent in 2014 and 4.2 percent in 2015 as the fiscal and financial restructuring that has been a drag on growth within the region and in the Euro Area loses intensity. Several domestic factors, including fiscal and monetary policies and policies addressing structural issues, are expected to generate differentiation in economic performance among countries in the region.

Risks and vulnerabilities: While overall risks are less pronounced than a year ago, the region’s economic outlook is still subject to various challenges. First, although the risk of a serious Euro Area crisis has diminished, outturns in developing Europe will remain sensitive to the speed of the recovery in the region’s high-income neighbors. Another risk is related with commodity prices. The growing supply and demand substitution brought on by high prices have recently weakened commodity prices. A sharper decline in commodity prices would have potentially important adverse consequences for commodity exporting countries in the region.

Developments in the global financial markets remain important for the region. A sudden reversal of global financial conditions—due to unexpected developments in Euro-area or in the United States—might affect significantly those countries with high external financing needs (current account deficits and amortization of external debt). In the longer term, the cost of capital is likely to rise as high-income countries step back from quantitative easing. Initially this could expose vulnerabilities in the region that have built up during periods of sustained low borrowing costs. In the long-term, it will reduce growth, capital flows and FDI to the region.

Box ECA.1 Country coverage

For the purpose of this note, the Europe and Central Asia region includes 21 low- and middle-income countries with income of less than $12,276 GNI per capita in 2010. These countries are listed in the table ECA.3 at the end of this note. This classification excludes Croatia, the Czech Republic, Estonia, Hungary, Poland, Slovakia, and Slovenia. The list of countries for the region may differ from those contained in other World Bank documents.
Recent Developments

After the significant headwinds of the past two years, there are signs of a rebound during the first quarter of this year.

Hit hard by the weakness in high-income Europe, the Europe and Central Asia region suffered a significant economic slowdown in 2012 (box ECA.1). The region’s growth fell to 2.7 percent in 2012 compared with 5.6 percent the year before. The slowdown was particularly severe in Eastern European countries, whose GDP grew less than 1 percent and actually declined in the case of Serbia. While the adjustment among Commonwealth of Independent States (CIS) countries was less severe, they also grew less quickly in 2012 than in 2011.

The early months of 2013 suggest that economic activity may have bottomed out for the Eastern European countries. While first quarter GDP data is available for only a few countries, they point to a rebound in economic activity. In Lithuania, for example, the real GDP grew 3.5 percent (y/y saar) in 2013Q1, up from 3 percent in the 2012Q4. The acceleration was boosted by strong export growth at 14.9 percent (3m/3m saar), which helped offset slowing retail sales. In Serbia, GDP growth rebounded strongly to about 1.7 percent (y/y saar) in the first quarter, mainly due to Fiat production, exports and base effects. Ukraine’s growth remained negative at -0.7 percent (y/y saar), but the pace of decline was significantly slower than the 2.5 percent (y/y saar) fall in the final quarter of 2012, suggesting that output picked up in the fourth quarter.

Higher frequency data for industrial production also point to strengthening activity in the region, with annualized growth of 2.4 percent rate in 2013Q1 (figure ECA.1). Industrial output grew particularly strongly in Serbia (rising at a 19 percent annualized pace). Other countries also reported positive growth including Romania (8.1 percent, 3m/3m saar), Turkey (3.8 percent), Kazakhstan (3.4 percent), Bulgaria (3 percent), Lithuania (1.8 percent) and Russia (1.4 percent). The strong rebound mostly reflects base effects, especially for Bulgaria and Serbia, following the contraction during the second half of 2012. The acceleration in economic activity in these countries was more than offsetting a 10.6 percent decline in Ukraine.

The USD value of imports in the region accelerated sharply during the first quarter, rising at a 25.2 percent annualized pace (3m/3m saar) in March suggesting significant firming of domestic demand. The rebound was particularly evident in Romania where the USD value of imports grew at a 3 percent pace (3m/3m saar) after a strong contractions in 2012Q4. That said there has been some easing in import value growth in Latvia during the same time.

While remaining above the expansion/contraction level of 50, business confidence indicators such as Markit’s Purchasing Manager Index (PMI) suggest a slight easing in economic activity for Russia and Turkey in April.

Despite the recent pick-up in global trade, the region’s exports have contracted so far in 2013

As discussed in the main text, much of volatility that characterized the period from 2008 until June 2012 appears to have eased, and after declining sharply in mid-2012 global trade is recovering, driven by developing countries import demand (see trade annex). Even in the Euro Area, import demand growth has turned positive during the first few months of 2013.
The recovery in import demand, particularly developing-country import demand has led a recovery in high-income and developing-country exports (see main text), but these benefits have not been shared by developing countries in Europe & Central Asia (figure ECA.2). In contrast, the USD value of their export contracted at a 0.4 percent (3m/3m saar) annualized rate in the three-months ending in March, with weak foreign sales in Russia and Latvia the main explanation. A 11.3 percent annualized decline in the value of Russian exports mainly reflected weaker commodities sales, particularly natural gas, which were hit by a slump in the European market where Russian natural gas is facing newfound competition.

For several other countries, the USD value of exports did surge, by an annualized 14.5 percent in the case of Romania and 9.4 percent in the case of Lithuania. The growth in Romania’s exports reflected steady improvement in the share of the car parts industry and transport equipment in total foreign sales. Lithuania’s exports were supported by robust oil exports—the country’s biggest traded commodity, while exports in manufacturing also picked up due to improved competitiveness following a large devaluation.

Similarly, Turkey’s exports bounced back in March by 4.8 percent annualized rate after declining sharply earlier in the year. The earlier sharp contraction was because of a decline in gold exports (and prices) with no sale to Iran in January and weakening exports to Europe—mainly to Germany, UK and Italy. That said gold exports to Iran (as payment for natural gas import) resumed in February but at a much slower pace than in 2012\(^{N1}\).

All three countries benefited from their rising sales to countries outside high-income Europe. In fact, many countries in the region have managed to diversify their export destinations in recent years, which should benefit the export performance of the region in coming months (see box ECA.2).

**Improved access to international debt markets...**

Global financial markets have been significantly calmer since July 2012, including during the first four months of 2013 (see the Finance Annex for details). Market risk perceptions have remained relatively stable, despite continued economic weakness in the Euro Area, political gridlock in Italy that has stalled reforms, and the Cyprus crisis that culminated in the imposition of capital controls—a first in the Euro Area.

In this improved environment, gross cross-border capital flows (international bond issuance, cross-border syndicated bank loans and equity issuance) to the Europe and Central Asia region strengthened in the second half of 2012 and into 2013, with inflows in during the first four months of 2013 reaching $88.5 billion, more than double their year earlier levels of $37.4 billion (figure ECA.3). While equity issuance remained subdued, both bank lending and bond issuance...
rebounded. Despite these improvements, inflows into the region remain low relative to pre-crisis flows.

Syndicated bank lending to the region, at $37 billion, showed the sharpest improvement, increasing three folds from its level a year ago. Even excluding the mega loans to the Russian company Rosnefte Gaz for their large acquisition in 2012, bank lending to the region was still more than twice as high as in during the first four months of 2012. The rebound in syndicated bank lending reflected a global phenomenon as the acute phase of Euro Area deleveraging appears to have passed. The moderation in its pace has been easing lending conditions in the region (see the discussion later).

Bond flows to the region were also robust. Several sovereigns and corporates successfully tapped international bond markets taking advantage of strong appetite for higher-yield developing-country debt, encouraged by low yields in high-income countries because of quantitative easing. For example, despite the downgrading of Ukraine’s sovereign credit rating by Moody’s and S&P in December 2012, the government and several companies issued $5.7 billion of combined international bonds. Regular regional emitters included Russia ($26 billion), Turkey ($8.7 billion), Kazakhstan ($3.5 billion) and Romania ($1.5 billion), while infrequent issuers such as Azerbaijan ($1 billion), and Serbia ($1.5 billion) also took advantage of conditions. Improved access to international bond markets is particularly important...
for countries with large external financing needs (current account deficit and amortization of debt). This year, this includes Ukraine with financing needs totaling 42.6 percent of GDP, Bulgaria (39.5 percent of GDP), Turkey (30.8 percent of GDP) and Romania (27.1 percent of GDP).

…with portfolio investments coming with their challenges

Several countries in the region also received large portfolio investment flows (foreign investment in local stock markets and local currency debt securities). During the first three months of this year, flows to local bond markets were particularly strong in Turkey ($7.3 billion), Romania ($4.7 billion), and Serbia ($1.9 billion) putting upward pressure on their currencies. As these flows tend to be volatile, managing the fluctuations can be quite challenging, and to the extent that countries rely on these flows to finance current account deficits they constitute a source of vulnerability.

After the sharp decline in 2012, FDI inflows to Europe and Central Asia are expected to rebound this year

Foreign direct investment (FDI) inflows to Europe & Central Asia region totaled only $109 billion in 2012, a 9 percent decline compared with 2011 (figure ECA.4). The sharp fall in FDI mostly reflects a 25 percent contraction in direct investment flows from high-income European economies—traditionally the region’s main source of FDI. In a process somewhat akin to the earlier episode of banking-sector deleveraging, multinationals from Greece, and the Netherlands repatriated substantial sums from their foreign holdings, including investments in the region. In addition, in contrast to other years, reinvested earnings were limited due to weak profitability and intercompany loans slowed down sharply.

Serbia experienced the sharpest (86 percent) decline in FDI inflows, followed by Macedonia, FYR (71 percent), Moldova (43 percent), Lithuania (32 percent) and Turkey (22 percent). In contrast, FDI increased in oil-exporting economies Azerbaijan (18.5 percent) and remained high at its 2011 level in Kazakhstan.

Limited high frequency data suggest a mixed picture so far in 2013. While FDI inflows to Russia surged in the first quarter because of a special acquisition deal (for $15 billion) and methodological changes, flows to other countries have been weak. Nevertheless, FDI inflows are projected to rebound in the second half of the year for other economies as well. Several countries including Romania, and Serbia might accelerate privatization efforts this year. With the sharp increase in FDI to Russia, FDI inflows to the region are forecast to increase by 20 percent—reaching $132 billion in 2013. In 2014, FDI flows to the region is expected to slow down mainly on the account of Russia following an adjustment for the 2013 mega deal. Excluding Russia, FDI flows are expected to rebound by 6 percent in the region in 2014. The recovery in FDI, may be particularly important for countries such as Georgia and Albania, where FDI accounts more than 30 percent of gross domestic capital formation.

With strong bond flows, rebounds in bank lending and FDI flows, net private capital flows (debt flows net of disbursements and equity flows net of disinvestments) to the Europe and Central Asia region are forecast to rebound to $255 billion (6.5 percent of the region’s GDP) in 2013 from an estimated $208 billion (5.7 percent) in 2012 (table ECA.1). Going forward, assuming there is no major set-back in financial markets confidence, net capital flows to the region are expected to strengthen along with global growth to reach $279 billion in 2015—around 5.9 percent of region’s
GDP. By 2015, all flows are expected to increase, with bond issuance expected to level off slightly as bank-lending picks up the pace, with the latter supported by increased South-South flows.

**Supply-side credit constraints in the region have eased along with improved global financial conditions**

As discussed in the January edition of GEP 2013, credit growth in the region was very weak during the second half of 2012. Real domestic credit growth has been negative for Latvia and Lithuania since early 2009, and sharply declined in Albania, Bulgaria, Macedonia FYR, and Romania. The intense deleveraging by European banks over the last two years has contributed to the tight credit conditions and weak credit growth, especially in countries with strong European bank presence (BIS December 2012). The recent pick up in international bank flows to the region, likely signals the end to the most intense phase of Euro Area deleveraging. While expected to continue, the slower pace of deleveraging should ease the supply side constraints when demand for loans picks up with the economic activity.

Recent data show a modest increase in real credit in Bulgaria (0.5 percent year-over-year in February) and Macedonia (2.2 percent) after contacting in 2012, and less rapid declines in Latvia and Lithuania. The rebound has been more robust for Turkey, where after slowing due to domestic monetary policy tightening, real credit growth rose 7.8 percent in the 12 months ending February. A large part of the increase was funded by foreign loans, with Turkish banks aggressively seeking wholesale financing abroad. Although the credit growth (nominal annualized growth of 20 percent) is much higher than its central bank’s official target at 15 percent, the central bank has not yet acted to restrain it as inflation pressures have subsided.

**Remittances flows to Europe and Central Asia are also expected to bounce back this year**

Remittances are an importance source of foreign currency and income for several countries in developing Europe and Central Asia. Remittance flows to the region are estimated to have fallen by 3.9 percent in US dollar terms to about $40 billion (1.1 percent of GDP) in 2012 (table ECA.1). The fall partly reflects the Euro depreciation against the dollar as remittances declined by a smaller 2 percent in Euro terms. Remittances flows declined in most countries in the region in USD terms (Migration and Development Brief 20). The exceptions were Tajikistan, Kyrgyz Republic, Moldova and Armenia, where flows increased by 28 percent, 14 percent, 10 percent and 8.5 percent, respectively as flows were supported by strong growth in Russia and high oil prices (Migration and Development Brief 17).

The weakness of the flows in the rest of the region mainly reflects that the preponderance of their migrants are in Western Europe, where economic growth has been weak and unemployment rising. Remittances to Romania have gyrated in recent years. They surged after accession into the EU in 2004 but dropped significantly after the crisis in 2008, partly due to increasing numbers of migrants returning home. Still, migrants are showing resilience in the face of these dampening effects, and are nearly sustaining remittances in euro terms.

As economic conditions improve in the European Union, officially recorded remittances to the region are expected to keep up with the region’s nominal GDP growth in 2013-2015, reaching $52 billion (1.1 percent of GDP) in 2015. Despite the projected slowdown in Russia (see the discussion later), still high oil price should continue to support remittance outflows.

**Output gaps and unemployment represent persistent problems in many countries with limited policy space**

Since the 2008/09 and European crises, several countries in the region—particularly developing Europe, had to deal with declining exports, European bank deleveraging, and high levels of external debt. As growth rates sharply declined, unemployment soared to record levels, as banks deleveraged and households and firms cut into spending in an effort to repair damaged balance...
sheets. Fiscal conditions deteriorated throughout the region, with severe consequences in a few countries where public debt levels had risen during the boom years.

The good news is that growth rate for many of the hardest-hit countries have recovered to levels close to their underlying potential output. Unfortunately, growth so far has not been strong enough to make significant inroads into existing unemployment and spare capacity in many countries (figure ECA.5). Several countries including Romania, Ukraine and Bulgaria have still large economy-wide output gaps (3 to 4 percent of their GDP). Several economies continue to suffer from high levels of unemployment. The unemployment rate is still in excess of 10 percent in Albania, Bulgaria, Latvia and Lithuania. More than 20 percent of the labor force remain unemployed in Serbia, Kosovo, and Macedonia FYR. Arguably, these economies have been caught in a high unemployment equilibrium. In the short run, policy options have been limited. Many of these economies are already constrained by high fiscal deficits. Inflationary pressures of last year’s bad crop and necessity of restoring banking-sector balance sheets have constrained the scope of monetary policies to stimulate growth.

On the contrary, Russia, Turkey and Kazakhstan remain among the exceptions in the region as their output gaps are relatively small (or positive). Russia

<table>
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<th>Table ECA.1</th>
<th>Net capital and workers’ remittances flows to Europe and Central Asia*</th>
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<tr>
<td>Other official</td>
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**Memo item:**

Migrant remittance inflows

| Central and Eastern Europe & Turkey | 37.0 | 38.0 | 39.0 | 40.0 | 43.0 | 47.0 | 52.0 |
| Commonwealth of Independent States | 19.8 | 18.9 | 16.1 | 16.7 |
| 17.2 | 19.1 | 22.9 | 23.3 |

Source: The World Bank

Note: e = estimate, f = forecast.

*The regional FDI numbers have been revised historically since some countries including Russia have started to report their balance of payment data under BMP6 methodology.*
has been growing at or above its potential growth rate indicated by its tight labor market and high capacity utilization. Similarly, Turkey’s current acceleration in growth has been generating inflationary pressures, and increasing current account deficits. For these economies, efforts to increase growth through monetary and fiscal stimulus risk being ineffective while adding to debt or inflationary pressures without any sustained progress in terms of increased output.

Inflationary pressures have recently moderated in most economies

Inflation has moderated in most economies due to declines in food prices following last summer’s poor crop, and the passing through of earlier administrative tariff and tax increases (figure ECA.6). Further inflation declines are expected among countries that suffered the biggest food price shocks. That said inflation remains at high levels in several middle-income countries. In Russia, inflation although down was 7.2 percent year-over-year in April, well above the central bank’s target of 5-6 percent. However, inflation is expected to decline to within this range as the adverse base effect from last year’s drought disappears and a better crop could even cause food prices to decline. In Turkey, despite the recent easing, pressures are likely to build in the later part of the year due to robust domestic demand and supply-side capacity constraints. In the absence of any significant relief from global commodity prices (Turkey is an energy importer) or any local food prices as it did last year, inflation is expected to rise beyond the central bank’s target of around 5 percent. Inflation in Romania remained at 5.7 percent year over year in February (5.8 percent in January) driven mainly by foods and services (due to regulatory tariff hikes), but is expected to go down toward the central bank’s target rate in the second half of the year. Inflationary pressures have eased slightly in Belarus, but inflation remains in double-digits.

In contrast, consumer prices fell in Azerbaijan and Georgia towards the end of 2012 due to weak domestic demand; decline in food prices; and due to the earlier nominal appreciation of Georgian lari against currencies of its main trading partners. While inflation has picked up in Azerbaijan, Georgia’s deflation continued in April, the sixth month in a row with falling prices, with prices down by 1.7 percent due to the weak economic activity.

…allowed central banks cut their policy rates

Against the backdrop of easing inflation, spare capacity, high unemployment and moderate growth, several central banks in the region including Albania, Azerbaijan, Belarus, and Georgia have cut their policy rates (figure ECA.7). Turkey’s central bank has been narrowing its interest rate corridor since last year and recently cut its main policy rate in April. The rate was cut despite a small output gap, the acceleration in credit growth, and persistent inflation in part to support growth and discourage the inflow of portfolio investment (see the discussion earlier).
In contrast, the Russian central bank has kept its main policy rates unchanged since December 2012 despite weakening growth. Similarly, the monetary policy in Ukraine remains restricted by its de-facto currency peg to the dollar. Maintaining the peg might be increasingly challenging with economic contraction.

**Outlook: A rebound with increasing differentiation among countries**

Despite the improved global environment, growth in the region is expected to rebound only slightly in 2013.

Although the global environment has become less volatile and growth appears to be strengthening, GDP growth in Europe and Central Asia is projected to rise only gradually in 2013 to 2.8 percent from 2.7 percent in 2012 (table ECA.2). Growth should firm further to 3.8 percent in 2014 and 4.2 percent in 2015 as the fiscal and financial restructuring that has been a drag on growth within the region and in the Euro Area loses intensity. Several domestic factors including fiscal and monetary policies and structural issues will generate differentiation in economic performance among countries.

The apparently anemic acceleration in 2013 mainly reflects the weakness of growth at the end of 2012. The quarterly profile of growth during 2013 is stronger than the annual growth rate because growth in the final quarters of 2012 was so weak (figure ECA.8). This low base effect reduces carryover into 2013, resulting in weak annual growth even if quarterly growth rates are relatively strong. While carry-over from 2012 is generally low in many economies in the region, it is negative for Ukraine and Georgia, and weak for Turkey and Bulgaria.

On the plus side, agricultural production is expected to be better this year in several countries. The summer and winter droughts in 2012 cut the growth rates significantly and generated inflationary pressures in several countries. Countries including Albania, Georgia, Kazakhstan, Romania, Russia, Serbia, and Ukraine will benefit from a higher contribution of agriculture this year.

Growth in developing *Central and Eastern Europe* is expected increase only slightly to 1.9 percent in 2013 from 1.5 percent as most of the factors that weighed down the growth last year continue to hinder the economic growth this year, but less intensively in some countries (see the table ECA.2 for the list of countries; table ECA.3 for individual country forecast). Monetary policy remains accommodative in most countries, while the pace of fiscal consolidation has eased in Romania, Latvia and Lithuania, reducing the drag on overall growth. However, major fiscal adjustments are still needed in several others, including Serbia and Montenegro. In addition, although there are signs of improvement, economic growth in high-income Europe still remains weak and is expected to pick up only gradually toward the end of the year. Thus although developing European economies will benefit from a gradual improvement in high-income countries and are therefore expected to see a firming in quarterly growth rates, this will have only a modest impact on whole-year growth in 2013. As a result, growth is expected slightly increase in almost all Central and Eastern European countries. The only exceptions are Latvia and Lithuania where economic growth is expected to ease in Latvia after more than 5 percent growth in 2012Q4.
over the last two years, and in Lithuania mainly due to the base effect from 2012’s exceptionally good harvest and projected weak growth in main trading partners including Russia and Latvia.

Going forward, growth in developing Europe is expected to rise in the medium-term to 3.1 percent by 2015 but will remain below their 2000-2009 average (table ECA.2). As discussed earlier, several economies still suffer from high unemployment rates and spare capacity. Prospects for the region critically depend on the progress in addressing external (large current account deficits) and domestic (large fiscal deficit, unemployment, and inflation) imbalances. Serbia has the widest twin deficits in the region. While spare capacity remains in the region, countries must focus on redressing structural weaknesses if they wish to return to the relatively robust growth rates of the pre-crisis period. Areas of focus should include increasing labor market flexibility, strengthening the business environment and financial market efficiency.

After the sharper than expected slowdown in 2012, growth is likely to pick up in Turkey on rising domestic demand, supported by robust domestic

<table>
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<tr>
<th>Table ECA.2</th>
<th>Europe and Central Asia forecast summary</th>
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<td>GDP at market prices b</td>
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<td>GDP per capita (units in US$)</td>
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<td>Imports, GNFS d</td>
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<td>Net exports, contribution to growth</td>
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<td>GDP deflator (median, LCU)</td>
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<td>Fiscal balance/GDP (%)</td>
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</table>

Memo items: GDP

| Transition countries e | 4.6 | 3.9 | 4.4 | 3.0 | 2.5 | 3.5 | 3.9 |
| Central and Eastern Europe f | 4.1 | -0.4 | 3.1 | 1.5 | 1.9 | 2.5 | 3.1 |
| Commonwealth of Independent States g | 4.7 | 4.7 | 4.6 | 3.2 | 2.6 | 3.7 | 4.0 |
| Russia | 4.4 | 4.3 | 4.3 | 3.4 | 2.3 | 3.5 | 3.9 |
| Turkey | 3.0 | 9.2 | 8.8 | 2.2 | 3.6 | 4.5 | 4.7 |
| Romania | 4.2 | -1.6 | 2.5 | 0.7 | 1.7 | 2.2 | 2.7 |


a. Growth rates over intervals are compound weighted averages; average growth contributions, ratios and deflators are calculated as simple averages of the annual weighted averages for the region.
b. GDP at market prices and expenditure components are measured in constant 2005 U.S. dollars.
c. Sub-region aggregate excludes Bosnia and Herzegovina, Kosovo, Montenegro, Serbia, Tajikistan and Turkmenistan. Data limitations prevent the forecasting of GDP components or Balance of Payments details for these countries.
d. Exports and imports of goods and non-factor services (GNFS).
e. Transition countries: CEE and CIS (f + g below).
f. Central and Eastern Europe: Albania, Bosnia and Herzegovina, Bulgaria, Georgia, Kosovo, Lithuania, Macedonia, FYR, Montenegro, Romania, Serbia.
g. Commonwealth of Independent States: Armenia, Azerbaijan, Belarus, Kazakhstan, Kyrgyz Republic, Moldova, Russian Federation, Tajikistan, Turkmenistan, Ukraine, Uzbekistan.
credit growth and relatively loose macroeconomic policies. Nevertheless, the growth in 2013 will be constrained by the weak carryover from 2012. The growth rate is expected to rebound to 3.6 percent from 2.2 percent in 2012. With the economy operating very close to its potential output growth, the rising domestic demand and declining tourism receipts will widen the current account deficit to 6.9 percent of GDP in 2013 from 6 percent in 2012. While access to external financing has been comfortable so far with the recent upgrade of its credit rating to investment grade, the heavy reliance on portfolio and short-term debt flows is an important vulnerability. Monetary policy is expected to remain active in balancing external and domestic demand while growth picks up with the forecasted global recovery, reaching 4.7 percent by 2015.

Growth in Russia is expected to slow down to 2.3 percent in 2013 from 3.4 percent in 2012 after continuously weakening over the last five quarters (on a year-over-year basis). In addition to disappointing export growth, domestic demand has been weak—partly due to increasing prices and easing in oil prices, which has constrained incomes, corporate profits and investment. At the same time, despite the increased capital flows, investment has not picked considerably. Similar to Turkey, Russia’s economy is operating close to its potential and faces high inflation, a tight labor market, and capacity constraints. But unlike Turkey, the Russian central bank has pursued a less accommodative stance keeping its main policy rates unchanged. However, this stance might change if inflationary pressures start to ease in the second half of the year with adverse base effect disappearing. In addition, starting this year fiscal policy will be constrained by a newly accepted budget rule. The rule implies that spending cannot exceed revenues more 1 percent of GDP, while revenues are calculated as a function of past long-term average oil price. Growth is expected to pick up together with the global economy only modestly to 3.9 percent by 2015 as the pace of expansion will be held back by potential output growth.

Growth in Kazakhstan is expected to remain stable at 5 percent in 2013 following the weak first quarter growth. Government consumption is expected to compensate for moderating private consumption and the economic slowdown in Russia. While expected to pick up by 2014 after a new oilfield becomes operational, medium-term growth in Kazakhstan will be held back by supply-side constraints.

Growth in Ukraine is forecast to remain weak at 1.0 percent in 2013, up from 0.2 percent in 2012. The increase will be supported by robust consumer demand with increasing retail sales, while industry continues to contract and global steel prices remain weak. The overall outlook remains challenging, with a high fiscal deficit, persistent current account deficit, high external debt, and the currencies de-facto peg to the dollar and declining foreign reserves all sources of concern. Reforms that may stem from ongoing discussions with the EU/IMF and Russia will be crucial factors determining the shape of growth going forward.

Growth rates in Azerbaijan and Kyrgyzstan are forecast to be higher in 2013 as high public investment spending boosts domestic demand and a recovery in Kyrgyzstan’s gold production. On the other hand, Armenia’s growth is expected to moderate after the strong growth in 2012, as prudent fiscal and monetary policies permit the economy to avoid overheating.

**Risks and vulnerabilities**

While risks are less pronounced, the region’s economic outlook is still subject to various challenges.

Although the risk of a serious Euro Area crisis has diminished, outturns in developing Europe will remain sensitive to the speed of the recovery in its high-income neighbor. Both a significantly stronger and weaker recovery in high-income Europe would have significant knock on effects for the region, including through the financial channel.

The recent easing in commodity prices in response to growing supply and demand substitution brought on by high prices, is a further source of uncertainty as to the pace of decline toward long-term equilibrium prices. As discussed in the main
text and the Commodity Annex, if prices ease more quickly than the baseline, government revenues, incomes and current account positions in exporting countries could come under pressure, even as lower prices benefitted importing nations. According to the simulations highlighted in table 5 in the main text, a rapid decline in oil prices might reduce the growth rate by 0.8 percentage points, the current account balance by 2.3 percentage points, and the fiscal balance by 1.8 percentage points in 2014 from the baseline scenario for oil-exporters in the region. The impact will be positive for oil-importers with increasing growth by 0.4 percentage points and improving both the current account and fiscal balance by 0.8 and 0.2 percentage points, respectively from the baseline scenario. The scenario for the metal price declines show smaller impact for the region.

Several countries have accessed international capital markets this year as cost of bond financing fell. Nevertheless, a sharp drop in confidence in financial markets—due to unexpected developments in Euro Area debt resolution and US fiscal situation—can lead to a sudden reversal of global financial conditions and adversely affect significantly the countries with high external financing needs (current account deficits and amortization of external debt).

In the longer term, developing country financial conditions may become more difficult as high-income countries step back from quantitative easing and base interest rates and spreads rise. The cost of capital in developing countries is likely to rise amid rising long-term yields in high-income countries. Initially this could expose vulnerabilities that have built up during periods of sustained low borrowing costs, intensifying financial market pressures in the region and even in a worst case scenario provoking local crises. Longer-term, higher borrowing costs would raise the cost of capital and cause firms and foreign investors to reduce investment levels with negative consequences for growth (see main text), capital flows and FDI (see World Bank, 2010 for an in depth discussion of channels).

Aside from these global risks for the region’s economies, banking systems in several countries have been under pressure by sharp slowdown in economic activity, weak credit demand and increase cost of foreign funding have increased pressures on profits. Non-performing loans (NPL) remain higher than 10 percent in several countries including Kazakhstan, Albania, Ukraine, and Serbia. The high levels of NPL in region’s banking system may constrain credit growth going forward, which has already been weak. Nevertheless, there is some level of resilience in most banks in the region with their capital adequacy ratios in excess of 10 percent by the end of 2012.
## Table ECA.3  Europe and Central Asia Country forecasts

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<th>Country</th>
<th>GDP at market prices (% annual growth) b</th>
<th>Current account bal/GDP (%)</th>
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World Bank forecasts are frequently updated based on new information and changing (global) circumstances. Consequently, projections presented here may differ from those contained in other Bank documents, even if basic assessments of countries’ prospects do not significantly differ at any given moment in time.

Bosnia and Herzegovina, Turkmenistan are not forecast owing to data limitations.

a. GDP growth rates over intervals are compound average; current account balance shares are simple averages over the period.

b. GDP measured in constant 2005 U.S. dollars.
Notes

1. Turkey did not sell any gold to Iran in January as banks and dealers waited until early February for the implementation of U.S. sanctions that tightened control over precious metal sales. The trade has resumed in February as the United States has given Turkey a six-month waiver exempting it from sanctions on trade with Iran, which is now due to expire in July.

2. By June 2012, three quarters of European banks had complied with the ECB’s capital ratio requirements. Moreover, according to the April ECB Bank Lending Survey, Euro Area banks are beginning to loosen credit standards. Euro Area banks have begun repaying ECB crisis loans and have already started to repay some of the loans well in advance (See Finance Annex).

3. The regional FDI numbers have been revised up historically since several countries including Russia have started to report their balance of payment data under BMP6 methodology. FDI flows to Russia surged in the first quarter of 2013 as the deal between Rosneft and BP around the TNK-BP sale that eventually resulted in the acquisition of 18.5 percent of Rosneft, worth almost $15 billion. Adjusted for this one-off deal, the FDI remained fairly stable during the first quarter of 2013.

4. The figure excludes Belarus because of its outlier status in terms of 2011 inflation, which reached 108.7 percent, after almost threefold devaluation of the national currency.

5. Carry over (or statistical overhang) is defined as the rate of growth that would be observed if quarterly GDP in year t remained unchanged from the level of the fourth quarter of the previous year. It therefore measures the contribution to annual growth in year t, of the quarterly expansion during the previous year (GEP 2012 June).

6. The EU required adjustment has been completed in Romania, Latvia and Lithuania to reach the 3 percent deficit target.
LATIN AMERICA and the CARIBBEAN REGION
Overview

After a sharp recovery from the global economic crisis in 2010, when regional output expanded by 6 percent, growth in the Latin America and the Caribbean decelerated markedly, to an estimated 3 percent by 2012. Supply side constraints have become apparent in some of the larger economies, where output was near or above potential during the recovery phase, and which contributed to relatively high inflation and deterioration of current account balances. Despite a sharp deceleration in growth, regional output is only now in line with potential GDP. Cyclical factors such as lower commodity prices and generally subdued global activity, in particular in high-income countries, have also weighed on growth. Private consumption remained relatively robust, while the contribution to growth from investment and exports weakened considerably.

Outlook for 2013-2015: The factors that have contributed to the deceleration in growth in the post-recovery period will continue to weigh on economic activity over the short-to-medium term. Growth in the region is expected to accelerate only modestly to 3.3 percent in 2013, and to about 3.9 percent over the medium terms. Growth is expected to firm somewhat from a very weak pace in Brazil and Argentina, while slowing down in most of the commodity exporters, largely on account of weaker commodity prices. Growth in Venezuela is expected to decelerate markedly as highly expansionary policies are reversed. Meanwhile Paraguay will see one of the sharpest accelerations in growth this year, on account of normalization in agriculture output. Growth in Central America will benefit over the medium term from firmer growth in the United States and improvements in terms of trade. Growth in the Caribbean will be held back by large fiscal adjustments necessary to bring fiscal deficits to sustainable levels and help reduce public debt burdens.

Risks and vulnerabilities: The severe downside risks to the global economy have eased significantly compared to last year, reflecting progress in Euro-area economies towards reducing fiscal and banking solvency risks and an easing in fiscal-cliff related risks in the United States. However, little progress has been made in setting the US fiscal policy on a sustainable path and by Japan to reduce its large general government debt to sustainable levels, and these continue to represent sources of risk for the global economy.

For the Latin America and the Caribbean the risks stem in part from the challenges of finding the optimal balance between macroeconomic policies to stimulate domestic demand in the short term and structural reforms to enable faster growth over the longer run. In addition ample global liquidity and higher and more volatile capital flows are complicating the task of conducting monetary policy and could, if interest rates are low, lead to rapid credit expansion and goods and asset price inflation. For commodity exporters, large fluctuations of export prices represent a major risk to the outlook.

Over the longer term as external financial conditions are likely to become tighter, higher financing costs could result in reduced investment spending and growth in the countries in the region and may also expose unsustainable positions. If greater progress is made to implement a wide range of structural reforms and address supply-side constraints to growth, economic expansion over the medium term could be more robust.
Recent economic developments

With growth decelerating to slightly below potential, the positive output gap nearly closed in 2012...

Growth in the Latin America and the Caribbean region decelerated an estimated 1.4 percentage points to 3 percent in 2012 (table LAC.1). In per capita terms growth has fallen below 2 percent for the first time since the global crisis. The growth slowdown was partly due to bottlenecks that constrained growth in some of the larger economies in the region, partly because of softening in global activity mid-year due to Euro Area uncertainty, and partly because of a decline in non-oil commodity prices. Even with GDP growth below potential in 2012, the positive output gaps that opened during the recovery from the 2009 crisis still persist or have only now closed. GDP in Brazil expanded only 0.9 percent, despite accommodative monetary and fiscal policies, held back by increasingly apparent supply side bottlenecks. Despite slow growth, unemployment remains low and inflation high. World Bank estimates suggest that the slowdown has only now opened up a negative output gap of 0.8 percent of potential GDP. Although potential growth has slowed due to a decline in investment and slower growth in total factor productivity, at 3.2 percent potential growth was still much higher than actual GDP.\textsuperscript{FN1}

In other South American commodity exporting countries growth remained robust, including Bolivia, Chile, Colombia, Peru, and Venezuela. In these economies, growth in private consumption contributed half or more of the total GDP expansion supported by still high commodity revenues. In Venezuela very expansionary policies contributed to a marked acceleration in growth to 5.6 percent and a wide positive output gap with respect to potential. Growth decelerated markedly only in Argentina to 1.9 percent from 8.9 percent, as exports underperformed and investment plunged, subtracting 0.01 and 1.2 percentage points from growth, respectively. Paraguay is one of only a couple of countries in Latin America to have recorded a decline in GDP, due to the impact of a severe drought, and slower growth in its major trading partners. Mexico continued to outperform the regional average for a second consecutive year, expanding close to 4 percent and contributing 1.1 percentage points to the regional growth, compared to a 0.3 percentage point contribution by Brazil and Chile. Mexico’s growth continued to be well balanced, with positive contributions from all demand components.

In Central America output expanded at a robust pace of close to 5 percent in 2012, the second consecutive year of above trend growth. Growth accelerated in Costa Rica to above 5 percent boosted by exports and private consumption and remained very robust in Panama, where exports and investment have made significant contributions to growth (in excess of 4 percentage points), supported by the Panama Canal expansion and several other large investment projects.

Growth in the Caribbean continued to disappoint, decelerating to 3 percent in 2012 as growth decelerated in the Dominican Republic and in Haiti, while Jamaica’s economy fell into recession. In most other economies in the region growth fell below 1 percent, with the notable exception of Belize’s economy, which expanded more than 5 percent.

Data from the first quarter of 2013 suggests that growth is easing

Growth had decelerated from 3.2 percent seasonally adjusted annualized (or saar) in the first quarter of 2012 to 1.6 percent by the third quarter, before reaccelerating markedly in the last quarter to a 3.5 pace in line with potential growth, as growth in the largest economies in the region accelerated into the year’s end. On an annualized basis fourth quarter GDP expanded 2.6 percent in Brazil, 4.5 percent in Peru, 2.7 percent in Mexico, more than 7.0 percent in Chile and Colombia. Among the countries that bucked the regional acceleration trend in the final quarter of 2012 were Paraguay, Peru, with GDP contracting in the former and decelerating in the latter. With relatively strong growth in the second half of 2012 and/or the fourth quarter of 2012, Chile, Peru, Colombia have strong carryovers for 2013, in excess of 1.3 percentage points, while Brazil’s carry over is relatively weak at 0.65 percentage points. For the region the carryover for 2013 growth is about 1 percentage points.
Regional growth in the first quarter as approximated by industrial production softened, with industrial production remaining relatively flat, after a slight contraction in the fourth quarter (figure LAC.1). Slower domestic consumption in conjunction with weak external demand caused economic activity to slow in many countries in the region. In Mexico GDP growth eased to a 1.8 percent seasonally adjusted annualized pace as domestic consumption and external demand showed signs of weakness. In addition government spending eased in line with past trends at the beginning of a new presidential administration. Similarly in Brazil growth eased to a 2.2 percent annualized pace in the first quarter of 2013, as exports contracted and both private and public consumption showed signs of weakening and despite an acceleration in investment growth. Growth decelerated markedly in Chile in the first quarter, to 2.1 percent quarter-on-quarter annualized pace, down from 8 percent in the fourth quarter of 2012 on account of a slowdown in investment, consumption, and sluggish exports. Meanwhile economic activity in Venezuela contracted 2.5 percent quarter-on-quarter (or 9.7 percent annualized pace) as private consumption slowed dramatically, while exports contracted, and inventories tumbled.

Similarly, export performance has weakened in the first months of 2013, with export revenues declining close to 12 percent annualized rate in the first quarter of 2013, after a robust performance in the fourth quarter of 2012 (14.8 percent). The decline comes even as world imports continued to expand at a solid pace over this period (10 percent). The quarterly decline was particularly pronounced in commodity exporters like Argentina, Brazil, Chile, Colombia, and Peru. Export revenues also declined in manufactures exporters like Mexico (10.7 percent saar).

Meanwhile imports expanded at slower pace of 8.4 percent annualized pace in the first quarter of 2013, after a strong recovery in the fourth quarter (31.6 percent), pointing to a possible moderation in domestic demand and rapidly deteriorating trade balances. Imports continued to rise at a rapid pace in Argentina, Brazil, and bounced back in Colombia, while import growth eased in Mexico in line with weaker exports.

**Inflation remains contained**

Inflation rates in the region have remained relatively anchored for the most part, especially core inflation, although they have remained stubbornly high or even accelerated in countries where economic output is at or near potential (e.g. Brazil, Uruguay). Currency devaluation has exacerbated local price pressures in Venezuela, while import restrictions and loose policies contribute to stubborn inflation in Argentina that continues to erode real incomes. Inflation decelerated in Chile, Colombia, and Peru on account of deceleration in food and energy inflation, but in some cases also on account of moderation in domestic demand. Lower food and energy inflation also contributed to the decline in inflation in Central American economies, while inflation in some of the Caribbean economies was low on account of weak domestic demand.

**Monetary policy guided by both domestic conditions as well as global liquidity**

Conducting monetary policy during the post-crisis period has been complicated by the very loose monetary policies pursued by several high-income countries, most recently Japan.

The benign inflation environment and very easy policy stances in high-income countries have
prompted some central banks in the region to cut policy rates. The Bank of Colombia cut its policy rate 200 basis points, as growth slowed since mid-2012, while Banxico, Mexico’s central bank cut the overnight rate 50 basis points in March 2013, the first cut since July 2009. In contrast Brazil’s central bank raised the Selic rate a cumulative 75 basis points to 8 percent embarking on what is expected to be a gradual normalization in its monetary policy (figure LAC.2).

Sluggish growth in some of the larger economies has prompted more accommodative macroeconomic policies despite becoming increasingly apparent that supply potential is lower than during the recovery from the global crisis in these economies.

Strong domestic demand in many countries in the region and in some cases small or positive output gaps have resulted in a worsening in current account positions in 2012. For commodity exporters the decline in non-oil commodity prices in 2012 has also played a role, with this group of countries recording some of the largest deteriorations in current account positions. One notable exception is Argentina, where compression in imports due to tough import controls, made possible an improvement in the current account balance. For the region as a whole the current account deficit deteriorated 0.4 percentage points, with a median deterioration of 0.1 percentage points of GDP.

Foreign currency earnings from remittances increased slightly to an estimated $62 billion, still below the 2008 peak of $64.5 billion. Remittances to Mexico (which accounts for 55 per cent of regional inflows) and Ecuador declined in absolute terms, while they rose relatively quickly in Brazil, Guatemala, El Salvador, and Peru.

Expressed as a share of recipient countries’ GDP they remained flat at 5.3 percent of GDP in 2012. The weak performance reflected still weak labor markets in the United States, and unemployment in Spain (another major destination for regional migrants) in excess of 25 percent of the labor force. Indeed, the very high unemployment rate in Spain and improved growth prospects in home countries forced many migrants to return home.

**Capital flows**

Very loose monetary policies pursued by several high-income countries, most recently Japan have contributed to ample global liquidity. With dramatic shifts in perceptions of risk in high-income countries there have been episodes of strong inflows and outflows of capital to developing countries, putting currencies under pressure (figure LAC.3). While data for annual flows do not suggest that capital flows have been unusually high, several countries have taken unusual measures – including lowering interest rates to dissuade foreign capital inflows.
Net capital inflows rose 19.3 percent in 2012 to about 6.5 percent of GDP, up from 5.5 percent of GDP in 2011, on stronger equity inflows. Net FDI flows increased by $17.3 billion and net portfolio inflows were up $16.8 billion in 2012 (table LAC.1). Together the equity inflows accounted for more than half of the increase in net capital flows to the Latin America and the Caribbean region. Net bond flows increased by an estimated $26.8 billion in 2012, while bank lending declined $10.3 billion.

Gross capital flows to countries in Latin America and the Caribbean region were 23 percent higher year-on-year in the first five months of 2013 (see Finance Annex and figure LAC.4). Equity placements jumped 154 percent on account of strong issuance by Brazilian firms, including a record developing country bond issuance of $11 billion by Petrobras. Meanwhile bank lending fell more than 30 percent year-on-year.

Reflecting ample global liquidity and despite increased costs, frontier-market sovereigns in the region like Honduras ($500 million) were able to successfully issue bonds. Bolivia ($500 million), Dominican Republic, El Salvador ($800 million), and Guatemala ($700 million) also came to the market last year to take advantage of investors’ search for higher yields. Costa Rica has managed to issue a $500-million 12-year bond and a $500-million 30-year bond while Panama issued a $750

| Table LAC.1 | Net capital flows to Latin America |
|-----|-----|-----|-----|-----|-----|-----|-----|
|     | USD, billions |     |     |     |     |     |     |
|     | 2008 | 2009 | 2010 | 2011 | 2012e | 2013f | 2014f | 2015f |
| Capital Inflows | 186.0 | 179.6 | 328.5 | 303.9 | 362.6 | 358.5 | 364.1 | 379.2 |
| Private inflows, net | 179.3 | 161.6 | 306.1 | 299.1 | 360.7 | 359.4 | 364.8 | 381.6 |
| Equity Inflows, net | 127.5 | 126.5 | 166.6 | 165.6 | 199.8 | 209.8 | 212.4 | 232.0 |
| Net FDI inflows | 137.2 | 84.9 | 125.3 | 158.3 | 176.3 | 192.2 | 191.0 | 206.4 |
| Net portfolio equity inflows | -9.7 | 41.6 | 41.3 | 7.4 | 24.2 | 17.6 | 21.4 | 25.6 |
| Private creditors. Net | 51.8 | 35.1 | 139.5 | 133.4 | 160.9 | 149.6 | 152.4 | 149.6 |
| Bonds | 8.9 | 45.9 | 72.9 | 85.2 | 112.0 | 89.3 | 83.1 | 79.6 |
| Banks | 40.8 | -1.7 | 21.7 | 51.7 | 41.4 | 43.6 | 45.2 | 51.4 |
| Short-term debt flows | 2.6 | -8.6 | 43.8 | -3.0 | 7.3 | 15.2 | 23.4 | 16.5 |
| Other private | -0.5 | -0.5 | 1.1 | -0.4 | 0.2 | 1.5 | 0.7 | 2.1 |
| Official inflows, net | 6.7 | 18.0 | 22.5 | 4.8 | 1.9 | -0.9 | -0.7 | -2.4 |
| World Bank | 2.4 | 6.6 | 8.3 | -2.9 | 0.4 | |
| IMF | 0.0 | 0.4 | 1.3 | 0.2 | 0.1 | |
| Other official | 4.3 | 11.0 | 12.9 | 7.5 | 1.4 | |


Note: e = estimate, f = forecast.
million 40-year bond. The long-term dated bonds issued at surprisingly low rates seem to indicate that investors’ are comfortable with longer-dated issuance. Many countries in the region are engaging in more active debt management to take advantage of investors’ willingness to buy longer-dated paper increasing the maturity of their debt, by pre-paying shorter-term debt. Furthermore the decline in cost of financing could help some countries in the region reduce the cost of debt servicing over the short to medium term.

### Economic outlook

**Growth is expected to firm gradually**

A gradual firming in the global economy, and still very easy external financing conditions will support a modest step-up in growth in the region to 3.3%.
percent (slightly down from our January 2013 projection) from 3.0 percent in 2012 (table LAC.2). Growth in selected resource exporting countries will be weaker due to recent declines in commodity prices. For commodity exporters, further declines in commodity prices will both reduce government revenues and foreign exchange revenues, placing pressure on currencies and government spending in those countries such as Argentina and Venezuela, where deficits are already high.

The output gap for the region as a whole more or less closed in 2012, and with the expected uptick, GDP in 2013 is projected to expand at roughly the same rate as potential so there should be no significant exacerbation of overheating pressures (figure LAC.5 and 6). However, with growth expected to accelerate even further in 2014 and 2015, partly due to relatively loose monetary and fiscal policies, inflationary pressures are expected to build and current account deficits to rise.

Growth in Brazil is expected to accelerate to 2.9 percent in 2013 and further to close to 4 percent over the 2014-2015 period, bolstered by spending on infrastructure and supportive private consumption. Monetary and fiscal policy are projected to remain expansionary (the public sector primary surplus declined below 2 percent of GDP in Q1 on a 12 months rolling basis). With the economy arguably operating at potential, the acceleration in growth will keep inflation near the upper limit of the targeted inflation range, while robust domestic demand in conjunction with relatively soft external demand and lower commodity prices will keep the current account balance in deficit at close to 3 percent of GDP by 2015. Over the medium-to-long term efforts by the government to address the supply side constraints and reduce the costo Brasil are expected to lift potential output gradually.

Growth in Argentina is also expected to accelerate to 3.1 percent in 2013, bolstered by a record harvest expected this season and by moderately stronger external demand from Brazil. However, growth is expected to underperform over the medium term remaining below potential growth, as distortions introduced by various policies aimed at holding back inflation cut into investment and total factor productivity growth. Fiscal policy is expected to tighten due to financing difficulties and softer commodity prices, which will further weaken growth.

Paraguay will have the fastest growing economy in the region in 2013, due to appropriately accommodative monetary and fiscal policies and the normalization of agricultural output, following last year’s drought. In contrast, Venezuela will see one of the most pronounced decelerations in growth in the region (more than 4 percentage points to 1.4 percent) due to expected post-election cuts to government spending, and weak real-income growth due to high inflation. Similarly growth in Ecuador is expected to decelerate by close to 1 percentage point to 3.8 percent.

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**Fig LAC.5** Growth in Latin America and the Caribbean is expected to accelerate only marginally through 2015

**Fig LAC.6** Output gaps to narrow in Latin America and the Caribbean in 2013

Source: World Bank

Note: 2009 data represents the average for the 2003-2007 period.
In Mexico growth momentum will ease only marginally to 3.3 percent in 2013, before reaccelerating to close to 4 percent over the 2014-2015 period. Recent labor and telecommunication reforms are expected to lift growth in by increasing total factor productivity and by attracting more investment to the country. Over the 2014-2015 period the economic recovery in the United States, and in particular firmer private demand, will also support stronger Mexican export and remittances growth.

Growth in Central America is projected to ease slightly to 4.3 percent as growth decelerates in almost all the countries in the region, despite terms of trade gains, as commodity prices, and oil prices in particular are expected to decline. Costa Rica remains one of the most competitive economies in the region, reflected in the strong export contribution to growth. Similarly export growth will remain robust in Panama.

The Central American countries, which were among the most affected in the region by the 2008/2009 global economic crisis, will continue to struggle to bring down fiscal deficits and public debt. Over the 2014-2015 period a more upbeat U.S. economy should help support growth in the region, boosting external demand for goods and services as well as remittances.

Growth in the Caribbean will ease slightly to 2.5 percent (table LAC.3), as growth in the Dominican Republic softens. Elsewhere growth is projected to remain restrained at around 2.4 percent due to very high debt levels, and relatively soft remittances and tourism revenues. Over the medium term large fiscal adjustments will be necessary to cut fiscal deficits to more sustainable levels and help reduce the public debt burden. These adjustments are likely to have negative consequences for growth in the short run.

Monetary policies in the inflation targeting countries are projected to gradually move to a more neutral stance. The pace of adjustment may be slower than it would have been in the absence of very easy monetary conditions in high-income countries, (in particular in the United States and Japan) even if inflation rates remain close to the upper bound of the target range, as some of the countries in the region may be wary of attracting excessive capital flows and of appreciating currencies. Although some (IMF, 2013) argue that inflation expectations have become more anchored -- inflation in the region remains and is projected to remain at or above the higher end of the target range in several of the inflation targeting countries that are once again running against capacity constraints. In countries with high inflation and exchange rate pressures the scope for monetary policy is very limited.

Exchange rates are projected to appreciate only slightly in some of the financially integrated economies in the region, given very easy monetary policy in the major high-income economies and better fundamentals in the developing countries relative to high-income countries. There could also be an increase in volatility in exchange rates, as in the shorter term more volatile portfolio inflows are likely to affect exchange rates in these economies, as policy makers will be only partially successful in sterilizing these inflows. Macro prudential measures and/or capital controls will prove once again helpful in preserving healthy banking systems in the context of excessive global liquidity.

### Risks and Vulnerabilities

The global economic environment has stabilized significantly since July of last year, and the likelihood and likely magnitude of external risks have declined and become more balanced, with upside risks more pronounced than even six months ago.

A larger-than-expected deceleration in China’s economic growth, and in particular in investment, above and beyond the soft landing envisaged in our base line would undercut growth in the region as external demand would be much softer with both price and quantity effects, in particular for South American commodity exporters. Similarly a steeper than envisaged fiscal tightening in the United States would have negative spillovers for the economies in the region that have strong economic ties with the United States. The reverse of these situations represent the upside risks for the region.
## Latin America and the Caribbean country forecasts

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**Source:** World Bank.

*World Bank forecasts are frequently updated based on new information and changing (global) circumstances. Consequently, projections presented here may differ from those contained in other Bank documents, even if basic assessments of countries' prospects do not significantly differ at any given moment in time.*

*Cuba, Grenada, St. Kitts and Nevis, are not forecast owing to data limitations.*

a. GDP growth rates over intervals are compound average; current account balance shares are simple averages over the period.
b. GDP measured in constant 2005 U.S. dollars.
c. GDP excluding binational corporations.
Increasingly risks are domestic in nature, and stem in part from the challenges of getting the correct balance between macroeconomic policies to stimulate demand in the short-term and structural reforms to spur faster growth over the longer run.

For those larger economies in the region where growth has slowed in the post-crisis period despite prolonged efforts at demand stimulus, the evidence seems to be accumulating that policies to boost domestic demand will not lead to higher growth if not accompanied by growth-enhancing policies that deal with supply side inefficiencies. Failure or delays in implementing such reforms could hold growth hostage over the medium term.

Ample global liquidity and higher capital flows has complicated the task of conducting monetary policy and there is a risk that relatively low interest rates in some of the financially integrated economies might fuel rapid credit growth and contribute to inflation pressures. In some cases temporary and transparent capital controls may be warranted to help manage capital flows and prevent build up of vulnerabilities in financial systems.

In so far as the overall international environment is less volatile countries may wish to give greater weight to the domestic inflationary pressures that these policies may be generating.

A further risk stemming from the current environment of easy external financing conditions and increased search for yield by international investors is that countries and private agents in the region may take on too much debt or have large currency or maturity mismatches. Real credit growth has expanded rapidly in several countries in the region, including in Brazil, Mexico, and Peru, while several Caribbean countries are already burdened by very high debt levels.

Over the longer term external financial conditions are likely to become tighter as high-income countries unwind their long-term positions and as base rates and spreads start to rise. Higher financing costs will likely reduce investment spending and growth in developing countries and may also expose unsustainable positions made possible by very easy external financing. Asset prices that have grown rapidly in the current environment may reverse course precipitously, stressing banking systems in the region.
Notes

1. Potential output is estimated by the World Bank, based on a production function methodology, using an estimate of total factor product growth based on the average TFP growth between 1995 and 2005, and an estimate of the capital stock constructed using investment data, the perpetual inventory method and assumed depreciation rate of 7 per cent, and the working-age population as the labor input (consistent with a constant labor force participation and natural unemployment rates). See Nehru and Dhareshwar (1993) for an earlier attempt at using a similar methodology.

2. Weighted average of remittances as a share of recipient country’s GDP.

3. Price controls in Argentina have helped contain inflation but could lead to shortages of certain goods.

References


Overview

More than two years after the Arab Spring began, economic activity remains weighed down by elevated political tensions and continued civil strife in the region. Regional growth accelerated to 3.5 percent in 2012 from minus 2.2 percent in 2011 reflecting mainly a rebound in Libya’s crude oil production to pre-war levels that doubled real GDP and a weak growth recovery in Egypt (to 2.2 percent in FY2012 from 1.8 percent in FY2011). Iran, the region’s largest economy, slipped into recession, with GDP falling by an estimated 1.9 percent due to international sanctions and lower oil output while Algeria’s growth remained subdued at 2.5 percent, supported by expansionary fiscal policy. Domestic demand and exports in Syria collapsed last year as the civil war intensified, with spillovers affecting activity in Jordan and Lebanon. Drought in Morocco reduced growth to 2.7 percent from 5.0 percent in 2011.

Outlook for 2013-15: Regional prospects depend critically on the evolution of domestic and cross-border political tensions. Aggregate regional growth is forecast to slow to 2.5 percent in 2013 mainly due to weakness in the region’s three largest economies, before recovering to 4.2 percent in 2015 as tensions ebb and the Euro Area, the region’s main trading partner, recovers.

Within the region, Egypt’s GDP growth is forecast to slow to 1.6 percent in FY2013 on elevated political tensions and worsening macroeconomic imbalances, before recovering to about 4.8 percent in FY2015 as political tensions recede and reforms are undertaken, although there remain considerable downside risks to this forecast. GDP in Iran is forecast to contract for the second straight year by 1.1 percent due to sanctions and soaring inflation before recovering to about 1.9 percent in 2015. Growth in Algeria is expected to rise modestly to 2.8 percent due in part to temporary disruptions to oil production, before firming to about 3.5 percent in 2015. Elsewhere, growth in Iraq and Libya is expected to remain relatively buoyant driven by their mineral sectors, although rising violence poses a risk to near term stability in Iraq. Meanwhile rising farm output in Morocco and strengthening external demand over the medium term should help lift growth towards potential in Morocco and Tunisia. Jordan’s and Lebanon’s GDP growth is expected to remain subdued in 2013 reflecting spillovers from Syria.

Risks and vulnerabilities: Political uncertainty, polarization and conflict. Prolonged political crises and conflicts—elections are upcoming in several economies and conflicts are gaining intensity in Iraq and Syria—pose risks to near term recovery, and to long term potential growth rates by depressing investment and increasing the likelihood that urgent structural reforms are delayed. More generally the long term structural challenges facing the region – which are a source of current volatility – remain the same as before the Arab Spring. A failure of political consensus needed to tackle these structural weaknesses will mean that they will likely contribute to low growth rates even when calm returns to the region.

Weakening macroeconomic fundamentals and rising fiscal sustainability risks. Rising fiscal outlays to fund difficult-to-reform food and fuel subsidies are generating serious fiscal and current account imbalances among oil importers – a situation exacerbated by rising borrowing costs and exchange rate depreciation, although the recent moderation in global food prices could provide some respite in the near term.

Euro Area and US recovery. Protracted weakness in the Euro zone would hurt economies with close trade, investment and financial ties to it. Any increase in global risk aversion would also reduce already depressed capital inflows into the region. On the upside, better-than-expected economic outcomes in the US and Euro Area should support growth, particularly in economies where political tensions are relatively muted.

Commodity price and geo-political developments: Oil exporters in the region could be very vulnerable if the projected gradual decline in commodity prices occurs more sharply than in the baseline. While benefitting importers, it would cut into incomes, government revenues and foreign currency earnings of oil exporters – forcing potentially significant adjustments.
Recent Developments

Aggregate regional growth picked up in 2012 in the developing Middle-East & North Africa region to 3.5 percent in 2012, mainly reflecting a recovery from a 2.2 percent contraction in 2011 due to social and political unrest in Egypt, and armed conflict in Libya. Political (domestic and international) tensions continue to weigh on economic activity and investment across the region. International sanctions are contributing to rising inflation and negative growth in Iran, while spillovers from the intensifying civil conflict in Syria, including the disruption of land trading routes, have cut into economic activity in Lebanon and Jordan with the latter also affected by energy shortfalls in Egypt. At the same time, weak economic conditions in European trading partners have acted as a drag on non-oil exports and tourism receipts.

Among oil importers, growth remained subdued during 2012 reflecting spillovers from conflict within the region and weak external demand from Euro Area trading partners. The main exception to this trend was Tunisia, where GDP growth accelerated to 3.6 percent in 2012 from just below 2 percent in 2011, supported by a recovery in tourism and increased domestic demand following an earlier relaxation of fiscal policy. Egypt’s economy grew by just 2.2 percent in 2012 in fiscal year terms, a modest recovery from the 1.8 percent outturn in 2011, supported by higher government spending and record remittance inflows. In calendar terms, the rebound was more substantial – 4.6 percent versus 0.5 percent in 2011 – but reflected a recovery from a low base.

Elsewhere, Lebanon’s GDP growth is estimated to have remained flat at 1.5 percent in 2012 as elevated domestic political uncertainty and spillovers from the conflict in Syria undermined tourism and scarce public resources came under pressure from growing numbers of refugees (estimated at 1 million plus in a total population of about 4.3 million). At an estimated 2.8 percent, Jordan’s growth was only slightly better than the 2.6 percent outturn in 2011, as slower manufacturing growth reflecting a domestic energy crisis offset higher public and private sector spending. However, private consumption in both Jordan and Lebanon benefited from added demand associated with a rising influx of Syrian refugees. Although Morocco has remained relatively free from political and social tensions, drought hurt agricultural output, while weak demand among Euro zone trading partners hit manufacturing and tourism, with growth slowing to just 2.7 percent from 5.0 percent in 2011 and the lowest since 2000.

Among oil exporters, growth experiences have been mixed. Thanks to a post-conflict recovery in oil production, Libya’s GDP expanded by 105 percent in 2012. Growth in Algeria was subdued at about 2.5 percent in 2012, supported mainly by rising government spending financed by relatively buoyant global energy prices. Post-war increases in crude oil production helped sustain an 8.4 percent increase in Iraqi GDP. Output in Iran, however, shrank an estimated 1.9 percent and inflation reached over 40 percent this year due to international sanctions and currency depreciations. Growth is showing signs of recovering in Yemen, but remains fragile with GDP barely expanding 0.1 percent in 2012 after contracting 10.5 percent in 2011. Although fraught with uncertainty, indications are that Syria’s conflict has caused GDP to shrink by nearly a third – reflecting a collapse in both domestic demand and exports.

Nascent economic recoveries among oil importers have suffered repeated setbacks over the past year

Periodic eruptions of political and social tensions or renewed weakness in the Euro Area have repeatedly set back nascent recoveries among developing oil importing economies in the Middle-East & North Africa region, with growth turning increasingly volatile in Egypt and Tunisia. For instance, since 2011 Egypt has experienced three separate episodes of a sharp deceleration or contraction in activity as political and social tensions erupted, punctuating rebounds in activity. In Tunisia, a recovery in early 2012 led by tourism and service sector growth was interrupted by social unrest in the second quarter and lower demand in the Euro Area, the country’s main trading partner.

Recent high frequency data up till March show a recovery in industrial output in Egypt from last
External trade activity weakened among oil importers in the first quarter. Recent seasonally adjusted export earnings data from Q1 (figure MENA.2) indicate that exports are stabilizing in Egypt and Lebanon after rebounding at the end of last year, but contracting sharply once again in Morocco in Q1. Jordan meanwhile has been hurt by the closure of land trading routes through Syria: exports to other countries in the region – some 50 percent of total exports in 2012 (figure MENA.3) – fell by an annualized 21.7 percent seasonally adjusted pace in the three months through February. Tunisia’s exports remained buoyant in Q1 helped by a recovery in agricultural, textile and some manufacturing exports.

Production in developing MENA oil exporters continues to contract

Industrial output in the MENA region resumed its downward trend in the second half of last year as producers due to rising domestic uncertainty, and increasing reliance by Egypt on exports of crude oil to cover imports and debts, leaving less for refineries to process for domestic use. Egypt’s natural gas exports to Jordan have suffered, at first because of sabotage that targeted the Arab Gas Pipeline in 2011, then by a temporary suspension of exports last October in an effort to cover a spike in domestic energy demand; and most recently in January this year because of rising social unrest in Egypt.

Export momentum weakened among some oil importers in the first quarter

Recent seasonally adjusted export earnings data from Q1 (figure MENA.2) indicate that exports are stabilizing in Egypt and Lebanon after rebounding at the end of last year, but contracting sharply once again in Morocco in Q1. Jordan meanwhile has been hurt by the closure of land trading routes through Syria: exports to other countries in the region – some 50 percent of total exports in 2012 (figure MENA.3) – fell by an annualized 21.7 percent seasonally adjusted pace in the three months through February. Tunisia’s exports remained buoyant in Q1 helped by a recovery in agricultural, textile and some manufacturing exports.
the boost from Libya faded. Aggregate regional production volumes fell by 27.2 percent annualized in Q4 last year, led by sharp drops of close to 16 percent in both Iran and Algeria.

More recently, aggregate regional production volumes excluding Libya (figure MENA.4) picked up in Q1. However this reflected a stabilization in in output in Iran following sharp declines over the past year due to crippling US and EU sanctions that had led to oil production falling to 2.63 mbd in September - the lowest in 23 years according to the International Energy Agency (IEA). As per latest IEA estimates, Iran's production was about 2.65mbd in May, with the country likely to cut output going ahead as exports to Asian buyers dwindle due to a tightening of international sanctions. Japan for example bought only 8000bd of Iranian oil in April, down 97 percent from April 2012. Prior to the sanctions, Iran used to produce about 3.5mbd and export about 2.5mbd of oil.

There have been production setbacks in other countries too, notably Algeria in the aftermath of the militant attacks in mid-January on the Amenas gas plants which account for about 10 percent of the country’s total gas output. Along with a slow recovery from these attacks, heightened security after the attacks also hurt crude oil production which temporarily fell to 1.14 million bpd in March from 1.16 mbd in February according to the IEA, although levels have since recovered.

Iraq surpassed Iran as the second largest oil producer in OPEC at the end of 2012. However crude oil production and exports fell slightly at start of this year reflecting disputes between Baghdad and the semi-autonomous region of Kurdistan that led to a halt in exports from the Kirkuk Ceyhan pipeline and weather-related disruptions in southern Iraq. Libya’s production has also fallen in recent months—most recently by 60,000 bpd in March— with reports suggesting that an ageing infrastructure is affecting output.

Activity in Syria has collapsed as the conflict has intensified, and it is likely that the economy contracted by nearly a third during 2012, possibly even more. As of December 2012 industrial production volumes were half their level at end-2011. Although difficult to gauge the true extent of economic damage from the conflict, mirror statistics from trading partners indicate that exports and imports fell by an unprecedented 85 and 79 percent respectively in 2012.

**Current plans by developing oil exporters to significantly raise investment may prove optimistic**

Given stagnating or declining production levels and sharply increasing domestic demand, oil exporters will need to invest heavily in infrastructure, exploration and production to raise production levels. However private capital and FDI inflows may fail to materialize because of security risks, poor legal environments for investment and political uncertainty, and, in the case of Iran, international sanctions.

In Iraq, government estimates count on capital expenditures of $30 billion per year in energy infrastructure to meet its production targets. But progress on this front is likely to be slow due to payment disputes with the Kurdish Regional Government, and delays in the passage of a law that would govern the development of Iraq's oil and gas wealth (the law was first announced in 2008, but has yet to be passed). Algeria is also planning to invest significantly in hydrocarbon exploration, notably in shale gas, and in refineries. However raising private investment may prove challenging given political uncertainty generated by upcoming presidential elections in spring 2014 and earlier reversals in investor-friendly provisions in investment laws that may deter investors.
Inflation pressures built up in 2012, and persist

The latest CPI data show that price pressures have remained strong, with annual inflation rising close to or over 7 percent (y/y) in Egypt, Tunisia and Jordan and, to over 10 percent (y/y) in Lebanon in the first few months of 2013 (figure MENA.5). In part this reflects partial fuel and energy tariff reforms in some economies (Jordan, Tunisia, Egypt) to contain soaring fiscal burdens from subsidies. In Jordan and Egypt, shortfalls in energy provision slowed production in other sectors and contributed to inflation pressures, with the latter also affected by a 13 percent depreciation of the currency since December. Growing inflation pressures in Egypt also likely reflect the negative impact of prolonged political and social tensions on absorptive capacity and potential output in the face of continued sharp increase in government expenditures (up 30 percent y/y in the first half of FY 2013).

Similar supply side constraints, combined with sanctions and a sharp fall in the value of the Iranian Rial have contributed to rising inflation in Iran, which (per official estimates) touched 38.5 percent in December. The market value of the Iranian currency dropped to 37,000 Rial per US Dollar in October from 25,000 in September compared to an official exchange rate of about 12,000 Rial. With the currency dropping further since the start of the year, inflation touched 40.7 percent (y/y) in March.

However inflation pressures remain subdued in several economies, including Morocco and Iraq, helped by generous food and fuel subsidies. Inflation in Yemen fell into single-digits in 2012 to about 7 percent (but has since accelerated), from a peak of 24.6 percent in October 2011, as improving security eased supply bottlenecks after the formation of transition government in early 2012. Inflation in Algeria decelerated to 3.1 percent in April on slower growth in (mostly imported) food prices.

Tourism-related revenues and jobs improved slightly in 2012,

Tourism inflows, a key source of foreign exchange and jobs (figure MENA.6) in the region, are recovering. According to the United Nations World Tourism Organization (UNWTO), aggregate tourist arrivals in North African economies rose 8.7 percent to 18.5 million in 2012, only slightly below the peak of 18.8 million visitors in 2010. In Tunisia, tourism revenues in 2012 reached $2.1 billion, up 30 percent from the previous year, supporting a strong recovery in the service sector. In Egypt, tourism revenues stabilized at around $10bn during 2012, although well below the $12.5 billion earned in 2010. As a result, the sector, which employs roughly one in every eight Egyptian workers (directly and
indirectly), only shed 14,000 jobs per industry estimates, versus half a million or so tourism related losses during 2011 (figure MENA.7).

The number of tourists to the Middle East economies (including high-income economies in the region) fell at a slightly slower pace in 2012 (-4.9 percent vs -6.7 percent in 2011) to 52.6 million. Jordan, which reported a 15.3 percent increase in earnings in 2012, Morocco and Iran have benefited from instability in neighboring countries, attracting visitors from the GCC economies and Central and South Asia that otherwise would have headed to traditional tourist hotspots such as Egypt and Lebanon.

Recent data however suggest that tourism related gains in Tunisia and Egypt are likely to have been lost in the wake of recent social unrest. Revenues from tourism fell 7.5 percent from a year earlier in Q1 in Tunisia, hit by security concerns after a political assassination in February, although the unrest has since eased. Reports from Egypt indicate sharp drops in hotel occupancy.

**Unemployment rates have eased slightly, but remain high**

High levels of unemployment, one of the catalysts for the Arab Spring uprisings, have shown modest signs of improvement in some economies. In Tunisia, the official jobless rate fell from 18.9 percent in 2011 to 16.7 percent in 2012 helped by a recovery in tourism. Growing tourism inflows have also supported a decline in official unemployment rates in Jordan, Morocco and Iran.

Nonetheless, unemployment remains extremely high (figure MENA.8), particularly among the youth and in urban areas. In oil exporting economies, strong growth in capital-intensive hydrocarbon sectors has boosted overall growth, but failed to generate many jobs. For instance, in Iraq, the oil sector accounts for only 1 percent of total employment versus a contribution to GDP of about two-thirds. In addition, large commodity export inflows contribute to Dutch Disease pressures, undermining the development of non-oil sectors that could potentially provide jobs. More generally, job creation across the region is being held back by a difficult business climate (figure MENA.9), and further hampered by political and economic uncertainty among oil importing economies.

**Remittance inflows rose during 2012**

With remittance inflows estimated at $49 billion in 2012, the Middle East and North Africa region experienced the fastest expansion of remittances in the world, growing by 14.3 percent in 2012 compared with 2011 (World Bank, 2013). Egypt received a record US$19 billion (8 percent of GDP), up from US$14.3 billion in 2011, making it the sixth largest receiver of official remittances in the world. Although Egypt has a large stock of highly

**Fig MENA.7**  A modest recovery in tourism during 2012 has yet to reverse sharp job losses in the sector during 2011

**Fig MENA.8**  Unemployment rates have declined modestly in some countries, but generally remain high
skilled expatriates in the US, the UK and other OECD countries, about two-thirds of its migrants are working in oil rich countries within the MENA region, which benefitted from relatively buoyant oil prices last year. Inflows were up by 10 percent in Tunisia and 6 percent in Jordan but remained broadly stable at about US$7.4 billion in Lebanon.

**Public finances have deteriorated sharply raising fiscal sustainability concerns**

Broad structural public finance reforms are needed in developing MENA economies, to ensure fiscal sustainability, and to limit vulnerability to adverse economic shocks. Public expenditures as a share of GDP tend to be large, and dominated by relatively rigid wages and entrenched subsidies, with a narrow revenue base heavily dependent on revenues from a few key sectors.

Deteriorating public finances during 2012 (figure MENA.10) in the region reflected a number of factors. These include: slippage in revenues due to underlying economic weakness; rising costs of imported but heavily subsidized food and fuel commodities; and expansionary fiscal policies to shore up flagging economies and to contain social discontent. Government outlays were up 15 percent and 11 percent \((y/y)\) in Algeria and Morocco during 2012 and by 30 percent \((y/y)\) in the first half of the current fiscal year in Egypt.

Rising fiscal deficits and public sector debt have added to growing fiscal sustainability concerns, notably in Lebanon and Egypt where spending pressures exacerbated by rising borrowing costs have pushed interest expenditures to about 40 percent and 25 percent of total revenues respectively in these economies. To finance its revenue shortfalls Egypt has relied heavily on borrowing from the domestic banking sector, and grant aid from the Gulf economies. Rising public-sector borrowing is crowding out private sector borrowing and increasing the exposure of the banking sector to sovereign risk. Meanwhile, delays in tax reforms have delayed the approval of a US$4.8 billion loan from the IMF, and in turn, assistance from other multilateral and bilateral partners despite indications that the fiscal deficit will reach over 12 percent of GDP in FY2013. Among oil exporters, fiscal surpluses have shrunk as revenues, despite strong growth, have failed to keep pace with surging public expenditures.

A number of economies are attempting fiscal consolidation in order to manage funding pressures and risks, with a focus on fuel and food subsidies given their significantly large share of total spending. Jordan liberalized fuel prices last year as part of an IMF $2 billion loan program, and a gradual reform of electricity tariffs is planned this summer to curb contingent liabilities associated with rising indebtedness of the state owned electricity company (which has been forced to sell power at below cost). Tunisia raised fuel prices by nearly 7 percent in March, the second hike in six
month, despite strong domestic opposition as inflation has increased. Algeria’s 2013 budget plans support fiscal consolidation of about 2 percent of GDP in the overall balance led by a decline in public sector wage expenditures, but worryingly also predicated on continued buoyancy in commodity prices and strong external demand which may not materialize. Lebanon, which posted a modest primary deficit of 0.4 percent in 2012, its first in several years, on rising public sector wage costs and weak revenue growth, is planning 3 percent worth of GDP expenditure cuts during 2013.

However, fiscal reforms have slowed in Morocco, and Iran. Following a small hike in fuel prices in June and a cut in the subsidy of imported wheat last year, Morocco has shifted consolidation efforts towards cuts in public investment spending (of about 2 percent of GDP for 2013) despite a subsidy bill estimated at 6 percent of the GDP. Although subsidy reforms have been proposed they remain highly politically contentious. Iran’s parliament has blocked the second phase of fuel subsidy reforms, with budget proposals for 2013 projecting about a one-third increase in overall spending over 2012 levels. Recently Egypt has taken some tentative steps towards liberalizing fuel and energy subsidies and tax reforms are also in the works as the fiscal situation has deteriorated, but reforms remain difficult given lack of political consensus and elevated social tensions.

External vulnerability has increased among oil importers

Rising current account deficits and balance of payments pressures combined with managed or fixed exchange rates have resulted in external financing difficulties, falling foreign exchange reserves (figure MENA.11), and repeated sovereign credit rating downgrades in several oil importing economies in the region. Higher current account deficits reflected an increasing cost of food imports compounded by weak European demand for North African exporters, reaching over 16 percent of GDP in Jordan and Lebanon (despite remittances estimated at 18 percent of GDP in the latter), and 9.6 percent in Morocco and 8.1 percent in Tunisia. Egypt posted a 3.1 percent of GDP deficit, with the trade deficit rising to 10.4 percent led by a sharp drop in merchandise exports and surging imports.

Trade deficits have shown signs of modest improvement entering 2013 in Jordan, Lebanon, Egypt and Tunisia. Foreign exchange reserves have also been partly bolstered in recent months reflecting external support from the IMF (Jordan), support from other regional economies (Jordan, Morocco and Tunisia), a rebound in foreign direct investment in Tunisia (up 85 percent during 2012) and short term private capital inflows in Lebanon. That said, excepting Lebanon, reserves are down by roughly a quarter in Tunisia, Jordan and Morocco compared to January 2011, amounting to only slightly higher than the critical 3 month import cover threshold in Tunisia and Jordan.

In Egypt, reserves are down by two-thirds from January 2011 (figure MENA.11), amounting to less than 2 months of import cover and the currency has fallen some 12 percent since late December. Dwindling reserves have forced the central bank to hold weekly foreign exchange auctions since December, and to raise its benchmark rate to 10.25 percent (up 75bp) in March to support the currency and combat inflation. Reflecting Egypt’s precarious fiscal and external position, CDS spreads have widened substantially to close to 700 basis points and the country has received substantial financing assistance from Qatar and Libya.

Current account positions among oil importers improved last year, but are likely to face pressures this year reflecting lower oil prices, and growing...
import needs as they invest in production and refining capacities. Libya’s current account position has improved, buoyed by recovery in crude oil production and continued elevated international prices, but current account positions have deteriorated in Syria and Iran, with the latter facing difficulty in securing buyers for its oil in Asia as international sanctions have tightened.

Financial flows to the region recovered slightly in 2012 but remain much lower than in 2010

Capital flows to the developing MENA region recovered modestly in 2012 to an estimated $17.5 billion after almost halving to $15.8 billion in 2011. The improvement reflected an increase in net FDI flows (up 22 percent) to Egypt, Morocco and Tunisia, although overall levels remain well below pre-Arab Spring inflows (table MENA.1). Morocco and Lebanon have also successfully issued sovereign debt over the last year worth $1.5 billion (in December) and $1.1 billion (in April, 20 percent of which was bought by overseas investors) respectively. Other sovereigns including Jordan and Egypt are considering debuting sukuk bonds later this year in international capital markets to finance fiscal deficits.

### Table MENA.1 Net Capital Flows to Middle East and North Africa

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<th>2013f</th>
<th>2014f</th>
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<td><strong>Other official</strong></td>
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<td>0.1</td>
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Source: The World Bank
Note: e = estimate, f = forecast

### Outlook

The outlook for the region as a whole remains dominated by domestic political developments, with added risks from external demand, commodity price and geo-political developments. Output for the region as a whole is projected to rise by 2.5 percent in 2013 (table MENA.2), and gradually firm to 3.5 percent and 4.2 percent in 2014 and 2015, buoyed on the one hand by stronger demand in the Euro Area and an assumed easing of regional political tensions, but held back on the other hand by declining oil prices and an assumed tightening of macroeconomic policies that begins to alleviate growing fiscal and inflation tensions.

In Egypt, the near term outlook remains difficult reflecting weak investor and consumer confidence on account of upcoming elections in the fall, widening fiscal and current account imbalances and delays in negotiating an IMF program. Egypt is expected to import natural gas for the first time in decades which will further add to external financing pressures. Official estimates project a bumper wheat harvest this year in Egypt, which could reduce food imports, but these are regarded as too
optimistic by some observers. Absent any major fiscal or balance of payments crisis, growth is expected to slow to 1.6 percent in the current fiscal year from 2.2 percent last year. Conditional upon a subsiding in political tensions and reforms being undertaken, growth should firm to about 3.0 percent next year and to about 4.8 percent in 2015, although this forecast remains subject to substantial downside risks (table MENA.3).

Growth is expected to pick up slowly in Tunisia. Although civil unrest experienced in February has receded, there remain tensions between conservative and secular forces. Exports showed signs of recovery in Q1, but a slow pace of recovery in Euro zone, its main trading partner, should temper gains in external demand and tourism inflows in 2013. Accordingly, growth is expected to rise to about 3.8 percent, only slightly higher than 3.6 percent in 2012, and to gradually pick up further to about 5 percent in 2015 as the external and internal environment improves.

Growth in Jordan is forecast to pick up somewhat to 3.3 percent in 2013 (from 2.8 percent), as confidence in the economy improves due to reforms taken as part of the IMF program, and also reflecting the boost to sentiment and activity from

<table>
<thead>
<tr>
<th>Table MENA.2</th>
<th>Middle East and North Africa forecast summary</th>
</tr>
</thead>
<tbody>
<tr>
<td>(annual percent change unless indicated otherwise)</td>
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<tr>
<td>GDP at market prices b</td>
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<td>GDP per capita (units in US$)</td>
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<td>PPP GDP d</td>
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<td>Private consumption</td>
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<td>Public consumption</td>
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<td>Imports, GNFS e</td>
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<td>Net exports, contribution to growth</td>
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<td>Current account bal/GDP (%)</td>
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<tr>
<td>GDP deflator (median, LCU)</td>
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<tr>
<td>Fiscal balance/GDP (%)</td>
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**Memo items: GDP**
- MENA Geographic Region f | 4.1 | 4.8 | 3.6 | 2.5 | 2.6 | 3.2 | 3.8 |
- Selected GCC Countries g | 3.8 | 4.6 | 6.1 | 5.3 | 3.8 | 3.8 | 4.0 |
- Developing Oil Exporters | 3.6 | 4.5 | -4.4 | 3.5 | 2.1 | 3.1 | 3.8 |
- Developing Oil Importers | 4.5 | 4.8 | 1.6 | 3.5 | 3.1 | 4.1 | 4.7 |
- Egypt | 4.4 | 6.0 | 0.5 | 4.6 | 2.3 | 3.9 | 4.9 |
- Fiscal Year Basis | 4.3 | 5.3 | 1.8 | 2.2 | 1.6 | 3.0 | 4.8 |
- Iran | 4.6 | 5.9 | 1.7 | -1.9 | -1.1 | 0.7 | 1.9 |
- Algeria | 3.4 | 3.3 | 2.4 | 2.5 | 2.8 | 3.2 | 3.5 |

**Source:** World Bank.
a. Growth rates over intervals are compound weighted averages; average growth contributions, ratios and deflators are calculated as simple averages of the annual weighted averages for the region.
b. GDP at market prices and expenditure components are measured in constant 2005 U.S. dollars.
c. Sub-region aggregate excludes Iraq and Libya, for which data limitations prevent the forecasting of GDP components or Balance of Payments details.
d. GDP measured at PPP exchange rates.
e. Exports and imports of goods and non-factor services (GNFS).
f. Geographic region includes high-income countries: Bahrain, Kuwait, Oman, United Arab Emirates and Saudi Arabia.
g. Selected GCC Countries: Bahrain, Kuwait, United Arab Emirates, Oman and Saudi Arabia.
### Table MENA.3  Middle East and North Africa forecast summary

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<th>2013</th>
<th>2014</th>
<th>2015</th>
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<td>3.3</td>
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<td>-2.1</td>
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</table>

**Source:** World Bank.

*World Bank forecasts are frequently updated based on new information and changing (global) circumstances. Consequently, projections presented here may differ from those contained in other Bank documents, even if basic assessments of countries’ prospects do not significantly differ at any given moment in time.*

Djibouti, West Bank and Gaza are not forecast owing to data limitations.

a. GDP growth rates over intervals are compound average; current account balance shares are simple averages over the period.
b. GDP measured in constant 2005 U.S. dollars.
c. The estimate for GDP decline in Syria in 2012 is subject to significant uncertainty.
the signing of an $18bn deal with Iraq to build an oil pipeline from southern Iraq to Aqaba. The pipeline which is expected to be completed by 2017 should help spur FDI and domestic activity and help lift growth to over 4 percent by 2015. However there remain downside risks from the conflict in Syria. Morocco’s economy should benefit from the recovery in agricultural sector output, which should lift growth to about 4.5 percent in 2013 from 2.7 percent in 2012 and to remain buoyant at just under 5 percent in the medium term supported by the recovery in the Euro Area.

Aggregate growth among oil exporters should slow in the near term reflecting a stabilization of production to a more sustainable pace in Libya, recession in Iran and production and export setbacks in Algeria and Iraq. Algeria’s growth is expected to pick up modestly to about 2.8 percent in 2013 (from 2.5 percent) in 2013 and gradually firm thereafter. Iran’s economy is expected to remain weak until some sort of resolution with Western governments over its nuclear issues can be reached. Until then domestic investment and private consumption should remain subdued with growth projected at about 1.9 percent in 2015, well below its average growth of 4.5 percent between 2000 and 2009.

Although a tentative agreement on oil payments between the Iraqi government and the Kurdish semi-autonomous region was reached in early May, longer term plans to raise Iraq’s oil output to about 3.3 million bpd (from nearly 3 million bpd currently) may prove challenging given the recent history of tensions between the two and also given the scale of infrastructure investment needed to realize the higher output. Accordingly medium term growth is projected to remain at close to last year’s outturns of about 8.5 percent. Near term risks have increased, however, given the escalation in conflict in recent months.

Capital inflows are expected to recover gradually in the region, rising to about US$30 billion in 2015, led mainly by growing FDI inflows as political tensions ease and reflecting infrastructure investment opportunities in both oil importing and exporting economies, including Algeria, Iraq and Jordan. Private capital flows to Egypt are likely to remain weak in the near term due to continued uncertainty there. However inflows should pick up, including inflows from GCC economies into construction and tourism sectors which have been diverted elsewhere into the region. For the region, equity inflows are also expected to recover but should remain modest compared to the pick up in bond inflows.

Risks and Challenges

The main risks and challenges facing the region are domestic. While a weaker outturn in the Euro Area would certainly impact the region, its likely influence pales compared with the potential impact of increased social and political tensions, or compared with the likely impact of a failure to address growing macroeconomic imbalances, including fiscal deficits bloated to unsustainable levels by fuel and food subsidies that amount to over a fifth of government revenues in several economies (figure MENA.12) and rising debt levels that threaten long-term fiscal sustainability, and for oil exporters the potential impact of a more pronounced than projected decline in commodity prices.

Political tensions and security risks remain elevated and there are growing signs of domestic political polarization in several economies. Elections are due in a number of countries this year or early next year, making for a challenging reform environment at a time of domestic unrest and persistently high levels of
unemployment. Already heightened tensions in Iraq and Lebanon could be further worsened by spillovers from Syria, with potentially destabilizing effects for these economies.

Over the longer term, the structural challenges facing the region—and which are currently a source of ongoing social and political tensions—remain much the same as before the onset of the Arab Spring. Consequently, unless progress is made on building political and social consensus needed to undertake the necessary structural reforms, then it is very likely that the developing Middle East and North Africa region will continue to lag other developing regions and that growth rates will remain relatively low even when calm is eventually restored to the region.

Much of the region faces very real challenges on the fiscal front, due in part to increased social spending to assuage tensions that have arisen in the context of the Arab Spring, but also because of high fuel and food prices that have sharply increased the cost of subsidy programs (figure MENA.12). Dealing with this would be difficult enough at the best of times, but is particularly challenging in the current slow growth and socially volatile period. Still, with such expenditures at some 6 percent of GDP in many countries, inaction does not appear to be an option. Experience from other countries suggests that explicitly combining a reduction in subsidies with a reinforcement of targeted assistance of the very poor can make such a reform more politically acceptable and minimize the negative poverty effects—while still reducing fiscal deficits.

Inaction risks a fiscal crisis, where markets refuse to finance additional deficits forcing a much sharper, less acceptable and more damaging cut in government spending. This is particularly the case for economies running low on foreign exchange reserves, with slowing of domestic reform efforts further undermining fiscal solvency and investor confidence, both domestic and overseas. In Egypt, a delay or halt in future aid disbursements could spiral into serious balance of payments difficulties given its already low level of reserves and undermine confidence in the banking sector which has high levels of exposure to sovereign debt.

**Commodity price and demand/supply risks:** The economies of oil exporters are particularly vulnerable to a shift in the price of oil. As discussed in the main text, global supply has responded to the higher prices of the past 10 years, and as a result large gaps have been generated between hydrocarbons in North America and the rest of the world. As existing bottlenecks increasingly allow this new supply (and that coming from Sub-Saharan Africa and elsewhere) to reach global markets, prices could decline much more quickly than in the baseline. In such an instance government revenues and current account balances would come under pressure.

Simulations discussed in the main text show the effects of a fall in real oil prices to $80 per barrel by mid-2014. They suggest that developing oil exporters in the Middle East and North Africa region (along with exporters in sub-Saharan Africa) would be hardest hit by such a decline, with GDP declining by 1.4 percent relative to the baseline, government balances deteriorating by as much as 2.1 percent of GDP and current account balances by 3.5 percent in 2014. For countries, like Algeria or Iran, where fiscal balances are already under pressure this could force sharp adjustments in demand, policy and exchange rates. Conversely, oil importers with stressed fiscal and balance of payments positions would benefit from such a decline, with GDP 0.5 percent higher relative to the baseline on average, and current accounts and fiscal balances improving by 0.5 and 0.2 percent of GDP respectively in 2014.

In the current environment, regional oil exporters will no longer be able to rely on high and rising prices, but will increasingly need to rely on increased output. This in turn necessitates reforms that would allow them to invest heavily in infrastructure, and exploration to raise current production levels which have stagnated or been steadily declining in recent years. However, private capital and FDI inflows may fail to materialize because of security risks, poor legal environments for investment and political uncertainty to varying degrees in Algeria, Iraq, Libya and Yemen and international sanctions in the case of Iran.

**Economic developments in the Eurozone:** The Eurozone (and to a lesser extent the US) account for the bulk of the region’s manufacturing, service and hydrocarbon exports.
Any setback to the ongoing recovery there could undermine exports and tourism in oil importing economies and export and fiscal revenues in Algeria and Iraq. Heightened risk aversion could also reduce already depressed capital inflows into the region and dent confidence, particularly in countries with large macroeconomic imbalances, high levels of debt and severely depleted fiscal and reserve buffers. On the upside, a faster than expected recovery in the Euro Area could provide positive tailwinds to these economies, reducing balance of payment and exchange rate pressures.
References


SOUTH ASIA REGION
Overview

South Asia’s regional GDP growth slipped to 4.8 percent in 2012, following a robust recovery in the years after the 2008 global financial crisis. A weakening global economy, coupled with domestic difficulties (including policy uncertainties, structural capacity constraints, and a poor harvest) contributed to weaker regional growth in 2012. The bulk of this regional slowdown reflects a continued deceleration in India (to 5 percent in the 2012 fiscal year ending in March 2013), but growth also slowed in other regional economies. Sri Lanka’s growth slowed sharply, by nearly 2 percentage points in 2012. Bangladesh, Pakistan, and Nepal are expected to experience less marked slowdowns in their respective 2012-13 fiscal years, although actual growth rates in Pakistan and Nepal are much lower than in other countries in the region. In contrast, Afghanistan experienced double digit growth in 2012.

The regional trade balance deteriorated in 2012 due to weakening exports and rising demand for crude oil and other imports. India’s current account deficit widened sharply, but robust remittance inflows bolstered current account positions in Nepal, Bangladesh, and Pakistan.

More recently, activity in South Asia has picked up from its mid-2012 slump, with industrial output rising at different paces in India, Pakistan and Bangladesh in the second half of 2012 and in the first quarter of 2013 - while in Sri Lanka industrial production stabilized in the fourth quarter of 2012. South Asia’s exports (and imports) are also increasing, in line with strengthening global trade and output.

Inflation has moderated in several countries, helped in part by the easing of international commodity prices. But in general, consumer price inflation in the region remains higher than the average for the group of middle-income developing countries, and inflation expectations are still very high in India. In addition, some countries have stepped up the reform agenda, seeking to contain fiscal deficits (including reduction of subsidies, by raising end-user fuel and electricity prices), and in the case of India, opening the economy further to international investment.

Outlook for 2013-15

Economic activity in South Asia is projected to strengthen during the course of 2013, buoyed by a gradual strengthening of external demand; a less volatile external environment; lower crude oil prices; reduced fiscal pressures due to lower fuel prices and lower subsidies; an improved crop (following last year’s weak monsoons); and continued remittance inflows. However, even as quarterly GDP accelerates, the sharp deceleration of growth in 2012 implies that whole year growth in 2013 will be a relatively weak 5.2 percent. Looking further ahead, the stronger underlying momentum in 2013, coupled with firming external demand and improvement in investment spending (assuming policy and fiscal reforms are sustained), should help to accelerate the region’s growth to 6.0 percent in 2014 and then 6.4 percent in 2015. Growth in India is projected to rise to 5.7 percent in the 2013 fiscal year, and accelerate to 6.5 percent and 6.7 percent in FY2014 and FY2015.

Risks and vulnerabilities

Risks to the outlook for the region are broadly balanced. 

External risks are diminishing but remain

External risks from the Euro Area and of fiscal sustainability in the United States have diminished. But the region’s vulnerability to a deterioration in financial flows has picked up due to rising current account deficits, notably in India. A more rapid than expected decline in commodity prices would help outturns by reducing current account and fiscal deficits, and by easing inflationary pressures and boosting domestic incomes.

Domestic challenges are gaining prominence

Domestic issues, including continued progress in fiscal consolidation; the quality of this year’s rice crop; and success in reversing the earlier increase in inflationary expectations will contribute to determining the pace of recovery going forward. Perhaps most importantly, will be continued progress in implementing reforms that relieve supply-side constraints, such as reducing energy supply bottlenecks, labor market reforms, improving the business climate, and investing in education, health and infrastructure.
Recent economic developments

GDP in South Asia decelerated sharply during 2012, extending a slowing trend following the rapid recovery from the financial crisis in 2008. Regional growth slowed from 10 percent in 2010 to 7.3 percent in 2011, and further to 4.8 percent in 2012 (figure SAR.1).

The slowdown in 2012 mainly reflects a continuing steep deceleration in India, which represents about four-fifth of the region’s GDP, to 5.0 percent in the 2012 fiscal year (April 2012-March 2013) from 6.2 percent in FY2011 and 9.3 percent in FY2010. But growth also slowed in other regional economies. Growth in Sri Lanka slowed sharply, by almost 2 percentage points in 2012. Fiscal year growth in Bangladesh, Pakistan, and Nepal is estimated to have slowed less markedly in their respective 2012-13 fiscal years, although actual growth rates in Pakistan and Nepal are much lower than in other countries in the region. Afghanistan was unique among the larger economies in the region, recording double digit growth in 2012.

A worsening external environment amid intensification of Euro Area debt tensions in mid-2012 caused a severe weakening of exports across the region. Regional exports fell by 4 percent (y/y) in US dollar terms in 2012 (-4.1 percent y/y excluding India), after two consecutive years of more than 30 percent increases. The Euro Area economy, South Asia’s largest export market, contracted by 0.5 percent in 2012, and although policy actions in high income countries stabilized financial markets, global trade only began firming in the fourth quarter. South Asia’s US dollar imports continued to rise in 2012, but at a much slower pace (4 percent y/y) compared with a 32 percent increase the previous year.

In consequence, trade balances as a share of GDP either deteriorated or trade deficits remained high in the region (figure SAR.2). India’s worsening trade deficit was reflected in a sharp widening of its current account deficit, which reached 6.7 percent of GDP in the fourth quarter of 2012. Sri Lanka’s current account deficit had widened even more earlier (to 7.8 percent of GDP in 2011) together with an overheating economy. Policy tightening measures curbed import demand, but weak exports meant that Sri Lanka’s trade deficit remained high, and its current account deficit declined only modestly to 6.6 percent of GDP in 2012. In Bangladesh, although exports declined in 2012 in line with the regional trend, imports fell even faster—in part due to a 10 percent depreciation of the taka relative to the US dollar, compared with the previous year—causing its trade deficit to narrow during the 2012 calendar year. Together

Fig SAR.1 A sharp slowdown in post-financial crisis GDP growth in South Asia, led by India

GDP growth

Note: Fiscal years for Bangladesh, Nepal and Pakistan span almost equally across two calendar years, with data for FY2011-12 shown in 2012 in the chart. For India, where the fiscal year runs from April to March, data for FY2012-13 is shown in 2012. GDP growth rates are shown in factor cost terms for India and Pakistan, and in market price terms for other countries. South Asia’s GDP growth rate for calendar years are based on country-level averages of fiscal year GDP growth rates (see Table.SAR.2).

Source: World Bank; Datastream, Haver.

Fig SAR.2 Trade deficits as share of GDP have widened in India, Pakistan and Sri Lanka

Trade balance/GDP (Percent)

Source: World Bank; Datastream.
with increased remittances, this resulted in an improved current account position. Despite growing trade deficits in Pakistan and Nepal in the 2012 calendar year, their current account positions were bolstered by robust migrant remittances inflows (see box SAR.1), and also by official transfers in the case of Pakistan. Below-average monsoon rains and a poor regional harvest in 2012 (agriculture constitutes about a fifth of South Asia’s GDP and over half of employment) also contributed to weaker growth across the region. In addition, structural capacity constraints and domestic policy uncertainties, as well as security concerns and social unrest in some countries, played a significant role in the slowing of regional GDP growth.

India’s GDP measured in factor-cost terms grew at a decade-low 5.0 percent in FY2012 (figure SAR.1). The aforementioned weakening of external demand and below-average monsoons exacerbated a domestic slowdown that was already underway, as building capacity constraints and bottlenecks kept growth in check despite sustained fiscal stimulus. This stimulus had helped the economy recover quickly after the financial crisis in 2008, and was gradually withdrawn in subsequent years. Uncertainty about the reform agenda, along with monetary policy tightening in 2010 and 2011 in response to rising inflationary pressures, led to a sharp slowing of investment growth and an increase in stalled projects (figure SAR.3). Weaker investment activity added to existing supply-side constraints and negatively impacted overall growth.FN1

GDP growth in Bangladesh and Sri Lanka has been around 6 percent or higher in recent years (figure SAR.1). Bangladesh’s exports have benefited in part from preferential access to European Union and US markets, while domestic demand and its current account position were partly cushioned by remittances (see Box SAR.1). However, weakening external demand, domestic supply constraints (including unreliable electricity provision), and social unrest resulted in growth slowing to 6.2 percent in FY2011-12 from 6.7 percent the previous fiscal year, with a further slowdown expected for FY2012-13. Bangladesh’s relatively fast growth during 2010-12, together with international commodity price increases and expansionary macroeconomic policies, resulted in inflationary pressures. Subsequent macroeconomic tightening and intensified domestic constraints, combined with disruptions caused by political unrest, contributed to the projected slowdown in FY2012-13.

Sri Lanka’s economy enjoyed a post-conflict rebound, growing at 8 or more percent in both 2010 and 2011. Growth has since slowed to a more sustainable 6.4 percent in 2012, in response to policy efforts to reduce overheating (amid rising domestic supply constraints), a drought, and weaker global demand for Sri Lanka’s exports.

Afghanistan’s robust 11.8 percent GDP growth in 2012, the highest in the region, was mainly due to an exceptionally good harvest and continued strong foreign aid inflows. In addition, mining activity also picked up. However, governance issues and an uncertain security situation present persistent challenges.

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FN1 See Box SAR.1.
for the economy. Bhutan’s economy grew strongly in recent years mainly due to hydropower generation and electricity sales to India—these revenues together with budgetary grants allowed it to finance a current account deficit exceeding a fifth of GDP. High credit growth and supply constraints resulted in an overheated economy and inflation rates rising to over 10 percent (in line with cost of imports from India). But policy tightening in 2012 moderated credit growth, while delays in new projects coming on-stream caused GDP growth to slow to an estimated 7.6 percent in the 2012-13 fiscal year from 9 percent in FY2011-12.

The Maldives, however, experienced political uncertainty, double-digit fiscal deficits (the highest in the region - see below), current account deficit of over a quarter of GDP, falling reserves (well below the critical 3 months of imports), and a halving of GDP growth to 3.4 percent in 2012. Tourism, a mainstay of the economy, was also adversely affected by slower growth in high income countries, and was only partly compensated for by an increase in Asian tourist arrivals.

Regional industrial production growth picked up in late 2012 and early 2013, but business sentiment weakened in India

Industrial activity has begun picking up from a mid-2012 slump at different paces across South Asian countries. India dominates the regional trend, with industrial production expanding at a 4.1 percent annualized pace during the three months ending in March (3m/3m, saar) (figure SAR.4). Available data show industrial production rose even more decidedly in Pakistan and Bangladesh—at a 22.6 percent annualized pace during the three months ending in March 2013 (3m/3m, saar) in Pakistan and at a 21.3 percent annualized pace in the three months ending in January in Bangladesh. Industrial production momentum in Sri Lanka stabilized by the end of 2012 after registering steep declines during the second half of the year (figure SAR.4).
Business sentiment in India, however, weakened markedly between March and May, with the Purchasing Managers’ Index for manufacturing recording its lowest reading in four years in May - although still slightly above the 50 mark, indicating expansion. This in part reflects still difficult domestic and external demand conditions (despite recent strengthening) and persistent electricity shortages. In contrast, the services sector index picked up in May on stronger demand, with increased optimism about the future among services firms.

South Asian exports have also started to recover from their 2012 slump

South Asia’s exports have also started to recover from their mid-2012 slump. Regional export volume growth picked up to a 12 percent annualized pace in the fourth quarter of 2012 from 6.5 percent (annualized) in the third quarter, and further to a robust 15.7 percent annualized pace in the three months to April (3m/3m, saar) (figure SAR.5). While India dominates the regional trend, Bangladesh’s export volume growth accelerated as a result of strengthening demand for its garment exports (although recent factory accidents could moderate the pace of increase going forward).

In Pakistan, following a relatively strong pickup in the second half of 2012, the momentum of export volume growth weakened in Q1 2013, in part as natural gas and electricity shortages cut into activity. The pace of decline, however, appears to have slowed in March and April. Available data suggest that the pace of earlier decline in Sri Lanka’s exports slowed in the second half of 2012 and momentum of export volume growth improved in recent months (figure SAR.5), although on a year-on-year basis, exports in US dollar terms were still 2.8 percent lower in March compared to the same month in 2012.

Inflation in South Asia shows signs of moderating, but price pressures remain

Regional consumer price inflation accelerated in the three months to February partly due to a surge in food prices and upward adjustments to regulated fuel prices. However, inflation shows signs of moderating, helped in part by easing of international commodity prices. India’s benchmark wholesale price index (WPI) inflation fell to a 3-year low of 4.9 percent (y/y) in April 2013— although consumer price index (CPI) inflation and core inflation (CPI excluding food and energy) were both above 8 percent (y/y) in April. In Sri Lanka, inflation moderated to 6.4 percent (y/y) in April, its lowest in almost a year, but rose to 7.3 percent in May.

Year-on-year inflation rates can however be influenced by base effects. Quarterly inflation provides a better measure of recent movements
(figure SAR.6). According to this measure, the momentum of CPI inflation remains strong in Bangladesh and India—although moderating slightly in Bangladesh—suggesting that price pressures continue to remain high in these countries. However, inflation has moderated markedly in Pakistan. Inflation momentum had been weakening earlier in Sri Lanka, but increase in regulated electricity prices caused inflation to rise in May.

The generally high CPI inflation rates in South Asian countries compared with the average for middle-income developing countries reflect supply-side production constraints, entrenched inflationary expectations, and the persistence of food inflation. Households’ inflation expectations in India remain stubbornly high, partly because of a steady upward trend in inflation over the past 7 years (figure SAR.7). Food inflation has remained persistently high in the region, partly reflecting agricultural production constraints and logistics bottlenecks. Despite the moderation in overall consumer price inflation, food inflation in India was over 10 percent (y/y) in April, and in Bangladesh and Sri Lanka was 8.4 percent and 7.9 percent, respectively, in May. In Pakistan, despite a moderation in headline inflation to 5.1 percent (y/y) in May, food inflation was a higher 6.5 percent. Moreover, core inflation (CPI excluding food and energy) in Pakistan remains above 8 percent, in part because of escalating costs due to energy bottlenecks and security concerns.

Private capital flows to South Asia have picked up since mid-2012

Private capital flows to South Asia have increased robustly since mid-2012 (figure SAR.8). Overall, net private capital inflows to the South Asia region rose from $73 billion in 2011 to $87 billion in 2012 (table SAR.1).

Following reform efforts in India since September 2012, private capital flows to India grew robustly led by portfolio equity inflows and bank lending. The increase in private inflows since mid-2012 was also a consequence of abundant global liquidity that resulted from financial market stabilization and accommodative monetary policies in high income

Fig SAR.6  Inflation momentum is moderating across South Asia, but still strong in India and Bangladesh

Fig SAR.7  Inflation expectations in India are still very high

Fig SAR.8  Gross capital flows to South Asia rebounded in the second half of 2012
countries. Foreign direct investment (FDI) received by India, however, declined by 22 percent (y/y) during the 2012 calendar year. As part of reform efforts (and given the need to finance a larger current account deficit), India undertook several measures to boost private capital inflows. These included raising limits on FDI in retail, broadcasting and aviation sectors; reducing withholding taxes on interest earnings on foreign investment in domestic bonds; faster clearances for large investment projects (including those with foreign participation); and in general, efforts to clarify tax and other regulations relevant for foreign investors. Gross capital inflows, however, moderated in recent months, in part due to growth concerns and further deterioration of India’s current account position in the fourth quarter of 2012.

In Sri Lanka, private debt inflows have risen as the government successfully issued several sovereign bonds in international markets. By contrast, in Pakistan, foreign investment inflows have been on a declining trend in recent years due to domestic uncertainties, an adverse investment climate, and energy shortages. This decline, together with repayment of official debt to the IMF, have added to pressures on Pakistan’s balance of payments position, with international reserves falling below 2 months of imports.

### Medium-Term Outlook

Following a steep deceleration in South Asia’s GDP growth to 4.8 percent in 2012, regional growth is projected to improve during 2013-15 (Table SAR.2). This recovery in regional growth will be helped by gradual improvements in both external and domestic conditions.

A stabilization of the global economic environment and a gradual recovery in global demand will provide something of a tailwind for South Asia’s GDP growth. However, output in the Euro Area economy, South Asia’s largest export market, is forecast to contract for the second year in a row in 2013, and growth will remain subdued in 2014 and 2015 (see GEP June 2013 main text). Economic activity in the United States, however, is more robust and projected to strengthen further. Much of the additional external demand for South Asia is projected to come from other developing countries, which have become increasingly important destinations of South Asian exports. South Asia’s exports to developing countries, including within the region, have risen from 19 percent of overall exports in 2000 to 35 percent in 2011 (14 percent and 26 percent for South Asia excluding India—see figure SAR.9).

### Table SAR.1 Net capital flows to South Asia

<table>
<thead>
<tr>
<th></th>
<th>2008</th>
<th>2009</th>
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<th>2013f</th>
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<td>Net portfolio equity inflows</td>
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<td>3.7</td>
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</table>

An expected normal agricultural season and increase in rural disposable incomes, together with lower crude oil prices and moderation in inflation, and continued remittance inflows (in countries where they are important relative to GDP), will support an improvement in activity in the South Asia region from mid-2013 onwards.

Although quarterly GDP is expected to pick up over the course of 2013, the sharp deceleration of growth in the previous year implies that whole year growth for the South Asia region in 2013 will be a relatively weak 5.2 percent. In the subsequent two years, South Asia’s regional GDP growth is projected to accelerate to 6.0 percent in 2014 and 6.4 in 2015, as a result of strengthening external demand and with gradual success in alleviating some of the domestic structural constraints that have held back growth.

Regional growth will be driven mainly by a projected pickup in India, whose GDP in factor cost terms is projected to grow 5.7 percent in the 2013 fiscal year (ending in March 2014), and then accelerate to 6.5 percent and 6.7 percent in FY2014 and FY2015, respectively. Exports and private investment, which slowed sharply in 2012, are projected to strengthen during 2013-15 and provide a boost to growth. However, how robust

### Table SAR.2 South Asia regional forecasts

<table>
<thead>
<tr>
<th>(annual percent change unless indicated otherwise)</th>
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<th>2010</th>
<th>2011</th>
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<td>GDP per capita (units in US$)</td>
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<td>5.8</td>
<td>3.3</td>
<td>3.8</td>
<td>4.6</td>
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</tr>
<tr>
<td>PPP GDP d</td>
<td>5.9</td>
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<td>7.3</td>
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**Memo items: GDP at market prices f**

| South Asia excluding India | 4.6 | 4.9 | 5.2 | 4.9 | 4.7 | 4.9 | 5.0 |
| India at factor cost       | 7.6 | 9.3 | 6.2 | 5.0 | 5.7 | 6.5 | 6.7 |
| Pakistan at factor cost    | 4.9 | 3.1 | 3.0 | 3.7 | 3.4 | 3.5 | 3.7 |
| Bangladesh                 | 5.2 | 6.1 | 6.7 | 6.2 | 5.8 | 6.1 | 6.3 |


a. Growth rates over intervals are compound weighted averages; average growth contributions, ratios and deflators are calculated as simple averages of the annual weighted averages for the region.
b. GDP at market prices and expenditure components are measured in constant 2005 U.S. dollars.
c. GDP figures presented in calendar years (CY) terms for Bangladesh, Bhutan, Nepal, India and Pakistan are calculated taking the average growth over the two fiscal year periods to provide an approximation of CY activity.
d. GDP measured at PPP exchange rates.
e. Exports and imports of goods and non-factor services (GNFS).
f. National income and product account data refer to fiscal years (FY) for the South Asian countries, while aggregates are presented in calendar year (CY) terms. The fiscal year runs from July 1 through June 30 in Bangladesh, Bhutan, and Pakistan, from July 16 through July 15 in Nepal, and April 1 through March 31 in India. Due to reporting practices, Bangladesh, Bhutan, Nepal, and Pakistan report FY2010/11 data in CY2011, while India reports FY2010/11 in CY2010.
that recovery will be, will depend on the pace of policy and fiscal reforms, and remains subject to significant uncertainty and downside risks. Some upside risks to the outlook include a faster than projected pickup in global demand and a larger than expected decline in commodity prices (see Risks and Vulnerabilities section below).

GDP growth in Pakistan is projected to only slowly accelerate from an estimated 3.4 percent in FY2012-13 to 3.7 percent in FY2014-15, with output being held back by a wide range of structural problems, including: weak investment (down a third since 2008 when expressed as a percent of GDP—see figure SAR.10), security uncertainties, unreliable energy inputs, and monetization of large fiscal deficits, among others. Balance of payments pressures have risen with reserves falling below 2 months of imports, notwithstanding robust remittance inflows. Policy actions to address the underlying adverse structural factors are critical to raising Pakistan’s longer-term growth potential.

Bangladesh’s growth slowed to an estimated 5.8 percent in the 2012-13 fiscal year ending in June. But growth is projected to pick up modestly to 6.1 percent in FY2013-14 and 6.3 percent in FY2014-15, as external demand strengthens gradually, and agricultural output returns to more normal levels. Several domestic weaknesses, including infrastructure gaps (electricity, roads) and social unrest are expected to hold back a firmer recovery.

In Sri Lanka, growth is expected to pick up to 6.5 percent in 2013 and 6.7 percent in 2014, aided by normal agricultural harvests, strengthening demand for exports, robust capital inflows, increase in infrastructure and other investments, and a revival of tourism (Table SAR.3). The relatively modest pickup in growth represents a return to underlying potential growth rates after rapid demand-fueled growth in 2010-11 opened up positive output gaps and resulted in inflation and current account pressures.

Some domestic uncertainties in Nepal appear to be easing and the political situation normalizing after formation of an interim government in March. This political normalization, expected timely monsoon rains, and continued increase in remittances should be favorable for economic activity in 2013 and beyond. However, private
## Table SAR.3  South Asia country forecasts

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World Bank forecasts are frequently updated based on new information and changing (global) circumstances. Consequently, projections presented here may differ from those contained in other Bank documents, even if basic assessments of countries’ prospects do not significantly differ at any given moment in time.

a. GDP growth rates over intervals are compound average; current account balance shares are simple averages over the period.

b. National income and product account data refer to fiscal years (FY) for the South Asian countries with the exception of Sri Lanka, which reports in calendar year (CY). The fiscal year runs from July 1 through June 30 in Bangladesh, Bhutan, and Pakistan, from July 16 through July 15 in Nepal, and April 1 through March 31 in India. Due to reporting practices, Bangladesh, Bhutan, Nepal, and Pakistan report FY2010/11 data in CY2011, while India reports FY2010/11 in CY2010. GDP figures presented in calendar years (CY) terms for Bangladesh, Bhutan, Nepal, India and Pakistan are calculated taking the average growth over the two fiscal year periods to provide an approximation of CY activity.

c. GDP measured in constant 2005 U.S. dollars.
sector industrial activity is likely to continue to remain lackluster. Overall, following an estimated 3.7 percent GDP growth in FY2012-13, Nepal's growth is projected to remain broadly stable at 3.8 percent in FY2013-14 and improve modestly to 4.1 percent in FY2014-15. To do better, the government will need to make energy provision more reliable, invest further in the skills and quality of Nepal’s workforce, enhance the predictability and transparency of the regulatory and tax regimes, while also strengthening the overall business environment.

Afghanistan’s economy remains dependent on agricultural performance and external aid. Moderate rainfall is projected to reduce growth to around 3 percent in 2013. The withdrawal of coalition forces, which have been a major source of demand, is likely to create challenges for sustaining growth. To assist in this transition, donors have pledged significant aid in the coming years. Although the security situation remains difficult, services and natural resource extraction are starting to contribute to economic activity. Growth will also be helped by continued rebuilding of infrastructure and essential services, foreign assistance, and foreign investment in natural resource sectors. Afghanistan’s GDP growth is forecast to accelerate to about 6 percent by 2015.

In Bhutan, hydropower projects coming on steam in coming years are likely to keep overall GDP growth high at about 8-9 percent annually in 2013-15. But lack of economic diversification poses challenges to generating employment and inclusive growth. In Maldives, in addition to deteriorating macroeconomic fundamentals discussed earlier, the country faces severe challenges in diversifying its economy beyond tourism. The economic outlook remains clouded by political uncertainty leading up elections in 2013/14 and by limited success in controlling fiscal outcomes.

An easing in global fuel prices (Brent crude oil prices fell 15 percent between mid-February and early-June - see figure SAR.11), together with expected normal monsoon rains, will help to curb price pressures. Modestly lower crude prices in 2013 and 2014 will also provide some relief to current account and fiscal positions. Lower crude oil prices will help regional governments in narrowing existing gaps between international prices and domestic administered prices, and lower the subsidy burden and reduce overall fiscal pressures.

But inflation pressures will still remain in the region. Ongoing and planned increases in administered fuel and electricity prices will add to headline price pressures in the near term, but as long as the higher inflation does not get ingrained into expectations, this should not result in a permanent increase in inflation. More importantly, supply side constraints in agricultural, energy and other sectors will continue to exert upward price pressures.

## Risks and vulnerabilities

Global uncertainties have receded since mid-2012 and both the severity and likelihood of downside risks from high income countries has diminished (see June 2013 GEP main text). Domestic policy and weather risks have now gained in importance for the South Asia region.

A key risk to the gradual acceleration in growth envisaged in the baseline scenario, is the success with which planned and announced reform policies are actually implemented during 2013-15. Based on backward looking indicators, growth could well be...
between 0.3 and 0.5 percentage points slower than in the baseline.

Political obstacles to passing and implementing reform legislation pose downside risks to the outlook. Reforms to the process of land acquisition for industrial projects and labor market reforms could prove contentious. In countries either exiting (Pakistan) or entering electoral cycles (Bangladesh, India, Nepal), spending pressures associated with elections could boost fiscal expenditure, adding to inflationary pressures and both internal and external imbalances. Risks in the post-election period include the possibility that past reforms are reversed or implementation delayed.

Weaker than expected monsoon rains present another downside risk for South Asia. A second poor monsoon in a row would adversely affect rural incomes and employment, contribute to persistence of food inflation (and in turn, overall inflation) and could reduce overall GDP growth by 0.5 percentage points or more. Moreover, weaker rural income growth would put greater demands on public spending (through automatic stabilizers and social welfare programs), which could make it difficult to achieve fiscal targets.

A weakening of reserve coverage of imports in Pakistan and the Maldives to below 2 months of imports suggests that their balance of payments positions could come under stress from unanticipated shocks. However, the reserve position of Bangladesh has improved in the most recent period, from robust remittance inflows and a recent improvement in trade. Sri Lanka’s reserves have also risen in line with an increase in private capital inflows.

A greater dependence on foreign investment inflows to finance India’s significantly larger current account deficit compared to the past has increased its vulnerability to a sudden reversal of investor sentiment. Several factors could result in a slowing or reversal of investment inflows—an unanticipated monetary tightening in some high income countries; resurgence of debt tensions; escalation of geopolitical conflict; and even disenchantment with the pace or nature of domestic reforms. Moreover, the sharply relaxed monetary policy in Japan could result in strong and disruptive private capital flows.

Revival of business sentiment remains a key element for South Asia’s regional growth. As discussed earlier, business sentiment in the manufacturing sector in India weakened to a four-year low in May (although the services sector index picked up). If business sentiment were to remain weak in coming months, this could adversely impact investment and growth.

An upside risk to South Asia’s growth outlook includes a significant decline in commodity prices compared to the baseline. If crude oil prices were to fall to an average level of $80 per barrel by mid-2014 due to additional supplies coming on stream in international markets, South Asia’s GDP would be 0.9 percent higher than in the baseline by 2014, current account deficit would be 1.4 percent of GDP lower, and fiscal deficit 0.7 percent of GDP lower (see table 5 in June 2013 GEP main text). Other upside risks include a more rapid resolution of structural constraints to growth than envisaged in the baseline, and faster than projected global growth during the forecast period.

Despite recent efforts at fiscal consolidation, relaxation of monetary policies and still large fiscal deficits pose risks

Central banks in South Asia cut interest rates sharply during the global financial crisis of 2008/09, but rates were appropriately raised subsequently as inflationary pressures rose (figure SAR.12). With the slowing of growth in 2012 and the recent moderation in year-on-year inflation, monetary policy in the region shifted toward a more accommodative stance. Policy rates in Pakistan were cut by 250 basis points in the second half of 2012, while Bangladesh, India and Sri Lanka cut policy rates in the first half of 2013. Sri Lanka’s central bank cut its policy rate by 25 basis points in late 2012 and again by 50 basis points in May after inflation moderated in the previous two months. The Reserve Bank of India reduced its key policy interest rate by a cumulative 75 basis points between January and May of 2013 as its benchmark wholesale price inflation declined, notwithstanding high CPI inflation.

Although inflation rates have moderated across several countries in the region, consumer price
inflation still remains high compared to the average for middle-income developing countries. India’s steep growth deceleration mostly closed a large positive output gap that had opened up in the post-financial crisis period. And notwithstanding either slower or weak growth in 2012, several other South Asian countries also appear to be operating either close to or above full capacity. Given lags in monetary policy transmission, an easing of monetary policies (together with still large fiscal deficits) could add to strengthening activity already underway in the countries operating at full capacity, resulting in additional inflationary and current account pressures, without much payoff in additional GDP growth.

The high fiscal deficits in the region also pose risks to the outlook, despite recent efforts at consolidation (see below). Large government borrowing programs can result in crowding out of private investment, and importantly, reduce available policy buffers to counter external or domestic shocks. Moreover, when underlying inflationary pressures are already high, the additional spending can further exacerbate inflation.

General government deficits exceeded 6 percent of GDP on average in 2012 in the region (figure SAR.12). India’s central government’s fiscal deficit fell to 4.9 percent of GDP in the 2012 fiscal year, below the 5.2 percent initially estimated, and down from 5.8 percent in FY2011. The government has pledged to further reduce it to 4.8 percent in FY2013 and 4.2 percent in FY2014. Despite the recent consolidation, India’s general government deficit (including state government fiscal deficits) is more than 7 percent of GDP. Pakistan’s general government deficit is estimated to have risen sharply in recent years to above 7 percent of GDP (figure SAR.13). Maldives’ fiscal deficit is significantly higher than the regional average, and rose further in 2012.

Several South Asian countries undertook fiscal reforms during the last year, particularly to their subsidy regimes. Fuel and food subsidies typically account for the bulk of subsidies, with subsidies in India and Sri Lanka at more than 2 percent of GDP, and over 3.5 percent of GDP in Bangladesh. Reforms to subsidy regimes have involved introducing more frequent adjustments to administered fuel and electricity prices, and measures to improve targeting of government benefits to the poorest beneficiaries. For instance, administered diesel prices in India are being raised at close to monthly frequency to gradually narrow the gap between international and domestic prices, while quotas have been imposed on subsidized provision of liquified petroleum gas (LPG) for domestic use. Sri Lanka raised electricity prices in April 2013 in order to curb the (quasi-fiscal) losses of the state electricity company. India has also undertaken an ambitious direct cash transfer program (based on Aadhar digital unique national identification numbers, already provided to nearly 400 million Indians) in order to better target government benefits and services, and to reduce leakages from the public distribution system.
Despite progress made in recent months, there are still challenges to moving towards market-based pricing of fuel and electricity tariffs in the region. Regulated fuel and electricity prices are often insufficient for energy producers to fully recover costs. These not only add to quasi-fiscal losses of public sector firms, but can also deter private investment in the critical energy sector.

Mobilizing sufficient tax revenues to fund social development and infrastructure investment remains a major challenge for the region. Tax revenues as a share of GDP are in general lower in South Asian countries when compared with the average for middle and low income developing countries (figure SAR.14). For sustained deficit reduction, expenditure restraint and better targeting of subsidies has to be combined with revenue mobilization (including measures to simplify the tax code, broaden the tax base, and improve compliance), so that necessary expenditure on education, health, and infrastructure do not suffer and impair future growth.

Conclusions

The South Asia region faces a number of longer-term economic challenges. Despite impressive gains in development outcomes in recent years (the region is on track to achieve three Millennium Development Goals by 2015 – halving extreme poverty, reducing maternal mortality, and providing access to safe water), South Asia will still be home to almost 400 million of the developing world’s 970 million poor in 2015, according to the World Bank’s Global Monitoring Report (see also Chen and Ravallion (2012) and Ravallion (2013)).

The sharp economic slowdown experienced in the post-financial crisis period exposed structural vulnerabilities and has made the task of reviving growth in a sustainable manner even more urgent. But with India’s positive output gap mostly closed after its steep growth deceleration, and given capacity constraints in most South Asian countries, policymakers need to remain vigilant against relying on short-term demand stimulus in order to avoid overheating (inflation and current account) pressures. South Asian countries should continue to rebuild their fiscal buffers to be able to deal with future crises.

Deepening supply-side reforms is critical to improving the efficiency of investment and raising the longer-term growth potential of the region. These include eliminating bottlenecks in project implementation and easing energy input constraints for firms, as well as labor market reforms, clarity in tax and business regulations for both foreign and domestic investors, and improving the overall business climate. Raising the quality of human capital through appropriate investments in education and health can boost productivity in South Asian countries over the longer term. Investment in infrastructure will help the formal private sector by reducing transportation and logistics costs, and also the poor in gaining access to markets and opportunities.
Notes

1 See GOI (2013), Rajan (2013), and Subbarao (2013) for some of the reasons behind India’s growth slowdown and the macroeconomic and structural challenges that the country faces in reviving growth.

2 The World Bank’s estimates of India’s central government fiscal deficit are slightly higher at 6.0 percent in FY2011 and 5.1 percent in FY2012. The difference is mostly accounted for by receipts from disinvestment in public sector enterprises. World Bank estimates excludes these (and any other one time receipts) from the government's revenue.

References


_____ . 2013b. World Economic Outlook, April. Washington DC.


GLOBAL ECONOMIC PROSPECTS | June 2013

Annex

SUB-SAHARAN AFRICA REGION
Overview

Strong domestic demand allowed Sub Saharan African economies to continue their robust growth trajectory in 2012, despite subdued global demand conditions. On aggregate the region grew at 4.4 percent in 2012 (this includes South Sudan whose GDP recorded a double digit contraction). Excluding South Africa, the region’s largest economy, the rest of the region grew 5.4 percent, with close to a third of economies growing faster than 6 percent (figure SSA.1).

Much of this growth was supported by investments in both the resource and non-resource sectors. Net foreign direct investment inflows to the region are expected to reach about $40 billion in 2013, up from $32.1 billion in 2012. Still high commodity prices (even if easing) is supporting investments in the natural resource sectors in several economies in the region. But the growth dynamism has not come only from the resource sector as investments (both domestic and foreign) have also flowed to the non-resource sector, in particular the service sub-sectors such as finance and banking, telecommunication, transportation and retail trade. Indeed, in several economies growth in the non-resource sector was stronger than the resource sector.

Better weather conditions and associated improved harvests, decelerating inflation, relaxation of earlier interest rate hikes and increased remittance inflows ($33 billion in 2013, up from $32 billion in 2012) broadly supported the resilience in household spending, albeit with differences across countries in the region. Fiscal policy for most economies in the region remains expansive with several governments rightly emphasizing the need to address infrastructural weaknesses. Debt levels also remain low. However, compared to 2008 levels, fiscal buffers in the region are yet to be restored, and in a number of countries the expansionary fiscal policy may actually be hitting against capacity constraints.

While the overall growth story for the region has been robust, not all countries are enjoying this robust growth. Indeed, growth in 2012 was weaker in countries that encountered conflict or political instability (e.g. South Sudan, Central Africa Republic, Mali, Guinea Bissau), major labor unrests (South Africa) sharp fiscal adjustments (Swaziland) and those impacted by severe adverse weather conditions.

Medium-Term Outlook. Going forward, the robust domestic demand factors that have underpin Sub-Saharan Africa’s growth performance in recent years and the projected strengthening of global demand are expected to support the region’s medium term growth trajectory. Regional GDP is projected to pick up to 4.9 in 2013, 5.2 percent in 2014, and 5.4 percent in 2015. Excluding, the region’s largest economy, South Africa, GDP growth for the rest of the region is expected to increase by 6.2 percent in 2013 and 2014, and further strengthen to 6.4 percent in 2015. Net private capital inflows are projected to reach $77.5 billion in 2015 from $48.3 billion in 2012. Household spending will be supported by rising incomes, increased remittance flows, and a stable macroeconomic environment. Although the gradual strengthening of the global economy and increased capacity in mineral exports will support export growth over the medium term, the net exports contribution to growth is expected to be modest or even negative, on account of strong import demand (especially capital equipment).

Risks to growth prospects. Nonetheless, there exist downside risks that could derail the projected robust growth outlook. While external risks to the outlook from the Euro Area crisis, or fiscal sustainability in the United States and Japan have diminished, new domestic and external risks and challenges have gained in prominence. Notable among these is the possibility that the recent easing in international commodity prices intensifies. Our simulations suggest that, while a 25 percent decline in oil prices will be beneficial to the oil importers in the region, oil exporters would experience a cut in growth by some 1.4 percentage points, with similar impacts for metal exporters in the event of a sharp decline in industrial metal prices. Domestic risks include the possibility of overheating in economies operating close to capacity; adverse weather shocks; and political unrest. On the upside growth could be stronger if high-income countries recover more quickly than envisaged or if ongoing infrastructural investments improve competitiveness and help unlock new sources of growth.
Recent Developments

**Investment flows continue to underpin growth in Sub Saharan Africa.** Gross fixed capital formation in Sub Saharan Africa has steadily increased from about 16.4 per cent of GDP in 2000 to about 20.4 per cent in 2011. The pick up in investment has not only contributed to growth directly, but it has also helped boost potential output in the region by raising the amount of capital with which labor has to work, albeit concentrated in specific sectors.

Data for 2012, suggest that this capital deepening process has continued. Imports of capital equipment, used as a proxy for domestic investment activity, have expanded at a robust 33.6% annualized pace in value terms during the fourth quarter of 2012, although this follows a sharp slump (-38.2%) in Q3 2012, when global economic activity was weaker (figure SSA.2).\(^{FN2}\) Fourth quarter capital goods imports were particularly strong in Angola, Cote D’Ivoire, Ethiopia, Ghana, Nigeria, Tanzania and Zambia - all economies where real GDP grew by an estimated 6.5 per cent or more in 2012.

**High commodity prices have supported investment flows to minerals sector.** With the region’s vast potential of unexplored mineral and hydrocarbon reserves and still high commodity prices (notwithstanding recent declines) foreign direct investment continues to flow to the natural resource sectors across the breadth and length of the region’s economies (see table SSA.1). Net foreign direct investment inflows to the region reached an estimated $33.4 billion in 2012, and are projected to rise a further 21% in 2013 (table SSA.2).

### Table SSA.1  Selected major ongoing explorations in the natural resource sector in Sub Saharan African economies

<table>
<thead>
<tr>
<th>Sub-region</th>
<th>Oil and Gas</th>
<th>Metal and Mineral</th>
</tr>
</thead>
<tbody>
<tr>
<td>West Africa</td>
<td>Ghana, Cote d’Ivoire, Sierra Leone, Liberia, Chad</td>
<td>Sierra Leone (iron ore), Guinea (iron ore)</td>
</tr>
<tr>
<td>East Africa</td>
<td>Tanzania, Uganda, Kenya</td>
<td>Eritrea (gold), Ethiopia (gold) Tanzania (gold, uranium)</td>
</tr>
<tr>
<td>Southern Africa</td>
<td>Angola</td>
<td>Mozambique (coal, iron ore), Zambia (copper), Botswana (copper), Madagascar (nickel), Malawi (uranium)</td>
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<tr>
<td>Central Africa</td>
<td>Cameroon</td>
<td>Gabon (manganese), Cameroon (iron ore), Democratic Republic of Congo (copper, cobalt, gold)</td>
</tr>
</tbody>
</table>

Source: Africa Mining
The non-minerals sector has also benefitted from increased investment flows, thereby supporting the dynamic growth of that sector. Although the natural resources sector is the pre-eminent destination for foreign direct investment inflows, increasingly non-minerals sectors, notably the services sector, is attracting the interest of foreign investors. Sectoral breakdown of cross-border merger’s and acquisition for the Africa region shows that over the 2010-2011 period the services and manufacturing sectors attracted an average of 53.4 per cent and 33.5 per cent respectively of all M&A purchases in the region.\(^\text{FN3}\) The primary sector accounted for only 13.2%. Similarly, the services and manufacturing sector attracted some 33.6 per cent and 41.2 per cent of all green field FDI into Africa.

Rising disposable incomes, an increasing work force, and the fact that many economies are growing from a low base have spurred on investments in telecommunications, retail and banking. For instance, the International Telecommunications Union estimates that mobile subscriptions in Sub-Saharan Africa grew 14.4 per cent in 2012 (higher than the developing country average of 8.1%). Indeed, in the region services sector growth well exceeds that of resource sector growth, even in long-standing resource rich economies (see box SSA.1).

The mining sector tends to require higher capital outlays and specialized technology than other sectors and therefore attracts a higher percentage of foreign investors. Domestic capital, on the other hand, plays a more significant role in service-sector growth. Thus, despite the increasing contribution of foreign direct investment flows to capital deepening in the region, FDI accounts for about only a fifth of the regions gross fixed capital formation (19.6 percent in 2010). Domestic credit growth figures attest to the rising importance of domestic intermediation. Year-over-year real credit grew 23.4 percent in Botswana (February 2013); 31.4 percent in Ghana (September 2012); 16.6 percent in Kenya (January 2013); 12.9% in Uganda (February 2013); 8.1 percent in Nigeria (March 2013); and 9.7 percent in South Africa (April 2013).
Sub-Saharan Africa Annex

But not all economies are benefitting from the investment flows. While strong on average, investment growth (both foreign and domestic) has been weaker in several other countries. Political instability is hurting investment, thereby curtailing economic growth in Central African Republic, Guinea Bissau, Madagascar, and Mali. Madagascar’s crisis for instance, is estimated to have cost it some $6.3 billion in lost growth over the 2009-2012 period, according to World Bank estimates. This contrasts with post-conflict economies such as Cote D’Ivoire and Comoros which are witnessing increased investment flows and a rebound in economic activity.

Fiscal deficits deteriorated in 2012 and fiscal policy is generally expansive in the region. In general, government expenditures in Sub Saharan Africa have been growing at par with GDP since 2009, and have stayed steady at about 30 per cent of GDP in the post-crisis period — about one percentage point higher than in 2008. Revenues, however, have not kept pace, and as a result, overall fiscal balances have deteriorated by about 2.6 percent of GDP since 2008.

For the region as a whole, fiscal policy appears to have eased in 2012, with cyclically adjusted balances having deteriorated by about 0.3 percentage points overall, with the largest deterioration occurring among oil exporters (figure SSA.3). Nevertheless, average structural (cyclically adjusted) deficits remain low. Moreover, although the region’s government gross debt to GDP ratio is rising it remains relatively low at 33.4 percent of GDP in 2012 (versus 29% of GDP in 2008). Nonetheless, there remain significant differences among countries in the region, hence while debt profiles remain sustainable for most countries in the region, it is a rising concern for a few economies.

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Box SSA.1 Growth in the non-resource sector in several Sub Saharan African countries, including resource rich ones, was higher than that of the resource sector in 2012.

In Botswana, where GDP expanded by 3.7 per cent in 2012, mining output contracted 8.1 per cent, whereas non-mining GDP growth was positive, with notable contributions from construction (14.4), financial and business services (9.7 per cent) and transport and communications (9.1 per cent).

Ghana, one of the new oil exporting economies in the region, grew at an estimated 7.9 percent in 2012, with the mining and quarrying sector (including crude oil) growing at 5.0 percent, whereas the services sector grew at 10.2 per cent. The fastest growing sectors were the information and communication sector (23.4 per cent), financial and insurance activities (23.0 per cent), real estate and other professional services (13.1 percent) and hotel and restaurants (13.0 percent).

In Kenya, where economic activity picked up to 4.7 per cent in Q3 2012, mining and quarrying picked up by 1.8 per cent, with much of the pick-up coming from a 6.9% expansion in the agriculture sector, a 6.8 percent increase in financial intermediation, a 13.7 percent increase in electricity and water output and a 5.2 percent rise in transport and communication services.

In Nigeria Q1 2013 GDP growth was 6.7 per cent with crude petroleum and natural gas contracting at 0.5 percent, while non-oil growth was at 7.9 percent. The lead growth sectors were telecommunications (24.5 percent), hotel and restaurants (13.6 percent) construction (15.7 percent) and real estate (13.6 per cent).

In Rwanda, where GDP grew by 8.7 percent in Q4 2012, the agriculture sector grew by 3 percent and contributed 1.1 percentage points to the overall GDP growth; the industrial sector grew by 11 percent and contributed 1.7 percentage points to the GDP growth; and the services sector increased by 12 percent and contributed 5.4 percentage points to the GDP growth.

In South Africa, where GDP increased by 1.9 per cent in Q1 2013 the mining and quarrying industry, finance and real estate and business services each contributed 0.7 percentage points (ppt). The growth in mining followed two quarters of negative growth. Wholesale, retail & motor trade, and transport, storage & communication each contributed 0.2 percentage points to GDP growth.

In Tanzania, where output expanded by an estimated 6.8 percent in 2012, the mining and quarrying sector expanded by 1.2 per cent in the first three quarters of the year, whereas there was double digit expansion in the real estate (10.1 percent), transport and communications (16.5 percent) and wholesale and retail sectors (16.1 percent).
Most government spending plans for countries in the region (e.g. Uganda, Ethiopia, Zambia, Niger, Namibia, Tanzania, South Africa, Ghana, Nigeria) are rightly targeting infrastructure spending (particularly power generation, transportation routes and port facilities), which remains a critical binding constraint to improving the competitiveness of economies in the region. Increasingly such infrastructure projects are being financed from new funding sources including from some large developing countries (in particular China but also India, Brazil and Russia) and from international capital markets. Indeed, over the past several years countries in the region have taken advantage of low interest rates and investor interest in the high-income world to tap international bond markets, sometimes for the first time. For example Rwanda raised $400 million in April 2013 in its maiden Eurobond issuance. And, other Sub-Saharan African sovereigns (Angola, Kenya, Ghana, Nigeria, Tanzania) have plans to borrow from international capital markets in coming months. A Bloomberg report estimates that excluding South Africa, sub Saharan African sovereigns will issue some $7 billion in international debt in 2013—the highest level since 2007.

Large positive output gaps in a number of economies suggest further expansionary fiscal policy could actually be counterproductive. Nonetheless, with demand in many Sub-Saharan African countries closing in on their supply potential, output gaps (an estimate of the difference between demand and supply) are small or even positive (implying demand in excess of supply, figure SSA.4). For these countries, an expansion of fiscal policy could be counterproductive as it could induce macro instability, with negative impacts on the investment environment and growth.

The challenge will be for policymakers to ensure that the hard earned gains of the past 15 years in terms of macroeconomic and fiscal stability are preserved, while at the same time continuing to lay the foundation for long-term growth by investing in areas of structural weakness, including infrastructure, education and health. A number of countries show signs of overheating, including rising inflationary pressures, increased current account deficits, suggesting that aggregate demand was pushing up against capacity constraints. For these economies, some tightening of policy may be needed. In many countries, where overall tax rates are low and structural deficiencies high this might be most efficiently achieved by raising revenues, while maintaining growth enhancing investments in education, health and infrastructure.

**Consumer spending has in general been supportive of growth, though differences exist among countries.** Consumer spending accounts for some 60% of GDP in Sub-Saharan Africa, and a major contributor to overall demand growth. With real per capita incomes increasing by 2.3% per annum over the past decade, rising household incomes have supported consumer demand in the region and contributed to its resilient and robust growth in recent years.
More recent developments point to much heterogeneity in the strength of consumer demand across countries in the region. Where quarterly national accounts data exist, sectors with strong participation of consumers grew strong in Nigeria (9.6 per cent in retail sector in Q3 2012), Tanzania (16.1 per cent retail sector growth in first three quarters of 2012) and in Ghana (real estate sector expanded at 13.1 per cent in 2012). However where growth was weaker whole sale and retail sales growth decelerated in South Africa to 1.9 per cent in Q1 2013 (from 3.2 per cent in Q1 2012) and in Kenya due to a credit squeeze at the time, the wholesale and retail sector expanded by 4.9 per cent in Q3 from 5.6 per cent the previous quarter. Affected by ongoing fiscal consolidation, in Botswana, household consumption grew at a below trend rate of 2.7 per cent in 2012. However, for the vast majority of countries in the region this data does not exist. Nonetheless, indirect measures point to steady outturns in private consumption, including: favorable weather conditions and decelerating inflation. In general weather conditions were particularly more favorable in the West African (Burkina Faso, Benin, Chad, Gambia, and Togo) and East African sub-regions (Kenya, Uganda) relative to a year earlier, thus supporting agricultural household incomes there. Nonetheless, flooding in selected parts of Nigeria and Mozambique impacted agricultural household incomes there. Although there was an up-tick in February, inflation for the region (on a GDP-weighted basis) fell to 6.9 per cent in February 2013 from 9.4 per cent (y/y) in January 2012 (figure SSA.5). Further, remittance inflows to the region increased by $1 billion to $31 billion in 2012 and are projected increase to $33 billion in 2013.

**Recent global developments impacted the various commodity exporter types in the region differently.** Among oil exporters, export volumes for 2012 were some 3.2% higher than in 2011, mostly due to an increase in exports from Angola, as export volumes in Nigeria and Sudan contracted. Reflecting the coming on stream of past investments in existing and new mines in several countries in the region, including Sierra Leone, Mozambique, Niger, and Zambia, export volumes from the predominantly metal exporters in the region expanded by 5.2%, notwithstanding subdued demand in the global economy and a 15% decline in the World Bank metal prices index. Export volumes of agricultural exporters expanded the most in the region (12.8%), due to weak base effects, improved rains in East Africa compared to a year earlier, and the lower cyclical sensitivity of agricultural commodities to global business cycles.

However, in line with developments in the global economy, exports from Sub Saharan Africa have been volatile, in particular industrial metals and oil exporters, which are more sensitive to global business cycles. Indeed, in the Q3 2012, as global imports plunged, so did export volumes in the region, in particular that of the region’s metal (-43 percent, 3m/3m saar) and oil (-36.8 percent, 3m/3m saar) exporters (figure SSA.6). However, along with the recovery in global import demand by the Q4 2012 Sub Saharan African export volumes rebounded, with the

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**Fig SSA.5** Inflation has decelerated in recent months

**Fig SSA.6** Growth in Sub Saharan African exporters by predominant export group

Source: World Bank; International Financial Statistics; IMF.
expansion in exports being sustained through Q1 2013. Indeed, for the first two months of 2013, export volumes are up 8.8 percent compared with the same period a year ago.

Trends in services trade, particularly tourism, are an increasingly important driver of growth in several Sub Saharan African countries (including traditional destinations such as Cape-Verde, Kenya, Mauritius, Seychelles and newer destinations such as Rwanda). Data from the UN World Tourism Organization shows that the growth in tourist arrivals to the region picked up by some 5 percent (y/y) in 2012, compared with a global average of 3.8 percent (figure SSA.7). Sub Saharan African countries that recorded strong growth in tourist arrivals included South Africa, Sierra Leone, Madagascar and Cape Verde.

The growth of tourist arrivals to destinations in the region notwithstanding the economic weakness in Europe is encouraging and reflects a diversification of source countries. For instance, in Mauritius, arrivals from Europe in 2012 (largest source market) fell by 2.6 percent, but arrivals from China rose 38.0 percent, and those from Russia by 58.9 percent. Further arrivals were up from elsewhere in Africa (13.2 percent), Australia (13.5 percent), Canada (18 percent) and South America (55.3 percent). Other countries fared less well, for instance the conflict in Mali led to a sharp decline in tourist arrivals there.

Medium Term Growth Prospects

Medium term GDP growth prospects for Sub Saharan Africa remain strong, with robust investment, resilient consumer demand, public investment in infrastructure and increased exports expected to continue to underpin the region’s growth performance, albeit with variations across countries. Regional GDP is projected to expand by 5.2 percent per year on average during 2013 through 2015, 4.9, 5.2, and 5.4 percent for 2013, 2014 and 2015 respectively (table SSA.3). Excluding, the region’s largest economy, South Africa, GDP growth for the rest of the region will be stronger at 6.2 percent in 2013 and 2014 and further strengthening to 6.4 percent in 2015. This strong growth will not be uniform, with countries facing political instability and serious labor unrests expected to significantly underperform. (see table SSA.4 for detailed country forecasts).

Domestic demand will be the major driver of growth. Investments to the natural resources sector in the region will continue to remain an important growth driver, with FDI in the natural resource sector increasingly being buttressed by investment in other sectors, particularly, rapidly growing, and underserved, domestic market especially in those economies with a rising middle-class, relatively larger populations and political stability (Nigeria, Kenya, Ghana, Tanzania etc).

Overall foreign direct investment flows to the region are projected to increase to $53.6 billion by 2015, from $33.4 billion in 2012. However not all economies in the region will benefit from rising investment inflows. Lingering political uncertainty (Madagascar, Central African Republic, Guinea, Guinea Bissau), persistent labor unrests (South Africa) and macroeconomic instability will sour the investment climate in a number of countries.

Domestic demand (both domestic investment and consumption) is expected to continue to benefit from the low interest rate and inflation environment, while household incomes should benefit from an expected increase in remittance.
flows from $31 billion in 2012 to $39 billion in 2015.

**Though exports are expected to rise over the forecast horizon, the contribution to growth from net exports will be marginal, on account of strong import demand.** Exports from Sub-Saharan Africa are expected to strengthen over the forecast horizon. The pickup is a result of strengthening global demand, particularly from the Euro Area (it’s largest trading partner), and a structural re-orientation of trade toward faster growing regions, notably Asia, and rising intra-regional trade. Export volumes in the extractive industries sector are expected to rise due to significant investments in productive capacity in recent years that are expected (Burkina Faso - gold, Mozambique - coal, Niger - uranium, Cameroon - oil, Sierra Leone – iron –ore etc.). Improving global conditions also bodes well for tourism to the particular benefit of the region’s main tourist markets (Gambia, Mauritius, Kenya, Tanzania, South Africa, Seychelles etc).

Despite the strong projected export growth, the contribution of net exports (exports less imports) to growth is expected to be modest or even negative, due to strong demand for foreign capital goods to meet infrastructure and other investment needs, as well as consumer durables and imported oil.

Overall, the regional current account deficit is projected to increase to about 2.8 percent of regional GDP in 2014 from 2.4 percent in 2012 before improving to 2.5 percent in 2015, and net exports are expected to be a modest drag.
However, for some oil exporters (Angola, Congo), net exports will continue to make a positive contribution to growth.

**Notwithstanding the robust growth outlook, significant development challenges remain.** Though Sub Saharan Africa has made progress in alleviating poverty (poverty levels in the region are forecast to fall to 42.3 per cent of the population by 2015 from 56.5 per cent in 1990), it still remains the only developing region not on track to attain the millennium development goal of halving extreme poverty by 2015 (Global Monitoring Report, World Bank 2013).

Part of the reason is because, most of the investment activity has created value in capital intensive sectors with limited backward linkages (e.g. mining), while labor intensive sectors have not been able to attract sufficient capital investment to increase productivity and employment. Hence the relatively limited flow of investment to existing labor-intensive sectors such as the agriculture sector and or low-skilled manufacturing sectors serves as a limitation to translating the robust growth the region is benefitting from to rapid job creation. This is all the more important given that the region has the youngest and fastest growing working age population.

**Risks**

Risks to the forecast are more balanced than in the recent past, and are increasingly local rather than external in nature.

**External risks**

**Fragile global economy.** External risks to the outlook (Euro Area, fiscal sustainability in the United States and Japan) are familiar, but the likelihood of them materializing has diminished as has the likely severity of the impacts. Moreover, upside risks — potentially stemming from a firmer than projected recovery in the United States, a reversal or easing of the currently pervasive pessimism in Europe — are more pronounced.

**New or more prominent risks** include overheating in some countries in the region, a more rapid easing in commodity prices than outlined in the baseline.

**End of commodity price supercycle.** The significant decline in global metals prices, in response to increased supply and substitution on the demand side, raises the specter of an even more pronounced easing of prices over the projection period as market expectations about future demand and supply adjust. Commodity prices are cyclical by nature (Global Economic Prospects, World Bank, 2009, pg 55), and while specifying the timing of turning points is extremely difficult, it would be imprudent to assume that current high prices will remain indefinitely or that only a smooth adjustment to long-term prices as in the baseline is the only likely outturn.

A more rapid adjustment which would see crude-oil prices decline to their estimated long-term equilibrium level of 80 (2012 dollars) within a two year horizon and a 25 per cent decline in metal prices would have significant consequences for Sub Saharan African commodity exporters, most of whom have undoubtedly benefitted from the recent high commodity price levels.

In the oil price decline simulation, Sub Saharan African would be the hardest hit of developing regions, with oil exporters in the region experiencing a deterioration of their current account balances by 4.5 per cent of GDP and fiscal balances by 2.9 percent of GDP by 2014 and real GDP growth would also be cut by some 1.4 percentage points compared to the baseline.
forecasts. Similarly, under the metal price scenario, where metal prices gradually decline by a cumulative 20% by June 2014, GDP growth for the regions metal exporters deteriorates by 0.7 percentage points in 2014 and an additional 0.5 percentage points in 2015. Nonetheless there will be differentiated effects across countries in the region as non-exporters of these commodities in the region could stand to benefit from positive terms of trade (especially the oil importers, when the price of oil declines, see figures SSA.8 and SSA.9).

For those economies that would be adversely impacted from the negative terms of trade impacts, the weaker commodity prices could lead to rapid depreciation of currencies, higher inflation outturns and weaker growth in less diversified economies with weaker domestic policy and external buffers. With the appropriate policy space and diversification of economies a sharp adjustment needn’t occur. Indeed, as observed in the 2009 period when commodity prices plunged, real GDP growth in sub Saharan Africa (excluding South Africa) expanded at a healthy 4.1 per cent, with the more economically diversified economies being hit less harder.

However unlike in 2008 when fiscal balances in the region were in a relatively stronger position, fiscal buffers for several countries in the region have yet to be fully rebuilt, thus limiting the ability of governments in the region to respond in a countercyclical way were a sharp decline in commodity prices to lead to weakening of private demand (investment and consumption). Indeed, under this scenario, access to international capital markets would likely become more restricted, and raising domestic debt could be expensive (i.e. if inflation goes up on account of weaker currencies and higher costs of imports) and with the unlikelihood of increased aid inflows given fiscal challenges in high-income countries, governments in the region with limited fiscal space could be forced to cut spending in a procyclical fashion, thereby reducing short-term growth prospects.

**Domestic risks**

With the steady strengthening of the global economy expected over the forecast horizon, the risks to Sub Saharan Africa’s growth being derailed are increasingly shifting from global to domestic sources.

**Macroinstability.** As noted in the recent development section, with rising inflation rates and deteriorating current account balances in a number of countries in the region, fiscal and monetary stimulus measures may fuel inflationary pressures, and add to debt levels without adding to output. The resulting macroinstability will inevitably be deleterious to long-term growth prospects.

Nonetheless, a prudent line needs to be drawn between fiscal austerity (which, under certain circumstances could also prove to be counterproductive) and governments carrying out the needed investments (education, health and infrastructure) that lay the foundation for medium to long-term sustainable growth. To sustain a robust durable growth trajectory over the medium to long term, economies operating close to capacity (as characterized by high and rising inflation and twin deficits) would benefit from building their external and domestic policy buffers.

This is all the more important given the possibility of exogenous shocks to government revenues from possible declines in commodity prices or even aid cuts (for more fragile economies in the region). Although of a different nature, the sharp fiscal consolidation in Swaziland (due to lower SACU revenue transfers) contributed to the contraction in that economy in 2012 (-1.5 per cent) and serves as a reminder of the importance of building policy buffers and diversifying economies.
Other downside risks include weather-related and political risks. With the agricultural sector being the largest employer in most economies in the region, even if not the largest contributor to GDP, and with most of the sector remaining rain dependent, output and incomes in the sector remain vulnerable to drought, floods and other forms of inclement weather. Poor harvests also threaten macroeconomic stability as food accounts for over 40% of the consumer price index basket for many economies in the region. Thus far weather long-term projections suggest a “normal” crop year in 2013, but weather conditions are more of an unknown in the outer years of the forecast.

While significant progress has been made on political stability over the past decade, there still remain elements of fragility in a few countries in the region that could compromise investment and growth, if not contained. These include the conflict in Mali as well as terrorist activity in certain parts of Nigeria; political paralysis in Madagascar; and political uncertainty in Guinea-Bissau. These and potentially new conflicts could hinder investment flows and derail growth prospects in these countries and their neighbors.

Nonetheless, isolated examples of this kind of development exist. For instance, in 2012, Huajian Group, a Chinese foot wear manufacturer set up shop in Ethiopia producing shoes for exports and with plans to foster a new global shoe making hub, with an investment plan of $2 billion over the next decade. Further, in February 2013, Toyota announced that it would start assembling trucks and buses in Kenya. These examples appear to be the exception rather than the norm. For these examples to become more widespread and a regional source of growth, significant additional efforts are needed to reduce existing impediments to investment in light manufacturing including: improving weak or absent infrastructure (especially power and transportation), unburdening cumbersome regulations that contribute to a high transactions cost environment, and eliminating trade barriers, in particular those stifling intra-regional integration.

**Entering manufacturing global value chains.** On the upside, however, the rising wage costs in China is providing opportunities for other developing countries (e.g. Vietnam) to become more competitive in the global light manufacturing production chains. Sub Saharan Africa may also have an opportunity to increase its involvement in these chains. Doing so would contribute to structural transformation, helping create higher productivity jobs, improving incomes and reducing poverty. Hindered by ongoing high cost of doing business relative to other developing countries, we do not include this possibility in our medium-term projections.
## Table SSA.4 Sub-Saharan Africa Country forecasts

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<th>Country</th>
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<th>Current account bal/GDP (%)</th>
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### Senegal

**GDP at market prices (% annual growth)**
- 2009: 3.6
- 2010: 4.1
- 2011: 2.6
- 2012: 3.7
- 2013: 4.0
- 2014: 4.6
- 2015: 4.7

**Current account bal/GDP (%)**
- 2009: -8.0
- 2010: -4.7
- 2011: -7.6
- 2012: -9.3
- 2013: -8.0
- 2014: -7.1
- 2015: -7.4

### Seychelles

**GDP at market prices (% annual growth)**
- 2009: 1.5
- 2010: 6.7
- 2011: 5.0
- 2012: 2.7
- 2013: 3.5
- 2014: 3.9
- 2015: 4.2

**Current account bal/GDP (%)**
- 2009: -14.1
- 2010: -19.7
- 2011: -22.4
- 2012: -22.8
- 2013: -22.9
- 2014: -21.1
- 2015: -19.2

### Sierra Leone

**GDP at market prices (% annual growth)**
- 2009: 9.0
- 2010: 4.9
- 2011: 6.0
- 2012: 18.2
- 2013: 17.1
- 2014: 14.1
- 2015: 12.1

**Current account bal/GDP (%)**
- 2009: -14.1
- 2010: -34.2
- 2011: -57.3
- 2012: -20.2
- 2013: -17.1
- 2014: -14.1
- 2015: -12.1

### South Africa

**GDP at market prices (% annual growth)**
- 2009: 3.2
- 2010: 2.9
- 2011: 3.1
- 2012: 2.5
- 2013: 2.5
- 2014: 3.2
- 2015: 3.3

**Current account bal/GDP (%)**
- 2009: -3.0
- 2010: -2.8
- 2011: -3.4
- 2012: -6.2
- 2013: -6.6
- 2014: -6.7
- 2015: -5.9

### South Sudan

**GDP at market prices (% annual growth)**
- 2009: 4.1
- 2010: 3.9
- 2011: 5.0
- 2012: -20.0
- 2013: 24.0
- 2014: 7.0
- 2015: 8.0

**Current account bal/GDP (%)**
- 2009: 11.8
- 2010: 30.1
- 2011: 17.4
- 2012: 4.7
- 2013: 4.3
- 2014: 7.6
- 2015: 11.2

### Sudan

**GDP at market prices (% annual growth)**
- 2009: 6.4
- 2010: 5.1
- 2011: 4.7
- 2012: -1.0
- 2013: 1.0
- 2014: 3.0
- 2015: 2.5

**Current account bal/GDP (%)**
- 2009: -5.9
- 2010: -0.5
- 2011: -1.0
- 2012: -7.8
- 2013: -8.6
- 2014: -7.9
- 2015: -8.4

### Swaziland

**GDP at market prices (% annual growth)**
- 2009: 2.1
- 2010: 2.0
- 2011: 1.3
- 2012: -1.5
- 2013: 0.8
- 2014: 0.1
- 2015: 0.5

**Current account bal/GDP (%)**
- 2009: -2.6
- 2010: -10.5
- 2011: -8.5
- 2012: -2.1
- 2013: 6.5
- 2014: 3.3
- 2015: 1.0

### Tanzania

**GDP at market prices (% annual growth)**
- 2009: 6.2
- 2010: 7.0
- 2011: 6.4
- 2012: 6.7
- 2013: 7.0
- 2014: 7.1
- 2015: 7.4

**Current account bal/GDP (%)**
- 2009: -9.1
- 2010: -12.8
- 2011: -19.7
- 2012: -19.6
- 2013: -19.8
- 2014: -19.9
- 2015: -20.1

### Togo

**GDP at market prices (% annual growth)**
- 2009: 1.8
- 2010: 4.0
- 2011: 4.9
- 2012: 5.6
- 2013: 5.5
- 2014: 5.1
- 2015: 5.0

**Current account bal/GDP (%)**
- 2009: -9.2
- 2010: -6.3
- 2011: -4.6
- 2012: -8.0
- 2013: -10.2
- 2014: -8.1
- 2015: -6.7

### Uganda

**GDP at market prices (% annual growth)**
- 2009: 6.8
- 2010: 5.9
- 2011: 6.7
- 2012: 3.4
- 2013: 4.8
- 2014: 6.2
- 2015: 7.0

**Current account bal/GDP (%)**
- 2009: -5.2
- 2010: -10.8
- 2011: -12.4
- 2012: -12.0
- 2013: -12.4
- 2014: -13.3
- 2015: -13.7

### Zambia

**GDP at market prices (% annual growth)**
- 2009: 4.8
- 2010: 7.6
- 2011: 6.8
- 2012: 7.3
- 2013: 7.0
- 2014: 7.2
- 2015: 6.8

**Current account bal/GDP (%)**
- 2009: -10.9
- 2010: 5.7
- 2011: 0.3
- 2012: 0.9
- 2013: 1.0
- 2014: 0.6
- 2015: 0.5

### Zimbabwe

**GDP at market prices (% annual growth)**
- 2009: -5.9
- 2010: 9.6
- 2011: 9.4
- 2012: 4.4
- 2013: 2.5
- 2014: 3.5
- 2015: 3.7

**Current account bal/GDP (%)**
- 2009: -12.2
- 2010: -23.0
- 2011: -39.7
- 2012: -29.9
- 2013: -24.8
- 2014: -19.0
- 2015: -15.8

---

**Source**: World Bank.

*World Bank forecasts are frequently updated based on new information and changing (global) circumstances. Consequently, projections presented here may differ from those contained in other Bank documents, even if basic assessments of countries’ prospects do not significantly differ at any given moment in time.*

Liberia, Somalia, Sao Tome and Principe are not forecast owing to data limitations.

a. GDP growth rates over intervals are compound average; current account balance shares are simple averages over the period.

b. GDP measured in constant 2005 U.S. dollars.
Notes:

1. South Sudan's contraction in GDP was due to the stoppage of oil exports arising from its dispute with Sudan. Previous editions of the Global Economic Prospects did not include South Sudan. Excluding South Sudan, GDP growth in 2012 was 4.6 percent, and excluding South Africa as well as South Sudan, GDP growth was 5.8 percent for the rest of the region.

2. The measure of capital equipment used is the aggregation of machinery and transport equipment imports.

3. This includes North Africa hence distorts the picture. FDI flows to North Africa are about a-third of the total to the Africa region.

4. The bond was over subscribed some seven times, in part reflecting the loose monetary policy in high-income countries in search of higher yielding securities.

5. Following a pattern where the supply responds to a lag in current prices since it takes time for investments to come on stream.