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Global Development Finance

The Development Potential of Surging Capital Flows

I: Review, Analysis, and Outlook

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The Development Potential of Surging Capital Flows

I: REVIEW, ANALYSIS, AND OUTLOOK 2006

THE WORLD BANK

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1818 H Street NW
Washington, DC 20433
Telephone: 202-473-1000
Internet: www.worldbank.org
E-mail: feedback@worldbank.org

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Foreword

ROBUST GLOBAL GROWTH AND A favorable financing environment provided the context for a record expansion of private capital flows to developing countries in 2005. These conditions now provide a unique opportunity for the international policy community to place development finance on a firmer footing before the tightening of global liquidity closes the window of opportunity.

Most of the record $491 billion in net private capital bound for the developing world in 2005 went to a small group of middle-income countries. Many of those countries took advantage of the growing inflows to improve their external debt profiles and accumulate large holdings of official foreign exchange reserves.

By contrast, many low-income countries still have little or no access to international private capital, and instead depend largely on official finance from bilateral and multilateral creditors to support their development objectives. With a decade remaining to attain the Millennium Development Goals (MDGs), expectations of a "big push" in development assistance escalated during 2005. Donors enhanced their efforts by scaling up aid volumes and reallocating them to the poorest countries, particularly those in Sub-Saharan Africa. In addition, the Multilateral Debt Reduction Initiative (MDRI) will provide additional debt relief to qualifying heavily indebted poor countries (HIPCs), reducing debt service and freeing up more fiscal resources for the MDGs.

At the same time, the development finance landscape is being transformed. A growing number of countries are issuing longer-term maturities in international capital markets, in some cases even denominated in local currencies. Domestic debt markets have become a major source of finance in some countries, attracting international investors in search of higher yields and potential gains from currency appreciation. Structured financial instruments such as credit default swaps allow investors to better manage exposure to credit risks associated with emerging market external debt portfolios. Financial integration among developing countries continues to deepen with capital flows between developing countries (so-called South–South flows) playing a prominent role. The role of the euro has evolved, gaining importance both as an international reserve currency and for debt issuance by governments and the corporate sector in developing countries. The emerging market asset class has matured far beyond the earlier dominance of U.S. dollar-denominated, high-yield, sovereign-debt instruments—indeed the Brady bonds issued in the 1980s that once exemplified this category have all but disappeared.

Global growth has remained surprisingly resilient to the rise in world oil prices over the past few years. Developing countries led the way with GDP growth in 2005 of 6.4 percent, more than twice the rate of high-income countries (2.8 percent). While inflation has, on the whole, remained subdued, there are signs of a pickup in several rapidly growing countries, which raises the possibility of overheating and the need for a tightening of macroeconomic policies. More generally, current account balances in oil-importing countries have deteriorated significantly, leaving them more vulnerable to subsequent adverse shocks.

Looking forward, while many of the external factors that have supported strong developing-country growth are projected to weaken, economic growth is expected to remain relatively strong. However, downside risks predominate. Persistent global imbalances, elevated current account deficits in some developing countries, and asset price over valuation are potential sources of risks to growth prospects in developing countries. In addition, a sharp supply shock could send oil prices even higher, with serious consequences for the most energy-dependent developing economies. A fall in non-oil commodity prices could have similar consequences for some of the poorest countries, which have benefited from higher metals and mineral prices. Finally, the Doha Round stands at

a critical juncture; governments need to agree on the key elements of a deal by mid-2006, but positions on the central issue of market access for agricultural and nonagricultural goods remain far apart.

A key priority for developing countries going forward is to pursue policies that strengthen their capacity to weather whatever global storms may be brewing. Continued macroeconomic stability is vital to ensure effective management of capital flows to advance long-term investment and growth. Countries must preserve sound financial management, with monetary and fiscal policies working in tandem to maintain debt sustainability and price stability. They must also build a system of risk management robust enough to respond to the needs of a more flexible exchange rate and open capital markets. Regulators in developing countries need to build their capacity to monitor credit default swap transactions and define a clear line of responsibility and necessary expertise to better manage the associated risks. Oil exporters face the special challenges of managing the risks surrounding volatile export revenues and using those revenues productively.

All countries would be affected by a disorderly unwinding of global imbalances, which would destabilize international financial markets and curtail global growth. But developing countries would suffer disproportionately, particularly if the imbalances were to foster a backlash of trade protectionism. With deepening economic and financial integration, all countries share responsibility for ensuring that policies are pursued that permit imbalances to unwind in an orderly and timely manner. This requires cooperation. The key policy prescriptions are well-known—the challenge is to make meaningful progress in implementing those policies. Policy makers in the major economies understand the importance of a coordinated approach and therefore have endorsed the proposal for the International Monetary Fund to play a more prominent role in coordinating the required collective action.

Global Development Finance is the World Bank's annual review of global financial conditions facing developing countries. The current volume provides analysis of key trends and prospects, including coverage of capital originating from developing countries themselves. A separate volume contains detailed standardized external debt statistics for 135 countries as well as summary data for regions and income groups. More information on the analysis, including additional material, sources, background papers, and a platform for interactive dialogue on the key issues can be found at www.worldbank.org/prospects. A companion online publication, Prospects for the Global Economy, is available in English, French, and Spanish at www.worldbank.org/globaloutlook.

François Bourguignon
Chief Economist and Senior Vice President
The World Bank

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The principal author was Mansoor Dailami, with direction by Uri Dadush. The report was prepared under the general guidance of François Bourguignon, World Bank Chief Economist and Senior Vice President. The principal authors of each chapter were:

Overview	Mansoor Dailami, with contributions from the International Finance Team and William Shaw
Chapter 1	Andrew Burns
Chapter 2	Mansoor Dailami, Ismail Dalla, Dilek Aykut, Eung Ju Kim
Chapter 3	Douglas Hostland, William Shaw, and Gholam Azarbayejani
Chapter 4	William Shaw, Dilek Aykut, Jacqueline Irving, and Neeltje Van Horen
Chapter 5	Mansoor Dailami, Johanna Francis, and Eung Ju Kim

Preparation of the commercial and official debt restructuring appendixes was managed by Eung Ju Kim, with inputs from Haocong Ren and Gholam Azarbayejani. The financial flow, debt estimates and the statistical appendix were developed in a collaborative effort between DECPG and the Financial Data Team of the Development Data Group (DECDG), led by Ibrahim Levent and including Nevin Fahmy, Shelly Fu, and Gloria R. Moreno. Background notes and papers were prepared by Paul Masson (University of Toronto), Michael Pomerleano (Operations and Policy Department of the Bank's Financial Sector), and Ivan Zelenko (Banking, Capital Markets, and Financial Engineering of the Bank's Treasury). The main macroeconomic forecasts were prepared by the Global Trends Team of DECPG, led by Hans Timmer and including John Baffes, Andrew Burns, Carolina Diaz-Bonilla, Maurizio Bussolo, Betty Dow, Annette de Kleine, Fernando Martel Garcia, Don Mitchell, Mick Riordan, Cristina Savescu, Shane Streifel, and Dominique van der Mensbrugghe. Gauresh Rajadhyaksha managed and maintained the modeling and data systems. Mombert Hoppe, Denis Medvedev, Sebnem Sahin, and Shuo Tan provided research assistance and technical support.

Contributors to regional outlooks included Milan Brahmbhatt (East Asia and Pacific); Asad Alam, Cheryl Gray, and Ali Mansoor (Europe and Central Asia); Ernesto May and Guillermo Perry (Latin America and the Caribbean); Mustapha Nabli (Middle East and North Africa); Ejaz Syed Ghani (South Asia); and Delfin Go (Sub-Saharan Africa).

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Selected Abbreviations

ABF	Asian Bond Finance
ABMI	Asian Bond Market Inititative
ADB	Asian Development Bank
ADRs	American Depositary Receipts
AfDF	African Development Fund
ASEAN	Association of Southeast Asian Nations
ASW	asset swap
BIS	Bank for International Settlements
CDS	credit default swap
CPIA	Country Policy and Institutional Assessment
DAC	Development Assistance Committee (OECD)
DRC	Democratic Republic of Congo
DSF	Debt Sustainability Framework
EBRD	European Bank for Reconstruction and Development
ELMI	Emerging Local Markets Index
EMBI	Emerging Markets Bond Index
EMBIG	Emerging Markets Bond Index Global
EMCDS	emerging market credit default swap
EMEAP	Executives' Meeting of East Asia and Pacific Central Banks
EU	European Union
FDI	foreign direct investment
FLIRBs	Front-Loaded Interest Reduction Bonds
FoBF	Fund of Bond Funds
G-3	Group of Three (European Union, Japan, United States)
G-7	Group of Seven (Canada, France, Germany, Italy, Japan, United Kingdom, United States)
G-8	Group of Eight (G-7 plus Russian Federation)
G-90	Group of Ninety (developing countries)
GDF	*Global Development Finance* (World Bank)
GDP	gross domestic product
GEP	*Global Economic Prospects* (World Bank)
GNI	gross national income
HIPCs	heavily indebted poor countries
IABs	interest arrears bonds
IDA	International Development Association (World Bank Group)
IDB	Inter-American Development Bank
IMF	International Monetary Fund
IPO	initial public offering
LDCs	least developed countries
mbpd	million barrels per day
MDGs	Millennium Development Goals
MDRI	Multilateral Debt Reduction Initiative
MERCOSUR	Southern Cone Common Market (Mercado Común del Sur)
MIGA	Multilateral Investment Guarantee Agency
NAFTA	North American Free Trade Agreement
NDF	nondeliverable foreign exchange forward market
ODA	official development assistance
OECD	Organisation for Economic Co-operation and Development
OPEC	Organization of Petroleum-Exporting Countries
PAIF	Pan-Asian Bond Index Fund
PPP	purchasing power parity
ROSCs	reports on the observance of standards and codes (IMF and World Bank)
SAARC	South Asian Association for Regional Cooperation
SADC	Southern African Development Community
SBI	State Bank of India
SME	small and medium enterprise
SOE	state-owned enterprise
UAE	United Arab Emirates
UNCTAD	United Nations Conference on Trade and Development
WDI	*World Development Indicators* (World Bank)
WDR	World Development Report (World Bank)
WHO	World Health Organization
WTO	World Trade Organization

Overview and Policy Messages: The Development Potential of Surging Capital Flows

2005 WAS A LANDMARK YEAR IN global development finance, in both the official and private spheres. International private capital flows to developing countries reached a record net level of $491 billion. The increase in private capital flows in 2005 was broad-based, with long-term bond issuance, bank lending, and portfolio equity showing strong gains. A wave of privatizations and cross-border mergers and acquisitions drew substantial foreign direct investment (FDI). Governments and private entities took advantage of favorable financial-market conditions to refinance outstanding debt and fund future borrowing, while local-currency bond markets in Asia and Latin America attracted substantial interest from international investors in search of higher yields and potential gains from currency appreciation. Meanwhile, financial integration among developing countries continued to deepen. Capital flows between developing countries (so-called South–South flows) are now growing more rapidly than North–South flows, particularly FDI. The strong gains in private capital flows have been supported by financial innovations, notably local-currency financing and structured financial instruments, such as credit default swaps and other derivatives, which have improved the ability of investors to manage their exposure to the risks associated with emerging market assets.

Development finance took center stage at a series of major international forums in 2005. With a decade remaining to attain the Millennium Development Goals (MDGs), expectations for a big push in development assistance escalated over the course of the year, with a strong focus on Sub-Saharan Africa, the only region not on track to meet any of the goals. There was broad agreement on the need to scale up aid significantly and to further reduce the debt burdens of heavily indebted poor countries (HIPCs) to provide additional financial resources needed to make progress on the MDGs. In keeping with those objectives, donors have enhanced their aid effort over the past few years and taken steps to improve the allocation of aid by providing more development assistance to the poorest countries, particularly those in Sub-Saharan Africa. Donors also have provided targeted support for trade facilitation and developed a framework for improving the effectiveness of aid. Overall, aid in the form of grants and concessional loans has risen, while net lending by the official sector on nonconcessional terms has declined significantly.

The global economy grew at a robust pace of 3.6 percent in 2005, with the developing world exceeding 5 percent growth for the third year running. Global economic and financial conditions remain favorable, on the whole, despite several potentially destabilizing developments, notably high and volatile oil prices, growing global financial imbalances, and rising short-term policy interest rates in some of the major industrial countries. International financial markets have remained resilient to the test of several major credit events, including the downgrading of two major U.S. automakers and the settlement of backlogged credit derivatives contracts that had come to the attention of U.S. regulatory authorities. The upward trend in private capital flows appears to have continued in the early months of 2006, and the short-run prospects are good. But the external environment could well prove less auspicious in the future than in recent years, depending critically on the course and dynamics of the necessary rebalancing of global savings and investment patterns to underpin

the orderly unwinding of large and unsustainable global financial imbalances.

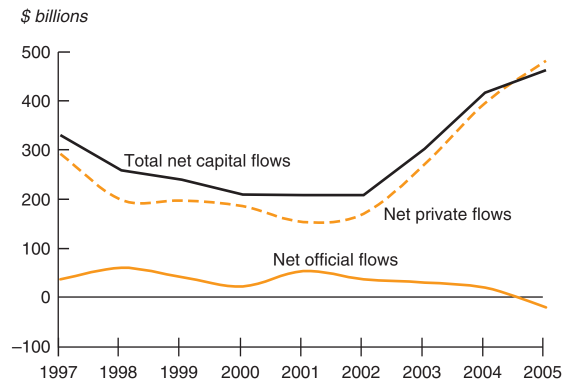
The surge in private capital flows offers national and international policy makers a major opportunity to bolster development efforts if they can successfully meet three challenges. The first is to ensure that more countries, especially poorer ones, enhance their access to developmentally beneficial international capital through improvements in their macroeconomic performance, investment climate, and use of aid. The second is to avoid sudden capital flow reversals by redressing global imbalances through policies that recognize the growing interdependencies between developed and developing countries' financial and exchange rate relations in the determination of global financial liquidity and asset price movements. And the third is to ensure that development finance, both official and private, is managed judiciously to meet the development goals of recipient countries while promoting greater engagement with global financial markets. These are the themes and concerns of this year's edition of *Global Development Finance*.

The broad surge in private capital flows continues

Net capital inflows from official and private sources increased from $418 billion in 2004 to $472 billion in 2005. While net official lending was negative, net flows of private capital to developing countries swelled for the third consecutive year, reaching $491 billion in 2005, the highest level on record (figure 1 and table 1). Demand for emerging market debt and equities remained strong, spurred by improved fundamentals in many developing countries and investors' search for higher yields in an environment where long-term interest rates remain low in major industrial countries, despite higher short-term interest rates. Developing countries' finances also received a boost from workers' remittances, which continued their steady increase of the past decade (box 1).

The increase in private capital flows has been broad-based, extending across most debt and equity components and across most of the developing world. Long-term bond flows (up $19 billion over 2004), medium- and long-term bank lending (up $28 billion), and portfolio equity (up $24 billion) showed the strongest gains. The cost of bond issuance has dropped for many developing countries, as long-term interest rates in industrial countries remain low (despite increases in short-term rates in the Euro Area, the United States, and elsewhere) and spreads on emerging market sovereign bonds continue to decline. Those spreads reached a record low of 174 basis points in May 2006 (figure 2). Short-term borrowing remained at approximately the same level as in 2004 and about $14 billion higher than in 2003, in sharp contrast to the negative flows of short-term debt that were seen from 1998 to 2001.

Figure 1 Financial flows to developing countries, 1997–2005



Source: World Bank Debtor Reporting System and staff estimates.

The rise in private flows also was widespread, with all regions experiencing an increase (table 2):

- A surge in flows to the Russian Federation and Turkey helped to boost flows to the Europe and Central Asia region to $192 billion in 2005, up from $160 billion in 2004. The region accounts for 39 percent of developing countries' private flows, almost double the share it commanded in 2001.
- Stronger bond and equity activity increased private flows to Latin America and the Caribbean from $59 billion in 2004 to $94 billion in 2005. But the region's share of private flows to the developing world plummeted from 45 percent in 2000 to 19 percent last year.
- Flows to East Asia and the Pacific increased to $138 billion from $125 billion the year before, despite lower FDI to China. A marked strengthening in flows to several regional economies explains the increase.

Table 1 Net capital flows to developing countries, 1997–2005

$ billions

	1997	1998	1999	2000	2001	2002	2003	2004	2005e
Current account balance	–84.5	–89.4	–4.0	47.1	18.8	69.8	122.3	153.1	248.4
as % GDP	–1.5	–1.6	–0.1	0.8	0.3	1.2	1.8	1.9	2.6
Financial flows:									
Net equity flows	199.3	179.4	195.9	182.9	183.3	166.1	186.8	248.8	298.9
Net FDI inflows	168.7	172.4	183.3	168.8	176.9	160.3	161.6	211.5	237.5
Net portfolio equity inflows	30.6	6.9	12.6	14.1	6.4	5.8	25.2	37.3	61.4
Net debt flows	107.2	54.3	16.3	–1.0	–1.5	10.7	72.8	119.1	120.1
Official creditors	13.1	34.3	13.9	–5.7	27.4	5.2	–12.3	–28.7	–71.4
World Bank	9.2	8.7	8.8	7.9	7.5	–0.2	–0.9	1.3	0.7
IMF	3.4	14.1	–2.2	–10.7	19.5	14.0	2.4	–14.7	–41.1
Others	0.5	11.5	7.3	–2.9	0.4	–8.6	–13.8	–15.4	–31.0
Private creditors	94.1	19.9	2.5	4.7	–28.9	5.5	85.1	147.8	191.6
Net medium- and long-term debt flows	85.0	85.7	22.0	11.5	–6.2	1.2	30.2	77.8	122.3
Bonds	38.4	40.6	30.6	20.5	11.0	10.8	26.4	43.0	61.7
Banks	44.0	50.3	–7.1	–5.2	–10.8	–2.8	9.8	39.4	67.4
Others	2.7	–5.2	–1.5	–3.8	–6.3	–6.8	–5.9	–4.6	–6.7
Net short-term debt flows	9.2	–65.8	–19.6	–6.8	–22.7	4.2	54.9	70.0	69.3
Balancing item[a]	–169.5	–127.8	–175.0	–183.6	–118.8	–74.7	–90.3	–116.2	–274.5
Change in reserves (– = increase)	–52.4	–16.4	–33.2	–45.4	–81.7	–171.9	–291.6	–404.8	–393.0
Memo items:									
Bilateral aid grants (ex technical cooperation grants)	25.3	26.7	28.5	28.7	27.9	32.5	43.7	50.3	52.6
Net private flows (debt+equity)	293.5	199.3	198.4	187.6	154.4	171.5	271.9	396.6	490.5
Net official flows (aid+debt)	38.3	61.1	42.4	23.0	55.3	37.7	31.4	21.6	–18.8
Workers' remittances	71.2	73.1	77.0	85.2	96.4	113.2	141.2	161.1	166.8

Sources: World Bank Debtor Reporting System and staff estimates.
a. Combination of errors and omissions and net acquisition of foreign assets (including FDI) by developing-country private entities.
e = estimate.

Box 1 International migrant remittances

Remittances are the largest source of external financing in many developing countries. According to official statistics, in 2005 remittance flows—defined as the sum of workers' remittances, compensation of employees, and migrant transfers in the balance-of-payments statistics collected by the International Monetary Fund—are estimated to have exceeded $233 billion worldwide, of which developing countries received $167 billion. Unrecorded flows moving through informal channels push the total far higher, as they are conservatively estimated to amount to at least 50 percent of the recorded flows.

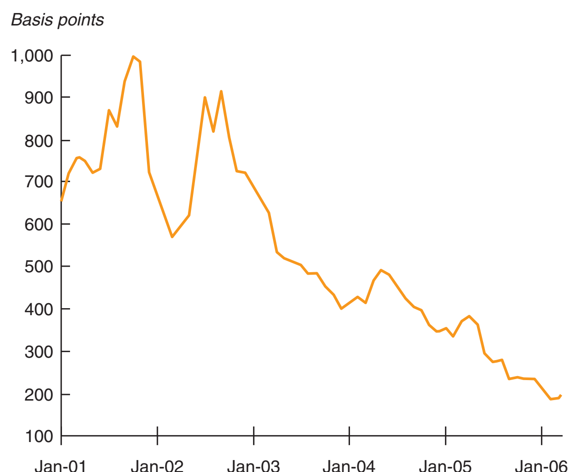
Remittances bring substantial benefits to developing countries:

- Household survey evidence, confirmed by cross-country analyses, indicates that remittances can have a significant impact on reducing poverty.
- Remittances are associated with increased household investment in education, entrepreneurship, and health—all of which have a high social return under most circumstances.
- Remittances tend to be countercyclical and thus support economic activity in the face of adverse shocks.
- By generating a steady stream of foreign exchange, remittances can improve a country's creditworthiness and enhance its access to international capital markets.

Recorded remittance flows to developing countries have doubled over the past five years, for several reasons. Increased scrutiny of financial transactions since the terrorist attacks of September 2001 has made remittances more visible. With the growth of competition in the remittance industry, costs have dropped in major corridors, while networks have expanded. Recently, high oil prices have swelled remittance flows from oil-exporting countries. Bahrain, Kazakhstan, Kuwait, Oman, Saudi Arabia, and the Russian Federation have been important sources of remittances to developing countries. The depreciation of the U.S. dollar (which raises the value of remittances denominated in other currencies) and growth in the number of migrants and their incomes have contributed further to the increase.

Source: World Bank, *Global Economic Prospects 2006;* World Bank staff calculations based on various data sources.

Figure 2 Benchmark spreads for emerging markets, 2001–6



Source: JPMorgan Chase.
Note: As of April 7.

The creditworthiness of most developing countries continued to improve in 2005, as upgrades by credit rating agencies handily outpaced downgrades. Moreover, the pace of credit upgrades rose to 46 in 2005, up from 31 in 2004. Many developing countries have taken advantage of the favorable financial conditions by issuing bonds with longer maturities in international markets—in some cases denominated in local currency. Others have been able to buy back existing debt using the proceeds of new bonds issued at lower rates. Also, many countries have pre-funded future financing requirements. Syndicated bank lending to developing countries set records in 2005. Gross bank lending of $198 billion, an increase of 77 percent over 2004, involved 1,261 transactions in a broad range of sectors, dominated by oil-and-gas projects and oil-import financing. Meanwhile, booming stock markets in emerging market economies boosted portfolio equity flows to a record $61 billion, up from $37 billion in 2004. However, private capital flows remain concentrated in just a few countries. In 2005 about 70 percent of bond financing and syndicated lending went to ten countries; three countries (China, India, and South Africa) accounted for almost two-thirds of all portfolio equity flows.

Rather than fueling domestic investment, the rise in net inflows of private capital in 2005 financed a substantial rise in developing countries' official reserve assets (almost as large as the record increase in 2004) and a very sharp increase in the accumulation of foreign assets by private entities—to $258 billion, again a record level (see figure 3).

The opening of capital accounts in the developing world has increased opportunities for capital outflows, enabling developing-country residents to improve their investment returns and reduce their risks through international diversification.

Global growth has propelled the surge in capital flows, but serious risks remain

Global growth has remained surprisingly resilient to the rise in world oil prices over the past few years. Despite a doubling of oil prices from early 2003 to late 2005, world GDP expanded by a robust 3.6 percent in 2005. Developing countries led the way, with GDP growth of 6.4 percent, more than twice the rate of high-income countries (2.8 percent).

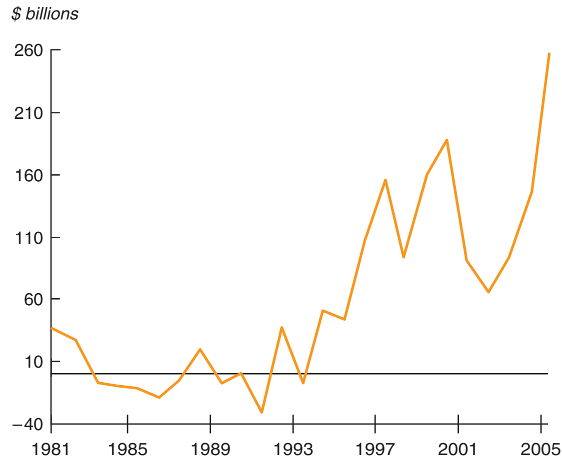
The impact of higher oil prices on economic growth and inflation has been more subdued than in previous episodes. Global growth was down only 0.5 percentage points, and the expansion among developing countries was 0.7 percentage points, slower than in 2004. The reduced impact

Table 2 Net private capital flows to developing countries by region, 1998–2005
$ billions

	1998	1999	2000	2001	2002	2003	2004	2005
East Asia and Pacific	6.5	28.8	28.0	39.2	58.9	81.5	125.4	137.7
Europe and Central Asia	66.7	50.9	51.5	33.1	59.7	101.1	160.2	191.7
Latin America and the Caribbean	98.9	95.8	85.2	59.5	28.2	49.9	59.3	94.4
Middle East and North Africa	8.1	2.6	3.3	4.8	8.3	7.8	8.3	14.6
South Asia	5.3	3.5	9.7	5.8	10.1	15.8	22.7	23.6
Sub-Saharan Africa	13.7	16.7	9.9	12.1	6.3	15.8	20.7	28.4

Sources: World Bank Debtor Reporting System and staff estimates.

Figure 3 Capital outflows by private entities in the developing world, 1981–2005



Sources: International Financial Statistics, IMF; and World Bank staff calculations.
Note: The size of the increase in private assets is hard to judge, since it is calculated as a residual and thus includes errors and omissions from elsewhere in the balance of payments.

reflects several factors, notably lower oil intensities, more flexible product and labor markets, exchange rate flexibility, and more credible monetary policy. Higher nonoil commodity prices have offset the impact of higher oil prices on the terms of trade of some countries.

Higher oil prices have had a major influence on the external and fiscal positions of most developing countries, however. For net oil *exporters*, higher oil prices have meant significant increases in external and fiscal surpluses, and higher foreign exchange reserves. For net oil *importers*, healthy current-account surpluses and ample foreign exchange reserves made it possible to cover the sizable increase in oil-import bills. Considerable increases in foreign aid for some of the poorest countries, particularly those in Sub-Saharan Africa, provided an additional source of foreign currency. But fiscal deficits have risen alarmingly in countries that subsidize domestic energy prices.

Despite high oil prices, growth in developing countries is expected to remain above 5 percent per year during the period 2006–8, well above the performance of the past two decades, and with inflationary pressures in check. The main risks to this relatively benign outlook are broadly unchanged since the last edition of *Global Development Finance*. The possibility that global imbalances might unwind in a disruptive fashion remains a risk—particular for heavily indebted countries and those with close economic ties to the United States. A second risk is that a sharp supply shock might send oil prices even higher, with potentially serious consequences for the most energy-dependent developing economies. A fall in nonoil commodity prices could have similar consequences for some of the poorest countries, which have benefited from higher metals and mineral prices. There is also a possibility that the current glut of liquidity in global financial markets may have caused investors to underprice the risk of emerging market assets (both debt and equity). Political risk has reemerged as a key concern for investors in several emerging market economies, where elections could portend major changes in policy direction. Finally, there is a risk that avian influenza (bird flu) could mutate into a form that is easily transmitted between humans and for which the population has limited immunity. Depending on the severity of the eventual disease, such a pandemic could kill between 14 million and 70 million people and lower global GDP by between 2 and 5 percent (with the latter number implying a global recession).

Capital flows are being transformed

Financial integration among developing countries

For much of its postwar history, development finance has been characterized as a one-way flow of capital from industrial countries to the developing world. But as developing countries have become more integrated with the global economy, they have emerged as important sources of capital flows in their own right. In the past decade, with rising incomes in developing countries and increasingly open policies toward trade and financial markets, developing countries have become a significant source of FDI, bank lending, and even official development assistance (ODA) to other developing countries.

Overall, growing FDI between developing countries in recent years has sometimes compensated for reductions in FDI flows from high-income countries. But South–South capital flows, in particular, have also opened opportunities for low-income countries, because developing-country investors are often possibly better able to handle the special risks

encountered in poor countries. Banks from developing countries play an increasingly prominent role in cross-border lending to low-income countries—borrowers in low-income countries received 17 percent of total South-South cross-border syndicated lending flows in 2005, up from 3 percent in 1985. Moreover, 27 percent of foreign bank assets in low-income countries are held by developing-country banks, compared to just 3 percent in middle-income countries. South–South FDI is significant for many low-income countries, particularly those located close to major investors.

Although South–South capital flows remain relatively small compared to North-South flows, they have the potential to change the landscape of development finance over the next few years, particularly if growth in developing countries continues to outstrip that in advanced countries and the trend toward deeper trade and financial integration persists.

Financial innovations

The market for debt issued by developing countries is expanding beyond the dollar-denominated, high-yield, sovereign debt instruments that had come to define the emerging market asset class, as exemplified by Brady bonds (which will drop to only 6 percent of the original amount outstanding once announced buybacks are completed). Today, the emerging market asset class includes a range of instruments in both local and foreign currency that offer the capacity to tap dollar and euro investors alike and cater to the funding needs of both sovereign and corporate borrowers on both the cash and derivatives sides of the market.

Credit default swaps—derivatives that provide insurance against defaults—are being applied in new ways in emerging markets. This has potentially important implications for the pricing and supply of debt capital to developing countries, offering investors a new way to take on exposure and enhancing the markets' ability to gauge credit risk. By transferring banks' credit risk from lending and trading activities to other market participants, credit derivatives have altered, perhaps fundamentally, the traditional approach to credit risk management and the lending business. While the emergence of this market could improve the ability of financial systems to diversify risk across a greater number of market participants, it remains a relatively immature and potentially vulnerable market because of infrastructural shortcomings, a lack of regulatory frameworks robust enough to cope with the market's dynamic nature, and the concentrated participation of a small number of dealers in emerging markets, which carries the risk that failure of a single player could have a destabilizing impact on the market.

Domestic debt markets

Local-currency bond markets in developing countries have, since the crises of the 1990s, emerged as a major source of long-term development finance. They are now the fastest-growing segment of emerging market debt. Driven largely by domestic institutional and individual investors, these markets grew from $1.3 trillion at the end of 1997 to $3.5 trillion in September 2005. Their rapid growth has enabled major developing countries to improve debt management by reducing currency and maturity mismatches. Robust domestic bond markets have also improved financial intermediation and contributed to domestic growth, as both the government and corporate sectors have readier access to long-term capital. However, bringing the local-currency bond markets in emerging economies up to the standards of mature markets will require concerted efforts akin to those of the East Asian countries, which have yielded early successes. But local-currency debt markets also present new challenges for policy makers. The development of domestic debt markets requires modern and professional debt management procedures—to manage debt on an integrated basis (that is, both local and international debt)—especially in countries with few capital controls.

The global role of the euro

Since its introduction on January 1, 1999, the euro has assumed an increasingly important international role. It has emerged as a principal issuing currency in the global debt market, as a vehicle for foreign exchange transactions, and as an important reserve currency for official holdings of foreign-exchange reserves. The elimination of exchange risk within the Euro Area has created a pan-European market for euro-denominated securities, attracting both sovereign and private borrowers, not only from Euro Area countries, but also from other countries—among them emerging market economies such as Brazil, Colombia, China, Mexico, and Turkey. Today's euro-denomi-

nated bond market rivals the dollar-based fixed-income markets in important respects, including size, depth, and product range.

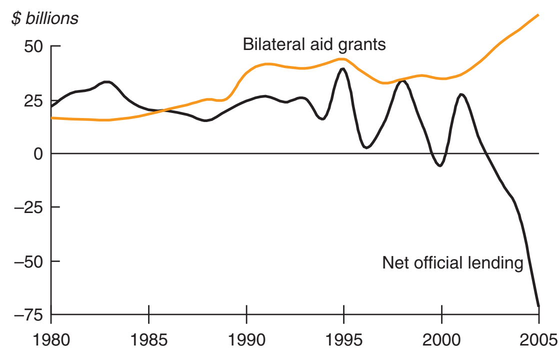
The euro is used increasingly in debt issuance, because it is the home currency of a large set of investors. It is less popular as a currency of denomination for reserves, owing to the dominance of the dollar as a vehicle for foreign exchange transactions and currency interventions—as well as the greater liquidity of the market for U.S. Treasury securities. Nevertheless, if the deteriorating U.S. current-account deficit sufficiently undermines confidence in the dollar, more official reserve holdings could be moved into euro-denominated assets, with the potential for a period of financial instability if the shift is abrupt.

Net official flows continue to decline

Official lending falling

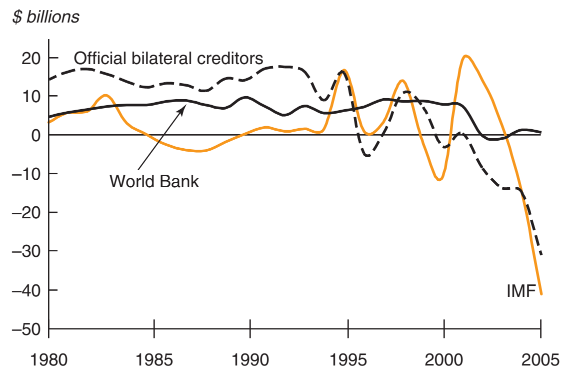
Net official flows of grants and loans continued to fall in 2005—for the fourth consecutive year—as a sharp decline in net official lending more than offset gains in bilateral aid grants (table 1 and figure 4). Net official lending came to –$71.4 billion in 2005, the third consecutive year of net outflows from developing countries. In three years, developing countries have repaid $112 billion in loans to creditors. This largely reflects repayments of nonconcessional loans mostly by middle-income countries. In contrast, aid (comprised of concessional loans and grants) has increased significantly during this period, particularly for low-income countries.

Figure 4 Net official lending and foreign aid grants to developing countries, 1980–2005



Source: World Bank Debtor Reporting System and staff estimates.

Figure 5 Net official lending, 1997–2005



Source: World Bank Debtor Reporting System and staff estimates.

The dramatic decline in net official lending over the past few years reflects, for the most part, large repayments to the International Monetary Fund (IMF) and large prepayments to bilateral official creditors (figure 4). In 2005 net debt *outflows* from developing countries to the IMF totaled $41.1 billion, down from a net debt *inflow* of $19.5 billion in 2001, implying a –$60.6 billion swing in net lending by the IMF over the period 2001–5. The sharp decline is due to large repayments on emergency assistance loans made to Indonesia and the Russian Federation in 1997/8, and to Argentina, Brazil, and Turkey in 2001/2. The sharp decline in 2005 reflects large repayments by Argentina ($2.4 billion), Brazil ($16.8 billion), Indonesia ($1.0 billion), the Russian Federation ($2.3 billion), and Turkey ($4.2 billion). Moreover, gross lending by the IMF has declined from about $30 billion in 2002–3 to only $4 billion in 2005. This reflects the marked improvement in international financial stability, supported by the favorable global economic and financial conditions. The IMF's outstanding credit has declined from special drawing rights (SDR) 71 billion in 2002/3 to SDR 23.5 billion in March 2006. Despite the low level of IMF credit outstanding, net lending by the IMF could continue to decline over the next few years with large scheduled repayments by Indonesia, Turkey, and Uruguay.

Net lending by the official bilateral creditors declined by $27.0 billion in 2005 mainly due to large prepayments to the Paris Club by the Russian Federation ($15 billion), Poland ($5.6 billion) and Peru ($2.0 billion). Russia financed a $15 billion prepayment to the Paris Club using domestic

financial resources, as its fiscal revenues increased dramatically in the wake of higher world oil prices. The prepayments by Peru and Poland were financed by borrowing in private capital markets, effectively substituting private debt for official (Paris Club) debt. Large prepayments to the Paris Club are expected to continue into 2006. In May 2006, Algeria and the Russian Federation made offers to prepay all of its remaining Paris Club debt, totaling $22 billion and $8 billion, respectively. Paris Club creditors have indicated their willingness to accept the proposals. Poland has announced its intention to prepay some of its €12.3 billion debt to the Paris Club, which will be due between 2005 and 2009.

More aid for the poorest countries, and more debt relief

Net disbursements of ODA by OECD DAC member countries increased dramatically in 2005, reaching $106.5 billion, up from $79.6 billion in 2004. Expressed as a share of gross national income (GNI) in donor countries, ODA has risen from 0.22 percent in 2001 to 0.33 percent in 2005, just below the 0.34 percent peak reached in the early 1990s. However, most of the record $27 billion increase in 2005 reflects debt relief provided by Paris Club creditors to Iraq (nearly $14 billion) and Nigeria (a little over $5 billion). Nevertheless, even excluding debt relief, ODA rose by 8.7 percent in real terms, up from a 5.6 percent average annual increase over 2002–4.

ODA is likely to decline as a percentage of GNI in 2006–7, as the debt relief component falls to more normal levels, before increasing gradually through the end of the decade. Donors have made commitments to increase ODA by $50 billion by 2010, half of which is targeted to go to Sub-Saharan Africa. Based on those commitments, ODA should reach 0.36 percent of GNI in 2010. Extrapolating this rate of increase would mean that the UN target of 0.7 percent would not be attained until 2030, 15 years after the 2015 deadline set for attaining the MDGs.

The international community made significant progress in 2005 to reduce debt burdens in some of the poorest countries. Debt relief provided under the Heavily Indebted Poor Countries (HIPC) Initiative and the Multilateral Debt Reduction Initiative (MDRI) will significantly reduce the debt burdens of poor countries that qualify. The 18 countries that reached the completion point prior to May 2006, under the HIPC Initiative, will see their total debt stock fall from an average level of 55 percent of GDP (before HIPC debt relief) to 13 percent (after MDRI debt relief).

Debt relief together with other special-purpose grants—for technical cooperation, emergency and disaster relief, and administrative costs—has accounted for a rising portion of ODA over the past few years. The increase in ODA as a share of GNI since 2001 reflects higher special purposes, rather than more flexible forms of funding. Donors have reallocated aid to the poorest countries, particularly those in Africa, and have continued to shift their resources from concessional loans to grants, with the goal of avoiding unsustainable increases in the debt burdens of aid recipients.

To ensure economic stability, developing countries must manage capital flows effectively

The current surge in private capital flows has occurred in the midst of much-improved domestic policies and global financial conditions compared with those that prevailed during the capital flows surge of the 1990s. This time around, governments have so far generally managed to avoid excessive expansion of aggregate demand, large current-account deficits, and sharp appreciations of the real exchange rate. However, the policy agenda for managing capital flows is broad and complex, and considerable challenges remain.

Effective macroeconomic policies

The improved response to the surge in capital flows this time around has been supported by the adoption of more flexible exchange rate regimes and a monetary policy framework that favors price stability. Inflation has fallen dramatically in virtually all developing countries, from a median of 11 percent in the mid-1990s to a median of 4.5 percent during 2002–5. At the same time, the greater autonomy in monetary policy afforded by more flexible exchange rates has allowed authorities to lower local interest rates. Flexible exchange rates and lower interest rates have drastically reduced the incentive to resort to short-term exter-

nal borrowing, a major vulnerability that contributed to the financial crises of the 1990s. Governments also have taken steps to accelerate development of domestic capital markets (especially local bond markets) to create more diversified financial markets that would be more capable of handling volatile flows in portfolio capital. These developments, along with the shift from debt finance to equity (particularly FDI), have contributed to the marked improvement in developing countries' net external liability position. The ratio of external debt to GNI for developing countries as a whole fell from a peak of 44 percent in 1999 to about 34 percent in 2004, while since the mid-1990s short-term debt has declined in most developing countries relative to long-term debt and foreign exchange reserves.

Progress has been made in simplifying the very complex web of capital controls and exchange rate restrictions imposed by many countries. But the gradual opening of capital accounts must be accompanied by a further strengthening of macroeconomic policies, the development of local capital markets and the institutions needed to regulate them, and the establishment of a system of risk management robust enough to respond to the needs of a more flexible exchange rate and open capital account. Liberalization of the capital account once implemented is difficult to reverse. A return to capital controls should be seen only as a policy of last resort, to be used to dampen excessive exchange rate volatility or to moderate large inflows of capital when other policies, such as interest rates and intervention in foreign exchange markets, prove fruitless.

Despite the considerable improvement in policies in recent years, the surge in capital flows still presents substantial risks to developing countries. Future risks to economic and financial stability will likely take a different form and character than those encountered in the past—and may expose institutional and macroeconomic weaknesses that cannot be anticipated at this juncture. One warning sign of potential troubles has been the surge in portfolio inflows that has been associated with a dramatic escalation of stock market prices and valuations in many developing countries, particularly in Asia, raising the risk of asset price bubbles. Other signs of possible trouble are appreciated exchange rates and current account deficits in some Eastern European countries. The impact of individual risks could be magnified if several were to occur simultaneously.

Prudent accumulation of reserves

The current account in many developing countries, particularly major oil exporters and emerging Asia, has moved from deficit to sizable surplus, intensifying the demand for reserve accumulation. That many of these countries have accumulated foreign exchange reserves far in excess of the level required for intervention and liquidity purposes partly reflects a desire to self-insure against global financial shocks. As the volume of reserves increases, however, so does the importance of balancing their use for intervention, investment, and insurance purposes against their domestic resource costs. For countries with large holdings of foreign exchange reserves, allowing local institutional investors to diversify their investment portfolio globally—while ensuring their more effective regulation—could provide a viable channel of capital outflow, as well as an opportunity to further diversify risk. This would transfer currency risks, currently concentrated on the books of central banks, to domestic institutional investors with a longer investment horizon and a greater ability to manage such risks. Such an approach is also more desirable for many developing countries than inducing adjustments through the current account as a way of absorbing reserves. In addition to allowing institutional investors greater scope to invest overseas, consideration should be given to enabling local residents to invest in approved international assets, as the Republic of Korea has done.

Careful management of oil-export revenues

Oil-exporting countries face particular challenges in managing volatile export revenues. Although high oil prices are now expected to persist, considerable uncertainty remains, and oil exporters should save a part of the windfall—for example, to reduce debt and make productive physical and social investments. Some countries have put aside a fraction of their oil revenues in a stable portfolio of diversified financial assets (referred to as "funds for the future"), thus reducing the risk of overconsumption of oil revenues and the potential for Dutch disease. Such funds require robust governance and legal frameworks to effectively insulate

earmarked oil wealth from political decisions guided by short-term agendas. The government must set and adhere to clear objectives for their investment, protection, and eventual use. Countries that depend heavily on oil revenues should also consider using derivatives to reduce the volatility of future income.

Improvements in standards for the corporate sector

A growing number of developing countries have made considerable efforts to meet international standards for transparency, corporate governance, and the regulation and supervision of financial systems. Although this is a global trend, individual countries take different approaches to adapting international standards to their corporate environment. Some, for example, are issuing codes that set compliance targets in tandem with laws setting minimum compulsory standards, while others are using codes to raise public awareness in advance of upcoming regulatory reform. The adoption of national codes of corporate governance in at least 60 countries by the end of 2005—including all of the Asian crisis countries, plus China, Colombia, Turkey, and Ukraine—underscores the growing recognition of the importance of corporate governance in enhancing investor confidence, a recognition that bolsters the resilience and stability of capital markets globally. Priority must now be given to effectively implementing and enforcing these new domestic policy and institutional reforms at the national level.

Multilateral cooperation is key to resolving global financial imbalances

Developing-country policies must be reinforced by renewed international efforts to promote stability and maintain a financial environment conducive to a balanced expansion and deployment of capital flows in developing countries. One major risk to stability is the growing imbalance in global payments and the associated market anxiety about the possibility of a disorderly adjustment of the imbalance through sudden changes in exchange rates and global interest rates. Such changes could destabilize and disrupt international financial markets, which would cause all countries to suffer.

Although a coordinated policy of intervention in foreign currency markets—similar to the Plaza Agreement of September 1985—is neither desirable nor feasible (given the changes in global financial market conditions and actors over the past two decades); a degree of multilateral cooperation is needed to address the current global imbalances. That approach, based on the mutual interests of deficit and surplus countries, should reflect the structural asymmetry between international reserve currencies and other currencies. At its center must be consensus on a blend of exchange rate and aggregate spending adjustments adequate to rebalance global aggregate demand toward surplus countries without causing a global recession. Ordinarily, policy coordination among key players is unnecessary, because floating exchange rates, accompanying monetary policies (oriented primarily toward domestic targets for inflation and economic activity), and independent central banks do their job to facilitate adjustment to any shocks hitting the world economy. But when the sustainability of the sources of finance for global payment imbalances is in doubt, as it is at present, multilateral cooperation to prevent sudden and disorderly market reactions becomes highly desirable, especially if the growing global imbalances create pressure for protectionist trade policies in some countries.

Developing countries, in particular, have much to gain from multilateral cooperation, and much to lose from its absence, and they would suffer disproportionately if instability were induced and a disorderly unwinding of global financial imbalances ensued. The world economy is moving toward a multipolar international monetary system in which the monetary and financial policies of the United States, Euro Area, Japan, and several key emerging market economies, including China, all exert substantial influence. Policymakers in emerging market economies should therefore strive to strengthen institutions and promote policies and mechanisms that will improve their ability to navigate in a world of increasingly integrated and interdependent financial and production systems.

1

Prospects for the Global Economy

Summary of the outlook

Confronted with capacity constraints in the resource sector, sharp rises in commodity prices, and a tightening of monetary policy among Organisation for Economic Co-operation and Development (OECD) countries, the global economy has slowed from the record pace posted in 2004. Nevertheless growth remains robust, especially among developing countries. Their GDP increased 6.4 percent in 2005 (4.3 percent for oil-importing developing economies, excluding India and China) as compared with 2.8 percent among high-income countries. The resilience of developing countries—which reflects a sustained improvement in the potential growth rate of many developing countries—has been heartening, especially given the magnitude of the oil-price shock. This brisk expansion is projected to continue, but slow towards a more sustainable pace of 5.9 percent by 2008. Such rapid growth argues against a sharp decline in oil prices, which are expected to remain above or close to $60 a barrel through 2008.

This relatively benign soft-landing scenario for developing countries faces both internal and external risks. First, the high growth of the past several years is generating tensions within individual countries. In several East European countries this has taken the form of rising inflation, currency appreciation, and high current-account deficits, while in others it has expressed itself in rising asset prices, inflationary pressure, and growing domestic tensions between fast and slower growing regions and sectors. Second, many of the buffers that permitted countries to absorb higher oil prices with a minimum of disruption have been exhausted, and countries have yet to fully adjust to higher oil prices. As a result, developing countries are much more vulnerable to potential external shocks, such as a disruptive resolution of global imbalances, a decline in nonoil commodity prices, or a hike in oil prices following a supply shock.

High oil prices have had only a limited impact on global growth

Lower oil intensities, more flexible product and labor markets, exchange rate flexibility, and more credible monetary policy have all reduced the real-side and inflationary impacts of higher oil prices. As a result, and in contrast to past episodes, monetary policy has remained accommodative and interest rates low. This, plus the fact that oil deliveries have continued to increase rapidly (as opposed to the 1970s and 1980s, when supply was cut), helps explain the resilience of output to higher oil prices. An additional factor for developing countries has been the substantial rise in the share of exports in GDP, which has increased the foreign currency inflows available to finance a given increase in the oil bill.

Adjustment was facilitated by solid initial conditions. In particular, many oil-importing developing countries entered the period of high oil prices running current-account surpluses and building up foreign currency reserves. This, plus high nonoil commodity prices and a rapid expansion in trade, meant that finding foreign currency to pay higher oil bills was relatively easy. In addition, foreign currency inflows for the poorest countries were bolstered by increasing aid flows, which in many cases rose by more than 0.5 percent of GDP in 2004 (the last year for which data is available).

While output has remained resilient, developing countries nevertheless have endured a large hit

on their incomes. On average, the rise in oil prices between 2003 and 2005 reduced real incomes in oil-importing countries by 3.6 percent and by as much as 10 percent for some low-income oil importers. For developing oil importers the additional expenditure, some $137 billion annually, exceeds by a large margin official development assistance (ODA, $84 billion in 2005 net of additional debt relief) and is about one-half of foreign direct investment (FDI) inflows ($234 billion).

Unsurprisingly, some countries are having difficulty adjusting. Fiscal deficits have risen alarmingly in several countries that subsidize domestic energy prices. In many African countries, utility firms, unable to pay mounting energy bills, have imposed rolling blackouts. Moreover, a few countries appear to be financing their higher oil bill through an unsustainably rapid reduction in international reserves. Finally, rising food and transportation prices have pushed inflation to worrisome levels in several countries in Africa and, to a lesser extent, South Asia. While it is not clear that an inflationary spiral has begun, an eventual economic slowdown appears likely if policy makers are forced to use macro policy measures to bring inflation back under control.

Developing countries face further adjustment challenges over the medium term

While the resilience of output to high oil prices is heartening, the initially comfortable current-account positions that allowed many developing countries to weather higher oil prices have now been absorbed. Moreover, many of the factors that allowed countries to deal with higher oil prices relatively easily in the short run imply that much real-side adjustment has yet to occur.

Adapting to more or less permanently higher prices poses substantial challenges, especially for those countries where high oil prices are already generating economic strain, as evidenced by excessive increases in current-account or fiscal deficits or by unsustainable financing of oil import bills through the depletion of reserves or bank borrowing. Policy makers in these countries must take urgent steps to increase energy efficiency in general and reduce oil dependency in particular. Unwinding energy subsidization programs would simultaneously relieve pressure on government finances and also promote private sector energy conservation. For those countries that have managed the recent rise in oil prices more easily, similar policy steps would reduce their vulnerability both to further oil shocks and other shocks, including a decline in nonoil commodity prices. For countries benefiting from fixed-price contracts at what are currently below-market prices, policy should encourage energy conservation now before the contracts expire or are renegotiated.

More generally, because higher prices are likely to be a more or less permanent fixture, countries need to take steps to improve their international competitiveness. Policies that stimulate productivity growth and investment in the domestic economy are most likely to be successful. Countries with flexible exchange regimes are likely to have more success in improving their export revenues and diminishing nonoil imports so as to reestablish a comfortable margin on the current account. Trade reform—domestic, behind-the-border reforms to improve competitiveness, accompanied by progress at the multilateral level—could further expand developing-country exports and the base upon which oil and other imports essential to development can be financed.

For oil exporters the challenge will be to use petroleum revenues in a way that minimizes economic distortions and maximizes development gain. Even if oil prices remain high for an extended period, most countries do not have the capacity to absorb these huge inflows immediately. As a result, they should resist the temptation to use oil-related budgetary revenues for programs that are politically popular but developmentally unsound. Instead, they should consider introducing or expanding oil funds by sequestering that part of revenues that cannot be productively placed in the domestic market and investing it abroad, where it will generate a permanent income stream to support development even after current prices ease or oil supplies dwindle. Recent steps by some oil-exporting countries that have unwound structural reforms for short-term political gain are unlikely to be helpful.

Global imbalances may have been exacerbated by high oil prices

The rapid rise in oil prices has contributed to global imbalances by increasing the U.S. current-account deficit by some $125 billion since 2002. It also has changed the nature of those imbalances by inducing a swing in the counterparts to the U.S. deficit away from oil importers and toward

oil-exporting countries. Their oil-related export earnings are up some $400 billion since 2002. These are being recycled—partly through increased imports, approximately 65 percent of additional export revenues are being spent as additional imports, and partly via financial flows. As a result, there is little likelihood that an excess in oil exporters' savings will lead to a global slowdown. Rather, increased financial flows—either directly or through third-party intermediaries, are contributing to low interest rates and, both directly and indirectly, to the financing of the U.S. current-account deficit.

Despite the ease with which the U.S. deficit is being financed, the continued accumulation of foreign liabilities is not sustainable. Unwinding these imbalances will almost certainly take a long time. Indeed, given the magnitude of the required adjustment, a gradual approach is to be preferred to an abrupt one. However, the longer significant steps to resolve the issue are delayed the greater will be the tensions implicit in the disequilibrium and the risk that they will be resolved in a disorderly manner. Of particular concern is that some of the temporary factors holding down interest rates (including corporate balance-sheet restructuring and financial flows from oil revenues) will ease, increasing the servicing costs on U.S. liabilities. That would add to the deficit and possibly raise concerns about its sustainability, driving interest rates even higher.

Resolving these imbalances is a common but differentiated responsibility requiring increased private and public savings in the United States, increased demand outside of the United States, and more flexible exchange rate management. Action on all fronts is required, particularly because in the absence of higher U.S. savings, increased foreign demand or exchange rate appreciation is unlikely to have a meaningful impact on imbalances.

The outlook for developing countries carries both internal and external risks

Prospects for a soft landing among developing countries are good, but a hard landing is also possible. In particular, many countries, notably in the Europe and Central Asia region, now have current-account deficits that exceed 5 or 6 percent of GDP. In some instances those deficits are associated with high interest rates, strong capital inflows, and appreciating currencies. The future ability of these economies to finance current levels of consumption and investment is vulnerable to changes in investor confidence or additional external shocks. Elsewhere, rapidly rising incomes may be contributing to asset bubbles in regional real estate and stock markets. In other countries, tensions arising from localized labor market shortages, combined with significant disparity in the degree to which regions or segments of the population are benefiting from growth, could prompt a harder-than-projected landing. These internal risks could generate a hard landing on their own or they could be triggered by and exacerbate an external shock. In particular, growth in several countries in South Asia and a few in Latin America is generating significant inflationary pressures requiring a tightening of macroeconomic policy if an abrupt slowdown in the future is to be avoided.

The principal external risks to the global economy have not changed much since the publication of the last edition of the World Bank's *Global Economic Prospects* (2005). These include the possibility that persistent global imbalances will resolve themselves in a disorderly manner, either through a significant increase in interest rates or a sharp depreciation of the dollar; the possibility that a significant supply shock will send oil prices even higher; and the possibility that nonoil commodity prices will weaken. Should any of these risks be realized, they might reduce global growth by between 1 and 3 percent, depending on the shock, with much of the slowdown borne by developing economies. Even if the impact of the shock is relatively benign at the global level, the increased current-account deficits of many oil-importing developing countries make them vulnerable. For heavily indebted countries, the most serious risk stems from the possibility of higher interest rates. For small oil-importing African countries, the largest risk is that nonoil commodity prices, particularly for metals and minerals, will decline.

The outturn from the Doha trade liberalization round poses a balanced risk to the outlook. The baseline scenario assumes an unambitious accord. However, an ambitious conclusion to the Round, including significant liberalization of trade in agricultural products and on-the-ground progress in the aid-for-trade agenda, could yield substantial benefits for developing countries. More importantly, a failure of Doha could go beyond this agreement by weakening the whole multilateral

trade liberalization process—resulting in a more fragmented path forward with fewer benefits for developing countries.

While a remote possibility, an influenza pandemic could have serious consequences

The continued spread of avian influenza (bird flu) among wild birds, with limited bird-to-human transmission, comprises part of the baseline forecast. A serious risk to the global economy is presented by the possibility that avian influenza mutates into a form of the flu that is easily transmitted between humans and to which the population has only limited immunity.

The potential human and economic consequences of such a pandemic are very large. They depend importantly on the nature of the flu that emerges and on the reactions of people as it spreads. Even a relatively moderate flu in terms of transmission and mortality could have serious consequences for the world economy if the global population has limited immunity. Estimates suggest that, depending upon the severity of the eventual disease, a combination of lost output due to illness, additional deaths, absenteeism, and private and public efforts to avoid infection could lower global GDP by between 2 and 5 percent (with the latter number implying a global recession). More important, between 14 and 70 million people could be killed.

Policy makers need to focus simultaneously on two critical tasks: (1) further strengthening efforts to monitor and curtail outbreaks of avian influenza at points (such as domestic poultry flocks) where the likelihood is highest of the disease mutating into a viable human-to-human form; and (2) developing and putting systems in place to minimize the human cost of a pandemic if one does emerge, whether by developing effective containment strategies or improving the world's capacity to rapidly create and distribute vaccines.

Global growth

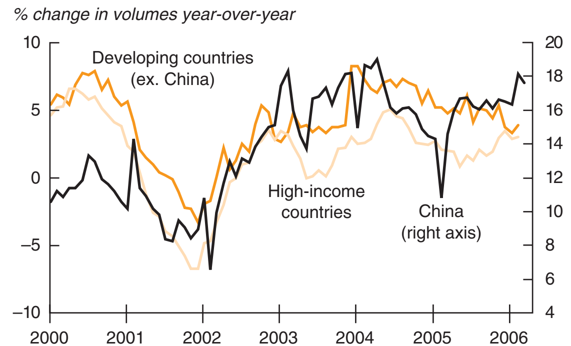
Despite oil prices that reached $60 a barrel in the second half of the year, the world economy grew by a very robust 3.6 percent in 2005. Developing countries led the way, expanding by 6.4 percent, more than twice as fast as high-income countries (table 1.1).

Outturns and prospects in high-income countries

Growth among industrialized economies in 2005 came in at 2.8 percent, substantially lower than the 3.3 percent recorded the year before. Industrial production and trade flows among these countries were particularly anemic. Industrial production growth declined from more than 5 percent in mid-2004 to less than 1 percent in late spring. Growth has since accelerated, reaching 3 percent (year-over-year) in the first quarter of 2006 (figure 1.1).

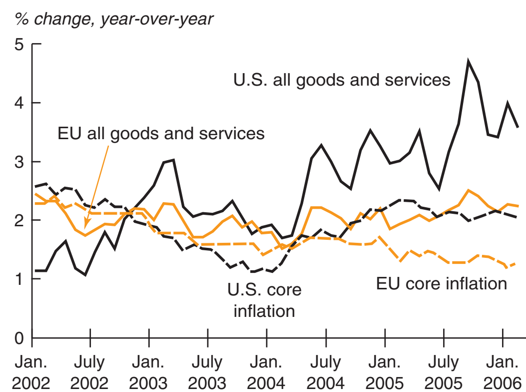
High oil prices, rising short-term interest rates, a cooling of the housing market, and an unusually disruptive hurricane season helped slow growth in the United States to 3.5 percent in 2005 as compared with 4.2 percent in 2004. Partly reflecting a bounce-back in activity following a weak fourth quarter, GDP expanded 4.8 percent in the first quarter of 2006. Although inflation

Figure 1.1 Industrial production remains robust



Source: World Bank.

Figure 1.2 Inflation in high-income countries



Sources: World Bank, Datastream.

Table 1.1 The global outlook in summary

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

	2004	2005*	2006**	2007**	2008**
Global conditions					
World trade volume	10.6	7.1	7.6	7.7	7.8
Consumer prices					
G-7 countries[a,b]	2.1	2.6	2.2	1.8	1.8
United States	2.7	3.4	2.9	1.9	2.0
Commodity prices (US$ terms)					
Non-oil commodities	17.5	13.4	5.8	–3.2	–5.8
Oil price (US$ per barrel)[c]	37.7	53.4	64.2	61.0	56.9
Oil price (% change)	30.6	41.5	20.2	–5.0	–6.8
Manufactures unit export value[d]	6.9	0.8	1.6	2.8	1.2
Interest rates					
$, 6-month (%)	1.6	3.6	5.1	5.2	4.9
€, 6-month (%)	2.1	2.2	2.6	3.1	3.9
Real GDP growth[e]					
World	4.1	3.6	3.7	3.5	3.5
Memo item: World (PPP weights)[f]	5.3	4.6	4.6	4.5	4.5
High-income countries	3.3	2.8	3.0	2.8	2.8
OECD Countries	3.2	2.7	2.9	2.7	2.8
Euro Area	2.0	1.4	2.1	2.1	2.2
Japan	2.7	2.8	2.8	2.1	1.8
United States	4.2	3.5	3.5	3.3	3.3
Non-OECD countries	6.2	5.5	5.1	4.7	4.7
Developing countries	7.1	6.4	6.3	6.0	5.9
East Asia and Pacific	9.1	8.8	8.3	8.2	8.1
Europe and Central Asia	7.2	5.7	5.5	5.4	5.1
Latin America and Caribbean	6.0	4.4	4.6	4.0	3.7
Middle East and N. Africa	4.7	4.8	5.3	5.2	5.1
South Asia	6.7	7.7	6.8	6.5	6.2
Sub-Saharan Africa	5.2	5.2	5.4	4.9	5.4
Memorandum items					
Developing countries					
excluding transition countries	7.2	6.6	6.4	6.1	6.0
excluding China and India	6.1	5.0	5.1	4.8	4.5

Source: World Bank.
Note: PPP = purchasing power parity; * = estimate; ** = forecast.
a. Canada, France, Germany, Italy, Japan, the United Kingdom, and the United States.
b. In local currency, aggregated using 2000 GDP Weights.
c. Simple average of Dubai, Brent and West Texas Intermediate.
d. Unit value index of manufactured exports from major economies, expressed in US$.
e. GDP in 2000 constant dollars; 2000 prices and market exchange rates.
f. GDP mesaured at 2000 PPP weights.

spiked following Katrina-related increases in gasoline prices, it has since declined and remains relatively muted at 3.4 percent in March 2006. Core inflation (price changes of goods and services other than energy and food) remains low at 2.1 percent, below the rate recorded in December 2004 (figure 1.2).

The relatively low oil intensity of European economies, significant excess capacity, and a relaxed macroeconomic policy stance limited the slowdown in Europe. For the year as a whole, growth was a relatively weak 1.5 percent (1.4 percent for the Euro Area), but this reflected a fourth-quarter pause in exports following a strong acceleration in the first nine months of the year. Since then economic activity has picked up with GDP in the Euro Area estimated to have increased by around 2.4 percent in the first quarter of 2006.

In Japan, growth has been strong, with industrial production ending the year up 5 percent and unemployment declining to 4.4 percent of the labor force. Overall, GDP increased by 2.8 percent, with both domestic and external demand contributing about equally to the overall result. As a result, both consumer and business confidence have improved.

The increase in oil prices in 2005 and early 2006 are expected to slow growth in high-income countries by about 0.25 of a percentage point in 2006 compared with what it would have been had prices remained stable. In the United States, improved net exports are projected to maintain the pace of growth in 2006, despite weaker consumer demand due to higher interest rates and a cooling of the housing market. For 2007/8, the balance of these forces is expected to reverse somewhat, leading to a moderate easing of growth.

Continued accommodative macroeconomic policy and pent-up investment demand following several years of very weak growth should maintain the recent acceleration of output in Europe during 2006. As a result, GDP is projected to expand by about 2.1 percent in 2006 and to continue growing at close to its potential rate in 2007/8.

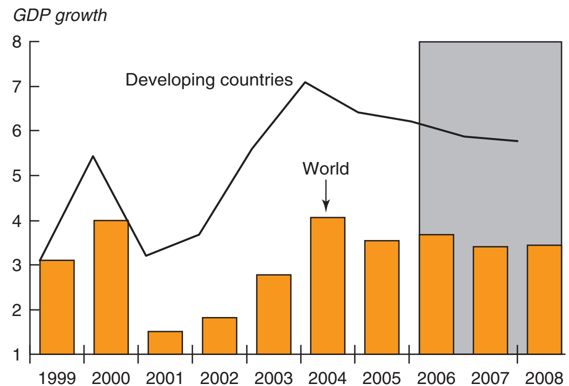
In Japan, vigorous growth in developing East Asia, renewed consumer and business confidence, and reduced drag from consolidation are all expected to keep the recovery strong in 2006. While the economy is projected to slow somewhat (partly because of less expansionary monetary and fiscal policies), GDP should expand at or above the economy's potential rate of growth.

Developing economy outturns and prospects

Notwithstanding high oil prices, economies in every developing region continued to grow at above-trend rates in 2005. Overall, the GDP of low- and middle-income countries expanded by an estimated 6.4 percent. The expansion was particularly robust in China and India, where output increased by 9.9 and about 8.0 percent, respectively. Excluding these countries, growth in other oil-importing developing countries came in at an estimated 4.3 percent, down significantly from 5.7 percent in 2004. At the same time, dwindling spare capacity in the petroleum sector caused the expansion of oil-exporting developing economies to ease from 6.6 to 5.7 percent, even though oil revenues continued to rise.

High oil prices, rising interest rates, and building inflationary pressures are expected to restrain growth in most developing regions in 2006/8 (figure 1.3). As a group, however, low- and middle-income countries should again outperform high-income economies by a wide margin. Growth in five of the six developing regions

Figure 1.3 Developing-country growth remains robust



Source: World Bank.

is projected to exceed 5 percent through 2008, with the Latin America and Caribbean region projected to expand 4.1 percent on average over the projection period.

Regional outlooks

More detailed descriptions of economic developments in developing regions, including regional forecast summaries, are available at http://www.worldbank.org/globaloutlook.

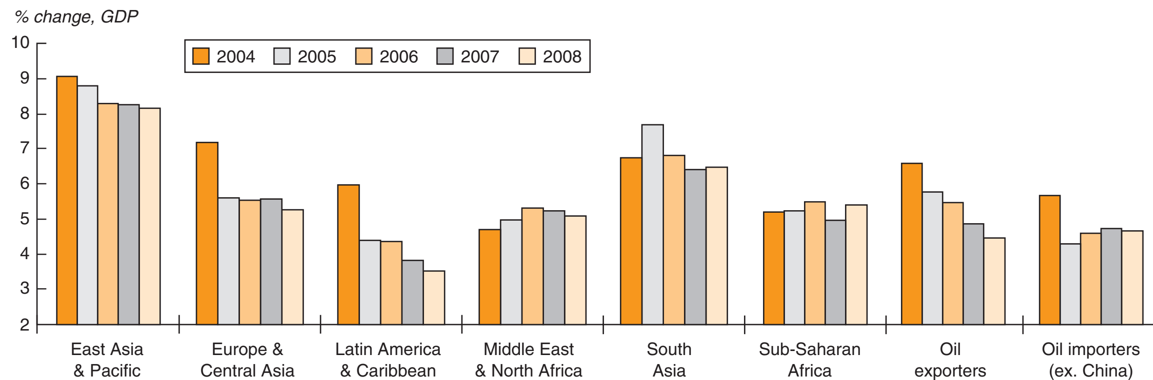
East Asia and the Pacific[1]

The economies of the East Asia and Pacific region continued to expand rapidly in 2005. Their GDP is estimated to have increased by 8.8 percent, down from 9.1 percent in 2004 (figure 1.4). Growth in China was very strong (9.9 percent), despite a substantial slowing in both private consumption and investment demand, because exports continued to grow rapidly, and imports slowed.

For other countries in the region, output expanded by a more modest 5.3 percent, as the slowdown in Chinese imports, weak global high-tech demand, and elevated oil prices translated into reduced export growth and rapidly rising producer prices. Among larger oil-importing countries in the region, GDP growth slowed relatively sharply in the Philippines and Thailand. Among oil-exporters, growth slowed in Malaysia, but picked up in Vietnam and Indonesia.

Strong exports and weak import demand in China meant that the region's current-account bal-

Figure 1.4 Regional growth trends



Source: World Bank.

ance improved, reaching a surplus of $143 billion (4.9 percent of GDP). Of the larger economies, only Thailand and Vietnam are running current-account deficits, while the surpluses of China and Malaysia exceed 6 and 15 percent of their respective GDP.

Output in the region continues to feel the effects of endemic bird-to-bird avian influenza. Cambodia, China, Indonesia, Laos, Thailand, and Vietnam are the countries most affected. So far some 200 million domestic birds (less than 1 percent of domestic bird production in the region but rising to 12 percent in Vietnam) have died or been killed to prevent the spread of the disease. As of early May 2006 no new outbreaks have been recorded among birds in Thailand and Vietnam, attesting to the effectiveness of preventive measures. However, new outbreaks have been recorded in China, East Java, Indonesia, Malaysia and Myanmar[2].

While the disease has had only a limited effect on GDP so far (depending on the country, the sector represents between 0.6 to 2 percent of GDP), its impact on incomes has likely been more acute. Poultry accounts for as much as 7 percent of the incomes of the poor.

As higher oil prices take hold, reduced investment growth in China and reduced global liquidity are expected to slow regional growth to around 8.1 percent by 2008. This reflects a modest slowdown in China, as slower export growth is partially offset by stronger domestic demand. Excluding China, growth in the remaining economies in the region is expected to come in at about 5.5 percent in 2006 through 2008. Stronger domestic demand, terms of trade effects and some currency appreciation are projected to result in about a $25 billion decline in the region's current-account surplus.

Europe and Central Asia

Economic activity in the Europe and Central Asia region grew by a robust 5.7 percent in 2005. High oil prices boosted demand in the region's oil producers, particularly in the Russian Federation, where real GDP increased 6.4 percent. That, in turn, contributed to strong exports for other countries in the region, notably the Baltics and the Commonwealth of Independent States. Turkey and other Central European countries participated in the export boom to a lesser extent, as they reoriented exports away from a still weak European Union.

The region received record capital inflows in 2005, reflecting favorable international credit conditions and the advancing EU accession process for new and candidate members. These flows contributed to rapid credit growth in the Baltics, Bulgaria, Romania, Turkey, and Ukraine, and a significant deterioration in current-account positions. High oil prices, substantial increases in the price paid for imported natural gas in some countries, and lax fiscal policy in the Czech Republic, Hungary, the Kyrgyz Republic, and Poland also boosted current-account deficits.

About half of the region's economies posted current-account deficits equal to or in excess of 5 percent of GDP in 2005. Current-account deficits exceeded 6 percent of GDP in Albania, Bulgaria, Croatia, Estonia, Georgia, Hungary, Latvia, Lithuania, Romania, and Turkey.

At the regional level these deficits were significantly offset by improved external positions of oil exporters, including Azerbaijan, where the deficit shifted from a 30 percent share of GDP in 2004 to 5 percent in 2005, as new oil capacity came on stream. This also propelled Azerbaijan's growth to more than 25 percent.

GDP growth is projected to slow slightly in 2006, coming in at 5.5 percent, as tighter international credit conditions and monetary policy are expected to slow domestic growth in the Commonwealth of Independent States (CIS) subregion. Elevated energy revenues, investment expenditure, and the projected recovery of western European demand are expected to sustain growth at relatively high levels in 2007/8. High fiscal and current-account deficits in a number of countries, including Hungary and Turkey, pose serious risks to the outlook. For regional oil exporters, key challenges include the need to foster greater investment and productive capacity in the nonoil sectors so as to improve economic diversification, control inflation, and prevent excessive exchange rate appreciation.

Latin America and the Caribbean

Economic activity in Latin America and the Caribbean is estimated to have increased by some 4.4 percent during 2005. Outturns were strong throughout the region, reflecting high levels of international liquidity, strong global demand, and high prices for the region's exports. Macroeconomic policy has also played a role. Except in Brazil and Mexico, where rising interest rates contributed to a slowdown in 2005, monetary policy in the region has been generally accommodative. Fiscal policy, in turn, has been relatively neutral. Despite windfall revenues from high international commodity prices and reduced debt servicing charges (due to reduced interest rates and lower debt stocks) most countries, with the notable exception of República Bolivariana de Venezuela, have avoided a significant pro-cyclical surge in spending. As a result, government deficits in the region have declined and "structural" balances actually improved in some countries. Nevertheless, structural rigidities in public expenditures remain an issue in a number of countries.

Increases in coffee, sugar, and metal prices largely offset the effect of higher oil prices and lower agricultural prices (notably soybeans) in many countries. High nonoil commodity prices and strong inflows of remittance prevented most countries in the region from experiencing a significant deterioration in their current-account positions. Indeed, with a few exceptions (Honduras, Nicaragua, Panama, Paraguay, and Uruguay), the current-account balances of most countries in the region have either remained constant or improved since 2002. These favorable external conditions contributed to a general pressure toward exchange rate appreciation that has been checked by accumulation of international reserves.

Looking forward, regional growth is projected to pick up in 2006 as easier monetary policy boosts output in Mexico and Brazil. Growth in most countries in the region is expected to be broadly stable in 2007 and 2008, slowing only somewhat in the face of a modest weakening in commodity prices and a gradual moderation in capital inflows. However, the expansion for the region as a whole is projected to slow toward 3.7 percent in 2008, reflecting a significant slowing in Argentina and República Bolivariana de Venezuela toward more sustainable growth rates.

Growth trends in Central American countries are projected to improve, partly because of the recent Central American Free Trade Agreement. The agreement should boost both trade (the United States is these countries' major trading partner) and investment, thereby lifting longer-term growth prospects. However, to reap the full benefits of this reform, further steps need to be taken towards improving road quality, increasing port and customs efficiency, boosting financial depth, and raising the quality and coverage of education.

A central risk to this forecast remains the possibility that as growth slows and commodity prices ease, government deficits will rise, potentially raising inflation or increasing uncertainty. Either result could lead to higher-than-projected interest rates and slower growth.

Middle East and North Africa[3]

High oil prices and strong oil demand continue to be key drivers for the developing economies of the Middle East and North Africa[4], where GDP is estimated to have increased by 4.8 percent in 2005. A 40 percent increase in oil revenues, to some $250 billion or (66 percent of their GDP), boosted public spending in oil-exporting developing countries in the region, causing their GDP to expand by 5.3

percent. This had spillover effects for the region's oil importers in the form of strong exports, tourism revenues, and inflows of investment and remittances. All of these factors helped to sustain robust growth among regional oil importers (4.2 percent), despite higher oil-import bills and relatively weak demand in Europe.

Looking forward, high oil prices are expected to continue feeding domestic demand in oil-producing countries—outstripping domestic supply and causing imports to continue rising rapidly, even as growth of export revenues slows. As a result, GDP in developing oil-exporting countries should expand by 5.2 percent in 2006 before slowing to around 4.8 percent in 2008. Their current-account surpluses should decline from around 20 percent of GDP in 2005 to about 8 percent of GDP in 2008. In the oil-importing economies, growth is expected to accelerate to about 5.3 percent, supported by stronger European growth, continued exports of goods and services to regional oil exporters, and a weaker negative effect from the reduction in textile and clothing quotas.

Prospects for the region remain clouded by geopolitical developments. For the region as a whole, western investors' risk perceptions have worsened. For the moment, this has been offset by an intraregional recycling of oil revenues, which has contributed to a sharp inflation in asset prices.

South Asia

Strong external demand and private consumption growth, supported by generally accommodative monetary policies, spurred growth in South Asia to a very robust 7.7 percent in 2005, led by India and Pakistan, which both expanded by about 8 percent. Excluding these two countries, regional growth was still a strong 5.3 percent. Robust regional clothing exports following the removal of quotas helped limit the overall deterioration of the current account, the deficit of which is estimated at 2.6 percent of regional GDP in 2005.

Despite some efforts to raise retail energy prices, higher oil prices have not been completely passed through to consumers. Nevertheless, inflationary pressures in the region have been building. Consumer prices rose 9.1 percent in 2005 as compared with 3.6 percent in 2003. To a significant degree, higher inflation reflects fluctuations in food prices. However, rapid growth, particularly strong domestic demand in response to a relaxed monetary policy stance in both India and Pakistan also played a role.

Because higher oil prices have not been passed through fully, there remains significant latent inflationary pressure from this source. In addition, implicit energy subsidies have raised fiscal deficits by as much as 0.7 percent of GDP between 2002 and 2005, apparently crowding out spending on education and health care in India (Devarajan and Ghani 2006).[5] Moreover, by impeding the price mechanism from restraining energy demand, the pass-through policy (along with robust domestic demand) has contributed to a deterioration equal to 4.0 percent of GDP in the region's current-account balance since 2003.

Growth is projected to weaken to about 6.8 percent in 2006, reflecting continued above trend growth in Pakistan and India. However, domestic capacity constraints and rising inflation are projected to cause growth to decline to a more sustainable 6.2 percent by 2008.

Notwithstanding this cyclical slowdown, growth is projected to remain robust with investment in both India and Pakistan expected to continue to benefit from strong external and domestic interest. This, plus a four-year infrastructure project (Build India) valued at 5 percent of GDP, are projected to augment capacity and support demand over the projection period. The services sector in India is expected to continue expanding rapidly, as a result of strong FDI inflows and outsourcing. Export growth throughout the region should remain strong, despite slower growth in the United States, partly because of increased demand from Europe.

Solid domestic demand should cause the current-account deficit to grow further, reaching around 3.5 percent of GDP in 2006 before improving somewhat as demand slows.

Sub-Saharan Africa

GDP in Sub-Saharan Africa expanded by an estimated 5.2 percent in 2005, bolstered by robust growth in resource-rich countries. Indeed, oil-exporting economies grew an estimated 6.4 percent in 2005, while growth in South Africa came in at 4.9 percent, lifted by high metal prices, strong consumer confidence, and low nominal interest rates. Economic activity in small oil-importing economies expanded by a slower but still robust 4.3 percent, down from 4.7 percent in 2004.

This strong performance marks a sharp departure from the weak and relatively volatile growth recorded by the region in the 1980s and 1990s. 2005 was the fifth year in a row that regional growth was at least 3.5 percent, and ended the first 5 year period since the 1960s that per capita growth remained positive in every year. Hearteningly this improved performance reflects stronger growth by many countries rather than very fast growth by a few. More than half of Sub-Saharan African countries have grown by 4 percent or more on average during the past five years, compared with fewer than one-quarter during the period 1980–95.[6]

Better subsistence and cash crops bolstered agricultural incomes and industrial production in many West African countries, while performance in East Africa was also good, despite drought in some areas. High metal prices bolstered growth in small resource-rich oil-importing economies.

The current-account position of oil exporters improved significantly because of higher oil revenues. However, external balances in many oil-importing countries have come under pressure. Excluding South Africa, the current-account position of oil importers deteriorated by 2.8 percentage points in 2005, reaching 6.4 percent of GDP. In Ghana, for example, the current-account deficit is estimated to have more than doubled to reach 6.8 percent of GDP, while in Tanzania it surged close to 6.2 percent of GDP. In several other countries, a failure to fully pass through higher prices has placed fiscal accounts under serious strain (Madagascar, Mauritius, Rwanda, and Uganda) or forced utilities to ration energy consumption by imposing rolling electrical blackouts (Madagascar, Malawi).

Looking forward, growth in established oil-exporting countries is projected to average more than 6 percent as new oil production is expected to come online in Angola, Republic of Congo, Equatorial Guinea, and Sudan. Moreover, Mauritania and São Tomé and Principe are expected to begin exporting oil in 2006.

Small oil importers are also expected to do well, with growth remaining at about 4.5 percent in 2008 as many countries benefit from debt write-offs and increased aid flows. Madagascar, Tanzania, and Uganda are expected to continue to profit from prudent macroeconomic policies and reforms implemented in previous years. In contrast, growth in sugar and textile producers (Lesotho, Mauritius, and Swaziland) is expected to weaken as European sugar preferences are withdrawn, while strong competition from low-cost textile producers in China and South Asia will continue to be a drag on regional exports. Continued rapid expansion in South Africa is expected to spill over into the Southern Africa Development Community. A more peaceful and stable sociopolitical environment will serve to accelerate growth in Liberia, Sierra Leone, and several other countries. On the other hand, should low-level conflicts, in places such as Chad, Côte d'Ivoire, Nigeria, and the Sudan escalate, they could bring down regional growth to a significant degree.

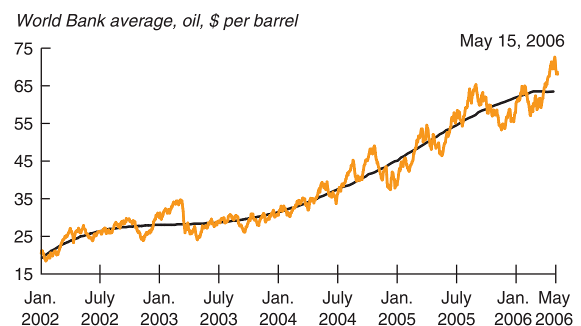
Commodity markets

The oil market

The sharp rise in oil prices since 2003,[7] which was driven by strong demand and dwindling spare capacity, showed signs of ending toward the end of 2005. Beginning in September 2005, the trend rise in oil prices marked a pause, with barrel prices fluctuating around \$63. However, the market remains tight, and the pricing power of OPEC has increased. As a result, prices are volatile, and sensitive to small changes in perceptions such as concerns over future supply, which sent barrel prices toward the \$73 mark in early May 2006, before declining once again (figure 1.5).

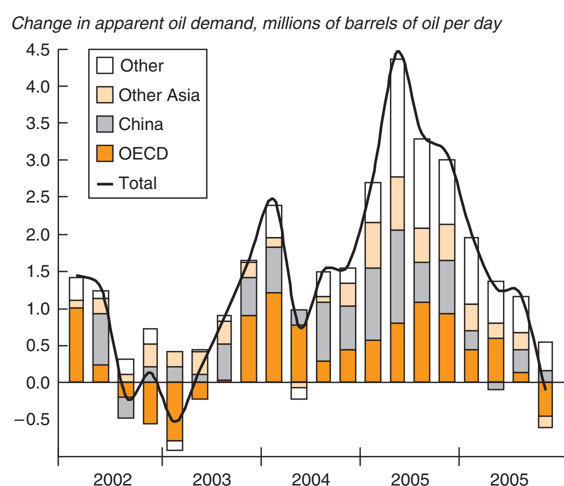
Oil demand slowed to 0.5 million barrels per day (mbpd) in the second half of 2005, from 3.5 mbpd in the first half of 2004 (figure 1.6). While slower GDP growth played a role in this decline, the most important factor appears to have been higher oil prices. Econometric models suggest that

Figure 1.5 An end to the trend rise in oil prices?



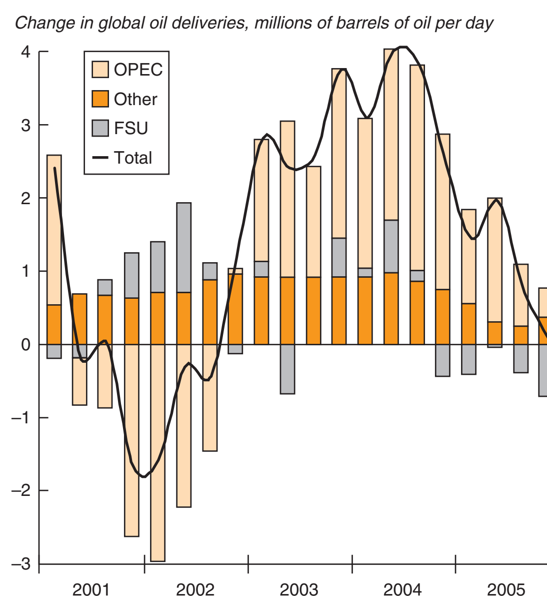
Sources: Datastream, World Bank.

Figure 1.6 Higher prices slow oil demand



Source: International Energy Agency.

Figure 1.7 A disappointing supply response



Source: International Energy Agency.

had prices remain unchanged, oil demand would have increased by some 2–2.5 mbpd.[8]

Incremental oil demand declined in all regions. In addition to prices, a number of special factors were at work. In the United States, higher petrol prices in the wake of hurricane Katrina provoked a sharp decline in both vehicle miles and gasoline consumption in the autumn, while a mild winter has also eased demand. In Asia, growth in oil consumption slowed, due in part to subsidy cuts in countries such as Indonesia and Thailand. In China energy demand eased partly because new electrical-generating capacity reduced the use of relatively inefficient diesel-fueled backup power generators.

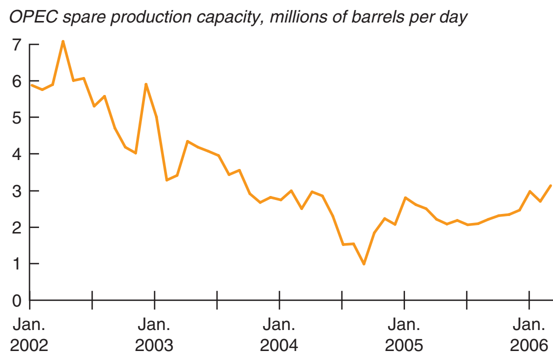
Notwithstanding some three years of higher prices[9] and the coming on stream of new fields in Africa and elsewhere, there has been no discernible acceleration in aggregate oil supply (figure 1.7).[10] This contrasts with the 1970s and 1980s, when increased output brought substantial new capacity online, helping to reduce prices.[11]

Aggregate supply has failed to respond, despite a sharp increase in investment activity among oil-exporting developing countries. Output from those sources has increased just 2.7 percent, or 0.9 mbpd (4.2 percent, or 0.2 mbpd, for African producers).

A number of factors have contributed to limit the response of aggregate oil supply:

1. Existing fields in the United States and in the North Sea have entered into a period of declining yields and the rate of increase in production of fields in the former Soviet Union has slowed.
2. A deterioration in the investment climate in some developing countries has lowered production levels and reduced investment, despite the existence of ample reserves.
3. Low oil prices during the 1990s limited incentives to explore for new oil. More recently, uncertainty over the durability of higher oil prices led firms to be cautious about investing in new (relatively high-cost) capacity, especially given the long lead times (between three and six years) needed to develop new fields.
4. Low investment in the past has contributed to a lack of skilled labor and equipment, further delaying the supply response.
5. A large share of known reserves is located in countries to which major oil companies do not have access. Major oil firms have been offered service contracts to help countries develop their resources. Thus far, however, oil companies appear to have found share buybacks and increased dividends to be a more profitable use of their earnings. Recent decisions in some developing countries to renounce existing contracts are unlikely to increase firms' willingness to invest further.

Figure 1.8 Spare production capacity remains low



Sources: World Bank, International Energy Agency.

The combination of still growing demand and a weak supply response has meant that although spare production capacity has improved, it remains tight (figure 1.8). Looking forward, investments in new productive capacity are increasing (up some 15 percent in 2005). Moreover, continued high prices will increase incentives to adopt more petroleum-efficient technologies and conserve fuel. As a result, demand growth is expected to remain relatively moderate (at about 1.5–2 million barrels per day).

Unless non-OPEC supplies rise much faster than expected (the International Energy Agency, 2005, projects non-OPEC supply to increase by 3 mbpd over the next three years), spare capacity will remain limited and OPEC's pricing power high. The organization has signaled its willingness to reduce output in line with demand.

Prices are expected to remain volatile but should gradually decline, reflecting the countervailing influences of continued strong growth in global output and limited increases in non-OPEC oil on the supply side, and increasing energy efficiency on the demand side. While the precise path to be taken in these conditions is largely unknowable, the forecasts reported in this chapter assume that barrel prices will begin moderating in 2006, averaging $64 for the year and decline gradually towards $57 in 2008.

However, the market remains vulnerable to disruption, whether by natural disasters or geopolitical events.[12] Hence, the possibility of sudden upward spikes in oil prices cannot be ignored, even if the general trend is one of stabilization or slight decline.

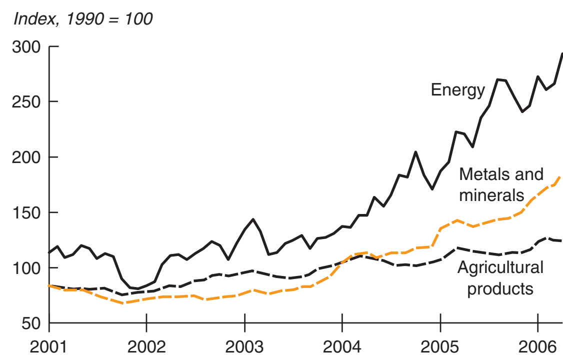
Nonoil commodities

The rise in oil prices since 2003 has been accompanied by increasing prices for agricultural goods, metals, and minerals (figure 1.9). Reflecting continued strong growth in global output, metals and minerals prices increased by some 27 percent in 2005 and up an additional 24 percent in the first four months of 2006. Increases in 2005 were concentrated in industrial metals, such as iron ore (up 72 percent), zinc (up 38 percent), and copper (up 21 percent). Prices for other metals and minerals also rose, but by less. Tin, the price of which fell by 13 percent over the year, stands out as an exception.

At the global level, prices of agricultural products have been relatively stable, up 9.3 percent between April 2006 and the same date a year earlier. High prices early in 2005 reflected a poor monsoon season in South Asia and drought conditions in Sub-Saharan Africa. Improved weather conditions, in combination with increased supply in some countries, contributed to an easing in agricultural prices through much of 2005, followed by a modest pickup in prices in the first quarter of 2006. Raw materials are up 11 percent since April 2005.

The recent strength of nonoil commodity prices is primarily a reflection of strong world demand in recent years and low spare capacity brought on by low prices during the 1990s. Prices also have been influenced by strong energy prices, because energy is a major input in the production of many commodities (notably aluminum), and because several commodities are important substitutes for petroleum-based products (such as rubber and sugar used in the production of ethanol). Overall, about one-third of the increase in nonoil

Figure 1.9 Commodity prices



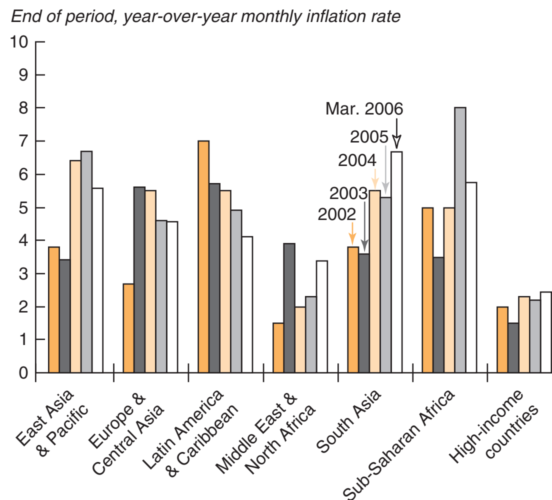
Source: World Bank.

commodity prices between 2002 and 2005 was due to higher oil prices (Baffes 2005).[13] Some of the very recent strength in the prices of precious metals may also reflect investor uncertainty in the face of a declining dollar and continued global imbalances.

Improved supply should ease the prices of most agricultural commodities beginning in 2006. However, the prices of close energy substitutes and energy-intensive products are expected to rise further. Overall, agricultural prices are projected to rise by about 10 percent in 2006 before easing by about 3 percent in each of 2007 and 2008. Strong demand from China and other developing economies, low stocks, and high energy prices are projected to push metals and mineral prices up some 25 percent in 2006, before they begin easing by about 5 percent in 2007 and 12 percent in 2008. Demand-driven increases in energy prices represent an upside risk to energy-sensitive non-oil commodities including food stuffs, whose yields depend on energy-intensive fertilizers.

Figure 1.10 Moderate increases in inflation

End of period, year-over-year monthly inflation rate



Source: World Bank.

Inflation, interest rates, and global imbalances

Inflation

Perhaps the most critical explanation for the limited impact of higher oil prices on output has been the weak response of inflation to higher oil prices—especially in high-income countries, where world interest rates are determined.

While inflation is up in virtually every region, most of the increase appears to reflect the direct impact of higher oil prices. With perhaps the exception of South Asia and Sub-Saharan Africa (see discussion below), there is little evidence of the rapid price pass-through or the wage–price spirals that characterized the oil shocks of the 1970s and 1980s (figure 1.10). Despite a pickup toward the end of 2005 in the United States, core inflation (the rate of price increase of goods and services, excluding food and energy) has increased relatively little (see figure 1.2). As a result, inflation expectations and interest rates have remained low, eliminating one of the principal mechanisms through which past oil shocks have slowed growth.

Many factors explain this inflationary performance—among them more flexible labor and product markets in high-income countries, lower oil intensities, more credible monetary policy, and more prudent fiscal policies. In addition, the rapidly expanding role of Asia and, to a lesser extent, the countries of the former Soviet bloc as low-cost manufacturing centers have served to dampen price inflation in high-income countries, where many of these products are consumed.

The pickup of inflation in Sub-Saharan Africa and South Asia is partly explained by food prices, which increased substantially in both regions during the course of 2005 and should be expected to ease in 2006 as crops improve. However, as is the case in a few Latin American countries, it also likely reflects overheating in those regions, which have been growing at historically high rates.

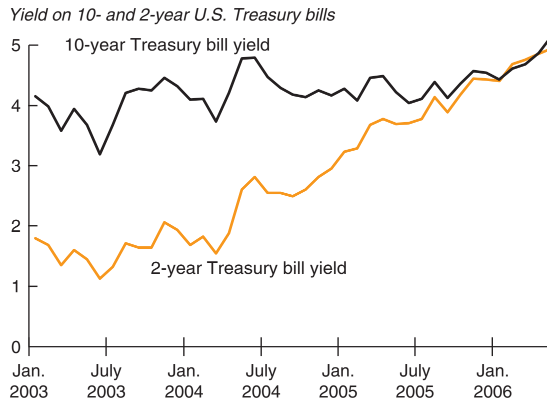
This possibility is particularly worrisome in the case of Africa, because the credibility of monetary authorities is not yet well entrenched. Should an inflationary spiral develop, it could have serious consequences for macroeconomic stability and affect the ability of those economies to sustain the strong growth of the past several years. In the meantime, continued aid flows to finance improved governance and social and physical infrastructure investments will be essential to raising the trend growth rate that these countries can sustain.

Interest rates

The subdued response of inflation has allowed monetary (and fiscal) policy to remain relatively accommodative. While short-term interest rates are

Figure 1.11 Flattening yield curve

Yield on 10- and 2-year U.S. Treasury bills



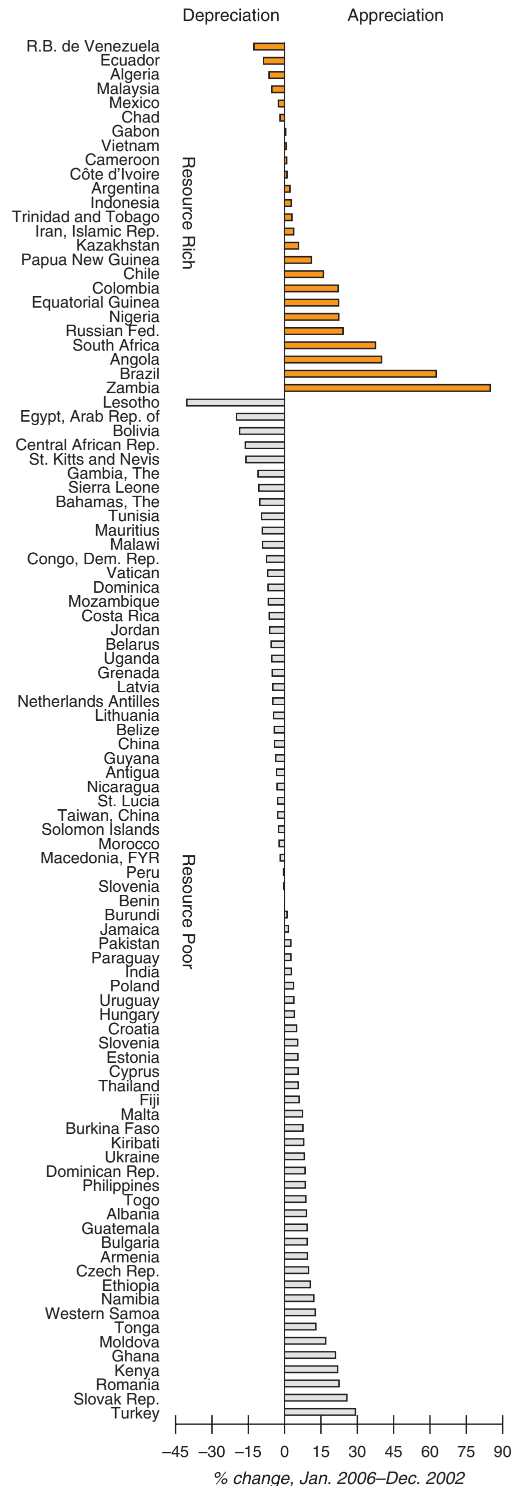
Source: World Bank.

rising, they remain low in real terms, and long-term rates have only recently begun rising in high-income countries. As a result, the yield curve has flattened significantly, with short-term bond yields virtually equal to longer term yields.

Indeed, on several occasions during February and March 2006 the yield on two-year U.S. Treasury bonds marginally exceeded that of the 10-year bond (figure 1.11). Such yield-curve "inversion" has historically been a good indicator of a future recession (Estrella 2005).[14] As such, these inversions may signal a slowing of the U.S. economy. However, they were very small and occurred with both short- and long-term real interest rates at low levels. Moreover, while the yield curve remains flat, long-term rates in April and early May were once again higher than short-term rates. In this context, the flattening of the yield curve reflects a broadly positive outlook for global growth, characterized by stable expectations for inflation, significant spare capacity in Europe, and an American economy that continues to expand quickly even as it slows in response to a more neutral monetary policy stance.

Developing economies experienced a similar flattening of the yield curve. Bond spreads continued to decline, reaching a historic low of 174 basis points for sovereign borrowers in May 2006. However, the combination of relatively stable bank spreads (around 100 basis points) and rising rates in high-income countries means that the average interest rate paid by developing countries actually rose over the past 12 months (see chapter 2).[15]

Figure 1.12 Changes in real effective exchange rate



Sources: World Bank, IMF.

Exchange rates

A further factor limiting the real-side consequences of higher oil prices is the wider adoption of flexible-exchange-rate regimes over the past two decades (see chapter 5). Among oil-importing developing countries that have not benefited from high metals and minerals prices, there was a modest tendency toward depreciation.[16] Unsurprisingly, among developing oil exporters the tendency toward appreciation was much more pronounced, with two-thirds of these countries appreciating by an average of 18 percent.[17] Such exchange rate fluctuations contributed to the resilient response of these economies to higher oil prices by facilitating adjustment to the change in relative prices implied by higher oil prices (figure 1.12). For oil importers, the depreciation transfers the price shock over a wider range of tradable goods and services. Moreover, by making exports more competitive and imports less so, the depreciation increases net exports, reducing the impact on economic output that would otherwise be observed as a result of reduced incomes and lower consumption.

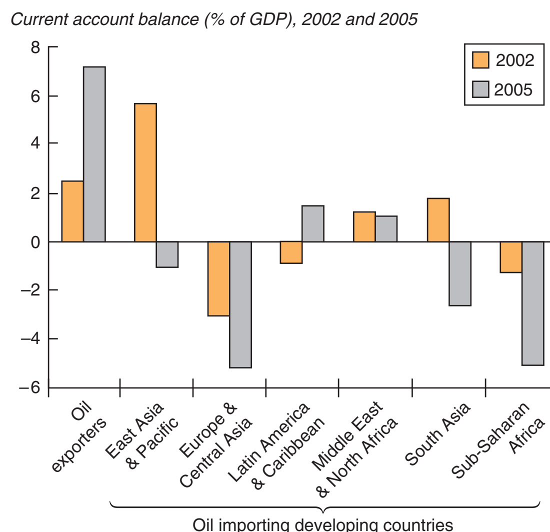
Most developing oil importers have financed higher oil bills successfully

Another factor behind the resilience of growth has been the relative ease with which developing countries were able to finance higher oil bills. Many developing countries entered into this period of higher oil prices with positive or near-zero current-account balances. As a result, despite deteriorations of 2 or more percent of GDP in many cases, current-account positions for most countries remain at levels that should not pose serious financing difficulties (figure 1.13).

In the poorest countries, substantial increases in ODA during 2004 and 2005 provided some of the foreign currency necessary to finance the increase in their oil bills (figure 1.14). For many African countries, the increase in foreign currency earnings from this source amounted to more than 0.5 percent of GDP in 2004 (data for 2005 are not yet available). Simulations suggest that for oil-importing poor countries, increased ODA inflows may have reduced the first-round impact of higher oil prices by as much as two-thirds (Diaz-Bonilla and Savescu, 2006) (figure 1.14).[18]

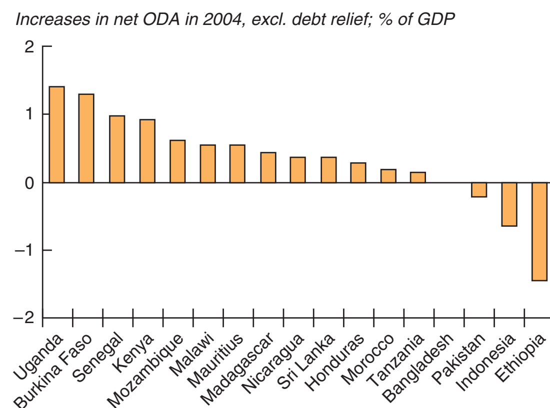
While some countries may have used the money directly to finance oil consumption, in most instances this was not the case. To the degree that projects financed by this aid had low import intensities, the foreign currency, after conversion to domestic currency, would be available to finance other imports—perhaps, but not necessarily, more expensive oil. Moreover, if there is a positive externality associated with domestic export activity (Frankel and Romer 1999; Ibrahim and

Figure 1.13 Developing countries' current-account balances



Source: World Bank.

Figure 1.14 Increased aid helped finance oil costs in 2004

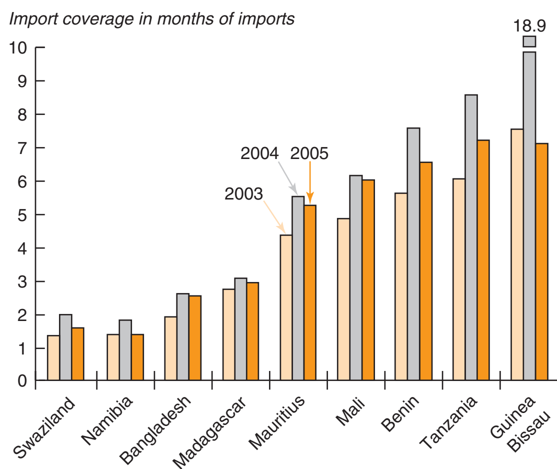


Sources: OECD, World Bank.

MacPhee 2003), the negative oil shock may actually have improved development prospects by partially offsetting the Dutch-disease effect associated with the increased aid.[19]

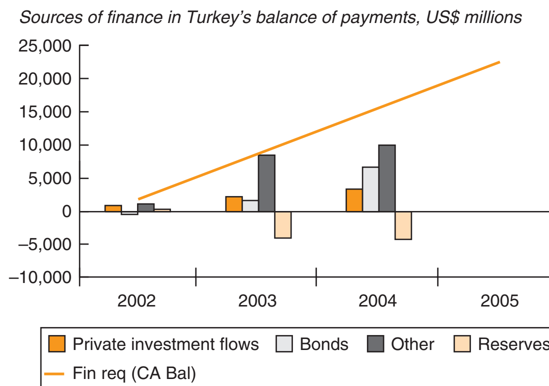
Despite these offsetting factors, several countries appear to be encountering difficulties financing their higher oil bills. In Africa, current account deficits among oil-importers (excluding South Africa) have soared and average more than 6 percent of GDP. Current-account deficits have also reached worrisome levels in many European and Central Asian countries. Many countries are experiencing fiscal difficulties because of less-than-complete pass-through. Madagascar, Malawi, and Sierra Leone have been forced to ration electricity consumption through rotating blackouts in an effort to conserve energy, suggesting that they may have met binding current-account constraints and are unable to finance additional oil imports. Several other countries appear to be consuming international reserves at unsustainable rates (Benin, Guinea Bissau, Mali, Tanzania) (figure 1.15). In still others, reserves represent a dangerously low share of monthly import cover (Bangladesh, Madagascar, Namibia, Swaziland). In all of these countries, policy makers will need to take concrete steps, including currency depreciation and energy conservation measures, so that domestic demand and the country's net revenue positions adjust to recent changes in relative prices.

Figure 1.15 Reserves in some countries are falling rapidly or worrisomely low



Source: World Bank.

Figure 1.16 Tensions associated with fast growth, the case of Turkey



Source: IMF.

Of particular concern are a number of countries that combine high current-account deficits, significant capital inflows, high interest rates, and an appreciating currency, notably Bulgaria, Romania, and Turkey (figure 1.16). These conditions pose serious problems for policy makers, as the capital inflows (initially in the form of direct investments) prompt an appreciation of the currency, increase domestic money supply, and raise inflationary pressures. In each of these countries monetary institutions have responded by raising interest rates, which reduces domestic money supply growth but has also induced additional financial inflows, adding to domestic liquidity and inflationary pressures.[20] While tighter fiscal policy has helped combat these tendencies, external deficits continue to rise and currencies to appreciate in many of these countries. Should capital inflows slow or stop, financing current levels of expenditure could be very difficult, placing these currencies under significant pressure. A sudden depreciation could generate an inflationary push—partially undoing recent achievements in stabilizing currencies and controlling domestic inflation.

More generally, the deterioration in the current-account position of oil-importing developing countries means that they are much more vulnerable now than they were in 2003. An important supply disruption that pushed oil prices even higher, or a decline in nonoil commodity prices, would be much more difficult to finance and could precipitate painful adjustments (see risks section).

Global imbalances persist

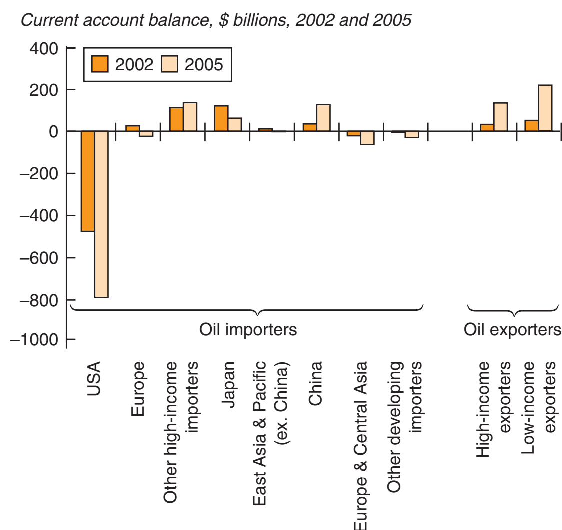
The imbalances in global spending patterns that have characterized the world economy over the past five years, with the United States consuming significantly more than it produces and running a large current-account deficit, persisted in 2005 (figure 1.17). High oil prices both exacerbated imbalances and changed their nature, contributing to about 40 percent of the additional deterioration of the U.S. current-account deficit in 2005.[21] At the same time, high oil prices caused the current-account position of almost all oil-importing countries to deteriorate and substantially boosted those of exporters. As a result, whereas in 2002 oil-importers in virtually every region except the United States were running a current-account surplus, now almost all are running deficits—with the notable exceptions China, Japan, Korea, and a few other high-income countries.

The sustainability of these imbalances and their financing is a question of growing concern (IMF 2006; World Bank 2005a, 2005b). Persistent current-account deficits have transformed the United States from being the world's most important creditor nation (with a net international investment position of 13 percent of GDP in 1979) to being the world's largest debtor (with a net asset position of –21 percent of GDP in 2004). Unless savings in the United States increase substantially, its net asset position is set to deteriorate sharply, reaching between 65 and 48 percent of GDP by 2015 (Higgins, Klitgaard, and Tille 2005).[22]

So far, financing of these deficits has not posed a serious problem for the United States, in part because of low interest rates and because of a generalized willingness of foreigners to hold American assets that yield lower returns than the foreign assets held by Americans.[23] As a result, despite the deterioration of its net asset position, the United States has continued to earn a positive net return on foreign investments.[24] If investor's willingness to continue accumulating such assets changed, U.S. interest rates would rise and the current account balance would deteriorate (by about 0.5 percent of GDP for every 100-basis-point rise in U.S. interest rates relative to foreign rates).[25] Over the past year, short-term interest rates in the United States have risen by about 100 basis points more than in Europe, bringing the overall difference to 220 basis points. The long-term differential is now some 100 basis points (figure 1.18). Although it is certainly too early to tell, this movement (and the decline in emerging-market risk premia against the dollar) could reflect a reassessment of the dollar as a safe haven.

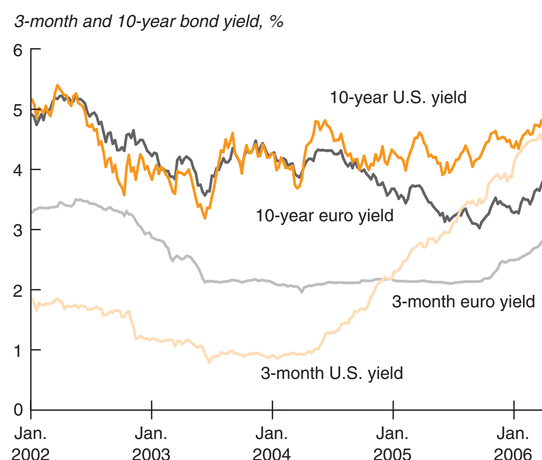
Independent of the reasons for these movements, the course of long-term interest rates continues to be sensitive to the willingness of nonmarket sources of finance (formerly developing-country central banks and now, increasingly, authorities in

Figure 1.17 Global imbalances



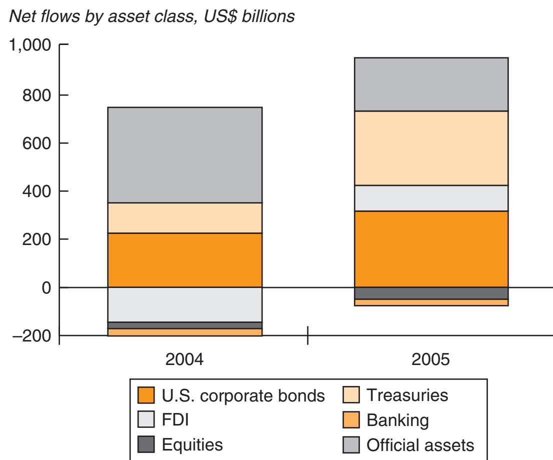
Source: World Bank.

Figure 1.18 Interest rate spreads support the dollar



Sources: World Bank, Datastream.

Figure 1.19 Funding the U.S. current account deficit



Source: World Bank.

oil-exporting countries) to purchase low-yield dollar-denominated assets. Lower reserve accumulation by oil-importing developing economies translated into a $130 billion decline in their purchases of U.S. Treasury bills and official assets (figure 1.19). This was only partly offset by a $14 billion increase in purchases by oil exporters. The need to meet this (nonmarket) financing shortfall may have been among the factors that pushed up long-term U.S. interest rates.

The tensions implicit in the U.S. current-account deficit are building and need to be addressed. Reducing global imbalances is a shared international responsibility, requiring a tightening of fiscal policy in the United States, increased imports abroad and increased exchange-rate flexibility. Implementation must necessarily be gradual—to avoid excessive disruption, both within the United States as macro policy is tightened and in developed and developing Asia as currencies are allowed to appreciate. However, to be effective and preempt market jitters the effort must be credible. In particular, in the absence of increased savings in the United States, increased domestic demand abroad and greater exchange rate flexibility are unlikely to have a significant effect on global imbalances and would likely exacerbate global capacity constraints—reducing the likelihood of a soft landing.

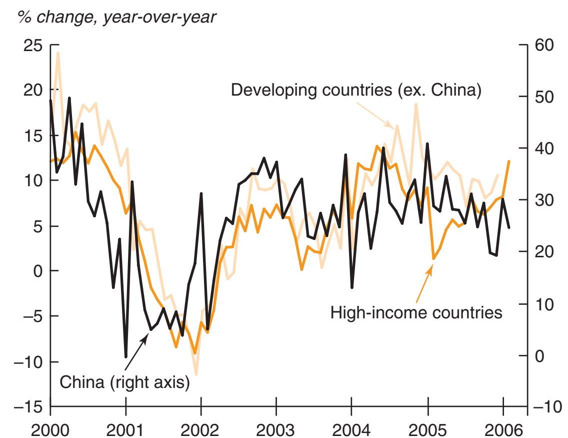
Although in the near term global imbalances are unlikely to provoke the serious currency crisis suggested by some (Roubini and Setser 2005), they do imply that the dollar will face further downward pressure and that U.S. interest rates will continue to exceed those in Europe. Indeed, between January and early May 2006, dollar cross rates have been relatively sensitive to interest rate differentials. During this period, it has depreciated 7 percent against the euro (4 percent against the won and 0.7 percent against the renminbi) and 2.3 percent in real-effective terms. Looking forward these trends are expected to continue and the dollar to depreciate slowly by about 5 percent per year over the projection period.

World trade

Overall, merchandise trade growth slowed somewhat in 2005, expanding by 8.9 percent, as compared with 11.8 percent in 2004 (figure 1.20). Most of the slowdown occurred during the first half of the year and among high-income countries. For 2005 as a whole, their export volumes increased only 6.0 percent, down from 10.2 percent the year before. However, toward the second half of the year and into 2006, outturns have improved, in part because of increased European exports to the Middle East.

In contrast, China's export volume expanded by 27.8 percent in 2005, almost exactly as fast as in 2004. Moreover, despite a slowing in the pace of Chinese foreign sales towards the end of 2005, export volumes have once again picked up—expanding by more than 25 percent during the first

Figure 1.20 Healthy growth in world trade



Source: World Bank.

two months of 2006. Other developing countries also continued to expand their market share. Their export volumes increased 10.3 percent, only somewhat slower than the year before. Here, too, trade growth decelerated early in the second half of 2005 but has since picked up.

Oil revenues of developing-country oil exporters nearly doubled between 2002 and 2005, increasing by some $215 billion. For all oil exporters, the increase was about $400 billion. However, oil exporters have increased their own imports markedly, and more than three-quarters of additional export revenues have been spent on additional imports.

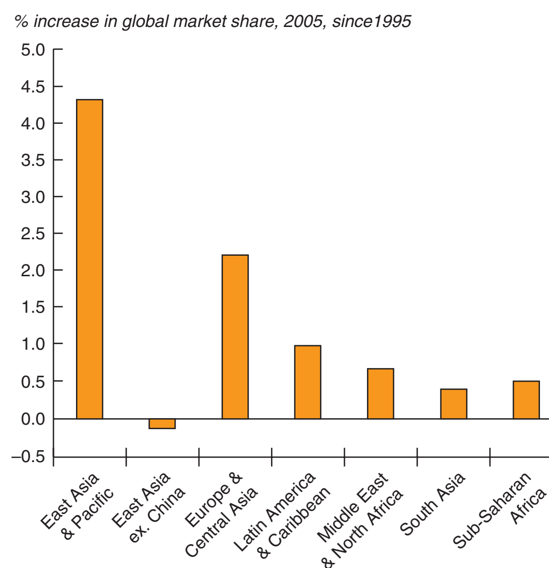
Oil exporters are also recycling petrodollars through financial markets. Between 2002 and 2005, oil-exporting developing countries increased foreign currency reserves by $255 billion (with $117 billion of the increase accounted for by the Russian Federation). In total some $245 billion has flowed into the United States as securities, bonds or bank deposits, while about $50 billion has been placed directly into the European banking sector. Unfortunately, because of the use of third-party intermediaries and reduced reliance on the banking sector (as compared with past episodes of high oil prices) it is particularly difficult to trace the destination of these funds (BIS 2005).

Not all regions shared equally in the recycling of petrodollars. In particular, the share of the United States in the imports of oil-exporting countries fell from 25 to 20 percent during this period.[26] In contrast, most developing countries increased their market share in the imports of oil-exporting countries. However, the increase in their export revenues paled in comparison with the increase in their oil bills.

Can developing countries continue to gain market share at recent rates?

The strong economic performance of low- and middle-income countries over the past several years reflects both rapid growth in world exports (up 90 percent since 1995) and an almost 50 percent increase in the market share of developing economies, up from 20 percent in 1995 to almost 30 percent in 2005. This improvement is due, in large part, to increases in the market share of China. Nevertheless, every developing region (except East Asia excluding China) has seen its global market share increase (figure 1.21).

Figure 1.21 Regional increases in market share



Source: World Bank.

The export boom of China is similar to past booms in a number of countries that are now classified as high income (Israel, Japan, the Republic of Korea, and Taiwan) in that it was mostly driven by an expansion in the range of goods exported. Thus, while technological progress, investment, and labor productivity growth contributed to a 290 percent increase in Chinese sales to the United States of products already on sale in 1992, more than 60 percent of the total increase came from the sale of goods that China did not export to the United States in 1992.[27] This contrasts with Bangladesh, for example (figure 1.22). That country's revenues from exports of traditional products to the United States increased by an impressive 173 percent between 1992 and 2005, but compared with China it managed only to generate one-tenth as much additional revenue from new products.

While not as marked as in China, there is evidence that other developing countries are diversifying the range of goods that they export and moving up the value-added ladder. Today, the revenues of developing countries from exports to high-income countries depend much less on raw materials (figure 1.23) and much more on higher-value-added goods (and services).

The rapid increase in the market share of China and other developing countries resulted from the exploitation of preexisting competitive