Global Development Finance

Charting a Global Recovery

I: Review, Analysis, and Outlook

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I: REVIEW, ANALYSIS, AND OUTLOOK 2009

THE WORLD BANK

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Washington, DC 20433
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Internet: www.worldbank.org
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1 2 3 4 12 11 10 09

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Cover art: Charles Arnoldi, “Jumbo,” 2000 (detail).
Cover design: Critical Stages.

ISBN: 978-0-8213-7840-3
eISBN: 978-0-8213-7841-0
DOI: 10.1596/978-0-8213-8213-7840-3
ISSN: 1020-5454

The cutoff date for data used in this report was May 26, 2009. Dollars are current U.S. dollars unless otherwise specified.

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Foreword

THE CRISIS OF THE PAST TWO YEARS is having dramatic effects on capital flows to developing countries, and the world appears to be entering an era of lower growth. This edition of *Global Development Finance* revisits the genesis of the turmoil—which began in a relatively small segment of the U.S. credit markets and mutated into a major worldwide financial and economic crisis—and explores the broad approach needed to chart a global recovery.

This year, global output is projected to fall by 2.9 percent; global trade by 10 percent. Growth in the developing world is expected to slow to 1.2 percent. Excluding China and India, GDP in other developing countries will fall at a rate of 1.6 percent. Meanwhile, private investment flows to developing countries plummeted by more than 40 percent in 2008 as access to international debt markets dried up and portfolio equity inflows all but ceased.

Unprecedented situations call for unprecedented policy responses. Through ambitious unilateral and multilateral actions, both conventional and unconventional, governments have drawn on monetary policy, fiscal stimulus, and guarantee programs to shore up the banking industry, which lay at the epicenter of the crisis. Those actions are beginning to have a positive impact on financial markets, where liquidity conditions in global interbank markets have begun to ease, credit risk premiums have narrowed, and equity markets have staged a tentative revival. However, the policy agenda for stabilizing financial markets and fostering global economic recovery is broad and complex. Major challenges remain.

Greater integration of the global economy and the increasing importance of private actors in international finance over the past three decades have brought enormous benefits to developing countries, but they also have widened the scope for economic turmoil. Consider trade and flows of private capital. The share of international trade in developing countries' output grew from 35 percent in 1980 to 57 percent in 2007. New markets opened for producers in the developing world, and prices lowered for consumers. But rising trade also widened channels through which a slowdown in economic activity in one group of countries could spread to other countries. Capital flows have grown with trade, and developing countries today are much more dependent on flows of private capital than they were at the peak of the boom of the 1970s. Once dominated by bank lending to sovereign governments, most capital now flows through a variety of transactions between private entities—and those flows respond rapidly to financial disruptions. Thus, even though most developing countries maintain better policies and have stronger institutions than they did at the onset of previous crises, more of them are nevertheless vulnerable to external disruptions. Emerging-market equities and investments have always been sensitive to the global economic cycle, but the current downturn has hit developing countries especially hard. Emerging-market borrowers, both private and public, will encounter increased competition from developed countries as the latter dramatically expand government deficit debt financing as well as government-guaranteed bank debt issuance.

The crisis has affected the external financing position of all developing countries—but not equally. Those that have high levels of external debt, large current-account deficits, and shallow foreign reserves are more likely to encounter difficulties in obtaining the finance they will need to avoid a more severe contraction in growth. Many private firms in the developing world will be hard pressed to service their foreign-currency liabilities with revenues earned in depreciating domestic currencies while confronting declining global export demand. The likelihood of balance-of-payments crises and restructurings of corporate debt in these countries warrant special attention. Countries that pursued prudent macroeconomic policies in the years preceding the crisis have more flexibility than others to respond to short falls with expansionary fiscal and monetary policies and so keep their domestic industries afloat.

Low-income developing countries, initially cushioned from the direct impact of the financial crisis, are now feeling effects that have spread through other channels. Net private capital flows will be insufficient to meet the external financing needs of many of these countries, and in view of the intense fiscal pressures triggered by the crisis, the prospects for large increases in aid flows are dim. The bulk of new commitments by international financial institutions will go to middle-income countries in 2009, and workers' remittances to low-income countries are projected to decline by 5 percent. Such sobering facts reinforce the importance of broad international agreement to mobilize the necessary resources to achieve the MDGs.

The financial crisis in today's integrated global economy has underlined the importance of coordinating policy so that measures taken in one country complement, rather than defeat, those taken in another. The economic channels through which nations trade goods and services also serve to propagate crisis when countries resort to protectionism. For that reason, it is imperative that countries coordinate policies to provide adequate financing for trade and resist the politically tempting tactic of protectionism—either in the trade or financial arena.

Recent actions by the world's central banks illustrate the utility of concerted action. With international banks operating in a multiple-currency world, central banks need ready access to several major currencies to fulfill their role of providing liquidity to their banks. Thus, the swap facilities that were created by the U.S. Federal Reserve and the People's Bank of China in response to the crisis are likely to be reinforced by other central banks acting in concert. Central banks in many countries, including some developing countries, also have acted together to reduce interest rates, expand their lending, provide guarantees to encourage more private lending, and take other action to jump-start credit markets stalled by the crisis.

Today's crisis constitutes a triad of tight credit, diminished confidence, and global recession, set in the context of an interconnected world economy. The world is transitioning from an extended credit boom and economic overheating to an era of slower growth. Looking to medium-term developments, participants in the international financial system—consumers, investors, traders, and firms—must adapt their behavior to the new realities of tightened credit conditions, a prominent role of the state in financial affairs, large excess capacity in many industrial sectors, and more closely coordinated regulatory policy. Governments, for their part, must support emerging signs of recovery in financial markets with persistent, robust policy efforts to transform the adverse feedback loop between the financial sector and the real economy into a positive one. In a world of global financial institutions, effective oversight of the financial system can be achieved *only* through coordinated efforts, because lax regulation in one jurisdiction makes it more difficult to enforce adequate standards elsewhere. Greater international cooperation in sharing information and establishing broad standards for regulation is important to making national regulators more effective and thus the global financial system more stable.

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 the role of international banking in developing countries. A separate volume contains detailed standardized external debt statistics for 128 countries, as well as summary data for regions and income groups. Additional material and sources, background papers, and a platform for interactive dialogue on the key issues can be found at http://www.worldbank.org/prospects. A companion online publication, "Prospects for the Global Economy," is available in English, French, and Spanish at http://www.worldbank.org/globaloutlook.

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Acknowledgments

THIS REPORT WAS PREPARED BY THE International Finance Team of the World Bank's Development Prospects Group (DECPG). Substantial support was also provided by staff from other parts of the Development Economics Vice Presidency, World Bank operational regions and networks, the International Finance Corporation, and the Multilateral Investment Guarantee Agency.

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Preparation of the appendixes on official debt restructuring was managed by Eung Ju Kim. Augusto Clavijo provided support for formatting figures and tables for the final version of the report, and Eugen Tereanu provided research assistance for chapter 3.

The estimates of financial flows and debt were developed in a collaborative effort between DECPG and the Financial Data Team of the Development Data Group (DECDG), led by Ibrahim Levent. DECPG's Global Trends Team, under the leadership of Hans Timmer, was responsible for the projections. The projections and regional appendix were produced by Oana Luca, Annette de Kleine Feige, Elliot Riordan, Cristina Savescu, and Ivailo Izvorski, in coordination with country teams, the offices of the chief economists of the Bank's regions, and the offices of directors of the Bank's Poverty Reduction and Economic Management network. Among those who contributed were Luca Barbone, Marcello Guigale, August Kouame, Ernesto May, Vikram Nehru, Ritva Reinikka, Sudir Shetty, and Augusto de la Torre. The short-term commodity price forecasts were produced by John Baffes, Betty Dow, and Shane Streifel.

Two background notes and papers were prepared by experts outside the Bank: Paul Masson (University of Toronto, international policy coordination) and Robert Hauswald (American University, the impact of crises on international bank lending). From within the Bank, notes and papers were received from Constantino Hevia (foreign bank responses in Latin America), Oliver Fratzscher (corporate risk management), Sanket Mohapatra (workers' remittances), Ismail Dalla (consultant, local capital market development and trade finance), and Dana Vorisek (monitoring of media coverage of the crisis). The online companion publication of GDF, "Prospects for the Global Economy," was prepared for the Web by Sarah Crow, Cristina Savescu, Yan Bai, and Maria Hazel Macadangdang, with the assistance of the global trends team. Technical help in the production of the Web site was provided by Reza Farivari, Shahin Outadi, Malarvizhi Veerappan, Cherin Verghese, and Kavita Watsa.

The report also benefited from the comments of the Bank's Executive Directors, made at an informal meeting of the Board of Directors on May 26, 2009.

Many others provided inputs, comments, guidance, and support at various stages of the report's preparation. Merli Margaret Baroudi, Marilou Jane Uy, Jeffrey Lewis, Robert Kahn, M. Willem van Eeghen, and Charles Blitzer (International Monetary Fund) served as peer reviewers during the Bankwide review of the manuscript. Within the Bank, additional comments were provided by Luis Pereira Da Silva, Alan Gelb, Celestin Monga, Maria Soledad Martínez Peria, Augusto de la Torre, Sergio Schmukler, and Norman V. Loayza.

Steven Kennedy and Marty Gottron edited the report. Rosalie Marie Lourdes Singson provided assistance to the team and to Merrell Tuck-Primdahl, who managed production and dissemination activities. Book design, editing, and production were coordinated by Aziz Gökdemir, Stephen McGroarty, and Denise Bergeron of the Office of the Publisher at the World Bank.

Selected Abbreviations

ADB	Asian Development Bank
AfDB	African Development Bank
BIS	Bank for International Settlements
CDSs	credit default swaps
CIS	Commonwealth of Independent States
DAC	Development Assistance Committee
DRS	Debtor Reporting System
EBRD	European Bank for Reconstruction and Development
EU	European Union
FDI	foreign direct investment
G-7	Group of Seven
G-20	Group of 20
GDP	gross domestic product
GTFP	Global Trade Finance Program
GTLP	Global Trade Liquidity Program
HIPC	heavily indebted poor country
IADB	Inter-American Development Bank
IBRD	International Bank for Reconstruction and Development
IDA	International Development Association
IFC	International Finance Corporation
IFI	international financial institutions
IMF	International Monetary Fund
IPO	initial public offering
LIBOR	London interbank offered rate
M&A	mergers and acquisitions
mb/d	million barrels per day
MDB	multilateral development banks
MDGs	Millennium Development Goals
MIGA	Multilateral Investment Guarantee Agency
NIE	newly industrialized economy
ODA	official development assistance
OECD	Organisation for Economic Co-operation and Development
OPEC	Organization of the Petroleum Exporting Countries
PRGF	Poverty Reduction and Growth Facility
REER	real effective exchange rate
saar	seasonally adjusted annual rate
SADC	Southern African Development Community
SDR	special drawing rights
WTO	World Trade Organization

Overview

ALMOST TWO YEARS AFTER PROBlems in the U.S. mortgage market set in motion the biggest financial crisis since the Great Depression, global financial markets remain unsettled, and prospects for capital flows to the developing world are dim. The intensification of the financial crisis in September 2008 dramatically altered the world economic outlook. Global output is now expected to shrink by 2.9 percent in 2009, the first contraction since World War II. International trade is likely to experience the sharpest drop since that time. Unemployment, already soaring in industrial countries, will follow a similar path in the export-dependent economies of East Asia, as high-income countries reel from an unprecedented asset-market bust, and global investors retreat from emerging markets.

The implications of these unfolding events for investment flows to developing countries have already been dramatic: total private capital flows in 2008 dropped to $707 billion (4.4 percent of total developing-country GDP), reversing the strong upward surge that began in 2003 and reached a pinnacle of $1.2 trillion in 2007 (8.6 percent of GDP). For 2009 the most likely scenario is that as global equity markets regain momentum and credit markets heal, net private flows to developing countries will remain positive—barely. But they will drop to $363 billion, approximately the level of 2004 and a decline of 5 percentage points of GDP from 2007. The magnitude of the decline is troubling for its macroeconomic consequences and for vulnerability to further shocks, particularly in countries in which banks and firms have high levels of external debt. Much of the $1.2 trillion external debt raised by emerging market banks and firms between 2003 and 2007 is now maturing, putting pressure on the borrowers' finances at the time when the average cost of external borrowing has increased to 11.7 percent, compared with 6.4 percent in the pre-crisis years when the debt was contracted.

Although extraordinary policy responses by governments around the world have helped save the global financial system from systemic collapse, they have not, thus far, closed the negative feedback loop between financial instability and economic recession. Fragile consumer confidence and a much-diminished appetite for risk among investors in developed countries have all contributed to a plunge in global aggregate demand. Simultaneously, the deepening economic downturn has caused major global banks to scale back domestic and international lending, thereby exacerbating the credit crunch. Actual bank lending in the United States and Europe, as well as surveys of bank intentions and credit terms, point to a slowing in the supply of bank credit to the corporate and household sectors. In recent months, that slowdown has become a decline. Likewise, foreign claims on developing-country residents held by major international banks reporting to the Bank for International Settlements declined by $200 billion between December 2007 and December 2008 (from $4.3 to $4.1 trillion).

To break the cycle and revive lending and growth, bold policy measures, along with substantial international coordination, are needed. In this regard, the joint announcement by the Group of 20 (G-20) leaders at their London summit in April 2009 was encouraging. The leaders vowed to strengthen the capacity of multilateral financial institutions to lend to emerging economies facing traditional balance-of-payments shortfalls or elevated risks from debt rollover and refinancing.

Addressing the various regulatory failures, bank governance shortcomings, and macroeconomic imbalances that contributed to the crisis has been another focus of the international policy response. Bad lending and poor investment decisions stemmed from lax regulation as well as from overconfidence and euphoria associated with low real interest rates and ample liquidity. Therefore, new measures that embrace all systemically important financial institutions (including hedge funds), that strengthen international accounting standards to improve transparency and asset valuation, and that bolster the Financial Stability Board are desirable and timely, even if their immediate success cannot be guaranteed.

In charting the course ahead, policy makers in developed and developing countries should give priority to four tasks: following up on the G-20's promise to restore domestic lending and the international flow of capital, addressing the external financing needs of emerging-market sovereign and corporate borrowers, reaffirming preexisting commitments to the aid agenda and the Millennium Development Goals (MDGs), and, eventually, unwinding governments' high ownership stake in the banking system and reestablishing fiscal sustainability.

Rapid progress on these fronts will make it easier for low-income countries to cope with the crisis. Already under severe strain, low-income countries face increasingly grave economic prospects if the dramatic deterioration in their capital inflows from exports, remittances, and foreign direct investment (FDI) is not reversed in 2010. As it stands, the amount of development assistance available to low-income countries will not fully cover their external financing needs in 2009, while the outlook for donor countries to increase aid significantly is bleak, given the intense fiscal pressures they face because of the crisis.

The global recession has deepened

The tight links between global trade in durable, capital, and high-tech goods, and the closely entwined investment spending that supports economic activity in both high-income and developing countries, can be detected in the vicious circle that now operates between the financial and real sectors of the global economy. The difficulty of obtaining capital, together with uncertainty about future demand, has delayed investments and caused a collapse in demand for durable goods, resulting in a sharp contraction in the production of and global trade in manufactured goods. World industrial production declined by an unprecedented 5 percent in the fourth quarter of 2008 (or 21 percent at an annualized rate). Output continued to decline in the first quarter of 2009, reducing the level of industrial production in high-income countries by 17.3 percent in March 2009, relative to its level a year before, and in developing countries by 2.3 percent relative to March 2008. The collapse in industrial production is truly global, with major producers of advanced capital goods particularly hard-hit—Japan (34 percent, year-on-year) as of March 2009, Germany (22 percent), and the Republic of Korea (12 percent).

GDP growth in developing countries is projected to slow sharply but remain positive in 2009, moving from 5.9 percent in 2008 to 1.2 percent. Nevertheless, developing countries as a whole will outperform by a sizeable margin high-income countries, whose aggregate GDP is projected to fall 4.5 percent in 2009. Two developing regions, Europe and Central Asia and Latin America and the Caribbean, are likely to end 2009 with negative growth. Moreover, when China and India are excluded, GDP in the remaining developing countries is projected to fall 1.6 percent or 0.6 percent in per capita terms, a real setback for poverty reduction. The simultaneous collapse in growth across high-income and developing countries cannot be explained solely by trade links, for the domestic economies of a large number of developing countries have been directly affected by the financial crisis. The reversal of capital flows, the collapse in stock markets, and the general deterioration in financing conditions have brought investment growth in the developing countries to a halt. In many developing countries, investment is falling sharply.

For developing countries that are significant commodity importers, one of the few silver linings of the financial crisis is that commodity prices are down some 35 percent from their record levels of mid-2008, limiting current-account deficits and helping to quell the inflation produced by high food and fuel prices during the years leading up to the financial crisis. Lower commodity prices have also had the salutary effect of mitigating the impact

of the current crisis on the poor. Commodity markets seem to have found a bottom, one that is still nearly 60 percent above the price levels of the late 1990s. In several markets, commodity production is being reduced because the marginal costs of exploiting the least resource-rich or most difficult-to-reach sites now exceed current prices.

While the global economy is projected to begin expanding once again in the second half of 2009, the recovery is expected to be much more subdued than might normally be the case. Global GDP is forecast to increase a modest 2.0 percent in 2010 and 3.2 percent by 2011, as banking sector consolidation, negative wealth effects, and risk aversion continue to weigh on demand throughout the forecast period. Among developing countries, expected growth rates should be higher (given stronger underlying productivity and population growth) but remain similarly subdued at 4.4 percent and 5.7 percent, respectively, in 2010 and 2011. Given the output losses already absorbed and because GDP only reaches its potential growth rate by 2011, the output gap (the difference between actual GDP and its potential) and unemployment are expected to remain high and recession-like conditions will continue to prevail.

Private capital flows are shrinking at an unprecedented rate

While the global economic cycle has always colored the emerging-market asset class, the current downturn has been especially noteworthy in its impact on asset valuation in equity markets and liquidity conditions in primary bond markets. Relative to their peers in mature markets, corporate and sovereign bond issuers in emerging markets have been particularly affected by liquidity concerns and risk aversion among investors. There was virtually no issuance between mid-September and mid-December 2008, in the wake of the collapse of Lehman Brothers. Local stock markets, meanwhile, experienced the worst yearly decline in recent history, as the MSCI Emerging Market Index sank 55 percent during the year, erasing some $17 trillion in market valuation. Investors' flight from perceived danger contributed to the sharp drop in capital flows to the developing countries, a trend that is very likely to persist through the end of 2009.

Although interest-rate spreads in developing countries have not widened by as much as in past crises, the decline in private capital flows to developing countries is expected to set a record. Net private debt and equity flows are projected to decline from a record high of 8.6 percent of GDP in 2007 to just over 2 percent in 2009, exceeding the peak-to-trough drop during the Latin American debt crisis in the early 1980s (3.3 percentage points) and the combined East Asian and Russian crises of the late 1990s (2.4 percentage points). Unlike in these past crises, however, the decline in inflows has hit every developing region. The most affected region is emerging Europe and Central Asia, which also experienced the largest expansion of inflows between 2002 and 2007. Net private inflows to the region were an estimated 6.4 percent of GDP in 2008, down from 15.1 percent in 2007.

Unlike portfolio equity and bond investments, FDI decisions are made with long-term horizons in view. They express the intention to build productive manufacturing facilities, exploit natural resources, or diversify export bases. Thus, FDI flows are less likely to be liquidated or reversed in times of crisis. Driven by the strong momentum of the first half of the year, FDI inflows to developing countries posted a slight increase in 2008, reaching $583 billion, equivalent to 3.5 percent of the aggregate GDP of developing countries. Almost all the increase occurred in middle-income countries, notably the Russian Federation, India, Brazil, and China. In contrast, FDI inflows to high-income countries fell sharply—from $1.3 trillion in 2007 to $827 billion in 2008. Most of the decline was concentrated in Europe; flows to the United States were up slightly compared with previous years.

Financing conditions have deteriorated rapidly

Developing countries will most likely face a dismal external financing climate in 2009. With private capital flows expected to post a dramatic decline, many countries will have difficulty meeting their external financing needs, estimated at $1 trillion, $600 billion higher than in 2003 at constant 2009 prices. Private debt and equity flows will likely fall short of meeting

external financing needs by a wide margin, estimated at $352 billion. Capital flows from official sources, along with drawdowns of foreign reserves, will help fill the gap in some countries. But where countries cannot secure adequate external financing, the external adjustment process will be abrupt—more so than projected for the developing world as a whole, requiring an even greater decline in domestic demand and putting additional pressure on the exchange rate. A number of countries (Belarus, Georgia, Hungary, Iceland, Latvia, Pakistan, Romania, Serbia, and Ukraine) already have received financial support from official sources, primarily the International Monetary Fund (IMF), with additional support from the World Bank, regional development banks, and the European Union (EU) to help alleviate balance-of-payments difficulties. The recent agreement by the G-20 to augment the lending capacity of the IMF and multilateral development banks will help high-income emerging-market and middle-income countries meet their external financing needs. However, little of such financing can be made available to low-income countries that have limited borrowing capacity.

The ability of countries to meet their external financing needs will depend largely on the extent to which firms can roll over their maturing debt. Some 700 corporations based in developing countries issued international bonds during the boom years of 2002–07, and almost 3,000 borrowed in the international syndicated bank loan market. Those corporations account for the bulk of outstanding short-term external debt and around three-quarters of the medium- and long-term private debt coming due in 2009. Two decades ago, corporations accounted for only about 20 percent of maturing medium- and long-term private debt.

Building confidence and strengthening policy coordination are critical to recovery and long-term growth

Among government officials, policy makers, and key market observers, calls to restore confidence in the global financial system have become an international mantra. A quick Web search of major media, for example, shows that the number of occurrences of "restore confidence" in October 2008 was 624 percent higher than the average for the first six months of 2008.

Governments have, by and large, "walked their talk" through a furious combination of unilateral and multilateral actions, drawing on a broad range of conventional and unconventional monetary policy, fiscal stimulus, and government guarantee programs to shore up the banking industry. Such actions have achieved some easing of liquidity conditions in global interbank markets, have supported a narrowing of credit risk premiums, and have underpinned a tentative revival of equity markets. However, the policy agenda for stabilizing financial markets and for global economic recovery is broad and complex, and major challenges remain. Several overarching themes will remain salient for policy makers over the next few years:

The global nature of the financial crisis places a premium on policy coordination

The deep international economic linkages among countries that provide the channels for negative spillovers across borders also enhance the scope for beneficial policy coordination. Indeed, efforts to stimulate aggregate demand through expansionary monetary and fiscal policies, to recapitalize insolvent financial institutions, and to restore the functioning of credit markets through the provision of liquidity are more likely to be taken—and are more likely to be effective—if there is broad agreement among the major governments on policy direction.

Governments' willingness to coordinate their policies can help reestablish confidence by ruling out beggar-thy-neighbor responses to the crisis. The danger of special interests using trade policy to protect particular industries is especially severe in a downturn. As for financial policies, measures taken to recapitalize commercial banks with public funds have introduced pressures for banks to concentrate lending activity on the domestic market (the so-called home bias in lending practices), at the expense of cross-border lending. In the years leading up to the crisis, a defining feature of global finance in developed countries was the escalating integration of the household sector into capital markets. Excessive credit creation, made possible through the technology of asset securitization, yoked

consumer spending to the expansion and profitability of the banking industry, with both serving as engines of economic growth. As household ownership of equities and bonds increased, households' wealth and income became more closely linked to capital markets, forging closer linkages between the real economy and financial markets—and increasing the likelihood of political intervention when trouble appears. In the United States, for instance, almost half of households currently own equities or bonds, up from 39 percent in 1989.

While the case for *fiscal policy coordination* is weak in normal times—because countries normally face very different challenges and priorities—it is called for today, as all countries are facing the same prospect of inadequate global demand. Stimulating aggregate demand through fiscal expansion is in everyone's interest at the moment, but each country will be reluctant to undertake it on the necessary scale because some of the expansionary effects will spill over to other countries, and because any country that acts alone—even the United States—may reasonably fear that increases in government debt will cause investors to lose confidence in its fiscal sustainability and so withdraw financing. Both of these constraints will be lessened by a commitment to coordinate a fiscal expansion globally. A joint international commitment to maintaining open markets for goods and services must be a central feature of governments' policy responses.

A balance must be struck between national and international mechanisms for improved regulation and crisis prevention

In designing and implementing reforms to strengthen financial markets and regulatory regimes, the first line of responsibility lies with national regulators, but greater international financial cooperation among regulators is an unavoidable imperative. Although changes in national regulations have begun to improve transparency and thwart excessive risk taking, today's highly integrated financial markets necessitate close coordination among authorities in order to bolster market confidence and avoid regulatory arbitrage. The international spillovers of the crisis in the financial area presently provide a powerful incentive for harmonization, because concerns over stability temporarily outweigh the urge to seek advantages for the "home team." It should be remembered, however, that regulatory cooperation is often resisted in normal times by policy makers eager to protect or enhance the competitive advantage of financial firms based in their own country.

Analysis conducted for this report suggests that not only the incentive for coordination, but also the gains to be had from it, are largest when there is a large common shock to confidence. But coordination must be in addition to, rather than a substitute for, national action. Because national regulators have the best access to information on their domestic institutions, they must retain principal responsibility for ensuring the stability of their own financial systems—without angling for a competitive advantage for domestic firms.

Over the medium term, governments must reestablish fiscal sustainability

Recent measures by central banks in the Euro Zone, Japan, the United Kingdom, and the United States to purchase private and government debt as a way of unfreezing credit markets have led to a significant expansion of their balance sheets and rapid growth of the monetary base in these countries, a process that has replaced, to a large extent, the accumulation of foreign exchange reserves by other central banks as the main engine of global liquidity.

Rising public debt levels and the rampant expansion of central banks' balance sheets will pose considerable challenges to economic stability once the recovery gets under way. The major industrial countries began the crisis with moderate debt-to-GDP ratios. However, the unprecedented amounts spent to bail out financial firms have already substantially inflated those ratios, and governments have taken on contingent liabilities in connection with various financial guarantees, the potential effects of which on government debt are unknown. Discretionary fiscal stimulus, as well as the operation of automatic stabilizers, will further increase debt ratios, perhaps doubling them in some countries if the downturn turns out to be as severe as is now envisaged. Government commitments will have to be financed, if not through taxation, then through the issuance of debt obligations. As the fiscal implications of such commitments are factored in, interest-rate expectations will be adjusted upward, raising the cost of capital for all borrowers, including those in developing countries.

The damage to low-income countries from the crisis must be mitigated

With so much at stake, there is an urgent need for the international financial community to take a hard look at recent developments, assess the vulnerabilities and risks that are the unintended products of current policy interventions and market changes, and evaluate the likely effects of those interventions and changes on development finance. Most of the available resources to be provided by the IMF and other international financial institutions are likely to be devoted to high-income emerging markets and middle-income countries that are likely to be able to repay the loans they receive.

In this climate, low-income countries that are already under strain deserve special attention. They have had little or no access to private foreign capital even in good times. A combination of policy and market failures has restricted their participation to occasional project finance deals, largely in extractive industries, and to the short-term loan market, mostly bank loans for trade financing.

That sobering fact should reinforce the importance of broad international agreement to mobilize the necessary resources to achieve the MDGs. After several decades of debt rescheduling through the mechanisms of the Paris Club, the sequence of official debt relief programs initiated under the Heavily Indebted Poor Countries measures of 1996 and culminating in the launch of the Multilateral Debt Relief Initiative in 2005 stand out as a remarkable exercise of multilateralism and sound economic sense. With fewer resources now available in low-income countries to service external debt, it is especially important that the world should build on—and certainly not back out of—those agreements.

These are the themes and concerns of this year's edition of *Global Development Finance*.

1

Prospects for the Global Economy

THE FINANCIAL CRISIS THAT ERUPTED in September 2008—following more than a year of financial turmoil—has become a global crisis for the real economy. Economic activity in high-income and developing countries alike fell abruptly in the final quarter of 2008 and in the first quarter of 2009. Unemployment is on the rise, and poverty is set to increase in developing economies, bringing with it a substantial deterioration in conditions for the world's poor and most vulnerable.

The outbreak of the financial crisis provoked a broad liquidation of investments, substantial loss in wealth worldwide, a tightening of lending conditions, and a widespread increase in uncertainty. Higher borrowing costs and tighter credit conditions, coupled with the increase in uncertainty provoked a global flight to quality, caused firms to cut back on investment expenditures, and households to delay purchases of big-ticket items. This rapid increase in precautionary saving led to a sharp decline in global investment, production, trade, and gross domestic product (GDP) during the fourth quarter of 2008, a trend that continued in the first quarter of 2009. The sharpest declines in economic activity were concentrated among countries specialized in the production of durable and investment goods and in countries with serious pre-existing macroeconomic vulnerabilities.

This suddenly very weak international environment accelerated the fall in commodity prices that began in mid-2008. By end-May 2009, oil prices were down 60 percent from their peak and non-oil commodity prices, including internationally traded food commodities, were off 35 percent. Lower food and fuel prices have cushioned the poverty impact of reduced activity to a degree and helped to reduce the pressure on the current accounts of oil-importing developing countries, even as they reduced surpluses among developing oil-exporters by as much as 17 percent of GDP.

Policy reactions to the crisis have been swift and, although not always well coordinated, have so far succeeded in preventing a broader failure among financial institutions, and thereby avoided a much more severe collapse in production. In the absence of public-sector assistance, the massive losses suffered by investment banks and other institutions would have forced commercial banks to sharply reduce lending—forcing firms to cut back on investment and production even more forcefully. Instead, bank lending continued to grow until very recently, although much less rapidly than in the past. These policy measures have not been costless. Fiscal balances in 2009 are expected to deteriorate by about 3 percent of GDP in high-income countries, and by about 4.4 percent of GDP in developing countries. Longer term, increased high-income country indebtedness may raise borrowing costs, potentially crowding out developing-country private and public-sector borrowers.

The drop in economic activity, combined with much weaker capital flows to developing countries, is placing a large number of low- and middle-income countries under serious financial strain. Many countries are having difficulty generating sufficient foreign currency from exports or borrowing to cover import demand. Overall, borrowing needs for developing countries are expected to exceed net capital inflows by between \$350 billion and \$635 billion (see chapter 3). Many countries are meeting this financing gap by drawing down on the international currency reserves they built up during good times. However, the sustainability of this strategy is uncertain.

Since September 2008, 16 countries have consumed 20 percent or more of their foreign reserves, and the current stock of reserves covers less than 4 months of imports in 18 countries.

The challenges of widening current-account deficits and deteriorating fiscal positions are most acute in the Europe and Central Asia region, partly because the recession is expected to be deepest there, but also because many countries entered the crisis period with double-digit current-account deficits (as a share of GDP) and/or elevated government debt. If, as appears likely, financing is not fully forthcoming for these economies, heavy compression of domestic demand and exchange-rate depreciation will be required to restore internal and external balances.

Despite the rapid decline in GDP in high-income countries during the first quarter of 2009, a number of indicators point to the beginnings of an economic recovery. Stabilizing and even recovering stock markets, modest improvements in exports in some countries, a recovery in consumer demand and the still-to-come demand-boosting effects of discretionary fiscal stimulus measures are among the factors pointing to the beginning of recovery. High frequency indicators vary distinctly by country at the moment, however, with data for the United States and China more suggestive of economic revival than those for western Europe and other developing regions. Moreover, several factors point to continued weakness. Unemployment continues to rise throughout the world, housing prices in many countries are still falling (adding to negative wealth effects), bank balance sheets are fragile, and much more consolidation and recapitalization required. As a result, the timing and strength of the eventual recovery in the global economy remain highly uncertain. Indeed, many countries are facing growing pressure on their currencies and banking sectors. Already several high- and middle-income developing countries have entered into special borrowing agreements with the International Monetary Fund (IMF) to prevent deteriorating external and fiscal positions from getting out of hand.

The baseline scenario presented in this edition of *Global Development Finance* depicts a much more subdued recovery than during a normal recession, partly because this downturn follows a financial crisis—which tends to be deeper and longer-lasting than normal ones—and partly because today's downturn has affected virtually the entire world, precluding the more typical scenario where recovery from a more geographically isolated downturn is at least partly achieved by exporting to healthier and more rapidly growing countries. In this scenario, global GDP, after falling by a record 2.9 percent in 2009, recovers by a modest 2.0 percent in 2010 and by 3.2 percent in 2011 (table 1.1). Banking sector consolidation, continuing negative wealth effects, elevated unemployment rates, and risk aversion are expected to weigh on demand throughout the forecast period.

Among developing countries, growth rates are higher (given stronger underlying productivity and population growth) but remain similarly subdued at 1.2, 4.4, and 5.7 percent, respectively, over 2009 through 2011. Given the output losses already absorbed—and because GDP only reaches its potential growth rate by 2011—the output gap (or the difference between actual GDP and its potential), unemployment, and disinflationary pressures are projected to build over 2009 to 2011.

A more robust recovery is possible, fueled by the substantial fiscal, monetary, and sectoral initiatives that have been put into place. So too is a much weaker outcome. In the latter scenario, the drag of the financial sector on economic growth, which is a key feature of the baseline, is projected to be more intense, while even weaker confidence impedes recovery in discretionary investment and consumer spending—leading to still slower growth. Moreover, pressure on current accounts, exacerbated by a weaker recovery, could force a number of countries (notably, several in Europe and Central Asia) into a much less orderly process of adjustment, characterized by substantial currency depreciation and painful cuts in domestic demand.

Immediate impacts of the crisis

What began in the summer of 2007 as an extended period of financial turmoil caused by the losses in the U.S. subprime mortgage market, erupted into a full-blown and global financial crisis in mid-September 2008, precipitated by the failure of the investment bank, Lehman Brothers. The realization that such a key player in the international financial system could fail shook the confidence of bankers, investors, and households alike and reverberated rapidly throughout the global economy (figure 1.1).

Table 1.1 The global outlook in summary

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

	2007	2008	2009e	2010f	2011f
Global conditions					
World trade volume	7.5	3.7	−9.7	3.8	6.9
Consumer prices					
G-7 countries [a,b]	1.7	2.9	0.5	0.8	1.3
United States	2.6	3.8	0.3	1.2	2.0
Commodity prices (USD terms)					
Non-oil commodities	17.1	21.0	−30.2	−2.1	1.4
Oil price (US$ per barrel)[c]	71.1	97.0	55.5	63.0	65.9
Oil price (percent change)	10.6	36.4	−42.7	13.4	4.6
Manufactures unit export value[d]	5.5	7.5	1.9	1.0	0.0
Interest rates					
$, 6-month (percent)	5.2	3.2	1.5	1.7	2.0
€, 6-month (percent)	4.3	4.8	2.0	2.2	2.3
Real GDP growth[e]					
World	**3.8**	**1.9**	**−2.9**	**2.0**	**3.2**
Memo item: World (PPP weights)[f]	5.0	3.0	−1.7	2.8	4.0
High income	**2.6**	**0.7**	**−4.2**	**1.3**	**2.4**
OECD countries	2.5	0.6	−4.2	1.2	2.3
Euro Area	2.7	0.6	−4.5	0.5	1.9
Japan	2.3	−0.7	−6.8	1.0	2.0
United States	2.0	1.1	−3.0	1.8	2.5
Non-OECD countries	5.6	2.4	−4.8	2.2	4.6
Developing countries	**8.1**	**5.9**	**1.2**	**4.4**	**5.7**
East Asia and Pacific	11.4	8.0	5.0	6.6	7.8
China	13.0	9.0	6.5	7.5	8.5
Indonesia	6.3	6.1	3.5	5.0	6.0
Thailand	4.9	2.7	−3.2	2.2	3.1
Europe and Central Asia	6.9	4.0	−4.7	1.6	3.3
Russian Federation	8.1	5.6	−7.5	2.5	3.0
Turkey	4.7	1.1	−5.5	1.5	3.0
Poland	6.7	4.8	0.5	0.9	3.5
Latin America and the Caribbean	5.8	4.2	−2.2	2.0	3.3
Brazil	5.7	5.1	−1.1	2.5	4.1
Mexico	3.3	1.4	−5.8	1.7	3.0
Argentina	8.7	6.8	−1.5	1.9	2.1
Middle East and North Africa	5.4	6.0	3.1	3.8	4.6
Egypt, Arab Rep. of[g]	7.1	7.2	3.8	4.2	5.0
Iran, Islamic Rep. of[g]	6.2	6.9	2.5	3.0	4.0
Algeria	3.0	3.0	2.2	3.5	4.0
South Asia	8.4	6.1	4.6	7.0	7.8
India[g]	9.0	6.1	5.1	8.0	8.5
Pakistan[g]	6.4	5.8	1.0	2.5	4.5
Bangladesh[g]	6.4	6.2	5.0	4.5	5.0
Sub-Saharan Africa	6.2	4.8	1.0	3.7	5.2
South Africa	5.1	3.1	−1.5	2.6	4.1
Nigeria	6.3	5.3	2.9	3.6	5.6
Kenya	7.1	1.7	2.6	3.4	4.9
Memorandum items					
Developing countries					
Excluding transition countries	8.2	5.9	1.8	4.7	5.9
Excluding China and India	6.1	4.5	−1.6	2.5	3.9

Source: World Bank.

Note:

PPP = purchasing power parity; e = estimate; f = 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 USD.

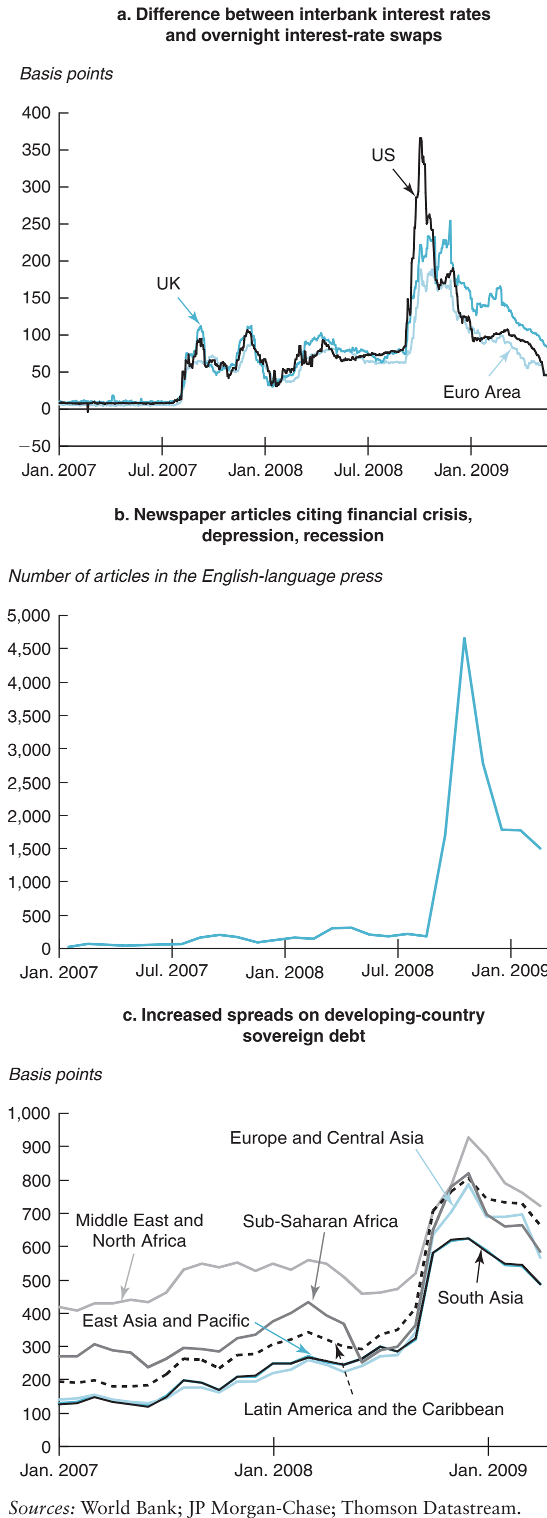
e. GDP in 2000 constant dollars; 2000 prices and market exchange rates.

f. GDP measured at 2000 PPP weights.

g. In keeping with national practice, data for the Arab Republic of Egypt, the Islamic Republic of Iran, India, Pakistan, and Bangladesh are reported on a fiscal year basis. Expressed on a calendar year basis, GDP growth in these countries is as in the table on the right.

GDP growth on a calendar year basis

	2008	2009e	2010f	2011f
Egypt, Arab Rep. of	6.7	5.1	4.2	4.6
Iran, Islamic Rep. of	6.9	2.5	3.0	4.0
India	7.3	5.9	8.1	8.5
Pakistan	6.1	3.3	1.8	3.5
Bangladesh	6.3	5.6	4.7	4.8



Sources: World Bank; JP Morgan-Chase; Thomson Datastream.

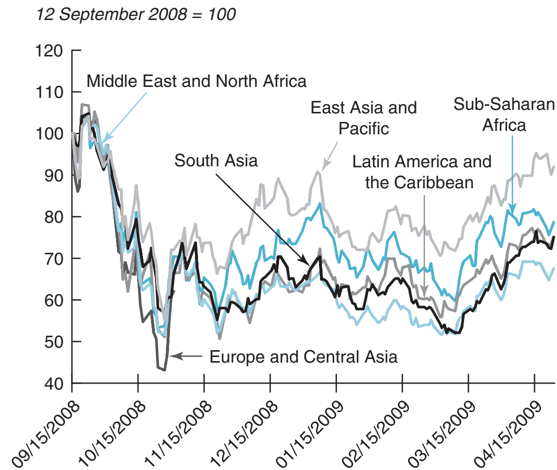
The initial loss of confidence in the financial system provoked a liquidity crunch in the interbank market (these events and their implications for financial flows to developing countries are discussed in further detail in chapter 2). Banks became extremely reluctant to lend to one another, and liquidity dried up rapidly, causing spreads between the interest rates banks charge each other (LIBOR, or the London Interbank Offer Rate for overnight funds) and what they expect to pay central banks (the overnight index swap rate) to jump to unprecedented levels (see figure 1.1, panel a). Uncertainty about the future and fears that the crisis could provoke a deep recession or even depression skyrocketed, evidenced, for example, by some 4,500 stories about the financial crisis and its potential negative effects appearing in major English-language print media in September 2008 (see figure 1.1, panel b).

The sudden drying up of liquidity and increased uncertainty also yielded a change in the pricing of risk throughout the global economy. Interest rate spreads on riskier assets, including the bonds of firms in developing- and high-income countries, and, to a lesser extent sovereign states, increased substantially (see figure 1.1, panel c). Increased risk aversion, a reassessment of growth prospects, and the need for firms and investors in high-income countries to strengthen their balance sheets resulted in a large-scale repatriation of capital from developing countries. As a consequence, stock markets the world over lost between 40 and 60 percent of their dollar values—the currencies of almost every country in the world depreciated against the U.S. dollar—implying a massive loss in global wealth (figure 1.2).

Successive interventions by authorities in both high-income Europe and North America (including substantial efforts by the Federal Reserve in the United States to intermediate directly between banks) have helped restore short-term liquidity.

As of end-May 2009, interbank spreads are down some 350 basis points since September 2008 in the case of the United States and by 200 basis points in the Euro Area. This, plus the fact that there have been no additional failures of major financial institutions or significant currency crises, has brought about a near-stabilization and even improvement in financial conditions over the period since March 2009. Spreads on developing-country bonds have narrowed (see figure 1.1, panel c), with the market now distinguishing better between the

Figure 1.2 Stock market wealth declined by 40 to 60 percent in dollar terms
Morgan Stanley Capital International Indexes



Sources: World Bank; Morgan Stanley; IFC/S&P.

risks posed by different countries. At the same time, stock market valuations are regaining ground in a number of countries.

Still, conditions continue to be tight and markets nervous. Interbank spreads remain above historical levels, and the IMF estimates that only a third of all financial sector losses have been booked at this stage (IMF 2009b). Similarly, developing-country spreads remain high, and, even though the base rates against which these spreads are calculated have declined in response to the post-crisis relaxation of monetary policy in high-income countries, yields and borrowing costs for developing-country firms have increased substantially—doubling in some cases—with potentially important effects on debt sustainability and the profitability of future investment (see below).

Global growth

The eruption of the financial crisis and the uncertainty that it provoked a crisis in the real economy. Individuals, suddenly uncertain about their job prospects and facing more expensive and difficult-to-obtain financing, delayed purchases that could be put off, typically consumer durables such as automobiles, refrigerators, and televisions. Similarly, firms delayed the implementation of investment projects, preferring to wait and see if such projects would remain profitable under future demand and financing conditions. This increase in precautionary saving (and the associated reduction in investment and consumer demand), together with increased borrowing costs and tighter lending standards, explains the unprecedentedly rapid fall in global demand for manufactured goods during the fourth quarter of 2008 and the first quarter of 2009. Moreover, while consumer demand has and will recover, saving rates are unlikely to return to earlier low levels, because households will continue to save to restore a proportion of the financial wealth destroyed during the crisis.

The cutback in fixed investment spending was widespread (table 1.2). It involved countries directly affected by the financial crisis, those with close links to affected commercial and investment banks, and those that suffered through the indirect channel of falling export demand. For some economies, notably those with large current-account deficits, these transmission channels were further amplified by a reversal in private capital flows, which forced a much sharper decline in domestic demand (see chapter 2).

Investment activity fell by an average of 4.4 percent (at a 16.5 percent annualized rate) in 27 of 30 high-income countries in the fourth quarter of 2008. The slowdown was not limited to the high-income countries where the financial crisis originated. In the 25 developing economies that report

Table 1.2 Investment demand fell sharply worldwide

	United States	Japan	Germany	Korea, Rep. of	Brazil	Russian Federation	Malaysia	Mexico	Lithuania
	(Growth in real investment, seasonally adjusted annual rates, percent)								
2007	−3.1	0.7	4.5	4.2	13.7	21.1	9.6	5.0	20.8
2008Q3	−5.3	−9.7	0.8	0.2	38.0	−13.9	1.7	1.9	−9.5
2008Q4	−22.0	−14.6	−10.2	−23.6	−33.9	−23.4	−34.5	−13.2	−45.2
2009Q1	−37.3	−27.5	−28.6	0.7	—	−30.4	−13.7	—	−65.8

Sources: World Bank; national statistical agencies.
Note: — = Not available.

quarterly national accounts data, investment growth in the final quarter of 2008 fell by an average of 6.9 percent, or at an annualized pace of 25 percent. Investment demand continued to decline precipitously in the first quarter of 2009. Investment fell at a 37 percent annualized pace in the United States, and by close to a 30 percent annualized rate in Japan, Germany, and Russia (table 1.2).

Consumer savings increased sharply as households cut back or delayed large expenditures. In the United States, the personal saving rate increased from 0.6 percent in 2007 to more than 5.7 percent in April 2009. Demand for consumer durables fell at a 22 percent annualized rate in the fourth quarter of 2008 in the United States, and by 20 percent in high-income Europe. Worldwide demand for autos plummeted by 30 percent in the quarter, sending firms in the United States, Europe, and Japan to national governments for emergency financial support. Data for the first quarter of 2009 suggest that consumer demand for durable goods may be stabilizing or even advancing—partly in response to government-sponsored incentives in several countries. In the United States, consumer spending increased at a 1.6 percent annual pace in the first quarter, led by a 9.6 percent annualized gain in durable goods (figure 1.3).

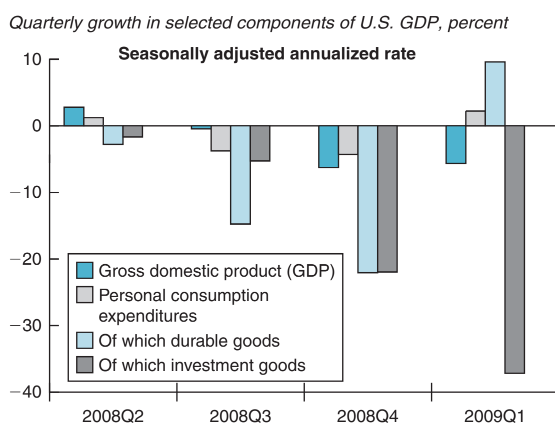
The falloff in consumption growth was less pronounced in other countries, save Japan, in part because savings rates in most economies were not as depressed as they had become in the United States. Nevertheless, increasing unemployment and the growing recession has pushed consumer confidence to all-time lows, which, in addition to the negative wealth effects from falling equity and housing prices, is weighing on—and will continue to weigh on—consumer demand for some time (the value of household assets in the United States declined by 14.7 percent, or $11.3 trillion, between the fourth quarter of 2007 and the fourth quarter of 2008). For developing-country commodity exporters, the decline in incomes resulting from lower commodity prices is exercising a similar effect, although lower food and energy prices will tend to boost the purchasing power of consumers in commodity-importing countries (see below).

Weak investment and consumer durable demand cut into global industrial production . . .

The pullback in demand for consumer durables and investment was reflected in a steep 13 percent fall in global industrial production between September 2008 and March 2009. Virtually every country that reports production data witnessed a sharp fall in output, and a wide range of countries are reporting capacity utilization rates below 70 percent (figure 1.4).

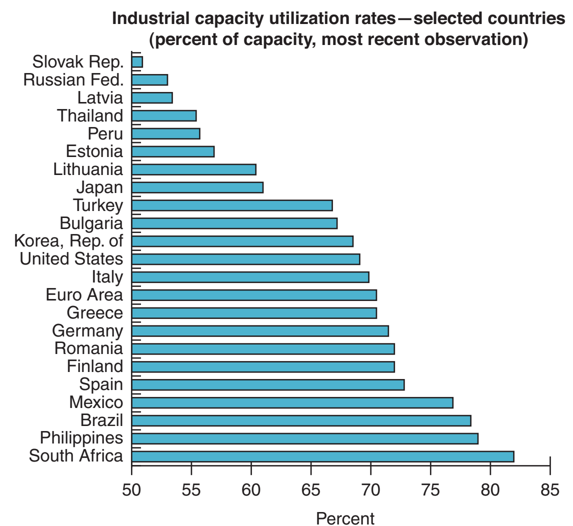
Figure 1.3 Increased uncertainty caused households and firms to delay purchases of durable and investment goods

Quarterly growth in selected components of U.S. GDP, percent



Source: United States Bureau of Economic Analysis.

Figure 1.4 Capacity is being underutilized throughout the world

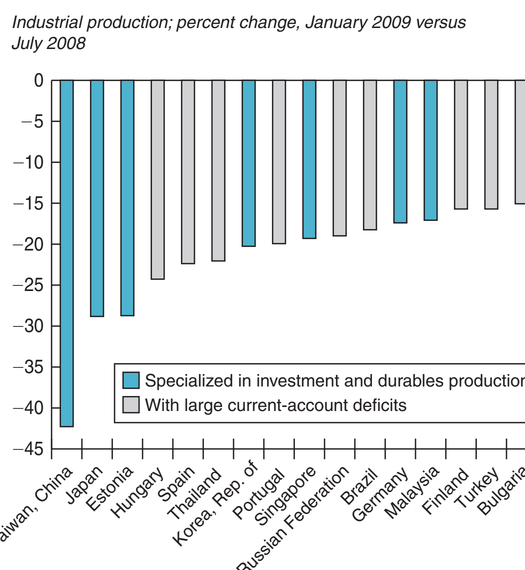


Source: Thomson Datastream.

Two groups of economies have been hardest hit: those specialized in investment, high-tech goods, and consumer durable goods; and those with large current-account deficits.[1] At the country level this is reflected in sharp declines in industrial activity in countries, like Japan and Germany, that specialize in the production of investment goods. Economies in Europe and Central Asia were also hit hard, both because their industrial sectors tend to be closely tied to high-income Europe and because the drying up of international capital flows (see chapter 2) has forced many into an even sharper domestic downturn (figure 1.5).

Figure 1.5 Reflecting increased precautionary saving, industrial production declined sharply

Industrial production; percent change, January 2009 versus July 2008



Sources: World Bank; national agencies.

. . . contributing to steep declines in global exports

Because consumer durables and investment goods tend to be heavily traded, the sharp uptick in firm and household saving in the fourth quarter translated into an equally steep and rapid fall in global trade (table 1.3). The world dollar value of goods trade declined some 30 percent between September 2008 and March 2009. Much of the decline reflected weaker trade in manufactured goods, the dollar value of which dropped 33 percent over the same period. The volume of exports of manufactured goods from member countries of the Organization for Economic Co-operation and Development (OECD), as a group, were down 10.8 percent in December 2008 from a year earlier.[2] Across OECD countries, the value of machinery and transport equipment exports fell 12.5 percent in December (year-on-year), representing a quarter of the total decline in goods exports.

This very strong contractionary force was amplified to an uncertain degree by a shortfall in trade finance. These short-term credits, which have a typical tenor of 120–180 days, are used to facilitate

Table 1.3 Export volumes and production plummet into early 2009

	Export volume growth (percent) 2008 (Whole year)	Export volume growth (percent) 2009 (Y/y latest)	Industrial production growth (percent) 2008 (Whole year)	Industrial production growth (percent) 2009 (Y/y latest)
World	**4.5**	**−24.1**	**0.5**	**−12.8**
High-income	**1.7**	**−24.3**	**−1.9**	**−17.6**
United States	6.0	−16.2	−2.2	−12.5
Japan	−1.6	−36.0	−3.2	−34.0
Germany	1.1	−22.6	0.0	−21.7
All developing	**5.0**	**−22.5**	**6.2**	**−2.5**
East Asia and Pacific	**4.8**	**−25.0**	**11.2**	**4.6**
China	14.6	−22.7	13.0	7.4
Europe and Central Asia	**1.7**	**−32.0**	**0.7**	**−14.0**
Russian Federation	0.0	−38.0	2.3	−16.8
Latin America and the Caribbean	**−7.0**	**−11.0**	**1.0**	**−10.2**
Brazil	−2.1	−29.0	2.9	−13.3
Middle East and North Africa	**6.5**	**−3.5**	**3.6**	**−0.5**
South Asia	**10.4**	**−23.7**	**4.1**	**−4.4**
Sub-Saharan Africa	**7.1**	**−5.0**	**1.0**	**−4.5**

Source: World Bank.

Box 1.1 Recent initiatives to bolster trade finance

The World Bank has contributed $1 billion as a partner in the Global Trade Liquidity Program, a coordinated global initiative involving governments, development finance institutions, and private sector banks expected to support up to $50 billion of trade in developing markets over three years. The Bank's private sector arm, the International Finance Corporation (IFC), is acting as an agent on behalf of the program partners and plays a central role in mobilizing funds for trade finance.

The Bank is also supporting trade in emerging markets through the IFC's Global Trade Finance Program, which assists smaller banks and entrepreneurs to arrange for letters of credit and other forms of trade finance. The resources of the program have been tripled from $1 billion to $3 billion.

The Bank is also helping countries improve their competitiveness and reduce trading costs through its Trade Facilitation Facility, a new $40 million multi-donor trust fund focused on measures to improve infrastructure, transport, logistics, and customs procedures.

Lending for trade-related infrastructure, regional integration, export development, and competitiveness and trade facilitation programs is also to be more than doubled to $3.6 billion in fiscal year 2009, up from $1.4 billion in FY2008 (July 2007–June 2008).

deals between distant partners with limited knowledge or business experience of one another. Although they cover only between 10 and 20 percent of all trade (most trade is conducted on an "open-account" basis between regular business partners), short-term credits tend to be most important for small and medium-sized exporters. Indeed, the share of such transactions in regional trade represents an estimated 40 percent in the East Asia and Pacific region in part because of the prevalence of such small traders. Recent research (Humphrey 2009) suggests that for a sample of 30 African firms, a lack of bank financing has not constrained exports, although anecdotal evidence from the same research suggests that firms in Latin America, the Caribbean, and Africa seeking to establish trade links have been more directly affected through this channel. As part of its efforts to temper the impacts of the crisis on developing countries the World Bank has put in place a number of initiatives to bolster trade finance (see box 1.1).

Overall, high-income and developing economies are in the midst of a steep and synchronized recession. However, there are early signs that the rate of decline in output is slowing. Consumer confidence is improving in both high-income Europe and the United States, as are forward-looking indicators of business confidence. Similarly, the most recent monthly data suggest that the sharp slide in export growth in the Group of Seven (G-7) countries may be easing. The value of goods exports in January and February fell by 3.4 and 2.4 percent, respectively, contrasted with 8.5 percent in each of November and December 2008; U.S. consumer demand rose in the first quarter of 2009; and data suggest that the slide in the U.S. housing market may have found bottom. Moreover, in both high-income Europe and North America a large part of demand is being met through inventory reductions rather than production—a process that cannot continue indefinitely and that if ended could add as much as two percentage points to GDP growth.

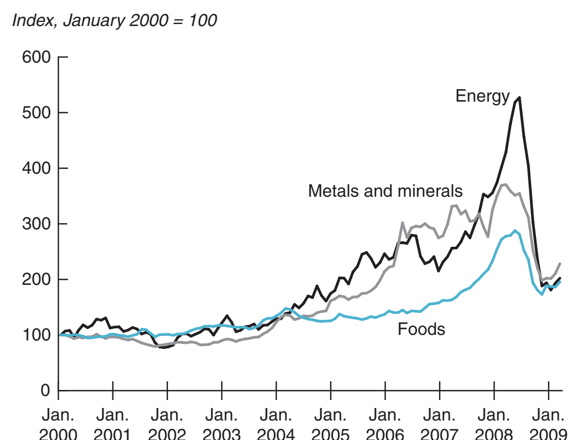
However, these signs of recovery are tentative, and should there be another round of bad news, confidence and uncertainty could be aggravated, delaying the recovery (see below). For example, business surveys suggest that investment growth will turn around in the second and third quarters of 2009. But, during 2008Q4 and 2009Q1, investment demand fell by almost 11 percent (38 percent at an annualized rate) in the United States.

Commodity markets

The slowing of global growth, which preceded the financial crisis by several months, prompted commodity prices to start falling in mid-2008 (figure 1.6). The eruption of the full-blown crisis and the rapid drop-off in economic activity since September of that year accelerated this process markedly. Demand for most commodities (notably, in high-income industries and in China) slowed or declined, particularly for oil and metals. By December 2008, crude oil prices

Figure 1.6 The sharp fall in commodity prices has now stabilized

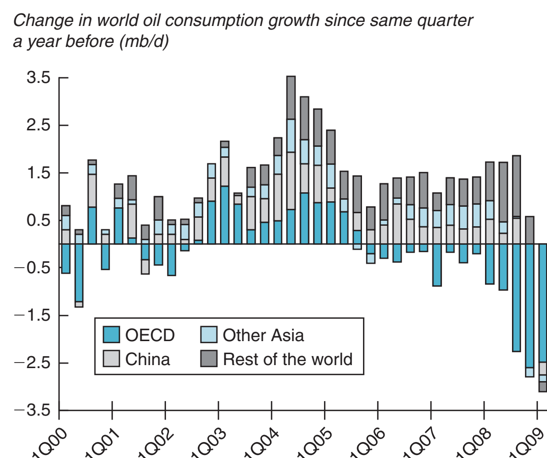
Index, January 2000 = 100



Source: World Bank.

Figure 1.7 Oil demand has fallen sharply along with global growth

Change in world oil consumption growth since same quarter a year before (mb/d)



Source: International Energy Agency.

had dropped to $41 a barrel, down more than 70 percent from the July peaks, while non-energy prices, including food, had declined by nearly 40 percent. Since December, prices have firmed, with crude oil prices up to $58 on average in May 2009, and prices for internationally traded foods and metals up 6 and 7 percent, respectively.[3]

The sharp decline in crude oil prices, from more than $140 a barrel in July 2008, reflected weaker global demand and the relaxation of some refining capacity constraints[4] that had contributed to high prices in the first half of the year.[5] World crude oil demand fell 3.6 percent between the first quarter of 2008 and the first quarter of 2009, with demand in OECD countries off 5.1 percent (figure 1.7). The fall in demand reflected both the declines in industrial activity and the effects of high oil prices during the first half of 2008. Although non-OECD demand continued to grow during the first three quarters of 2008 (led by strong gains in the Middle East), it too turned negative in the first quarter of 2009 as Middle Eastern demand growth slowed substantially and Chinese demand declined.

For 2009 as a whole, world oil demand is projected to fall by 2.6 million barrels a day (mb/d), with continuing large falloffs in high-income countries and slight declines across most developing regions. Production by members of the Organization of the Petroleum Exporting Countries (OPEC) is being curtailed sharply, while non-OPEC oil deliveries are expected to fall by 0.3 mb/d this year. This, coupled with expectations of a slow recovery in global growth, has contributed to the recent recovery in oil prices. Prices are expected to continue rising at a moderate pace over the medium term, with the weak pace of global GDP and ample spare capacity precluding a rapid rise in oil prices. How successful OPEC is in cutting supply will affect outturns in the short term. Should OPEC members reduce oil production by enough, prices could fall below the projected average of $55.5 a barrel for 2009.[6]

The financial crisis and the steep falloff in economic activity have disrupted the development of long-term supply in the hydrocarbon sector. A number of smaller producers have been forced to scale back operations due to financial constraints and several high-cost investment projects in the sector have been cancelled or deferred, notably oil sands projects in Canada. However, planned investment among the major companies has remained relatively high and their major projects, e.g., deepwater offshore, are expected to be completed. Moreover, the weaker investment demand has relaxed some of the acute constraints in the supply of investment inputs (oil rigs, materials, specialized equipment, and skilled labor), and, as a result, exploration and exploitation costs have declined. Most of the obstacles to future supply are "above-the-ground" constraints (as opposed to a shortage of oil in the ground)—such as access to reserves

(three-fourths of the world's reserves are controlled by national oil companies), political problems, and the reluctance of national oil companies to engage international companies to facilitate the extraction and discovery of reserves. Nevertheless, all major oil-exporting countries are investing in new capacity, and Saudi Arabia has repeated its intention to maintain surplus capacity.

Medium-term prospects are difficult to judge, and while the consensus in the industry is for a further spike in oil prices, this appears unlikely. High prices have stimulated development of alternative technologies, and pushed governments and consumers to use energy more efficiently. Consumers' shift away from fuel-inefficient cars, the mainstreaming of hybrid automobile technologies, the recent passage of laws tightening U.S. energy efficiency standards, increasing environmental pressures—coupled with the modest pace of the expected recovery—all argue against OPEC's more than 6 mb/d in spare capacity being reabsorbed very quickly.

Demand for metals weakens; prices expected to remain soft

Most metals prices peaked in March 2008 (nickel and zinc prices peaked much earlier), but the collapse of economic growth and with it demand for many metals (table 1.4) caused prices to drop much further into 2009 before rebounding somewhat in recent months on strong import growth into China, mainly due to re-stocking.

Metals prices are expected to be relatively stable over the remainder of 2009, with most of the 41 percent decline projected between 2008 and 2009 having already occurred. As a result, spending on new extraction projects has been slashed, and output is declining because lower prices have rendered many difficult-to-exploit mines uncompetitive. The downturn has led to a buildup of spare capacity, which can be brought back into production relatively easily, and should keep prices from rising by much when demand recovers. However, because prices have been just covering exploitation costs, no further major declines in metals prices are expected, with the possible exception of copper, where prices remain above the marginal cost of production. Over the forecast period, metal prices are expected to remain broadly stable—rising in line with inflation in 2010 as demand recovers.

Prices of agricultural commodities fall to pre-crisis levels

Improved supplies resulting from favorable harvests have boosted global stocks of most agricultural commodities. This, along with weaker demand for internationally traded food commodities, has allowed prices to fall back to their December 2007 levels—with the largest declines among agricultural products whose prices had increased the most. In particular, lower crude oil prices coupled with pressure in many European countries to reconsider biodiesel mandates, has reduced the attractiveness of using edible oils for biodiesel production and contributed to a substantial decline in their prices. Overall, concerns about the adequacy of global food supplies have subsided, and many of the export bans and high export taxes that were put in place during the food price spike of 2008 have either been eliminated or substantially reduced.

Most of the price swings in agricultural raw materials reflect changes in rubber prices, which track the price of crude oil. Increased production and wider use of genetically modified cotton in

Table 1.4 Metal demand plummeted with industrial production

	2002–06	2007	1H08	2H08	1Q09
	(Annualized percent increase)				
World					
Oil	2.0	1.2	0.9	−1.5	−3.7
Aluminum	7.5	10.4	5.6	−6.0	−20.3
Copper	3.0	6.6	1.4	2.3	—
China					
Oil	9.1	4.6	5.0	3.6	−3.5
Aluminum	19.9	42.8	15.9	−4.7	−10.4
Copper	9.6	34.6	5.3	12.8	—

Sources: CRU International Limited; International Energy Agency; World Bureau of Metal Statistics.
Note: — = Not available.

Table 1.5 Most developing-country currencies depreciated sharply against the majors

	2008-Q3		September 2008 to date	
	USD/LCU	REER	USD/LCU	REER
	(Percentage change, year-on-year)			
United States	.....	−6.5	.....	16.1
Euro Area	8.3	5.6	−5.7	−2.0
Japan	10.5	3.4	10.8	16.8
Brazil	16.6	20.8	−30.4	−15.9
Russian Federation	7.8	7.5	−34.4	9.0
India	−5.3	−8.1	−14.8	−5.5
China	9.7	6.6	0.4	6.6
Memo items:				
World	**6.2**	**−1.8**	**−9.7**	**−1.1**
High-income countries	**6.3**	**−1.4**	**−7.8**	**−0.6**
All developing countries	**6.1**	**−2.4**	**−15.3**	**−2.8**
East Asia and Pacific	5.1	4.9	−4.5	−1.2
Europe and Central Asia	12.3	3.7	−32.1	3.0
Latin America and the Caribbean	7.1	5.8	−20.4	−17.0
Middle East and North Africa	4.5	−1.9	−6.8	7.2
South Asia	−6.1	−21.3	−11.9	1.2
Sub-Saharan Africa	0.0	.....	−16.4	0.8

Source: World Bank and International Monetary Fund.
Note: USD/LCU: Exchange rate expressed as dollars per local unit (an increase implies appreciation of the local currency); REER: real effective exchange rate (an increase implies an appreciation of the local currency in real terms versus all countries).

China and India meant that the price of cotton did not increase during the boom, and in the past months the price has declined due to weak import demand from China, the world's largest cotton user (and textile manufacturer). Prices of beverages declined 30 percent between their peak in June and December 2008, as both coffee and cocoa supplies appear to be ample.

Looking forward, agricultural markets are likely to remain well supplied, and stocks are beginning to return to normal levels, although weather-related production problems (especially in South America) could always intervene. Easier market conditions are likely to prevail for several years. As a result, agricultural prices are anticipated to average 21 percent lower in 2009 than in 2008, and prices in 2010 are expected to remain broadly stable.

Exchange rates and inflation

The intensification of the financial crisis in September 2008 inspired a significant reversal in capital flows, away from developing countries and toward high-income countries, notably the United States. The need to repatriate liquid assets to cover losses elsewhere and an increase in home bias on the part of global investors, caused the currencies of almost all developing economies to depreciate against the U.S. dollar (table 1.5). The collapse in commodity prices also played a role in exchange-rate depreciation for developing commodity exporters, such as Argentina, Brazil, and the Russian Federation, and also for high-income commodity exporters such as Australia and Canada. In the immediate aftermath of the crisis, only a few currencies appreciated or held their ground against the dollar, among them the Chinese renminbi and the currencies of several oil exporters that are pegged to the dollar. Many developing currencies depreciated by 20 percent or more, but the extent of depreciation was much less severe in real effective terms—because most currencies depreciated against the dollar simultaneously.[7]

The depreciation of developing countries' currencies has meant that the local currency price of many commodities fell much less sharply than the dollar price of these commodities. For example, the Brazilian price of internationally traded wheat and oil fell by 12 and 25 percent, respectively, between July 2008 and February 2009, contrasted

with a drop of 25 percent and 65 percent in dollar terms. In addition, the depreciations have increased the local currency cost of servicing dollar-denominated debt. While depreciation will improve the competitiveness of affected countries, the extent to which this can be translated into increased exports will be diminished by the depressed state of world demand.

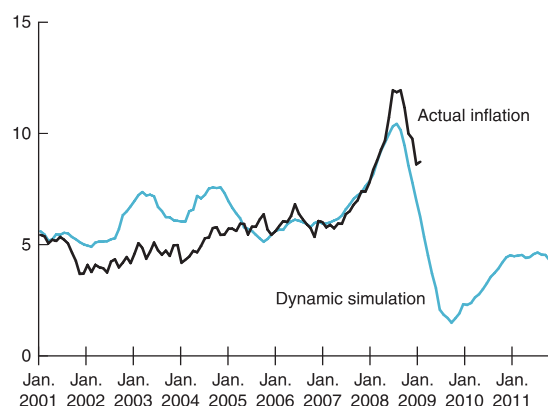
Commodity prices and headline inflation

Consumer price inflation in the G-7 countries is projected to decline from 2.9 percent in 2008 to 0.5 percent in 2009 due to lower commodity prices, weak demand, and rising unemployment. Global consumer price inflation is projected to decline, but deflation is not expected to be an enduring problem because of the additional liquidity that has been placed into financial markets, and because stabilizing commodity prices will no longer be exercising a strong negative influence on the overall price level.

Among developing countries for which separate food price data are available, econometric evidence suggests that median inflation, after increasing from about 6 percent in 2007 to a peak of more than 16 percent by mid-2008, could decline to less than 2 percent by the end of 2009 (figure 1.8). Headline inflation is projected to pick up in 2011 to near 5 percent, as underlying core inflation once again becomes the dominant influence on overall rates of price changes. This general pattern is likely to be observed in all developing countries but should be most striking in those countries (notably in Sub-Saharan Africa) where food represents a large share of total consumption expenditure. Even if headline inflation temporarily falls below zero in several developing countries, the risk of widespread deflation remains limited.

Figure 1.8 Falling food and energy prices to bring inflation under control

Percent change in developing-country consumer prices, historical and dynamic simulation



Source: World Bank.

The fall in internationally traded food prices and the anticipated decline in domestic inflation should alleviate some of the more acute increases in poverty incurred during the first half of 2008. Updated estimates suggest that the increase in local food prices between January 2005 and their average level of 2008 may have increased extreme poverty by between 186 and 226 million people.[8] The decline in international prices since that time has contributed to a reduction in domestic food prices—but with a lag. Projections of local prices for the remainder of 2009 suggest that for the year as a whole, the number of people drawn into extreme poverty because of higher food prices could decrease to between 96 and 109 million (table 1.6).

Table 1.6 Increase in the number of poor due to changes in food prices since December 2005

(millions)

	Given food prices in 2008		Given expected food prices in 2009	
Region	Lower bound estimate	Upper bound estimate	Lower bound estimate	Upper bound estimate
East Asia and Pacific	112	133	66	78
Europe and Central Asia	8	9	2	3
Latin America and the Caribbean	1	2	0	0
Middle East and North Africa	26	37	8	11
South Asia	14	20	−2	−5
Sub-Saharan Africa	24	26	21	22
Developing world	186	226	96	109

Source: World Bank, Global Income Distribution Dynamics Model.
Note: Lower bound estimate assumes low-income farm laborers work for low-income farm owners. Upper bound estimate assumes low-income farm laborers work for rich farm owners (see World Bank 2009). Poverty line is 1.25 international 2005 dollars per day.

Policy reactions

Governments and central banks have responded to the crisis in a generally decisive and helpful—if not always well-coordinated or orchestrated—manner (chapter 3 provides a comprehensive review of the policy response to the financial crisis). High-income countries, where the bulk of the banking sector adjustment must take place, have expanded the scope of deposit insurance schemes to cover larger deposits and new institutions, recapitalized some banks, taken equity positions in others, extended the range of securities accepted as collateral in central bank lending, and provided unprecedented amounts of funding to banking systems in general. By reducing the uncertainty of holding funds in high-income countries, many of these moves have had the unintended side effect of increasing the relative risk of holding funds in developing countries. As such, they may have contributed to the capital outflows from developing economies and the increase in their risk premiums that has been observed.

Governments have also offered guarantees to specific markets (for example, the United States has offered guarantees on securities backed by auto loans, credit card loans, student loans, and certain small business loans). Notwithstanding these efforts and private sector recapitalizations, much more restructuring is required. The IMF (IMF 2009b) estimates that total write-downs related to the crisis in the banking sector will probably total $4.1 trillion. Of that, it estimates that U.S. banks will require further capital injections of $525 billion and that European banks may require as much as $1.27 trillion.

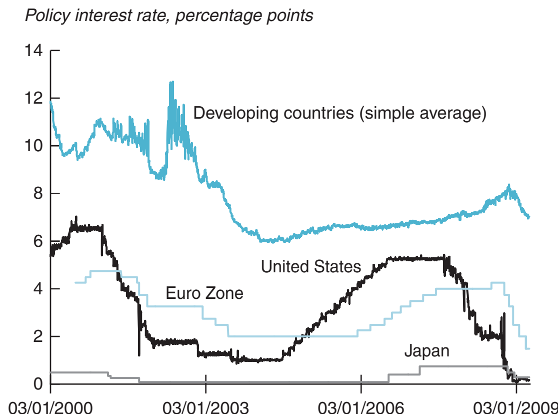
Countries have also responded by easing monetary conditions. Policy interest rates have been reduced sharply throughout the world and especially in the United States. Among high-income countries, rates have fallen by an average of 180 basis points since mid-September 2008 (table 1.7). Continued weak financial conditions also led major central banks to adopt unconventional expansionary measures, including purchases by the U.S. Federal Reserve and the Bank of England of long-term government securities, interventions by the Fed in the mortgage and commercial paper markets, and purchases of corporate bonds and commercial

Table 1.7 Policy interest rates have dropped across most of the world

	Dec-07	Sep-08	Dec-08	Latest	Change since September 15, 2008
Nominal policy rates					
United States	4.52	1.94	0.52	0.15	−1.79
Euro Area	4.00	4.30	2.70	1.14	−3.16
Japan	0.80	0.80	0.40	0.30	−0.50
Developing countries	8.20	8.75	9.10	8.00	−0.75
East Asia and Pacific	7.40	7.30	5.50	5.30	−2.00
Europe and Central Asia	6.00	6.30	6.50	6.40	0.10
Latin America and the Caribbean	8.20	9.15	9.20	6.87	−2.28
Middle East and North Africa	9.00	11.20	11.50	11.50	0.30
South Asia	8.55	9.15	9.70	9.45	0.30
Sub-Saharan Africa	10.50	10.50	10.00	10.00	−0.50
Real policy rates					
United States	0.42	−3.00	0.43	0.90	3.90
Euro Area	0.90	0.40	1.30	0.67	0.27
Japan	0.10	−1.30	0.00	0.60	1.90
Developing countries	2.25	−0.75	1.64	1.64	2.39
East Asia and Pacific	1.10	−4.50	−2.20	3.37	7.90
Europe and Central Asia	−2.40	−4.80	−0.50	1.65	6.40
Latin America and the Caribbean	0.10	−1.00	1.50	1.67	2.66
Middle East and North Africa	2.10	−2.50	2.50	3.50	6.00
South Asia	−0.25	−3.95	−4.70	1.60	5.55
Sub-Saharan Africa	4.60	−3.00	−2.45	−2.45	0.55

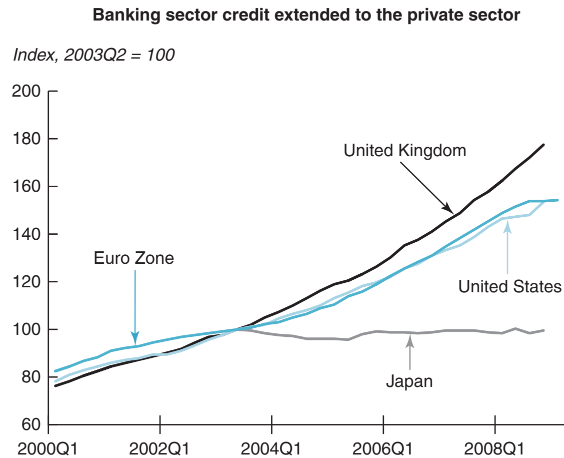
Sources: World Bank; Thomson Datastream.
Note: Policy rates for developing regions are medians; real interest rates are calculated as nominal rate less current-period CPI inflation (y/y), using median inflation rates for developing countries.

Figure 1.9 Policy interest rates in both high-income and developing countries have been sharply reduced



Sources: World Bank; Thomson Datastream.

Figure 1.10 The contraction in bank lending has been limited



Source: National authorities.

paper by the Bank of Japan. As a result of these steps, the balance sheets of central banks have expanded at an unprecedented rate. The U.S. monetary base increased from $900 billion in September 2008 to $1.5 trillion by February 2009.

Developing countries have also reversed the overall stance of monetary policy, with policy interest rates having been cut in three-quarters of the countries for which data are available (figure 1.9). As a result, the median policy rate for developing countries has declined from 8.1 percent in December 2008 to 6.6 percent at the end of May 2009. Despite relatively modest declines in nominal policy interest rates in developing countries, real interest rates in these countries have declined to around 1.6 percent on average, because high commodity prices drove up inflation in 2008 and the decline in commodity prices has yet to pass through fully to local prices (see above).

So far, efforts to support banks have prevented a sharp decline in lending, although the pace at which lending has increased has slowed (figure 1.10). The money pumped into the banking sector has been intended directly or indirectly to shore up capital and to prevent banks from being forced to cut sharply into their lending. Based on the most recently available data, total bank credit to the private sector continued to grow in all of the major economies during the fourth quarter of 2008. Indeed, the stock of outstanding corporate loans increased at double-digit rates in both the United States and the United Kingdom during the period, possibly suggesting that the "credit crunch" was not the key reason for the sharp falloff in investment. In contrast, corporate lending in Europe was stagnant,[9] and the latest data suggest that credit in Europe stopped expanding in the first quarter of 2009. Whether this slowdown reflects weaker demand for loans or constrained supply is not clear.

But data on bank lending do not capture the precipitous decline in securitization and other financial innovations that underpinned the rapid rise in liquidity during 2003–07. By one measure, in the months before the crisis, loans held as securitized assets in the "shadow banking system" (banks' off-balance-sheet structured investment vehicles) were more than half again as large as those held on balance sheet and included in the data in figure 1.10 (Helleiner 2009). More than 20 percent of U.S. private credit market debt was securitized by the end of 2008 (Federal Reserve 2009).

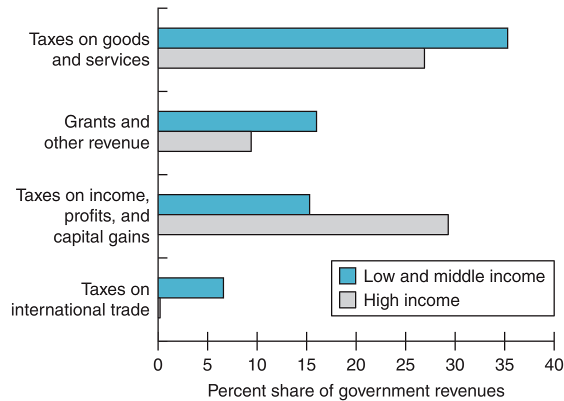
Fiscal responses

High-income countries and a number of middle-income economies have responded to the crisis by approving proactive countercyclical spending, and by letting automatic stabilizers, such as unemployment insurance and welfare systems, operate.

Government deficits in high-income countries are expected to increase by around 3 percent of GDP on average during 2009. The increase reflects a number of factors: reduced tax revenues (taxes

Figure 1.11 Much weaker industrial production and exports will cut deeply into government revenues in developing countries

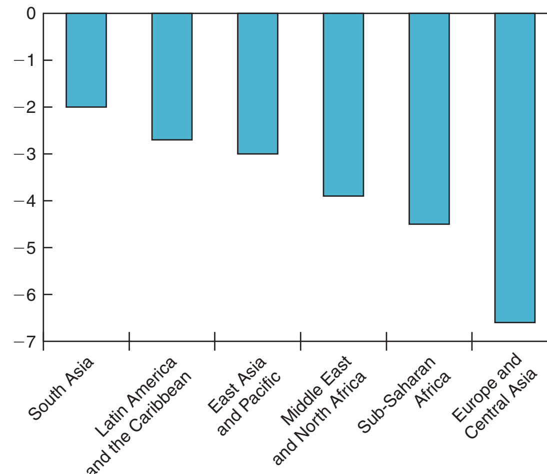
Key sources of central government revenues among developing countries



Source: World Bank.

Figure 1.12 Government balances are expected to deteriorate most sharply in Europe and Central Asia

Projected change in fiscal balance between 2008 and 2009, percentage points of GDP



Source: World Bank.

on business profits tend to be particularly volatile); upfront contributions to support financial systems (including capital injections, purchases of assets and lending by the treasury, and backing by the treasury for central bank support);[10] automatic stabilizers (rising expenditures for unemployment insurance and welfare systems); and proactive stimulus packages.

Overall, the discretionary component of the easing is expected to amount to only 1.6 percent of high-income GDP, with automatic stabilizers accounting for the remainder (IMF 2009b). The largest discretionary stimulus packages announced so far are in Spain (2.3 percent of GDP), the United States (2.3 percent), Australia (2.1 percent), and the United Kingdom (2 percent). Smaller measures have been announced among major European countries (0.7 percent of GDP for France, 1.5 percent for Germany, and 0.2 percent for Italy). However automatic stabilizers tend to be more pervasive and reactive in Europe. Such expenditures are projected to increase by 2 percent of GDP in the United Kingdom and France, contrasted with 1.5 percent of GDP in the United States. While the widening of fiscal deficits, coupled with the financial measures described above, will likely help to reduce the depth and prospective length of the global recession, the additional debt and increase in long-term spending obligations they entail will also present challenges to economic management once recovery takes hold (box 1.2).

The fiscal positions of developing countries are also expected to deteriorate, perhaps by more than those of high-income countries. Lower levels of industrial activity will reduce indirect taxes on domestic goods and services (which account for some 33 percent of developing-country tax receipts) and on trade (8 percent of receipts) (figure 1.11). Resource-related revenues of many commodity exporters are also falling with the decline in commodity prices. And higher bond spreads imply higher borrowing costs on new debt issuance (especially problematic for countries with a high proportion of debt in short-term instruments). A further potential public-sector liability may arise if high interest rates force private (or public) companies, the bulk of whose debt tends to be concentrated in short-term instruments, to come to the government for assistance (as already has happened in a number of countries).

The largest increases in fiscal deficits are expected to arise in developing Europe and Central Asia, where contraction in trade and production is particularly severe, social safety nets have broad coverage, and the private sector has a large debt burden denominated in foreign currency (figure 1.12). The next largest increase is anticipated

Box 1.2 Managing the recovery: Coping with the future impact of recent policies

The expansionary policies and financial sector interventions undertaken by governments and central banks over the past months should reduce the depth and length of the recession. They also, however, will pose a challenge to economic management once the global economy begins to recover.

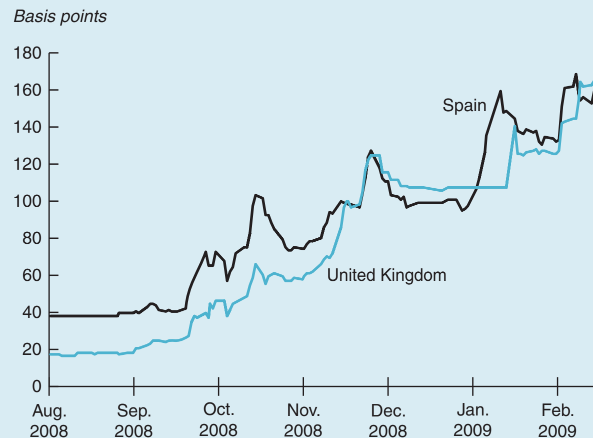
First, governments in high-income countries, including Belgium, France, Ireland, the Netherlands, the United Kingdom, and the United States, have increased their stakes in the financial system to an extent not seen since the Great Depression. They have become involved in compensation, dividend, and risk management decisions that governments may not be well placed to make. An eventual return to private sector control of the banking system is critical to reestablishing an efficient financial sector.

Second, the huge expansion of the money supply, reflected in the surge in central bank balance sheets, will need to be unwound to contain inflationary pressures once investors and consumers begin to spend again.

Third, reducing fiscal deficits to maintain debt sustainability will be an important political challenge. The major industrial countries (save Japan) began the crisis with modest ratios of debt to GDP. However, the unprecedented amounts spent to bail out financial firms, discretionary fiscal stimulus measures, and the impact of the recession on taxes and transfer payments have already substantially increased those debt ratios. Moreover, governments have taken on additional contingent liabilities related to various financial guarantees, and the potential effects of these liabilities on government debt remain unknown. For example, the quality of the assets on the balance sheets of some central banks has deteriorated markedly. Well-timed disposal of these assets as market conditions improve will be important to limit fiscal losses.

Experience with unsustainable increases in fiscal deficits during the 1970s and 1980s showed how painful the reestablishment of sustainability can be. This will be especially difficult if interest rates rise to reflect the increase in debt ratios or higher inflation, adding to governments' borrowing costs. Already the costs of buying credit protection on government debt issued by advanced economies have increased sharply, particularly for the United Kingdom and Spain, both hard hit by the downturn (see figure). Among the negative effects of large-scale government borrowing will be crowding out of other borrowers—private firms and developing-country borrowers—whose revival will be key to a resumption of global economic growth. Thus governments should be vigilant to reverse quickly the fiscal stimulus that is now necessary.

Markets are pricing in an increased risk of sovereign default on the debt of Spain and the United Kingdom
Spreads on five-year credit default swaps



Source: Thomson Datastream.

for Sub-Saharan Africa, where government revenues are especially dependent on indirect taxes, and in the case of commodity exporters, on ad valorem taxes and fees on commodity exports.

External balance and vulnerabilities

The crisis has gone a long way to unwinding—in an admittedly disorderly fashion—many of the tensions that precipitated it. Sharply higher savings in the United States over the past several years, has greatly reduced the extent of the global imbalances that had been characterized by very high current-account deficits in the United States and surpluses elsewhere, notably in China (figure 1.13). The current-account deficit of the United States diminished to an estimated 3.5 percent of GDP in the first quarter of 2009, down from more than 6 percent during the course of 2007; and China's trade surplus, though still very high, has

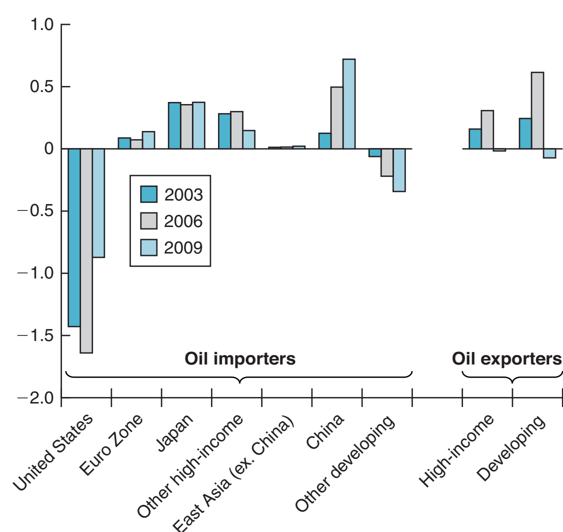
Table 1.8 Lower commodity prices have reduced imbalances

	2nd oil shock	Commodity boom	Financial crisis	Change in current account balance
	1979–82	2005–08	2009–10	2009/2008
Oil exporters		Current-account balance % of GDP		(percentage points)
High-income	**5.2**	**3.8**	**−0.4**	**−5.8**
OECD	−0.1	0.3	−1.1	−2.1
Non-OECD	29.6	29.8	5.2	−27.9
Developing	**−2.6**	**6.3**	**1.2**	**−7.8**
East Asia and Pacific	−1.2	4.8	2.2	−2.6
Europe and Central Asia	...	7.1	2.2	−6.6
Latin America and the Caribbean	−3.3	1.6	−1.4	−4.7
Middle East and North Africa	−0.4	19.8	7.8	−20.7
Sub-Saharan Africa	−5.0	7.9	−2.5	−16.5
Oil importers				
High-income	**−0.6**	**−1.3**	**−0.2**	**1.0**
OECD	−0.6	−1.6	−0.4	1.0
Non-OECD	1.5	5.1	4.6	1.0
Developing[a]	**−4.3**	**−3.0**	**−3.4**	**1.2**
East Asia and Pacific[a]	−6.3	2.1	1.2	0.4
Europe and Central Asia	−4.5	−6.4	−5.3	2.0
Latin America and the Caribbean	−5.8	−0.5	−2.8	0.1
Middle East and North Africa	−7.3	−4.9	−4.3	4.9
South Asia	−1.7	−2.2	−1.7	2.2
Sub-Saharan Africa	−3.3	−6.7	−8.1	0.1

Source: World Bank data.
Note: a. excluding China.

Figure 1.13 The crisis has reduced global imbalances

Current-account balance as percent of world GDP



Source: World Bank.

also declined as a share of GDP. Lower commodity prices have reduced current-account surpluses among oil exporters and deficits among importers (table 1.8). The current-account balances of developing oil-exporting countries are projected to move from a surplus of 6.3 percent of GDP during the 2005–08 commodity boom to a surplus of 1.2 percent in 2009–10.

While the increase in U.S. savings and lower interest rates have contributed to the reduction in its current-account deficit, longer-term prospects for imbalances are less certain. The very large monetary and fiscal stimulus that has been put in place will reduce overall savings (the sum of private and public saving) in the United States, especially if the authorities have difficulty in reversing the stimulus when the economy recovers. Moreover, the monetary expansion has already regenerated the low interest rates that contributed to the excess liquidity in the first instance. If too expansionary, these stimulus measures could regenerate very strong demand conditions and a return to low savings rates in the United States.

Lower oil prices should provide current-account relief for many countries

The decline in oil and other commodity prices has improved the terms of trade for many developing countries. For oil-importing developing countries,

lower import and higher export prices have increased incomes by about 1.2 percent of GDP between 2009 and 2008 (table 1.9). For countries such as Fiji, Jordan, and the Seychelles, the estimated impact of these price changes exceeds 10 percent of their GDP. Other countries with positive gains in their terms of trade (in excess of 5 percent of GDP) are Nicaragua, the Kyrgyz Republic, Togo, Honduras, Lebanon, and Dominica. Terms-of-trade effects between early 2009 and the average price of 2008 are most pronounced for oil-exporting countries. On average, oil-exporting developing economies are projected to suffer terms-of-trade losses equivalent to 6.8 percent of their GDP. The largest income losses are for Equatorial Guinea, the Republic of Congo, the Islamic Republic of Iran, and Azerbaijan, amounting to about a quarter of their 2008 GDP. For metals-exporting countries, the deterioration in terms of trade has been less marked but is still large—in part because lower food and fuel prices have offset some of the terms-of-trade losses from lower metals prices.[11] Compared with 2007—when commodity prices were closer to their current levels—all of these terms-of-trade effects are much more modest.

The impact of lower food prices on terms of trade for most economies will be relatively small, because most food consumed in developing countries is produced domestically. Exceptions tend to be small island economies and other countries for which food imports account for a large share of overall merchandise imports (such as Benin, Comoros, Eritrea, Haiti, Senegal, Somalia, and the Republic of Yemen).

The region that stands to lose most is the Middle East and North Africa, which is projected to suffer a terms-of-trade decline of close to 12 percent of GDP in 2009, followed by Sub-Saharan Africa, dropping 16.1 percent. In contrast, South Asia and East Asia and the Pacific—regions heavily dependent on oil imports—will register the largest terms-of-trade gains: 2.7 and 1.7 percent, respectively.

Table 1.9 Lower commodity prices should improve terms of trade for oil importers

Country groups	Terms of trade as % GDP, 2009/2008
Net oil exporters	
All developing	−6.8
East Asia and Pacific	−0.3
Europe and Central Asia	−7.9
Latin America and the Caribbean	−3.8
Middle East and North Africa	−16.3
South Asia	...
Sub-Saharan Africa	−13.4
Net oil importers	
All developing	1.2
East Asia and Pacific	2.1
Europe and Central Asia	1.1
Latin America and the Caribbean	−1.1
Middle East and North Africa	4.2
South Asia	2.7
Sub-Saharan Africa	−0.7

Source: World Bank.

Serious vulnerabilities remain

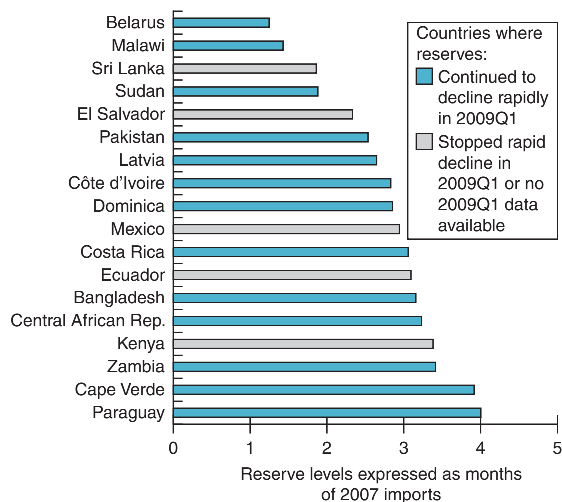
While the current-account positions of oil-importing developing countries are expected to improve over the course of 2009, deficits in a number of countries remain exceptionally high. More than 43 low- and middle-income countries registered current-account deficits in excess of 10 percent of GDP during 2008. In years past, these deficits were relatively easily financed by strong capital inflows. However, the financial crisis has sharply curtailed such flows, with total private inflows projected to decline from more than $1 trillion in 2007 to just $360 billion in 2009. At the same time, the external financing requirements of developing countries are expected to have increased, implying a financing gap of between $350 billion and $635 billion in 2009.

The effects of this shortfall have already been manifested in the pressures on the banking sector and currencies of a number of developing and high-income countries. Several countries have opened lines of credit with the IMF, while others are meeting shortfalls by reducing their international financial reserves. Many developing countries have seen their reserves fall by 20 percent or more since September 2008. For several, the decline in reserves followed an earlier period of accumulation, and reserve levels remain comfortable. But for at least 18 countries, reserves have been depleted to the point where they no longer cover four months of imports (figure 1.14). In most of these countries, reserve levels have stabilized more recently, but in at least five, reserves continued to decline by 5 percent or more a month during the first quarter of 2009.

Other countries have been forced to deal with much tighter borrowing conditions and large current-account deficits by reducing imports and current-account deficits. Fully 20 countries whose

Figure 1.14 Many developing-country reserves have reached worrisomely low levels

Developing countries whose reserves have declined by 20 percent or more since August 2008 and whose current levels are low

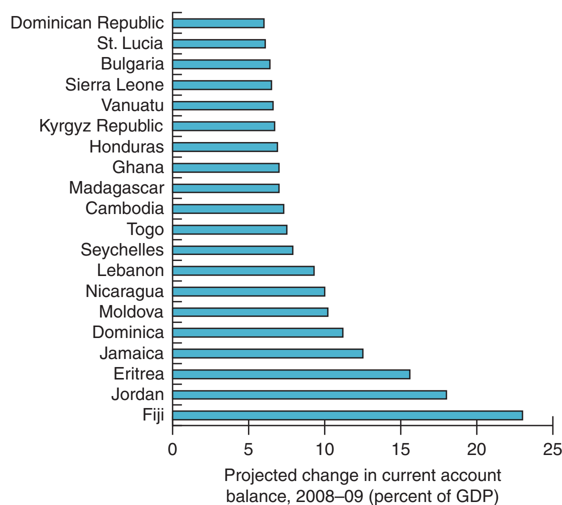


Sources: World Bank; Thomson Datastream.

current-account deficits in 2008 totaled 10 percent or more of GDP are expected to undergo internal adjustments that lower that deficit by 6 percent or more of GDP (figure 1.15).

Figure 1.15 Many countries will need to reduce imports sharply due to reduced access to foreign capital

Countries with large current-account deficits that are projected to undergo large real-side adjustments



Source: World Bank.

An uncertain medium-term outlook

Prospects for the recovery of the global economy are unusually uncertain. The sharp decline in global GDP, industrial production, and trade in the fourth quarter of 2008 and the continued weakness in the first quarter of 2009 are without modern precedent. So, too, is the extent to which the cycle has been synchronized across the planet. The fragility of banks and other financial institutions further complicates the assessment of when and how the recovery will take shape.

While there are incipient signs of a stabilization of activity in the United States (a recovery in consumer demand, increased housing sales, a rebound in the stock market) and of recovery in China (an increase in industrial production, acceleration of credit supply, and sharp gains in government spending), there are also ample indicators of a deepening and spreading recession. Unemployment is rising, housing prices continue to decline—adding to negative wealth effects. And, although no major bank has failed since October 2008 and many reported positive earnings in the first quarter of 2009, huge losses (IMF 2009b), restructuring, consolidation, and government intervention remain the order of the day.

A subdued recovery

The baseline projection presented in this edition of *Global Development Finance* is characterized by a subdued recovery from the current deep recession. The main cyclical factors that made the downturn so steep—the sharp fall in investment, rapidly rising precautionary savings, the use of inventories rather than new production to meet demand, and the postponement of durable goods purchases—are likely to ease in the second half of 2009 and push growth into positive territory by 2010. Cost-cutting measures and inventory reductions are running their course, and at some point firms will stop drawing down on and begin taking orders for new industrial output to catch up to underlying demand. In high-income countries, consumer demand and manufacturing orders have already improved or are improving, although for the moment available data do not show a similar turnaround in investment demand. These normal drivers of cyclical recovery will be amplified as the already-passed monetary and fiscal stimulus measures kick in during the

second half of 2009—boosting consumer and investment demand directly through government expenditure and transfers, and indirectly through very low interest rates.

However, the expected recovery is projected to be much less vigorous than normal. The large overhang of devalued assets and nonperforming loans will limit the extent to which the banking sector is able to finance new investment and consumer spending. Banking-sector consolidation, combined with mounting unemployment, negative wealth effects, and increased risk aversion will drag on growth throughout the forecast period. Because GDP growth only reaches its potential pace by 2011, the output gap (the difference between actual GDP and its potential), unemployment, and disinflationary pressures continue to build (figure 1.16).

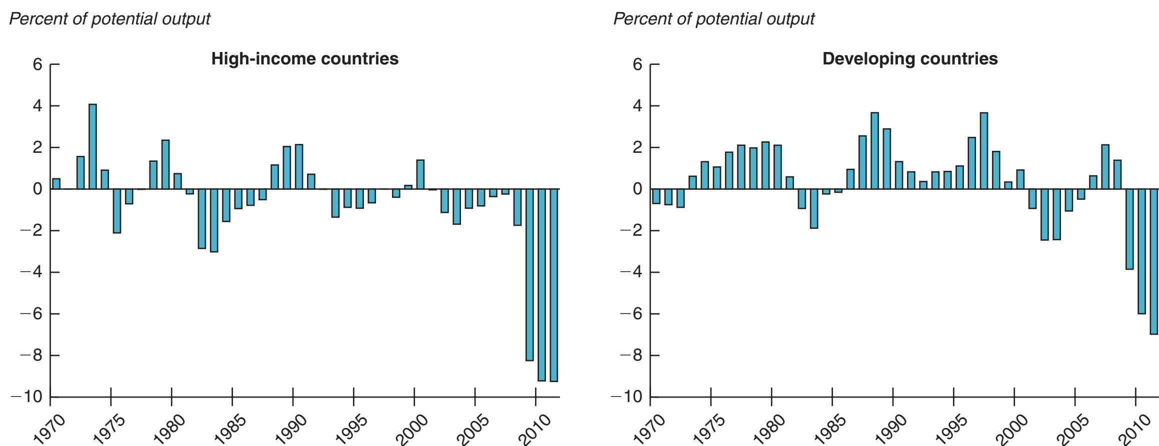
Notwithstanding the beginning of a recovery in the second half of the year, global GDP is projected to contract by a record 2.9 percent in 2009 considered as a whole (the first decline in world output since the 1960s and probably since World War II).[12] Output is then expected to rise a modest 2.0 percent and 3.2 percent in 2010 and 2011, respectively. After falling a projected 10.4 percent in 2009, tight financing conditions and abundant spare capacity should keep gains in global investment to a modest 2 percent and 4.7 percent in 2010 and 2011, respectively. Partly because of the heavy share of investment goods in global merchandise trade, global trade of goods and services is expected to decline by an unprecedented 9.7 percent in 2009, before picking up to a 3.8 percent and 6.9 percent rate of increase in 2010 and 2011, respectively.[13]

GDP in high-income countries is projected to fall 4.2 percent in 2009, recovering only modestly to a 1.3 percent pace in 2010 and to 2.4 percent in 2011. Notwithstanding the return to positive growth, these economies will remain depressed even in 2011. Unemployment will only be starting to decline at that time, and the output gap, the difference between the productive capacity of an economy and the actual level of demand, will likely have reached some 6 percent of GDP.

Prospects for developing countries are for an almost equally sharp 4.7 percentage point deceleration of GDP growth in 2009. The GDP of all developing countries combined is projected to increase by only 1.2 percent, or by only 0.1 percent in per capita terms. Excluding India and China, economic output in the developing world is projected to fall 1.6 percent, or 2.9 percent in per capita terms. GDP is projected to decline in two developing regions: by 2.3 percent in Latin America and the Caribbean and by 4.7 percent in Europe and Central Asia.

The recovery of output in developing countries is projected to be even more sluggish than in high-income countries. GDP growth is expected to increase by only 4.4 percent in 2010 and by 5.7 percent in 2011, as still weak activity in high-income

Figure 1.16 Despite projected stronger growth, considerable excess capacity remains even in 2011
Output gap: difference between actual GDP and potential output as a percent of potential output

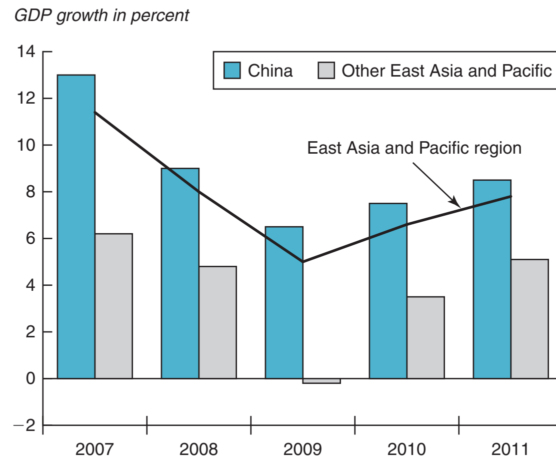


Source: World Bank.

countries drags on growth, and capital inflows to developing countries remain about half their pre-crisis levels (see chapter 2).

In this weak overall environment, commodity prices are projected to recover only slowly. After halving in 2009, oil prices are forecast to rise by less than 10 percent a year over 2010–11, as demand for oil increases slowly and continued surplus capacity prevents any return to the price levels of the first half of 2008. The recovery in the prices of metals and minerals will be even slower, while agricultural prices are projected to remain stable in 2010–11 (after the 21 percent drop forecast for 2009). Thus producers of commodities (other than oil) are expected to see a continuing decline in their terms of trade vis-à-vis manufactured goods.

Figure 1.17 The recovery in East Asia and Pacific will be led by China



Source: World Bank.

Regional outlooks

More detailed discussions of prospects for developing regions, including country-specific projections, are available in the Regional Outlooks appendix at the end of this volume and online at www.worldbank.org/globaloutlook.

East Asia and Pacific had little direct exposure to the toxic securitized assets and other sources of financial turbulence that originated in the financial centers of the OECD. But the region has felt the crisis particularly hard because of its well-developed trade links with the high-income countries and substantial capital inflows that over the past years have helped fuel an investment boom.

Investment in developing East Asia and Pacific represented 36 percent of GDP in 2008, much higher than its 26 percent share in the rest of the developing world. As the international environment deteriorated beginning in September 2008, private investment in East Asia and Pacific came under substantial pressure. The rising cost of capital, falling equity prices, rising bond spreads, and rapidly declining foreign demand sent exports and manufacturing production in the region to double-digit declines.

Regional exports in dollar terms dropped a full 48 percent between September 2008 and February 2009, while industrial production declined 4.6 percent over the same period.[14] In turn, investment spending for the countries outside of China declined at an unprecedented 25 percent annualized rate during the first quarter of 2009 (saar). Partly as a result, the region's GDP growth is projected to slip to 5 percent in 2009 from 8 percent during 2008, with China's 6.5 percent advance almost fully offsetting the 0.2 percent GDP decline for the remainder of the region (figure 1.17).

Faced with a quickly deteriorating situation, most developing economies in East Asia and Pacific eased monetary policy aggressively by lowering interest rates, reducing reserve requirements, and in some cases, providing direct liquidity into the banking system. To the extent affordable, most have launched fiscal stimulus programs; the most ambitious of these is in China.

GDP for the region is anticipated to revive over the course of late 2009 and into 2010, though for several countries, including Malaysia, Thailand, and the Philippines outright recession is anticipated this year. Recovery is expected to be relatively gradual, reflecting substantial fiscal stimulus in China combined with a gradual recovery of demand for the region's exports among high-income countries. GDP should increase by 6.6 percent in 2010 and by 7.8 percent by 2011.

Europe and Central Asia has been the region most adversely affected by recent developments, and economies in the region may be the most at risk. Since the end of the Cold War, growth in the region has relied heavily on increased trade linkages and investments from the European Union (especially for the countries of central and eastern Europe). As a

result, the abrupt reversal of capital flows and weaker demand for exports hits particularly hard. Sharply declining economic activity in Russia has also produced considerable spillover effects across the Commonwealth of Independent States (CIS).

Conditions have been made more difficult by the large current account deficits that evolved during this period and for which financing now appears in short supply. Many countries entered the global financial crisis with current-account deficits in excess of 10 percent of GDP, which made them especially vulnerable to a reversal of capital flows. Further buildup of foreign debt has become problematic, and meeting repayment obligations on short-term debt might become difficult in a number of countries (figure 1.18). The adjustment process is especially harsh because exports to the Euro Area are declining, and oil revenues—which fueled demand and remittances in the CIS—are falling.

The currencies of a number of economies in the region are under pressure and several countries have sought the assistance of the IMF in order to forestall a serious crisis. At the household and firm levels, the accumulation of large debt levels denominated in foreign currencies raises the risk of default and potential systemic difficulties in the event of adverse currency movements.

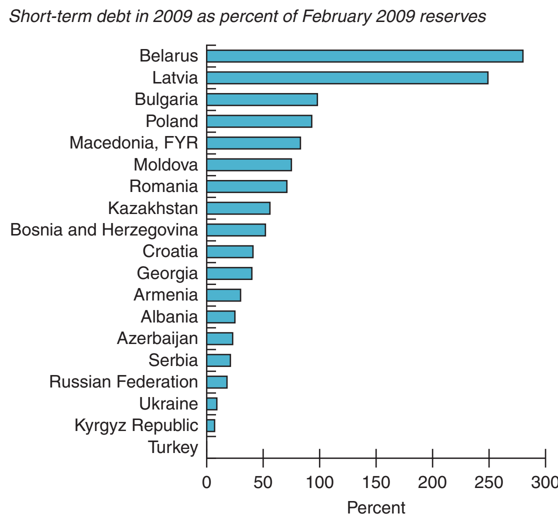
Under these very trying circumstances, output in the region is projected to fall 4.7 percent in 2009 and recover only modestly in 2010, growing by 1.6 percent. Continued adjustment and negative wealth effects suggest that even in 2011, growth at 3.3 percent will be below the region's potential rate, and little progress is likely to be made in reducing unemployment.

Latin America and the Caribbean entered this crisis period supported by much stronger fiscal, currency, and financial fundamentals than the region had in the past. Nevertheless, it is feeling the crisis on the financial side. Foreign funds were withdrawn quickly, equity markets tumbled, and exchange rates have plummeted. Some countries are suffering more than others because of the close trade and remittance ties they have with the United States, while others are feeling the effects of sharply lower commodity prices and of markedly weaker external demand that have cut into incomes. These factors have contributed to a sharp deceleration and even contraction in GDP growth in the final quarter of 2008 in several economies in the region (figure 1.19).

Brazil's large resilient domestic market has offered some cushion against declines in exports; however, it will be increasingly squeezed if external demand slides further. Countries such as Chile and Peru have used good years to improve their fiscal and reserve positions, creating room for expansionary

Figure 1.18 High short-term debt-to-reserves ratio in Europe and Central Asia

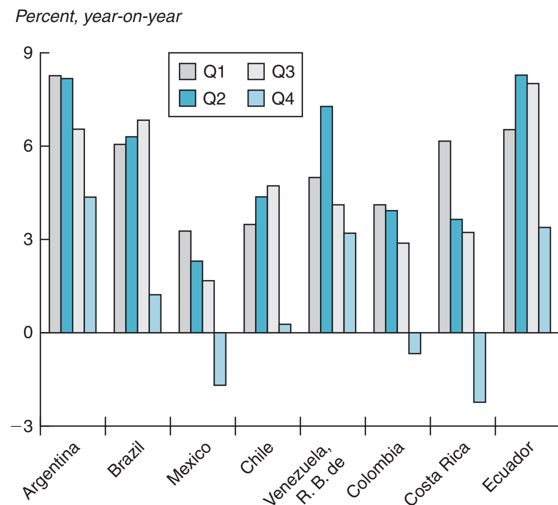
Short-term debt in 2009 as percent of February 2009 reserves



Sources: International Financial Statistics; Bank for International Settlements; World Bank.

Figure 1.19 GDP growth deteriorated markedly in the fourth quarter of 2008 in several major economies in Latin America and the Caribbean

Percent, year-on-year



Source: World Bank.

policies, but an extended, deep recession will take a toll on growth. Tourism and remittances have also suffered, particularly affecting countries in Central America and the Caribbean.

Output for the region as a whole is projected to decline by 2.3 percent following gains of 4.2 percent in 2008. However, this aggregate masks diverse outcomes. Mexico, having suffered significant disruption due to the novel A H1N1 flu, and having strong financial and trade ties with the United States, is projected to see output fall by 5.8 percent in 2009. GDP is projected to contract less sharply in countries like Brazil that have a more diversified portfolio of export markets and resilient domestic demand. Weaker terms-of-trade for commodity exporters will pressure budgets in a number of countries, some of which failed to build up sufficient buffers during the commodities boom. Moreover, the scope for fiscal stimulus varies greatly across countries in the region.

Reflecting Latin America and the Caribbean's improved fundamentals, its recovery is projected to be fairly robust, with growth reaching 2 percent in 2010 and 3.3 percent by 2011.

The Middle East and North Africa region has been less directly affected by the credit crunch than other regions. But local equity and property markets have come under intense pressures, and weaker GDP growth and flows of foreign direct investment from the countries of the Gulf Cooperation Council are cutting into activity among the developing countries of the region. Moreover, the effective collapse of growth in the Euro Area (a critical export market for the region) has resulted in sharp declines in non-oil exports, remittances, and tourism receipts, further dampening prospects for the more diversified economies. Remittances, services exports, and FDI flows to the region are expected to fall fairly sharply as a share of GDP from a peak of 9.5 percent in 2007 to 7.2 percent by 2011.

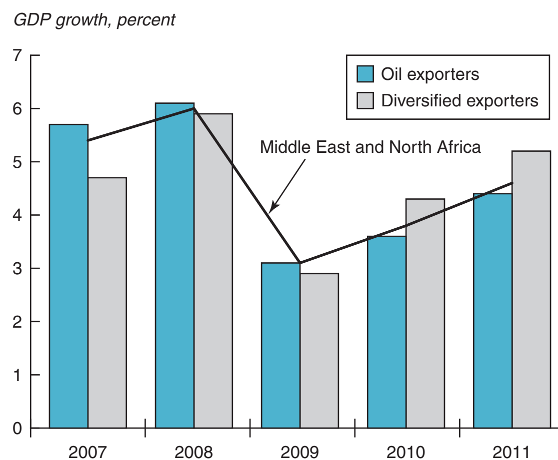
Growth is projected to halve to 3.1 percent in 2009, from the strong 6 percent advance during 2008. Fiscal revenues and expenditures in oil-exporting countries will be adversely affected by the sharp decline in oil prices. Oil revenues among developing exporters are estimated to drop precipitously from $320 billion in 2008 to $140 billion during 2009, the change equivalent to 28 percent of the group's GDP. Although lower food and fuel prices should boost incomes among oil and food importers in the region, that will not be sufficient to offset the heavy falloff in export volumes and international services revenues attendant upon the deep recession in the Euro Area. As a result, current-account balances are projected to deteriorate.

The recovery among Middle East and North African developing countries is expected to be less vigorous than elsewhere, partly because the slowdown had been less pronounced and because oil demand and prices are expected to remain low. Growth is projected to pick up by just seven-tenths of a percentage point in 2010 to 3.8 percent before improving to a 4.6 percent pace by 2011. The diversified economies should see growth pickup to a faster clip than the oil-dominant economies over 2010–11, as the array of factors that restrained their growth turn more favorable (figure 1.20).

In South Asia, GDP is projected to expand 4.6 percent in 2009, down from 6.1 percent in 2008. Capital inflows have diminished considerably, which has contributed to a falloff in investment growth. Although the decline in oil prices since the middle of 2008 has improved terms of trade for the region, weakening demand in South Asia's export markets is being felt sharply in the manufacturing sector and has tempered the growth of services exports, including high-tech and tourism. Remittance inflows have decelerated sharply or contracted in recent months, and are expected to decline in 2009, albeit with some lag as conditions in host countries

Figure 1.20 Growth to slow sharply for both oil and diversified exporters in the Middle East and North Africa

GDP growth, percent



Source: World Bank.

falter. GDP growth rates are projected to rebound fairly briskly, with regional output increasing by 7.0 percent in 2010 and 7.8 percent in 2011.

Given already high budget deficits, countries in the region have limited room to expand fiscal policy. Food and fuel subsidy bills have begun to shrink, which is creating some space on the expenditure side, even if only for shifting outlays to meet other demands. Lower commodity prices have provided a strong disinflationary impulse to economies in the region, which has allowed policy makers to pursue more expansionary monetary policies. The pressure on current accounts from reduced exports, combined with lower capital inflows, was initially met by drawing down international currency reserves to support their exchange rates. More recently, countries have shifted to a posture of conserving reserves, and permitted their currencies to devalue.

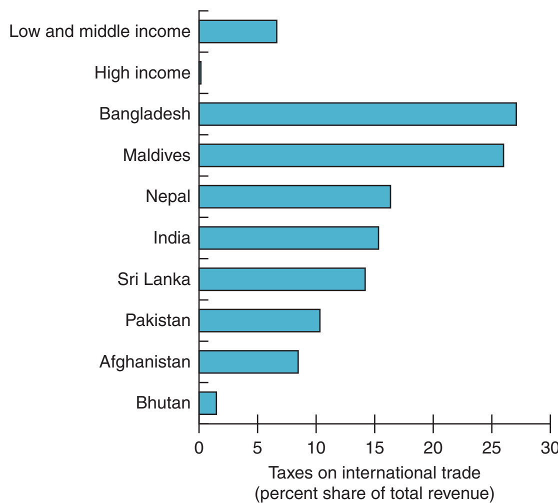
Downside risks to the forecast are pronounced. On the domestic front, they are centered on the region's large fiscal obligations and relatively high reliance on taxes on trade and large subsidy programs, both of which would lead to heightened fiscal pressures in the event of a protracted global recession (figure 1.21). Ongoing budgetary pressures are also likely to lead to cuts in development spending, which could have long-term effects. Large fiscal deficits also represent a threat to long-term growth, weighing on potential output by crowding out private investment due to increased public-sector borrowing and higher interest rates.

Sub-Saharan Africa. The global financial and economic crisis has hit Sub-Saharan Africa hard, because of reduced external demand, plunging export prices, weaker remittances and tourism revenues, and sharply lower capital inflows, notably FDI. Growth in the region is expected to decelerate sharply this year to 1 percent down from an average of 5.7 percent the previous three years (figure 1.22). GDP declined during two quarters in South Africa, the region's largest economy, for the first time in 17 years and some large oil-exporting and mineral-dependent economies are also expected to see output drop. As elsewhere, the expected recovery in 2010 will be weak, with growth rising to a below-trend 3.7 percent for the region as a whole, 4.3 percent excluding South Africa. Sub-Saharan Africa's disappointing growth outturn will translate into a decline in per capita GDP of close to 1 percent in 2009, the largest since 1994, marking a pause in poverty reduction.

Reflecting slow GDP growth, low commodity prices and government revenues that are relatively dependent on formal and traded activities,

Figure 1.21 Government revenues in South Asia very dependent on trade

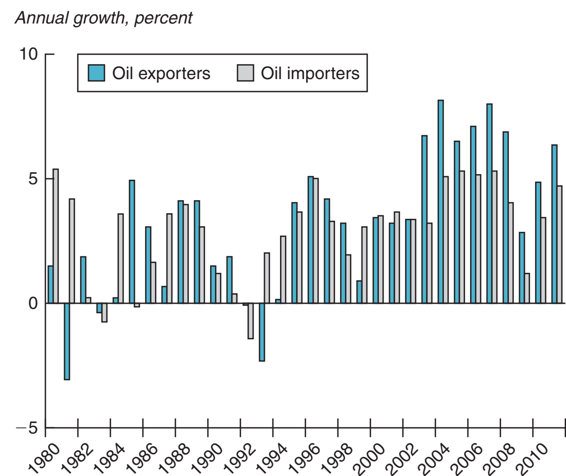
Shares as of 2007 for countries (except Bhutan = 2004) and 2006 for income groups



Source: World Bank.

Figure 1.22 Economic growth in Sub-Saharan Africa is projected to decelerate abruptly in 2009 to the lowest level in almost a decade

Annual growth, percent



Source: World Bank.

both current-account and fiscal balances are set to deteriorate markedly this year, and improve only marginally in 2010, impeding the implementation of counter-cyclical policies. In countries heavily reliant on commodity export revenues, fiscal balances will deteriorate sharply, cutting into much-needed infrastructure expenditure and social programs, while borrowing requirements crowd out the private sector investment. On the positive side, widening output gaps and lower food and energy prices are putting downward pressure on inflation, although the impact of last year's high food and fuel prices is still being felt in many countries in the region. Much weaker demand and price conditions in the mining sector have reduced employment in the sector, cutting into remittances in many countries, notably those in southern Africa.

Prospects for continued diversification away from the primary sector and toward higher value-added sectors have weakened because the region's manufacturing sectors have been dealt a heavy blow.

Risks

Given the severity of the downturn, its synchronized nature, and the weakened state of the world's major financial institutions, there is much more than the usual level of uncertainty surrounding future prospects. As the recent outbreak of a novel form of influenza in Mexico serves to remind us (box 1.3), the world's economy is at a particularly vulnerable juncture, where an event that might otherwise have carried relatively minor economic consequences could have a much broader impact.

Not all of the uncertainty concerns the possibility of slower growth, although the economic and human costs of a deeper or more protracted recession are most troubling. One upside scenario concerns the possibility that private sector confidence and the financial sector respond more robustly and more quickly than is assumed in the baseline. Under such circumstances, the fiscal and monetary stimulus already in place could provoke a more rapid recovery than anticipated, which could rekindle inflationary pressures. In this scenario, the authorities would be forced to respond with a relatively quick tightening of policy measures that could induce a second round of below-potential growth toward the end of the projection period.

A protracted recession

The main downside risk to the outlook is that the confidence and wealth effects of the financial crisis are much more persistent than in the baseline, and that the consolidation efforts of banks constrain lending more durably. In this scenario, second-round effects intensify—including rising unemployment and the bankruptcy of firms that might have survived a milder recession and unemployment. Instead of recovering somewhat during 2010, global investment could decline by another 5.5 percent, with the sharpest contractions in those countries experiencing the most marked reversals in capital flows and in investor confidence.

In this scenario, the projected rebound in private consumption would be much weaker due to slower income growth and higher savings, notably, in high- and middle-income countries where households have more discretionary income with which to maneuver. As a result, instead of rebounding as in the baseline, global trade would continue to decline, intensifying the pressures on the most vulnerable middle-income countries (those with current-account deficits in excess of 10 percent of GDP). In the protracted recession scenario reported in table 1.10, this causes severe currency crises characterized by sharp exchange-rate depreciations and even more significant reductions in domestic spending in many economies.

Overall, this scenario implies that the fall in world output in 2009 would be deeper than in the baseline because the recovery expected in the second half fails to emerge. Output would stagnate in 2010, before rebounding by 3 percent in 2011. World trade volumes would fall a further 4.7 percent in 2010, bringing global trade volumes almost 17 percent below 2008 levels. In this scenario, GDP in developing countries would register a very modest 2.0 percent increase in 2010, with the bulk of the weaker performance concentrated in Europe and Central Asia, where GDP is projected to decline by an additional 1.5 percent. Not all countries in the region would be affected equally, and several (such as Latvia, Lithuania, and the Russian Federation) are projected, even in this downside scenario, to experience stronger growth than in 2009.

Box 1.3 Potential economic impacts of the A H1N1 flu outbreak

At the time of this writing (June 1, 2009), the outbreak of H1N1 flu has not run its course, although there are encouraging signs that it is neither as deadly nor as easily spread as might have been first thought. Initial estimates suggest that its clinical severity is similar to that of the Hong Kong flu of 1968–69 and that while its infectiousness (rate of spread) is higher than normal flu it is in the lower range of previous influenza pandemics (Fraser and others 2009). Younger populations and individuals with chronic disease appear to be most vulnerable, in part because as much as 33 percent of people 60 and older appear to have some immunity to it (Centers for Disease Control and Prevention, 2009).

To date, the World Health Organization reports some 12,954 laboratory confirmed cases of the flu in 46 different countries, and 92 deaths. More than 90 percent of the cases recorded so far are in North America, with all but 12 deaths having been in Mexico—which accounts for about one-third of all cases.

It is not yet known what explains the much lower mortality rates outside of Mexico. Possible explanations include: a much higher incidence of disease than reported in Mexico and therefore a lower mortality rate, the timing of the outbreak toward the end of the flu season in the Northern hemisphere, and some aggravating and as yet unknown cofactor.

So far, the economic costs of the epidemic have been concentrated in Mexico and in the transportation sectors. Air travel to and from Mexico is down by 80 percent, and hotels in popular resorts report vacancy rates as high as 80 percent. Overall, tourism revenues are down an estimated 43 percent, increasing Mexico's external financing gap because tourism is an important source of foreign currency. Following an initial closure of restaurants, theaters, and sports stadiums, the Mexican authorities ordered all businesses to shut down for five days in an effort to stem the spread of the disease. Because this last measure fell over a long weekend, its economic effect was much smaller than it would have been had it been declared during the course of a full business week. Should recent levels of disruption in the commerce, restaurant, hotel, and transportation businesses in the Mexico City region (representing 30 percent of the country's GDP) persist, they could reduce second-quarter GDP by as much as 2.2 percent.

Although the spread of A H1N1 appears to have eased, its spread is likely to pick up as the flu season begins in the southern hemisphere and again when it returns in the northern hemisphere. Even if it does not mutate into a more deadly form, a second wave of the flu in low-income countries' could have serious consequences—given poor countries limited capacity to monitor and treat an outbreak and the higher incidence of chronic disease within their populations (the pre-existence of chronic health conditions and delays before medical intervention appear to be among the factors that have contributed to deaths where they have occurred). More worrisome is the possibility that H1N1 could mutate into or combine with a more aggressive form of the flu—such as H5N1 (avian influenza). As a flu for which much of the world's population has limited pre-existing immunity (WHO 2009), A H1N1 could infect as much as 35 percent of the world's population (WHO 2006)—spreading throughout the world in as few as 180 days during flu season.

As compared with a normal flu season, where some 0.2–1.5 million die (WHO 2003), deaths from even a mild new flu might include an additional 1.4 million people worldwide. A more virulent form, such as the 1918–19 flu, which was more deadly for healthy adults than a normal flu, could have much more serious consequences, killing as many as 1 in 40 infected individuals (Barry 2005), or some 71 million. Some authors suggest that as many as 180 million to 260 million could die in a worst-case scenario (Osterholm 2005).

Simulations of the potential economic and human costs of a global pandemic undertaken for the 2006 *Global Development Finance* report in the context of avian influenza (Burns, van der Mensbrugghe, and Timmer 2006, 2008) suggest that the costs of a global influenza pandemic could range from 0.7 to 4.8 percent of global GDP depending on the severity of the outbreak. The lower estimate is based on the Hong Kong flu of 1968–69, while the upper bound was benchmarked on the 1918–19 Spanish flu. In the case of a serious flu, 70 percent of the overall economic cost would come from absenteeism and efforts to avoid infection. Generally speaking, developing countries would be hardest hit, because higher population densities, relatively weak health care systems, and poverty accentuate the economic impacts in some countries.

Table 1.10 A protracted recession

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

	2007	2008	2009e	2010f	2011f
Global conditions					
World trade volume	7.5	3.7	−11.9	−4.7	5.8
Real GDP growth[a]					
World	**3.8**	**1.9**	**−3.6**	**−0.4**	**3.0**
Memo item: World (PPP weights)[b]	5.0	3.0	−2.4	0.2	3.8
High income	**2.6**	**0.7**	**−4.8**	**−1.2**	**2.2**
OECD countries	2.5	0.6	−4.8	−1.2	2.1
Euro Area	2.7	0.6	−5.3	−2.8	1.7
Non-OECD countries	5.6	2.4	−5.8	−1.2	4.2
Developing countries	**8.1**	**5.9**	**0.5**	**2.0**	**5.5**
East Asia and Pacific	11.4	8.0	4.2	3.9	7.5
Europe and Central Asia	6.9	4.0	−5.8	−1.5	3.0
Latin America and the Caribbean	5.8	4.2	−2.7	0.2	3.1
Middle East and North Africa	5.4	6.0	3.0	3.4	4.5
South Asia	8.4	6.1	4.0	4.7	7.6
Sub-Saharan Africa	6.2	4.8	0.2	0.6	5.3
Memorandum items					
Developing countries					
Excluding transition countries	8.2	5.9	1.2	2.4	5.7
Excluding China and India	6.1	4.5	−2.2	0.3	3.7

Source: World Bank.
Note:
PPP = purchasing power parity; e = estimate; f = forecast.
a. GDP in 2000 constant dollars; 2000 prices and market exchange rates.
b. GDP measured at 2000 PPP weights.

Policy challenges

Developing countries face an extremely challenging policy environment. Falling government revenues and limited access to external sources of capital constrain most countries' ability to respond with countercyclical fiscal policies. Based on past experience, an inability to maintain spending at earlier levels—let alone to increase outlays to meet the challenges associated with the slowdown—will oblige many governments to pursue a procyclical policy cutting back on spending precisely when it is most needed.

Demands on social assistance programs are climbing; these are immediate and pressing needs. As a result, spending on longer-term issues such as infrastructure, health, and education tends to take a back seat or even get cut when additional financing is unavailable. Just maintaining core public spending on education and health and preventing a widening of infrastructure gaps would require an estimated $200 billion in 2009. About $42 billion of additional external financing would be required in 2009 to assist those countries with limited fiscal capacity.

In the current context, with external finance heavily constrained (see chapter 3), many developing countries will be unable to meet these challenges unless additional support from high-income countries is forthcoming.

The implications for poverty reduction and the Millennium Development Goals of a failure to maintain social spending could be far-reaching. For example, following the East Asian crisis in the late 1990s, it took almost a decade for the poverty headcount to regain its pre-crisis level in affected countries. Very young children who are seriously affected by poor nutrition may endure permanent cognitive impairment and never catch up to their peers who were born in more fortunate times. Following the Indonesian crisis in 1997–98, the number of children 7 to 12 years old not enrolled in school doubled in rural areas to 12 percent in a few years. The crisis also affected health outcomes; infant mortality increased by over 3 percentage points during the crisis.

Not only is social spending essential to protect the vulnerable and avoid loss of human capital, it also is a more effective form of fiscal stimulus than tax cuts. Investments that reduce infrastructure bottlenecks in developing countries can have even larger multipliers (IMF 2009a; Hooper and Sløk 2009).[15] Raising the infrastructure services of all Sub-Saharan countries to the level in Mauritius could add as much as 2.2 percentage points to per

capita growth (Calderón and Servén 2008), while achieving the level in the Republic of Korea could raise growth by 2.6 percentage points.

Notes

1. Econometric evidence suggests that a 10 percent rise in capital spending in developed countries will elicit a 6.6 percent increase in global manufacturing output. Country sensitivities vary, with stronger links in the United States, and the Republic of Korea (both with elasticities of 2.1), Singapore, and the Central European countries (1.5).

2. Data refer to 28 OECD countries, excluding Canada, Greece, and Mexico, for which the OECD Stat does not report monthly data. The 28 countries are Australia, Austria, Belgium, the Czech Republic, Denmark, Finland, France, Germany, Hungary, Iceland, Ireland, Italy, Japan, the Republic of Korea, Luxembourg, the Netherlands, New Zealand, Norway, Poland, Portugal, the Slovak Republic, Spain, Sweden, Switzerland, Turkey, the United Kingdom, and the United States.

3. Over the same period, the dollar appreciated against most currencies, rising by 4.4 percent in real effective terms.

4. Refineries struggled to produce sufficient distillates to meet newly mandated ultralow sulfur diesel fuel standards in high-income countries. Lack of refining capacity to produce this distillate from lower-grade oils increased demand (and the price) for light, sweet crude oil by between 3.2 and 5.1 million barrels a day at the peak.

5. World Bank (2009) provides more in-depth discussion of the causes of the run-up in commodity prices during 2008 and their long-term prospects.

6. Prices during the first five months of 2009 averaged $46, thus even if prices continue to rise from their end-of May level of $58, the average price of oil during the whole year will be lower than its current level.

7. The real effective exchange rate is an index of a country's exchange rate with that of its key trade partners (weighted by export and import shares) and corrected for inflation differentials.

8. These estimates are consistent with the methodology used in World Bank (2009), but are based on a more complete history of local food prices in 2008 and an enhanced methodology for estimating the influence of international prices on domestic prices.

9. Corporate lending rose at an annualized rate of 22 percent and 15 percent, respectively, in the United States and the United Kingdom during the fourth quarter of 2008, despite the sharp contraction in activity. Some observers attribute this development to firms arbitraging the low interest rates on existing credit lines or compensating for reduced access.

10. The eventual cost of these up-front contributions is difficult to estimate because it depends on the extent to which the assets acquired hold their value over time.

11. Metals exports represent close to half of the merchandise export revenues in countries such as Chile, Guinea, Jamaica, the Kyrgyz Republic, Mali, Mauritania, Mongolia, Mozambique, Papua New Guinea, Peru, Surinam, Tanzania, and Zambia.

12. Calculations of global GDP before 1960 are complicated because large parts of the world were not covered by national accounting statistics before that date, and indeed, many developing regions had yet to emerge from colonial rule. Maddison (2004) has made a valiant effort to estimate global GDP during this and even earlier periods.

13. The projection for 2009 is broadly consistent with the recently reported forecast of the World Trade Organization for a 9 percent decline in merchandise trade. The value reported here is higher mainly because it includes the growth in internationally traded services, which are much less cyclically sensitive than goods alone.

14. Industrial production in this reference excludes China, as difficulties in seasonally adjusting the time series data for output over the months covering the annual Lunar New Year introduces substantial distortions that render the variable noncomparable with others in the database.

15. Hooper and Sløk (2009) report multipliers for different forms of fiscal expenditure. The mean of these multipliers ranges from 1.2 for purchases of goods and services (including infrastructure spending) down to 0.2–0.5 for various forms of tax cuts.

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2

Private Capital Flows in a Time of Global Financial Turmoil

THE GLOBAL FINANCIAL CRISIS THAT followed the September 2008 collapse of several major financial institutions, including Lehman Brothers, severely constrained developing countries' access to international financial markets, as investors deserted developing-country markets for what they perceived to be safer securities. In October, developing countries' access to external finance further deteriorated, as sovereign bond spreads reached a seven-year high of 874 basis points—levels not seen in six years. No developing-country government or firm issued a single bond on international markets in October or November. A principal index of emerging stock market prices (MSCI) plummeted 42 percent between Lehman's collapse and mid-December, as panicked investors sold off holdings on a large scale and currencies came under heavy downward pressure. Spreads on trade credit for several major borrowers rose to three to five times their record low 2007 level.

The effects on capital flows to developing countries were dramatic. Despite strong performance in the first half of 2008, net private capital inflows dropped to $707 billion (4.4 percent of developing-country GDP) by the end of the year, reversing an upward trend that had begun in 2003 and that peaked at $1.2 trillion in 2007. As inflows sagged, net capital outflows increased. Net equity outflows reached $244 billion (1.5 percent of GDP) in 2008, up from $190 billion (1.4 percent of GDP) in 2007. Emerging Europe and Central Asia bore the brunt of the financial crisis, accounting for 50 percent of the decline in capital flows. But the downturn touched all regions, with the exception of the Middle East and North Africa, where flows increased slightly.

The growing integration of developing-country economies into the global economy, and the increasing importance of their firms and households in international finance over the past decade, have brought enormous economic and financial benefits (World Bank 2007). But the same developments have also widened the scope for economic turmoil when global conditions deteriorate. Indeed, the broad reach of the current crisis can be traced through the dense web of trade and financial linkages among countries. Developing countries are much more dependent on private capital flows today than during the 1990s. Almost one-quarter of their total domestic capital formation was funded, in the years immediately preceding the crisis, by foreign capital. For the past three years, more than one-third of developing countries received private capital flows in excess of 6 percent of their GDP. In several countries of Eastern Europe—notably Bulgaria, Kazakhstan, Latvia, Romania, and Ukraine—the levels were 20 percent or more. The downside of that greater dependence is that a withdrawal of capital flows has a broader and deeper impact.

The composition of private debt flows has changed as well. Once dominated by bank lending to sovereign governments, capital now flows through a variety of transactions between private entities—and those flows respond rapidly to financial disruptions. The growing share of countries with open capital accounts has greatly magnified the potential for rapid changes in capital outflows in response to changes in economic conditions. Thus, even though most developing countries maintain better policies and have stronger institutions than they did at the onset of previous crises, more countries are nevertheless vulnerable to

external disruptions. The situation is particularly dire for the many countries that face the possibility of a downgrade in their credit rating, because lower ratings will make it more difficult for borrowers—corporate and sovereign—to manage their external liabilities and fund investment projects by accessing international bond markets.

This chapter first reviews financial flows to and from developing countries in 2008, describing how the crisis has affected emerging markets since the collapse of Lehman Brothers. It then discusses the prospects for capital flows and workers' remittances in the medium term.

The key messages are highlighted below:

- The tendency of risky assets to underperform in a cyclical financial downturn notwithstanding, the dramatic plunge in emerging local equity markets, coupled with the widening of spreads on dollar-denominated bonds and downward pressure on borrowers' currencies, bespeak a degree of large-scale capital repatriation not seen in recent years. As global portfolio managers came under increasing liquidity pressures, they sold off emerging market assets to fund their own capital redemptions. Evidence available to date seems to indicate that much of the repatriated investment was drawn out of markets in East Asia and the Pacific, which are more liquid than those in some other developing regions and have been a dominant destination for emerging-market equity investors. At the same time, multinational companies began to reduce their exposure through higher repatriation of profits.
- International capital inflows are projected to decline further in 2009, sinking to $363 billion (2.5 percent of GDP) before recovering in 2010 in tandem with the recovery in global economic growth discussed in chapter 1. Developing countries' participation in international bond markets picked up in the first months of 2009, but the prospects for continued improvement in access to international sources of capital are limited. The severe global downturn anticipated for this year (chapter 1) will continue to depress lenders' interest in developing countries and reduce investment flows. Going forward, developing countries may face sharp competition for funds as industrial-country governments begin in earnest to issue the securities necessary to finance their fiscal stimulus and bank rescue plans.
- The role of international banks in intermediating capital flows to developing countries is changing, as banks adjust to new realities born of the crisis. The implications of greater government involvement and tighter regulation for banks' lending to developing countries are now coming into view, as the total amount of loans outstanding with banks reporting to the Bank for International Settlements (BIS) declined in the last quarter of 2008, with all signs pointing to a continuation of that trend through 2009. Tight liquidity conditions in interbank markets drove banks' lending decisions in the early phase of the crisis—a restraint on credit that now has been moderated by massive liquidity injections from major central banks. More recently, the forces driving banks' credit decisions have been directly and indirectly related to the onset of the global economic recession, the associated weakening of the banks' balance-sheets, and the further tightening of credit standards. Econometric analysis conducted for this report confirms the importance of these two channels—the erosion of large lenders' balance-sheet quality (captured by various loan-performance and capitalization measures) and the tighter credit standards (measured by opinion surveys of loan officers). It therefore appears that the recently formed consensus to focus policy attentions on the health of the international banking system should benefit developing-country borrowers, to the extent that banks' balance sheets can be repaired and recapitalized.
- Foreign direct investment (FDI) inflows—the largest component of international capital flows to the developing world—are also projected to decline by 30 percent to $385 billion in 2009. Driven by the strong momentum of the first half of the year, FDI inflows to developing countries posted an increase in 2008 and remained at 3.5 percent of their combined GDP. Many factors that had led to the expansion of cross-border mergers and acquisitions (M&As)—chiefly high economic growth, favorable financing conditions, high corporate

profits, booming stock markets, and increased involvement by private equity firms, hedge funds, and sovereign wealth funds—are now absent. With weak corporate earnings and tough bank financing of deals, M&A transactions are now more difficult to initiate and fund. Significantly lower M&A transactions in the first quarter of 2009 signal weaker FDI inflows to developing countries.

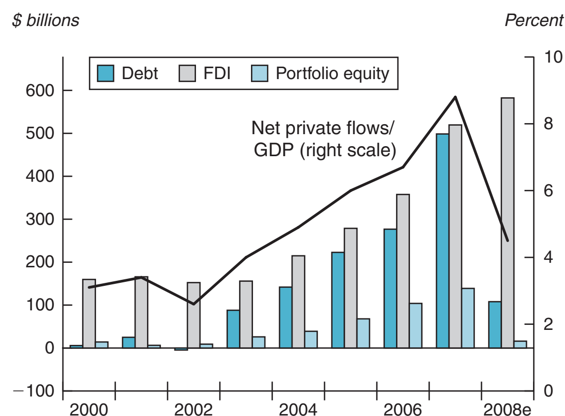
- Of the many consequences of the 2008 crisis, the most significant for development finance is likely to be the shift among foreign investors from private to public risk in emerging markets. The shift, if enduring, could be particularly costly for emerging market corporations. Before the crisis, a growing number of such corporations enjoyed access to international debt markets for the sophisticated financing they needed to grow and build a global presence through trade, investment, and cross-border M&A. Between 2003 and 2007, firms based in emerging markets raised $1.2 trillion in external debt via syndicated bank deals and bond issues, while only $237.2 billion went to the sovereign sector. So far in 2009, the balance of external financing between sovereign and corporate shifted, with the share of corporate sector declining to 66 percent of the total from 90 percent in 2008. As initial public offerings fell steeply in 2008 and local stock markets' share prices plunged, corporate finance in emerging markets faltered, signaling weaker growth prospects and fewer opportunities to generate employment in emerging economies.
- In the past, remittances have been stable, or even countercyclical, during economic downturns in the recipient economy. The present crisis, however, is affecting the countries from which remittances originate. Future flows are bound to be affected by the simultaneous economic recession in the high-income countries and lower growth in the developing countries, each of which host half of migrants from the developing world. Although the aggregate decline in worldwide remittance flows as a result of the crisis is expected to be small, the situation may prove more serious for some small, poor countries where remittances make up a relatively large share of GDP.

The global financial crisis severely reduced private capital flows to developing countries in 2008

The global financial crisis brought to an abrupt end the surge in private capital flows to developing countries that had occurred during 2003–07. In 2008, total net international flows of private capital to the developing world fell to $707 billion (4.4 percent of developing-country GDP) from the record-high level of $1.2 trillion (8.6 percent of GDP) reached in 2007 (figure 2.1 and table 2.1). Net portfolio equity flows plunged by almost 90 percent from $139 billion to a mere $16 billion in 2008. Similarly, private debt flows declined substantially to $108 billion from $499 billion, driven by the sharp fall in short-term debt flows, which moved from $202 billion in 2007 into negative territory (−$16.3 billion), and in bond financing, which came to just $11 billion in 2008, compared with $85 billion in 2007. Net medium- and long-term bank flows were $123 billion, 40 percent lower than in 2007. The rate of increase in FDI slowed markedly, ending the year at an estimated $583 billion, $60 billion higher than 2007.

The downturn affected all developing regions but to various degrees, with the exception of the Middle East and North Africa, where flows increased slightly (table 2.2). Emerging Europe and Central Asia were the hardest hit, accounting for half of the $451 billion decline in capital flows (figure 2.2). Across regions, the decline was concentrated in short-term debt flows (48 percent),

Figure 2.1 Net private capital inflows to developing countries, 2000–08



Sources: World Bank Debtor Reporting System; staff estimates.
Note: 2008 figures are estimated.

Table 2.1 Net capital inflows to developing countries

$ billions

	2001	2002	2003	2004	2005	2006	2007	2008e
Current account balance	15.5	68.6	118.4	171.2	306.6	438.2	406.1	377.9
Financial flows:								
Net private and official inflows	224.2	162.4	258.6	370.7	498.7	668.3	1157.7	727.3
Net private inflows	197.3	156.8	269.1	396.5	569.7	739.2	1157.5	706.9
Net equity inflows	172.3	161.5	181.0	254.7	347.2	462.7	658.6	599.0
Net FDI inflows	166.0	152.5	155.5	216.0	279.1	358.4	520.0	583.0
Net portfolio equity inflows	6.3	9.0	25.5	38.7	68.1	104.3	138.6	15.7
Net debt flows	51.9	0.9	77.6	116.0	151.5	205.6	499.1	128.3
Official creditors	26.9	5.6	−10.5	−25.8	−71.0	−70.9	0.2	20.4
World Bank	7.5	−0.3	−0.5	1.6	2.8	−0.4	4.9	7.1
IMF	19.5	14.1	2.5	−14.7	−40.1	−26.7	−5.1	10.9
Other official	−0.1	−8.2	−12.5	−12.7	−33.7	−43.8	0.4	2.4
Private creditors	25.0	−4.7	88.1	141.8	222.5	276.5	498.9	107.9
Net M-L term debt flows	2.1	0.7	26.6	73.3	135.9	166.4	296.4	124.2
Bonds	10.2	10.1	20.4	36.0	56.2	26.6	85.4	10.5
Banks	−1.9	−3.2	10.4	41.3	84.2	144.6	214.5	123.0
Other private	−6.2	−6.2	−4.2	−4.0	−4.5	−4.8	−3.5	−9.3
Net short-term debt flows[a]	22.9	−5.4	61.5	68.5	86.6	110.1	202.5	−16.3
Balancing item[b]	−159.1	−69.9	−90.7	−144.9	−419.5	−476.6	−486.3	−657.7
Change in reserves (− = increase)	−80.4	−160.6	−285.5	−396.2	−385.5	−629.9	−1077.3	−447.3
Memorandum items								
Private inflows excluding short-term debt	174.4	170.7	203.9	340.7	483.3	629.1	955.0	723.2
Net FDI outflows	12.7	16.8	22.4	44.5	59.2	125.2	138.8	164.0
Net portfolio equity outflows	10.8	6.0	8.2	7.2	11.6	21.5	50.6	80.0
Workers' remittances	95.6	115.9	143.6	161.3	191.2	229.0	265.0	305

Source: World Bank Debtor Reporting System and staff estimates.
Note: e = estimate.
a. Combination of errors and omissions and transfers to and capital outflows from developing countries.
b. Net bank lending numbers might be different from numbers in GDF 2009, volume 2.

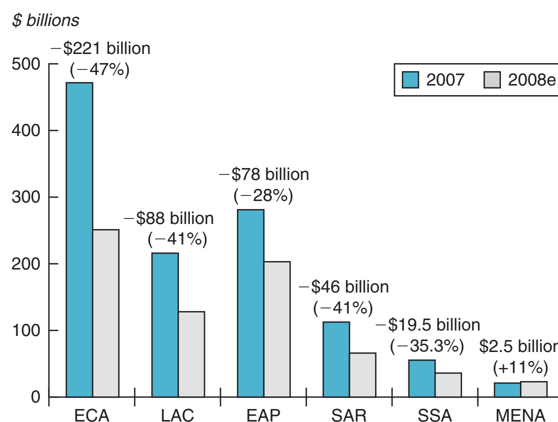
Table 2.2 Net capital inflows to developing regions, 2005–08

$ billions

	2005	2006	2007	2008e
Total	570	739	1158	707
By region:				
East Asia and Pacific	187	206	281	203
Europe and Central Asia	192	311	472	251
Latin America and the Caribbean	113	85	216	128
Middle East and North Africa	19	25	21	23
South Asia	25	72	113	66
Sub-Saharan Africa	33	40	55	36

Source: World Bank Debtor Reporting System and staff estimates.
Note: e = estimate.

Figure 2.2 Net private capital inflows to developing regions, 2007–08



Source: World Bank Debtor Reporting System and staff estimates.
Note: e = estimate.

portfolio equity (26 percent), and bonds (20 percent). Almost all regions experienced significant setbacks in short-term debt flows. Short-term debt accounted for a major share of the decline in East Asia and the Pacific (67 percent), South Asia (56 percent), and Europe and Central Asia (45 percent). In Sub-Saharan Africa, on the other hand, two-thirds of the $15 billion decline came in portfolio equity, with the rest in bond financing.

FDI inflows rose slightly in 2008. Most of the $63 billion increase flowed to the East Asia and Pacific and South Asia regions. FDI inflows to India doubled, reflecting economic reforms in recent years and progress in opening up additional

sectors for foreign investment. The high commodity prices that persisted through most of 2008 continued to support investment in resource-rich developing countries such as Angola, Brazil, Chile, Kazakhstan, and the Russian Federation. Because the unfolding crisis had an even more profound effect on FDI within the industrialized world (causing a 40 percent drop in 2008), the developing world increased its share in global FDI to a record 40 percent in 2008 from an average of 25 percent over the last decade. (Global FDI amounts to about $1.4 trillion.)

In 2008, foreign exchange reserves accumulation in the developing world slowed considerably, as many countries drew down reserves to cope with the impact of the financial crisis (see chapter 3 for a detailed discussion on foreign exchange reserves). The year ended with reserves up only $447 billion, about half of the almost $1 trillion increase seen in 2007.

The "balancing item" that reconciles the balance-of-payments accounting identity between the current and capital accounts and changes in foreign reserves fell by $172 billion to –$657.7 billion (see table 2.1). This item captures capital outflows as well as the various errors and omissions that are entailed in measuring capital- and current-account transactions in the balance of payments. With growing financial integration, capital outflows from developing countries have increased significantly in recent years. Driven by ample liquidity and a desire to diversify their assets, investors and multinational companies in developing countries have acquired assets and invested in debt markets abroad—both in developed and developing countries. Part of the balancing item can be explained by the resulting increase in net equity outflows, which reached $244 billion (1.5 percent of GDP) in 2008 from $190 billion (1.4 percent of GDP) in 2007. Net FDI outflows increased by $20 billion to an estimated $162 billion in 2008, led by the Russian Federation ($50 billion), China ($25 billion), Brazil ($18 billion), Malaysia ($15 billion), and India ($13 billion). Most of the outflows from Russia and China reflected investments in extractive industries, whereas the Malaysian investments were in financial services and the Indian in energy and services. Portfolio equity outflows also rose to $80 billion in 2008, from $50 billion in 2007.

Another part of the balancing item stems from the way that exchange rate valuation effects are taken into account in calculating changes in foreign reserves. Reserve holdings in each country at year-end are first converted into dollars before calculating changes in reserves from the end of the previous year. In contrast, the various current and capital account flows are converted into dollars at average exchange rates. The following exercise was undertaken to determine the importance of exchange rate valuation effects on reserves: A portfolio of reserve holdings was constructed by allocating the dollar value held by developing countries into the four main reserve currencies (U.S. dollar, euro, pound sterling, and Japanese yen). After changes in reserves were calculated for each reserve currency in each year, the resulting flows were reconverted to dollars. Calculating exchange rate valuation effects on reserve changes in such a manner instead of on reserve holdings raises the estimate of reserve accumulation by $108 billion (14 percent) in 2008 and reduces it by around $80 billion in 2006–07 (11 percent), which acts to stabilize the year-to-year fluctuations in the balancing item.

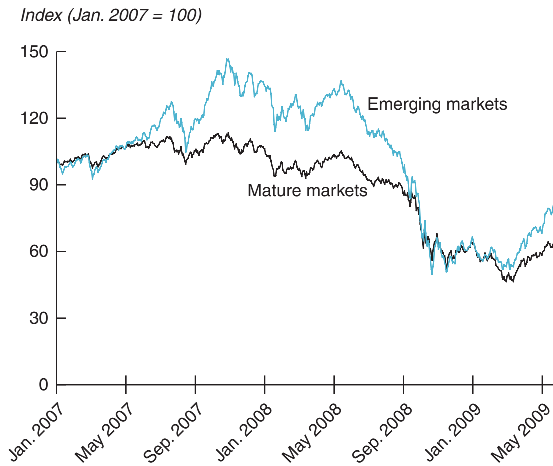
The downturn began in late 2008, as part of the global financial crisis

Most of the decline in net private capital flows to developing countries in 2008 occurred in the last quarter of the year, following the deterioration of global financial markets. As discussed in chapter 1, the financial turmoil began in the summer of 2007, as the distress in U.S. subprime mortgage markets became increasingly clear through a string of events that culminated in the collapse of Lehman Brothers in September 2008 (GEP 2008).[1] Those events depressed the confidence of investors and financial institutions in the ability of counterparties to make good on their financial commitments. Uncertainty over the ability of major financial institutions to survive the crisis, coupled with the sharp rise in volatility, drove investors toward safe assets. Meanwhile, financial institutions intensified their deleveraging process—shedding assets and raising capital—leading to major outflows from global markets, including the developing-country markets reviewed in the previous section.

The resilience of developing countries to the global financial crisis broke down after September 2008

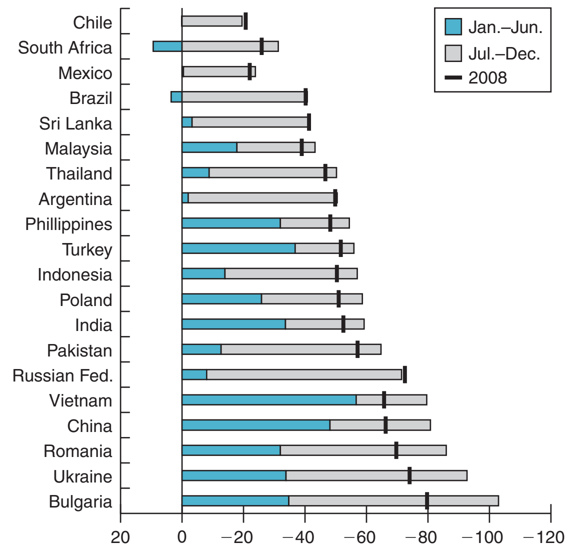
Developing countries exhibited a certain degree of resilience to the emerging crisis during the first half of 2008. As the crisis intensified in September,

Figure 2.3 MSCI equity index from January 2007–February 2009



Source: Bloomberg Data Service.

Figure 2.4 Declines in developing-country stock markets in 2008



Source: World Bank staff estimates.

however, with a massive retreat from risky assets all around the world, the financial markets in developing countries felt the heat. Their stock markets joined those in high-income countries, falling 40 percent in dollar terms (figure 2.3). Bond spreads spiked, bond flows dried up, and (although difficult to document) there was a sharp increase in capital outflows. Virtually all the currencies in the world depreciated against the U.S. dollar, with some developing-country currencies losing more than 50 percent of their value.

The downturn in equity prices began early in 2008 but intensified dramatically in September (figure 2.3). The MSCI index (measured in U.S. dollars) dropped by 13 percent between January and June, then another 13 percent from July to mid-September, as markets in major commodity exporters such as Brazil and Russia reacted to the drop in commodity prices. It then plummeted by 42 percent between mid-September and mid-December.

Following further declines in January and February 2009, the fall in global equities ceased in March, led by financial stocks, as investor sentiment improved amid tentative signs of greater global economic optimism. But it is uncertain at this point whether stock markets have turned the corner. Upcoming economic data and corporate earnings reports still carry relatively high downside risks. Surprisingly, emerging market equities fared much better since March 2009, posting a gain of 60 percent, compared with the mature markets' gain of 33 percent.

With several other financial institutions coming under increasing stress during the second half of 2008, major international banks, hedge funds, and other investors—especially highly leveraged ones—were impelled to sell off their riskier assets, producing major outflows from emerging market equities and equity funds. Emerging market equity funds posted a record net outflow of $48.3 billion in 2008, compared with a net inflow of $54 billion in 2007. Outflows initiated by foreign portfolio investors were $30 billion in the third quarter alone, the highest quarterly level since 1995. Outflows continued in October and November but ceased in December, when the leak was breached by net inflows of $1 billion. Most of the repatriated capital was drawn out of East Asia and the Pacific, traditionally a dominant destination for emerging-market equity investors. Foreign investors withdrew $25.7 billion from emerging-country Asian stocks in 2008. In contrast, investors pulled out only $4.9 billion from funds in emerging Europe and $5.9 billion from funds in Latin America.

The impact of the sell-off on local equity markets was widespread among developing countries, but some were hurt more than others (figure 2.4). Stock markets in Brazil, China, India, and Russia experienced some of the biggest declines in 2008.

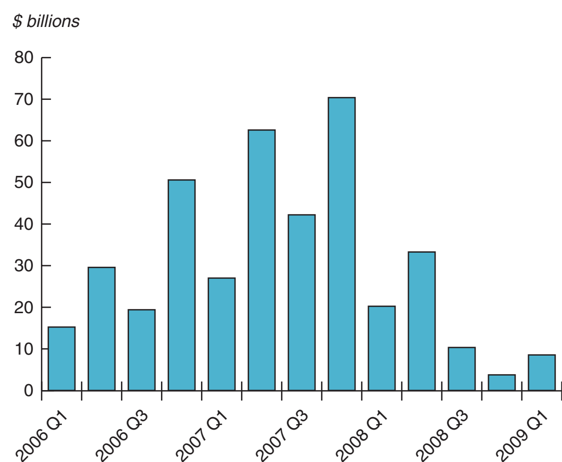
Russia was the worst performer of the four, chalking up a 72.5 percent decline in local currency terms. The fall of share prices resulted in margin calls and severe trading losses among major domestic banks, which brought the country's money market to a halt. Markets in the other three countries lost more than half of their value—Brazil posted a 40 percent decline, India 52 percent, and China 66 percent. The magnitude of the correction during the second half of the year was much more severe for Brazil and Russia than for China and India, reflecting the fact that the sharp drop in commodity prices affected the first two countries more than the second two. Even the best-performing emerging markets—those in Chile, Mexico, and South Africa—posted losses of more than 20 percent in 2008. Those with heavy external financing needs (especially certain emerging European economies) suffered larger declines in stock market prices (chapter 3). Due to the broad scope of the crisis, its impact on equity prices in developing countries has been deeper and broader in comparison to past episodes (box 2.1).

Equity issues in developing countries plunged with the fall in stock markets. Gross equity issuance fell to $67.6 billion in 2008, compared with $202.16 billion in 2007 (figure 2.5). Developing-country companies only raised $3.8 billion in the fourth quarter of last year, posting the worst quarterly volume since the third quarter of 2004. The same picture emerges from the collapse in initial public offerings (IPOs) (figure 2.6). About 52 IPO deals were withdrawn or postponed in 2008, the highest annual total on record. The value of completed IPO deals in 2008 was $27.7 billion from 149 issues, down 78 percent from record highs of $124.4 billion from 403 issues in 2007.

The sharp decline in IPO activity was due in part to the lack of participation by hedge funds, many of which have suffered major losses in the ongoing crisis. Hedge funds in recent years have become a dominant force in primary emerging equity markets. They are now considered a crucial part of IPO transactions—in developed and developing countries alike—owing both to the volume of their purchases and their early involvement in the IPO process. But lately many hedge funds have faced a wave of fund withdrawals and significant losses. The industry as a whole shed a fifth of its value last year, shrinking from its 2008 peak of $1.9 trillion to $1.5 trillion at the end of the year.

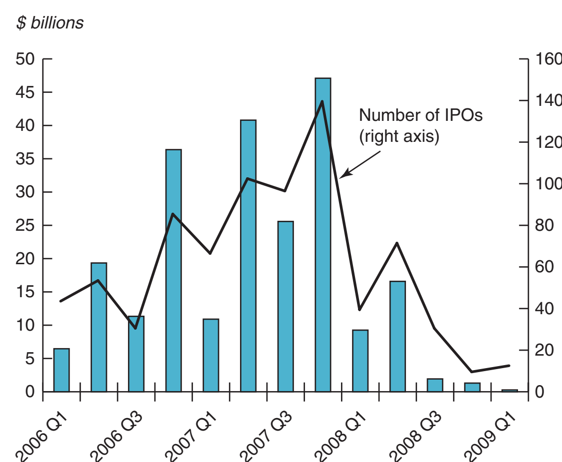
IPO activities are off to the slow start this year as a total of 11 deals by developing countries raised only $300 million in the first quarter of 2009, the lowest quarterly volume since the third quarter of 2001. This compares with 39 deals in the first quarter of 2008 that raised $9.3 billion. There was no IPO activity at all in Latin America and Sub-Saharan Africa during the first quarter of 2009. Most of the quarterly volume occurred in East Asia, where nine deals were made.

Figure 2.5 Gross equity issuance by developing countries, 2006–08



Source: World Bank staff estimates.

Figure 2.6 IPO activities in developing countries, 2006–08



Source: World Bank staff estimates.

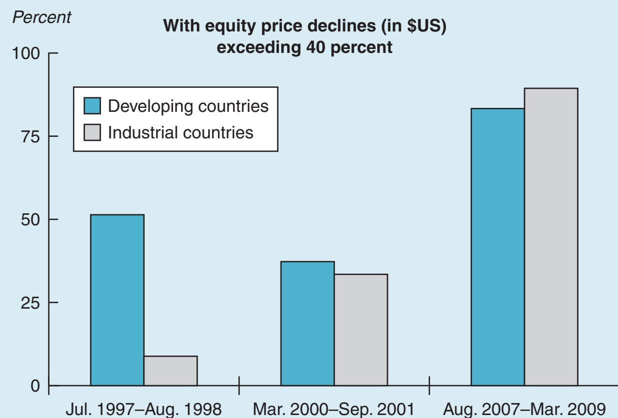
Box 2.1 The impact of the current financial crisis has been much deeper and broader than previous crises

Financial crises in developing countries over the past 50 years fell most heavily on a limited number of countries that had built up significant weaknesses. Other countries also were affected, owing to trade ties with the most-affected countries or the presence of similar weaknesses, which led investors to anticipate similar crises, and to the tendency of investors to withdraw from high-risk assets in times of economic difficulties. Nevertheless, in previous crises many developing countries were able to maintain their growth rates and escape significant financial disruptions. Although the full impact of the current financial crisis on growth is still unfolding, virtually all developing and high-income countries have suffered a deterioration in equity prices and, in the case of developing countries, sovereign bond spreads. The broad scope of the crisis greatly complicates prospects for recovery.

Developing countries' equity prices illustrate the broad reach of the present crisis in comparison to past episodes. Two in three developing countries have experienced equity-price declines of more than 40 percent in local currency, and three in four in U.S. dollars, since the peak reached in October 2007. During the Asian and Russian crises (July 1997 to August 1998), the proportion was just one in two (in U.S. dollars) (see figure on the right).

The average decline in developing countries' equity prices (in U.S. dollars) also has been more pronounced than in previous crises (figure below). This time around, the composite index for emerging markets (MSCI equity index) has fallen by almost 80 percent from the peak reached in October 2007, much greater than the 57 percent fall during the Asian and Russian crises.

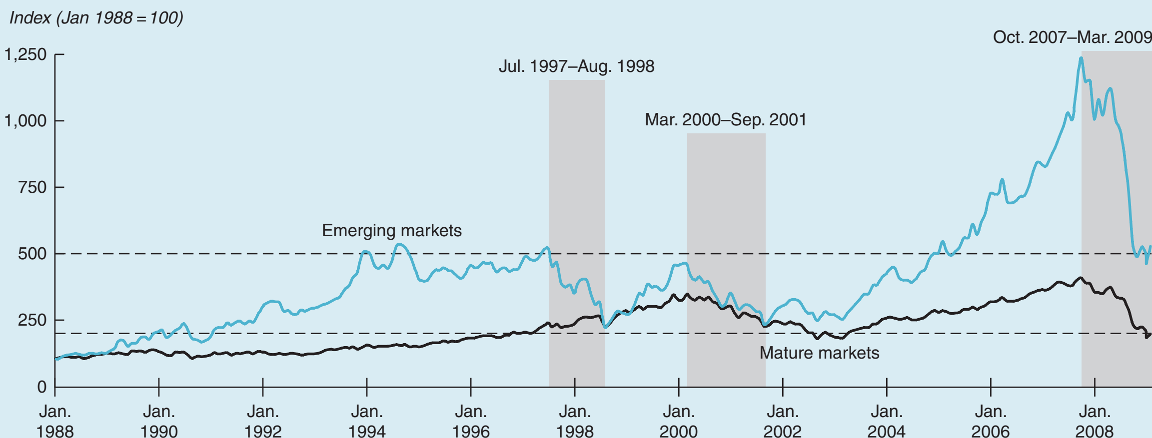
Countries with declines in equity prices during three crises



Source: World Bank staff calculations based on equity price data from MSCI Barra and nominal exchange rates from Datastream.

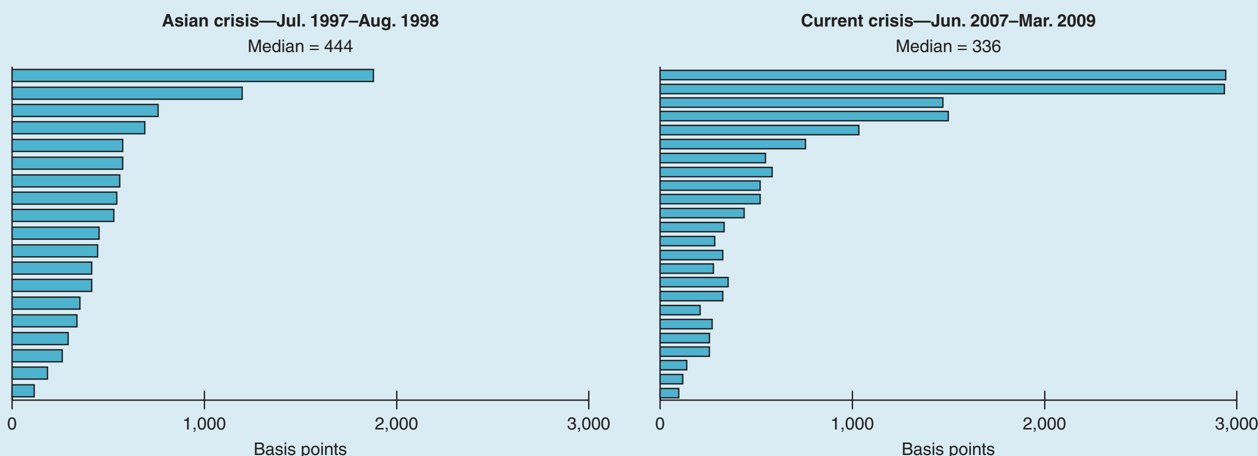
International equity prices, January 1998–January 2009

U.S. dollars



Source: JP Morgan.

Changes in emerging market bond spreads during two major economic crises

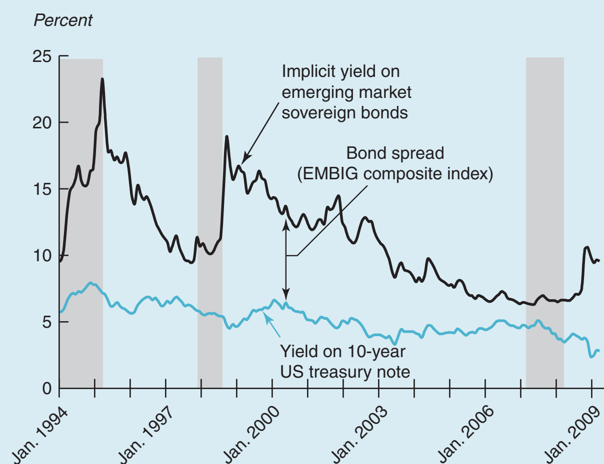


Source: JP Morgan.

More developing countries also have experienced a substantial widening of secondary-market spreads in this crisis than in previous episodes. For example, while the median rise in developing countries' secondary-market spreads[a] since mid-2007 has been 336 basis points, spreads have widened by more than 1,000 basis points in five countries (Argentina, Ecuador, Kazakhstan, Pakistan, and Ukraine). During the Asian and Russian crisis, the median increase was higher (444 basis points), but only two countries (the Russian Federation and República Bolivariana de Venezuela) experienced an increase of more than 1,000 basis points (figure above).

Note that during the current crisis, with significant monetary easing by major central banks, the decline in benchmark interest rates (2.6 percentage points from mid-2007 to end-2008 for 10-year U.S. treasury notes) has moderated the impact on borrowing costs: the yield on emerging market sovereign bonds tied to 10-year U.S. treasuries rose by only 330 basis points. The benchmark interest rate also declined during the Asian and Russian crisis but to a lesser extent (140 basis points between September 1997 and September 1998). During the Mexican peso crisis (which was triggered by a sharp increase in U.S. interest rates) the yield on emerging market sovereign bonds leaped to a record high of more than 23 percent (figure below).

Emerging market sovereign bond spread and yield, January 1994–March 2009



Source: JP Morgan.

a. In 2009, countries with secondary-market spread information include Argentina, Brazil, Bulgaria, Chile, China, Colombia, Ecuador, the Arab Republic of Egypt, Indonesia, Jamaica, Kazakhstan, Lebanon, Malaysia, Mexico, Pakistan, Peru, the Philippines, Poland, Russian Federation, South Africa, Turkey, Ukraine, and Vietnam.

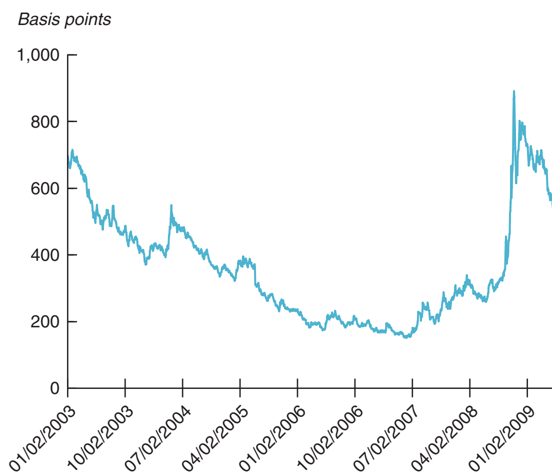
Developing countries' access to international bond markets suffered as well

International bond issuance by developing countries contracted as the crisis unfolded. The reassessment of credit risks and increased risk aversion on the part of international investors led to a surge in bond spreads worldwide. The high-yield spreads in industrial countries widened by more than 1,000 basis points between mid-September and early-December of 2008. Emerging market spreads were less affected than high-yield corporate borrowers in mature markets, widening by only 385 basis points over the same period. Nevertheless, spreads on developing countries' sovereign bonds reached a seven-year high of 874 basis points in late October, comparable to levels reached at the height of the Russian crisis a decade ago (figure 2.7).

In the last quarter of 2008, spreads on higher-risk bonds rose more than those on lower-risk bonds, reflecting the increased risk aversion among investors. The average spread in the B-rated category widened by 728 basis points, while spreads on bonds rated investment grade widened by an average of just 310 basis points (figure 2.8). The difference reflects both tiering within the corporate market and higher increases in spreads on corporate versus sovereign bonds.

So far in 2009, the spreads for emerging market debt tightened by 260 basis points from the end of last year, closing at 464 basis points in late May. The tightening in spreads occurred across the entire spectrum of credit risk, reflecting a slight increase in investors' appetite for riskier assets.

Figure 2.7 Emerging market bond spreads widened sharply at year's end, 2003–09



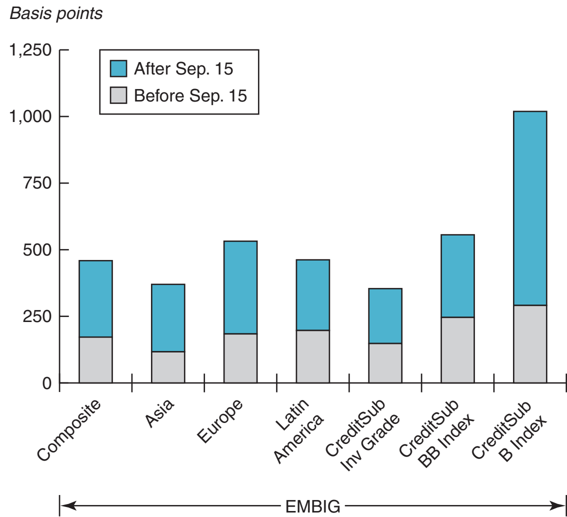
Source: Bloomberg.

Credit quality declined as bond spreads widened, with 17 downgrades of emerging market sovereign bonds in the fourth quarter of 2008—and no upgrades (figure 2.9). The deterioration in credit ratings was largely concentrated in Latin America and emerging Europe, with recent downgrades registered in the Dominican Republic, Ecuador, Kazakhstan, Romania, the Russian Federation, and República Bolivariana de Venezuela. So far in 2009, another 7 credit downgrades have occurred: in Jamaica, Latvia, Lithuania, Mongolia, Russia, Thailand, and Ukraine.

The escalation of the global crisis increased investors' fears that developing countries would default on their debt. In times of distress, when a country loses access to international capital markets, the prices of sovereign credit default swaps (CDSs)—a form of insurance protection against debt default—are often considered a leading indicator of the perceived risk of government debt. Traders use them to speculate on changes in sovereign credit quality. For example, in October 2008, sovereign CDS spreads in emerging market economies widened sharply, particularly in Argentina, South Africa, Turkey, and Ukraine (figure 2.10). Some of these countries were considered risky because of their need for substantial external financing (see chapter 3 for further discussion). In Argentina, however, five-year CDS spreads skyrocketed to more than 4,000 basis points (representing a cost of more than $4 million to insure $10 million of government debt over five years) after the government carried out a de facto nationalization of the country's private pension fund system. CDS spreads on Ukraine also spiked to 2,849 basis points in October, as the country sought and received $16.5 billion in emergency loans from the International Monetary Fund (IMF). Some emerging market countries that are considered relatively stable, such as Brazil and China, were also hit hard, signifying growing aversion to the perceived riskiness of emerging market countries as a class in the worsening global economic climate.

The financial crisis had a marked impact on bond issuance worldwide. The decline in global bond issuance began in the second half of 2007, and the volumes remained low throughout 2008.

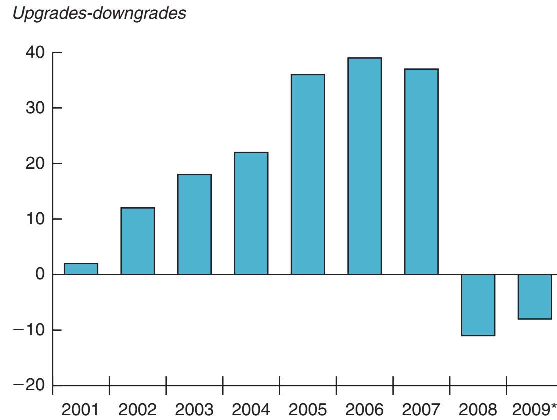
Figure 2.8 Bond spreads widened in all asset classes in 2008



Sources: JP Morgan; Bloomberg.

But the impact became definite in developing countries after September. Not one developing-country firm or sovereign issued a bond on international markets in October or November (figure 2.11), although December saw a $300 *million* issue by a Russian corporation and a $2 billion issue by the Mexican government.

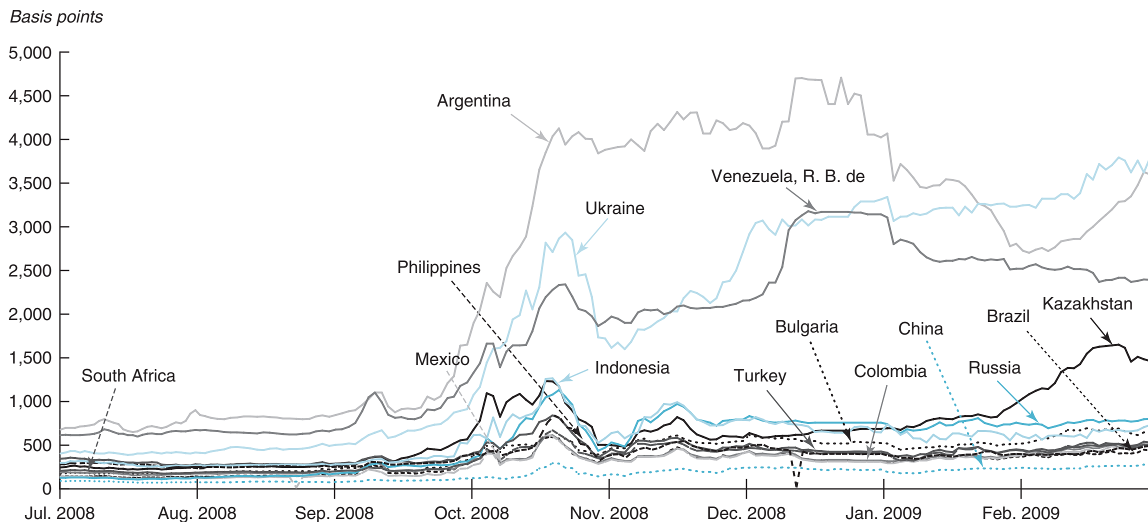
Figure 2.9 Deteriorating credit quality for emerging markets in 2008



Sources: JP Morgan; Bloomberg.
*As of April 2009.

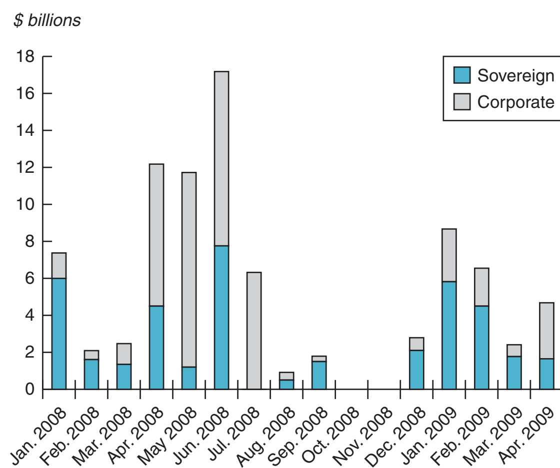
Issuance was surprisingly strong in the first two months of 2009. Sovereign borrowers have continued to tap the market, taking advantage of improving market conditions. In fact, sovereigns have dominated borrowing activity so far in 2009, accounting for $12 billion of the almost $17 billion in total borrowing (table 2.3). The sovereign bond market in 2009 remained open not only for creditworthy borrowers, such as Brazil and

Figure 2.10 Sovereign five-year credit default swap spreads, July 2008–February 2009



Sources: JP Morgan; Bloomberg.

Figure 2.11 Bond issuance by developing-country governments and firms, January–February 2009



Source: Dealogic Loan Analytics.

Poland, but also for B+ issuers, such as Turkey and the Philippines. Poland also made a successful return to the market at the end of January, with a €1 billion Eurobond sale, even as three emerging Europe sovereigns suffered ratings downgrades, with a subsequent widening of spreads. In contrast, corporate borrowers, most in Latin America, raised just $5 billion over the same period. Corporate issuance has been limited to high-grade borrowers, suggesting that the market remains closed to high-risk corporate borrowers. As a result, the share of sovereign in bond financing surged to 70 percent compared with the average of 35 percent over the past few years (2005–08).

In April, bond issuance by developing countries was limited. Only Colombia and Indonesia came to the market. Indonesia raised $650 *million* from sales of its five-year global Islamic bond, part of the country's budget financing plan for 2009. The issue marked the first U.S.-dollar-denominated Islamic bond this year. The reception was strong, with more than $4 billion in orders. The Colombian government also tapped the international debt market for $1 billion by reopening its 10-year, dollar-denominated bond. The government may have been pre-financing for 2010. Colombia sold the bond initially in January to cover this year's external funding needs, part of an early rush in bond issuance from emerging markets that required issuers to offer an enhanced risk premium to entice investors. On the corporate side, much of the 2.3 billion issuance was by the Russian gas company, Gazprom.

The collapse of the stand-alone investment banks seems to have had little impact on the developing-country bond market, as other international financial institutions filled the gap, and the concentration of emerging market bond arrangers increased only slightly after the collapse (table 2.4).[2] Since the last quarter of 2008, HSBC has almost tripled its market share to 14.4 percent from 5 percent during the previous seven quarters. With its acquisition of Lehman Brothers' U.S. investment banking business at the end of the third quarter of last year, Barclay Capital also gained a larger share in the market.

The reversal of short-term debt was significant . . .

Flows of short-term debt (debt with an original maturity of one year or less) to developing countries were strong during the first half of 2008.

Table 2.3 Emerging market bond issuance in 2009*

Country	Announced	Maturity	Size ($ billion)	Yield to maturity (%)	Issue price
Brazil	6-Jan-2009	15-Jan-2019	1.0	6.223	98.135
Colombia	6-Jan-2009	18-Mar-2019	1.0	7.634	99.136
Turkey	7-Jan-2009	14-Jul-2017	1.0	7.629	100.000
Philippines	7-Jan-2009	17-Jul-2019	1.5	8.668	99.158
Poland	22-Jan-2009	3-Feb-2014	1.3	5.940	99.725
Mexico	11-Feb-2009	17-Feb-2014	1.5	6.102	99.424
Indonesia	26-Feb-2009	4-Mar-2019	2.0	12.097	99.276
Lebanon	13-Mar-2009	19-Mar-2012	0.4	7.500	100.000
Panama	18-Mar-2009	15-Mar-2015	0.3	7.162	101.000
Peru	25-Mar-2009	30-Mar-2019	1.0	7.326	99.500
Colombia	14-Apr-2009	18-Mar-2019	1.0	7.509	99.990
Indonesia	16-Apr-2009	23-Apr-2014	0.7	8.994	100.000

*As of April 28th.
Source: Dealogic Loan Analytics.

Table 2.4 Major book-runners for emerging market bonds, 2007Q1–2009Q1

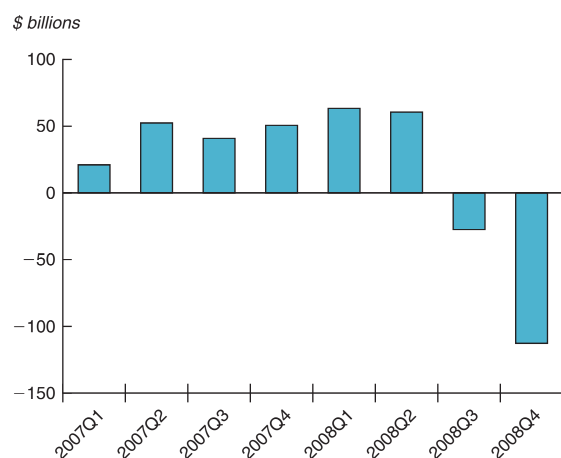
2007Q1–2008Q3				2008Q4–2009Q1			
Rank	Bookrunner	Deal value ($ billion)	% share	Rank	Bookrunner	Deal value ($ billion)	% share
1	Deutsche Bank	25	12.7	1	HSBC	25	14.4
2	Citi	23	11.8	2	Goldman Sachs	23	9.8
3	Credit Suisse	19	9.4	3	Barclays Capital	19	9.7
4	ABN AMRO	17	8.5	4	Citi	17	8.3
5	UBS	16	8.1	5	UBS	16	8.1
6	JP Morgan	14	7.3	6	Morgan Stanley	14	8.1
7	Barclays Capital	12	6.0	7	Credit Suisse	12	7.0
8	HSBC	10	5.0	8	JP Morgan	10	6.9
9	Bank of America/Merrill Lynch	9	4.4	9	Deutsche Bank	9	4.9
10	Morgan Stanley	8	4.1	10	VTB Capital	8	4.1
			77.3				81.2

Source: Dealogic Loan Analytics.

However, flows became negative in the third quarter of the year and later registered a sharper drop ($113 billion) in the last quarter of the year following the deterioration of the global financial markets (figure 2.12).[3] For the year, the stock of short-term debt in developing countries declined by $16 billion to $831 billion, well below the peak reached in 2007 (see further discussion in chapter 3).

Short-term debt flows have exhibited higher volatility than medium- and long-term flows, particularly during crises. During the Asian crisis, for example, short-term debt fell more sharply in developing countries than did other flows. The reason may be that in times of crisis lenders tend to shift their portfolios to more creditworthy borrowers, which are in a better position to serve longer-maturity loans.

Figure 2.12 Short-term debt flows to developing countries, 2007Q1–2008Q4



Source: World Bank staff estimates based on Bank for International Settlements data.

Note: Flows are calculated as the change in the stock between periods. These numbers might vary from the data reported by the World Bank due to difference in sources for some countries. World Bank Debt Reporting System (DRS) data are obtained, whenever available, directly from country authorities.

Access to trade finance has become more difficult

Many countries borrowed short-term to finance their growing trade as firms contracted short-term loans to finance imports and prepay for exports. In China, for example, trade finance in 2007 amounted to $133.1 billion, accounting for more than half of the country's short-term debt. Similarly, all of India's $45 billion in short-term debt is trade-related (table 2.5).

Table 2.5 Short-term debt stock in developing countries by sector, 2008Q3

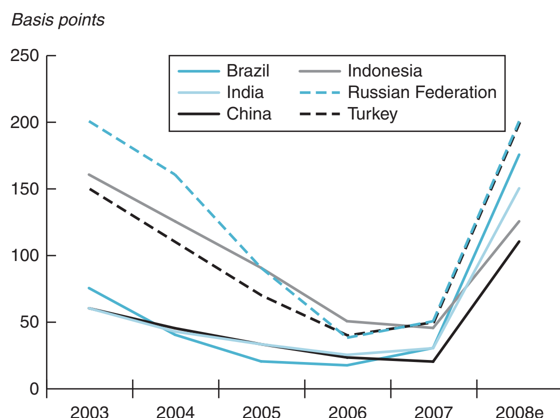
		Corporate	
Country	Banks	Total	Trade credit
Russia	63.6	38.4	—
Brazil	46.4	1.1	0.3
Turkey	26.2	28.1	26.0
Poland	28.5	21.2	17.3
Mexico	4.5	21.3	7.6
Indonesia	7.3	10.8	1.6
South Africa	21.3	5.5	3.4
Thailand	4.4	16.2	11.7
Chile	3.2	15.4	12.3
India	—	46.8	46.3
Malaysia	36.4	2.2	—
Total	**226.1**	**202.7**	**126.7**
Memo: China	133	69	—

Sources: World Bank Quarterly External Debt Statistics (QEDS) (except for China); Central Bank of China (for China).
Note: — = Not available.

As a result, the sharp drop in short-term debt has also strained trade finance. Many developing countries worried that limited access to trade credit would affect global trade. In fact, in early October 2008, the Brazilian government announced that because its exporters were having trouble obtaining trade credit it would use its reserves to maintain the flow of credit and keep trade moving. Monthly balance-of-payments data for Brazil indicate that net flows of trade credit provided by nonresidents turned negative in October 2008 and remained so into December (BIS 2009). Amid concerns about the cost and continued availability of trade finance, the World Trade Organization (WTO) held an experts meeting on November 12, 2008. Several measures were floated, including an increase in trade finance.

In part, these changes reflected the higher capital requirements that banks faced as the creditworthiness of recipients of trade credit was downgraded. Indeed, capital requirements for trade finance tripled under the Basel II Accords over Basel I. In 2008 as the financial crisis intensified, the spreads on trade finance credit increased by a factor of three to five in major emerging markets, including China, Brazil, India, Indonesia, Mexico, and Turkey (figure 2.13). For example, the spread (over the 6-month LIBOR) for Turkey jumped to 200 basis points in November from 70 basis points in the third quarter, while Brazil's spread more than doubled in 2008. Similarly, spreads for several Sub-Saharan countries jumped from 100 basis points to 400 basis points, and most banks moved away from funding open-account facilities to more traditional forms of cash-backed or collateralized letters of credit.

Figure 2.13 Spreads on trade finance credit spiked in 2008



Source: World Bank staff estimates based on information from various international bank documents.
Note: e = estimate.

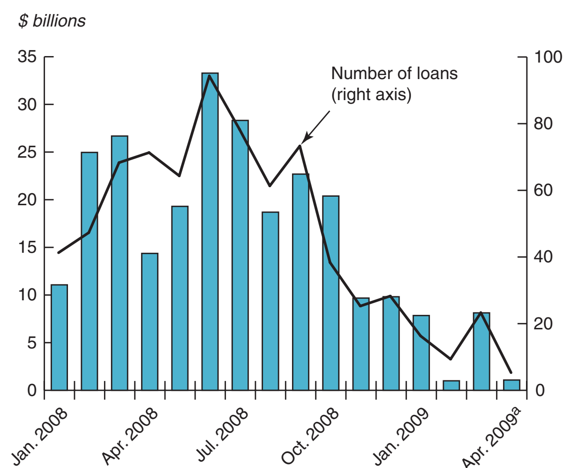
Several countries entered into bilateral agreements to ease the strains on access to foreign currencies, including trade credit. In December 2008, the U.S. Federal Reserve entered into currency swap agreements with some of its counterparts, including Brazil and Mexico. Each partner in the agreement received a swap line of $30 billion. In addition, the United States and China—acting through their respective import-export banks—created a bilateral trade facility of $20 billion. In March 2009, China entered into similar agreements with its major trading partners (Argentina, Belarus, the Republic of Korea, Malaysia, Indonesia, and the Philippines) by providing swap facilities in its currency.

The decline in syndicated bank lending was more gradual than that of other debt flows in 2008 . . .

Several developing countries continued to access bank credit following the collapse of Lehman Brothers. Syndicated bank lending commitments (the only segment of international bank lending for which high-frequency data are available) declined by $80 billion in 2008, a drop of 25 percent, from record-high levels in 2007.

The drop in syndicated bank lending was modest compared with the 75 percent decline in bond financing and 50 percent decline in portfolio equity issuance during the same period. Even in the fourth quarter of 2008, syndicated loan commitments totaled $39.8 billion, down just $13 billion from the same period in 2007—but the number of transactions was halved. The bulk of the deals in the fourth quarter involved large long-term financing for energy projects. During October and November, Chinese banks financed energy projects in Kazakhstan ($7.5 billion) and Uzbekistan ($3.5 billion). Although most of the deals were guaranteed by the creditor's government, almost 90 percent of the loans went to the private sector. In contrast to project finance, syndicated loans for refinancing totaled only $2.7 billion, compared with an average of $10.4 billion for the first three quarters of the year.

Figure 2.14 Syndicated bank lending to developing countries, January 2008–April 2009



Source: Dealogic Loan Analytics.
a. April 2009 data is until April 26, 2009.

. . . but deteriorated significantly in the first quarter of 2009

But in the first quarter of 2009, syndicated bank lending to developing countries fell sharply (figure 2.14). Only 46 transactions totaling a mere $17 billion took place in the first quarter of the year, the lowest since 2003. While syndicated bank lending exhibits high volatility when viewed through high-frequency data (monthly or quarterly), the first quarter of 2009 marks a sharp decline from the same periods in 2007 ($81 billion, 171 transactions) and 2008 ($63 billion, 156 transactions). In January, three large syndicated loans valued at $8 billion were made to private companies in Mexico and Russia.[4] After an unprecedentedly subdued February, the Brazilian energy company Santo Antonio Energia managed in March to arrange a 25-year loan valued at $3.5 billion in local currency for project financing. As of the end of April, only five deals valued at $1.1 billion had been made.

There was an increase in bank-lending from other sources . . .

In contrast to syndicated bank lending, the first months of 2009 were an outstanding period in terms of (bilateral) bank lending from other sources to developing countries—although the picture is skewed by the presence of a few very large loans. In February, five large loans valued at $32 billion were made, a volume comparable to that of all such loans made in 2007 ($32.4 billion) and 2008 ($36 billion) (table 2.6). The two loans that the China Development Bank granted to Russian oil companies are the largest bilateral bank loans ever made in the developing world. The record-setters are 20-year pre-export loans with special clauses governing oil delivery for the duration of the loan. In most of the bilateral loans made so far in 2009, the lender was a quasi-governmental entity.

Even FDI inflows—the most stable international capital flows—showed signs of slowing in the last quarter of 2008

FDI inflows to developing countries tend to be more stable than other kinds of capital flows because FDI investors—mostly multinational companies—take a longer-term view than most portfolio investors and lenders. Nevertheless, the global financial crisis has begun to cut into FDI inflows to developing countries. In the fourth quarter of 2008, flows to 25 middle-income countries declined to their lowest level since the fourth quarter of 2006 (figure 2.15).

In some countries, multinationals repatriated larger shares of their income from direct investment

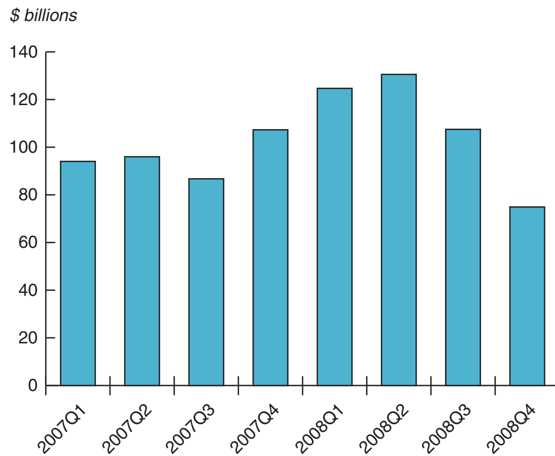
During the first three quarters of 2008, multinational corporations repatriated growing shares of income from some large countries, leaving less

Table 2.6 Major bilateral bank loans in February 2009

Borrower (Country)	Lender (Country)	Sector	Value ($ billion)
Rosneft (Russia)	China Development Bank (China)	Oil & Gas	$15
Transneft (Russia)	China Development Bank (China)	Oil & Gas	$10
SamrukKazyna (Kazakhstan)	Vnesheconombank (Russia)	Finance	$3
Prominvestbank (Ukraine)	Vnesheconombank (Russia)	Finance	$1

Source: Dealogic Loan Analytics.

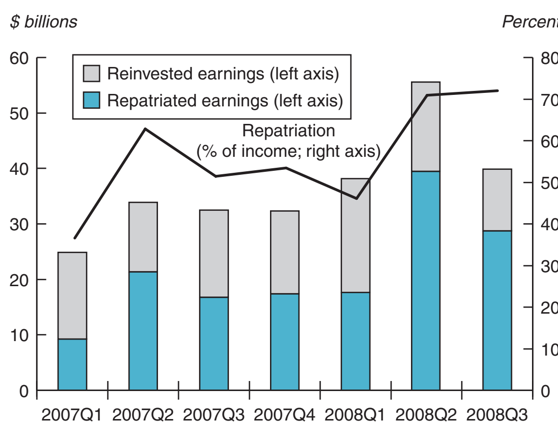
Figure 2.15 Quarterly FDI inflows to selected developing countries dipped in 2008



Source: World Bank staff estimates based on data from central banks of selected developing countries.

Note: Countries include Brazil, Bulgaria, Chile, China, Croatia, Egypt, India, Indonesia, Jordan, Kazakhstan, Malaysia, Mexico, Pakistan, the Philippines, Poland, Romania, Russia, South Africa, Thailand, Turkey, Ukraine, and R. B. de Venezuela.

Figure 2.16 Distribution of income from FDI in selected economies, 2007Q1–2008Q3



Source: World Bank staff estimates.

Note: Countries include Bulgaria, Chile, Colombia, India, Poland, Russian Federation, and Thailand.

for reinvestment (figure 2.16). Repatriation as a percentage of income increased to as much as 70 percent during the second and third quarters of the year, compared with an average of 50 percent in previous quarters. Nevertheless, because of the significant rise in FDI income in 2008, the value of earnings reinvested in the same economies still increased by $5 billion (to $47 billion) during the first three quarters of the year compared with the same period a year earlier.

Several factors (such as stable payment of dividends, tax rates, and other regulations) affect corporate decisions to reinvest or repatriate equity earnings (World Bank 2007). During the previous crises centered in host economies, multinational companies repatriated earnings in excess of current income or called in intra-company loans to reduce their exposure to a country quickly without selling assets (box 2.2). Following the Asian crisis, for example, U.S. multinationals repatriated *all* their FDI income from the region (World Bank 2004). Over the last 10 years, by contrast, multinationals have reinvested 30 to 40 percent of their income from foreign operations back into the host country. Reinvested earnings and intra-company loans made up 20 percent and 15 percent of FDI flows to developing countries, respectively.

Some troubled financial institutions have begun to repatriate assets

Some financial institutions, positioning themselves to weather the crisis, have been raising capital by selling assets (mostly in their noncore business) in developed and developing countries. The sales lead to direct disinvestments from developing countries when domestic companies buy the assets. For example, in 2008, two troubled institutions, American International Group Inc (AIG) and Citigroup, sold their shares in Brazil's Unibanco (for almost $1 billion) and in India's Global Services Ltd (for $500 million) to local companies. In December 2008, AIG sold its consumer finance businesses in Argentina, Brazil, Colombia, and Mexico. More recently, it also sold its subsidiaries in Thailand to a local company for $500 million.[5]

In 2008, the value of such sales by developed-country financial firms to local companies in developing countries doubled to $11 billion, well up from $5 billion in 2007 (figure 2.17). Anecdotal evidence indicates that this trend has continued in 2009. While the amount of these sales is small in the aggregate, it may represent a considerable decline in FDI inflow for some of the affected countries.

A sharp drop in cross-border M&A transactions in developing countries signals weak FDI flows in 2009

An early indicator for the projected decline in FDI inflows is the slowdown in cross-border

Box 2.2 The composition of foreign direct investment in times of crisis in the host economies

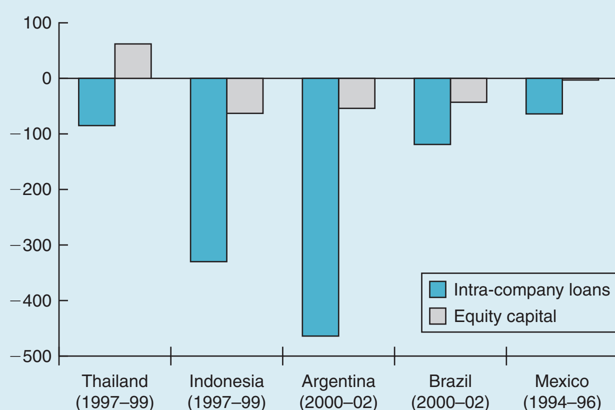
By definition, foreign direct investment (FDI) comprises equity investment, reinvested earnings (earnings not distributed as dividends and earnings of branches not remitted to the direct investor), and intra-company debt transactions (OECD 2008). Intra-company debt transactions include the borrowing and lending of funds, including debt securities and trade credits, between parent and subsidiaries and among subsidiaries.

The resilience of FDI can be traced to its equity component, which reflects the long-term strategic behavior of foreign direct investors. In contrast to the relatively stable equity component, intra-company loans and reinvested earnings are often used as a means to adjust FDI exposure (World Bank 2004). During a crisis in a host country, repaying loans or repatriating earnings is often easier than selling off direct equity. Also, a direct equity holding usually reflects a long-term strategic commitment and may not change immediately following a crisis—although it may change if the crisis is prolonged. This can be seen from the experience of some countries that faced financial crises, where the decline in intra-company loans following the crisis was significantly larger than the decline in the equity component of FDI (figure on the left). In the case of Argentina, for example, intra-company loans fell 464 percent between 2000 and 2002, indicating that subsidiaries paid back their (accumulated) intracompany loans to their parents. At times, the intra-company-loan component of FDI may be subject to the same degree of volatility as international debt flows (World Bank 2004).

Crises can also affect companies' dividend repatriation strategies. Companies usually expect steady dividend flows from their subsidiaries, implying that reinvested earnings fluctuate with the company's income (World Bank 2008). Following a crisis, however, companies may increase their dividend repatriation significantly. For example, after the Asian crisis, in 1999, U.S. companies in affected countries repatriated income in excess of their earnings that year from developing countries. Thus, their reinvested earnings became negative (figure at right). Similarly, in the midst of Argentina's financial crisis in 2002, repatriated earnings outstripped equity earnings by a factor of five, as corporations attempted to evade the introduction of controls on outflows and foreign exchange transactions.

Other factors, such as investment climate, may play a role in multinationals' repatriation strategies. The portion of equity earnings that is repatriated tends to be lower (and thus the share of reinvested earnings higher) in countries with better investment climates. Sudden shifts in political risk and the imposition (or threat) of capital controls can lead to abrupt changes in repatriated earnings (World Bank 2004; Lehmann and Mody 2004; Desai, Foley, and Hines 2002).

Intra-company loans versus equity components of FDI during financial crisis



Distribution of US earnings in developing countries

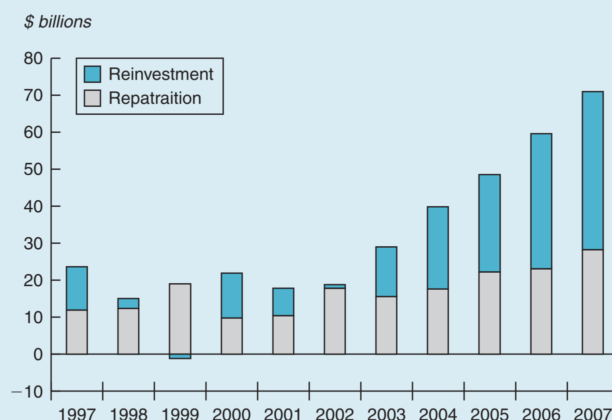
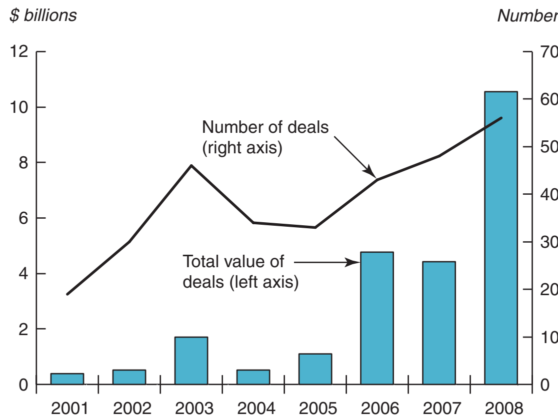


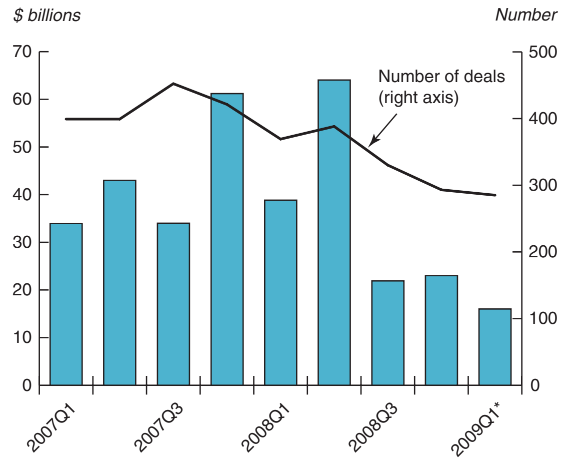
Figure 2.17 Repatriation of assets by financial firms from selected developing countries, 2001–08



Source: Staff estimates are based on the M&A data compiled from Bloomberg.

Note: Only cross-border acquisitions, in which the acquiring firm buys more than 10 percent of the target firm are included. The countries are Argentina, Brazil, Bulgaria, Chile, China, Colombia, Egypt, India, Indonesia, Kazakhstan, Malaysia, Mexico, Pakistan, Peru, the Philippines, Poland, Romania, Russia, South Africa, Thailand, Turkey, Ukraine, and Vietnam.

Figure 2.18 Cross-border M&A flows to developing regions, 2007Q1–2009Q1



Source: See figure 2.17.

mergers and acquisitions (M&As) in developing countries. M&A flows have been one of the main drivers of FDI inflows in developing countries in recent years, accounting for some 30 percent of FDI. In the first quarter of 2009, M&A activity declined to $16 billion in inflows, compared with more than $30 billion in the previous two years (figure 2.18). Lower acquisitions by developed-country multinationals—reflecting lower earnings and less financing available for investment—accounted for much of the decline.

Remittance flows began to slow down in 2008

The value of the remittances that migrant workers send home to their families in developing countries increased to $305 billion (1.9 percent of GDP) in 2008 from $281 billion (2.1 percent of GDP) in 2007 (table 2.7). However, the pace of remittances slowed sharply beginning in the third quarter of the year as the economic crisis gathered strength in the countries where migrants work. Recorded flows to Latin America and the Caribbean have already stagnated since 2007, as the U.S. recession, especially in the construction sector, has reduced the employment and income of Latin American (especially Mexican) migrants. It should be noted, however, that tighter enforcement of immigration rules in the United States may well have pushed more remittances into hand-carried and other unrecorded channels.

Remittances continued to grow in 2008 in other regions, although the pace of growth began to slow in the second half of the year. Growth was particularly impressive for countries in South and East Asia, which are relatively less dependent on remittances from the United States and more dependent on the countries of the Gulf Cooperation Council (GCC). High oil prices (until mid-2008) and robust economic growth in the oil-exporting countries of the Middle East contributed to strong demand for migrant labor from South Asia. Bangladesh and Nepal have reported a surge—year-on-year growth of more than 40 percent through September 2008—in remittance inflows, although the pace of growth moderated in the fourth quarter of 2008 in response to the sharp decline in the price of crude oil—and as the crisis spread to the GCC countries. Officially recorded remittance flows to South Asia are estimated to have swelled by 31 percent in 2007 and by 27 percent in 2008 to an estimated $66 billion in 2008. But remittances to Sub-Saharan Africa appear to have

Table 2.7 Remittance flows to developing countries, 2002–08 (US$ billion)

	2002	2003	2004	2005	2006	2007	2008e
All developing countries	115.5	144.3	164.4	194.8	228.7	280.8	305.4
as % of GDP	*1.9*	*2.1*	*2.0*	*2.0*	*2.0*	*2.1*	*1.9*
By region							
East Asia and Pacific	29.5	35.4	39.2	46.7	53.0	65.3	69.6
Europe and Central Asia	13.7	15.5	22.2	31.2	38.3	50.4	53.1
Latin America and the Caribbean	27.9	36.6	43.3	50.1	59.2	63.1	63.3
Middle East and North Africa	15.2	20.4	23.0	24.3	25.7	31.3	33.7
South Asia	24.1	30.4	28.7	33.1	39.6	52.1	66.0
Sub-Saharan Africa	5.0	6.0	8.0	9.4	12.9	18.6	19.8

Source: World Bank staff estimates. Remittances are defined as the sum of workers' remittances, compensation of employees, and migrant transfers – see www.worldbank.org/prospects/migrationandremittances for data definitions and the entire dataset.
Note: e = estimate.

decelerated sharply from a high growth rate of 44 percent the previous year, in part because of a slackening in flows to Nigeria following the 70 percent increase recorded in 2007.[6]

Remittance flows may fall with the global financial crisis

In the past, remittances have been stable, or even countercyclical, during economic downturns in the recipient economy. The present crisis, however, is affecting the countries from which remittances originate. Future flows are bound to be affected by the simultaneous economic recession in the high-income countries—including the United States and Western Europe, which account for almost two-thirds of the remittances that migrants send home to developing countries—and lower growth in the developing countries that account for about 10–30 percent of remittance flows to other developing countries.

Remittance flows from the countries of the GCC may fall slightly, as the recent decline in oil prices and the spread of the crisis to the financial sector of these countries—especially Dubai in the United Arab Emirates (UAE)—depresses the construction activities that employ thousands of migrants from developing countries in South Asia and the Middle East and North Africa. However, it is important to distinguish between the impact of the crisis on Dubai, which is more dependent on trade, finance, and real estate than are other parts of the UAE and other GCC countries, which depend primarily on oil revenues. In recent years, remittance outflows from Saudi Arabia have been uncorrelated with oil prices. Like Saudi Arabia, many GCC countries are following a long-term strategy of infrastructure development, drawing on large reserves accumulated over the years. It is unlikely that such countries will delay infrastructure investments and lay off migrant workers in large numbers. Remittance flows from the GCC countries are forecasted to decline modestly by 3 percent in 2009 (Ratha and Mohapatra 2009).

Increased uncertainty about exchange rates during a period of unusually high volatility may further depress remittance flows. In the last quarter of 2008 and early 2009, the U.S. dollar gained strength against the currencies of many major migrant destinations, such as the Euro Area, the United Kingdom, Canada, Australia, and New Zealand. The appreciation of the U.S. dollar has depressed the value of remittances from these countries, at least in U.S. dollar terms. A similar effect was at work in Russia, a major source of remittances to countries such as Tajikistan, as the ruble depreciated against the U.S. dollar by more than 35 percent between August 2008 and March 2009. A similar decline in outward remittances in dollar terms is also expected in other important South-South remittance corridors, such as India to Nepal, South Africa to the countries of the Southern African Development Community (SADC), and Malaysia to Indonesia.

Under the base-case scenario, in which the number of migrants remains constant at its 2008 levels, remittance flows to developing countries are expected to decline by 5 percent to $290 billion in 2009 and to recover to $299 billion in 2010 (table 2.8). In the Middle East and North Africa, remittance flows for 2009 are expected to decline modestly by 1.4 percent from their 2008 levels in dollar terms. The expected decline will be more than 4 percentage points in East Asia and the Pacific, Latin

Table 2.8 Outlook for remittance flows to developing countries, 2009–10

		Base case		Low case	
	2008e	2009f	2010f	2009f	2010f
All developing countries	305	290	299	280	280
By region:					
East Asia and Pacific	70	67	68	64	64
Europe and Central Asia	53	48	50	46	47
Latin America and the Caribbean	63	60	62	58	58
Middle East and North Africa	34	33	34	32	32
South Asia	66	63	65	61	62
Sub-Saharan Africa	20	19	20	18	18

Source: Ratha and Mohapatra 2009.
Note: e = estimate; f = forecast.

America and the Caribbean, South Asia, and Sub-Saharan Africa. Flows to emerging Europe and Central Asia, on the other hand, are expected to decline in U.S. dollar terms by 10 percentage points.

Faced with weakening job markets, many destination countries are tightening immigration access. The impact of the crisis on remittance flows may be accentuated if new migration slows significantly and if some migrants are forced to return home in response to the crisis. In this low-case scenario, remittances to developing countries would register a sharper decline of 8.2 percent to $280 billion in 2009, and remain stagnant in 2010. In 2009, if the low-case scenario held, all developing regions would suffer a larger drop in flows, with the Europe and Central Asia region experiencing the largest decline. An additional risk not reflected in the low case reported in table 2.8 may arise from unexpected movements in exchange rates. For example, a depreciation of the euro from its current level may result in an even larger decline in remittance flows expressed in U.S. dollar terms.

The situation is particularly serious for countries in which remittances are a large share of GDP

Although the aggregate decline in worldwide remittance flows as a result of the crisis is expected to be small, the situation may prove more serious for some small, poor countries where remittances make up a relatively large share of GDP, such as Tajikistan (45 percent), Moldova (38 percent), Tonga (35 percent), Lesotho (29 percent), and Honduras (25 percent). For these and other countries, declines in remittance inflows have been compounded by the strengthening of the U.S. dollar against the currencies of migrant-destination countries such as Russia, which is the main source of remittances for Central Asian countries such as Armenia, Moldova, Kyrgyz Republic, and Tajikistan. Many of the workers from these countries are employed in the oil and gas industry in Russia, sectors already suffering from a precipitous decline in global prices. Compounding that decline, Russia's currency depreciated sharply in the second half of 2008 and into early 2009 (when the ruble fell about 35 percent against the U.S. dollar), significantly reducing the local-currency value of ruble-denominated remittances.

A similar decline in outward remittances in dollar terms is also expected from India to Nepal, South Africa to SADC countries, and Malaysia to Indonesia. This kind of decline need not mean any significant loss of purchasing power for the beneficiaries of remittances, but the falling dollar volume can make it more difficult for governments to meet their external payment obligations. Furthermore, a strengthening dollar also means that goods and services and assets back home are significantly cheaper in dollar terms, which may encourage migrants to send more remittances for investment purposes. This latter effect—a surge in remittances as the local currency depreciates against the U.S. dollar—was evident in the U.S.-Mexico corridor in October 2008, and is believed to be going on currently in South and South-East Asia, and to an extent in Moldova and Tajikistan.

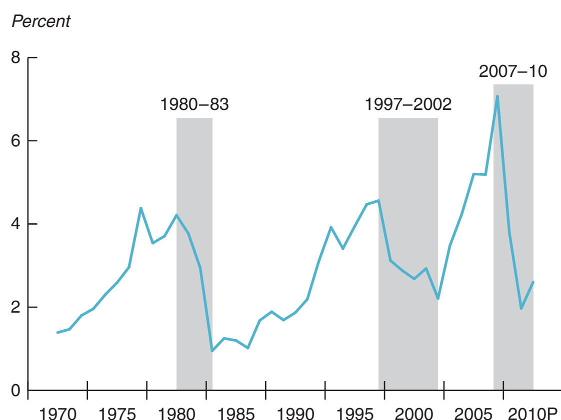
Prospects: The fall in private capital flows will continue in 2009

The present crisis already ranks as one of the most difficult financial and economic episodes in modern history—and it is not yet over. Its full

impact on developing countries, in terms of international financial flows and the real economy (chapter 1), will not become apparent until later in the year. Despite some signs of a turnaround, with outflows from several emerging equity markets appearing to slow, markets have remained highly volatile. Developing-country sovereigns have carried out only a few international bond issuances so far in 2009, while developing-country corporations—which have major refinancing needs—are likely to continue to be shut out from international bond financing. Bank lending has fallen considerably through the first quarter of 2009, and risks remain in the sector. Even more worrisome is the increasing evidence of a major plunge in FDI inflows to developing countries.

Taken together, the signs point to a continued drop in private capital flows to developing countries in 2009. Net private debt and equity flows, which comprise net debt flows (incoming disbursements less principal repayments) and net equity flows (FDI and portfolio inflows less outflows), are projected to decline from a record high of 7 percent of GDP in 2007 to just 2.6 percent in 2010 (figure 2.19), exceeding the peak-to-trough decline during the Latin American debt crisis in the early 1980s (3.3 percentage points) and the Asian and Russian crises of the late 1990s (2.4 percentage points). As in previous crises, the decline is expected to affect all categories of debt—bonds, bank loans, and short-term debt.

Figure 2.19 Net private capital flows as a share of GDP in developing countries, 1970–2010



Source: World Bank Debt Reporting System and staff estimates.
Note: Estimate for 2008; projections for 2009–10.

FDI inflows are expected to fall for the first time in a decade

In 2009, FDI in developing countries is projected to fall by 30 percent to $385 billion—a decline of about 1 percentage point of GDP. (Annex 2A describes the forecasting model.) The fall is less sharp than that projected for debt flows (more than 4 percentage points). But, if realized, the expected decline in FDI will mark the first fall of more than 10 percent since 1986. The relative resilience of FDI stems from the longer view of its investors and the large fixed costs that multinational firms incur to develop an integrated network to support FDI operations. Rapid disinvestments of large, fixed, illiquid assets are considerably more difficult than the pulling of loans or the sale of stock holdings. In previous crises these factors were enough to sustain direct investments in the face of economic downturns (Albuquerque, Loayza, and Servén 2005; Lipsey 2001; World Bank 1999).[7]

Slower global growth in 2008 squeezed the profitability of almost all multinationals, while tight credit conditions and weak global demand are limiting the ability and willingness of multinationals to expand. FDI flows may also be affected by the drop in commodity prices, as oil and mineral investments played an important role in the surge in FDI to developing countries after 2003. Several energy companies have already announced cutbacks in their investment plans, and some energy deals have been postponed or canceled.[8] Global investors also have concerns over policies of nationalization and state control in some countries, as well as signs of protectionism. Still, energy-oriented FDI will not cease completely for several reasons. Chief among them are that many companies with expertise in energy exploration still have a strong cash position, the prices of developing-country energy assets are falling sharply, and some state-owned firms will continue to invest to promote energy security.

A sharp decline in private debt flows is expected in 2009 . . .

Private debt flows to developing countries are projected to fall in 2009 to –0.3 percent of GDP, with much of the movement in short-term debt. Although medium- and long-term debt is not projected to slide into negative territory, it is expected to be limited in 2009. The fact that lenders tend to lengthen the maturity structure of their portfolio

during crises is likely attributable to a compositional effect: lenders shift their portfolios to more creditworthy borrowers, who are in a better position to service longer-maturity loans.

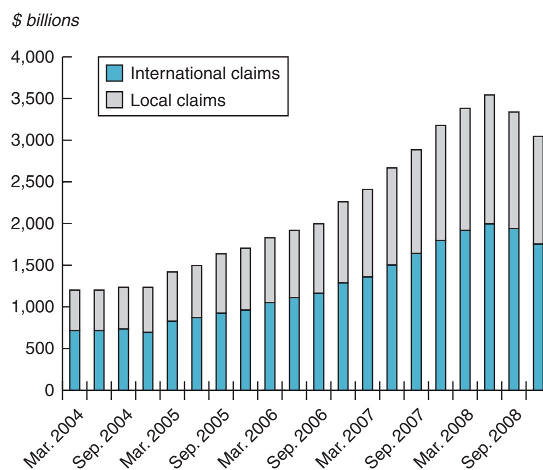
In the current crisis, three factors seem to be affecting the supply of credit from international banks to developing countries. Those factors are (a) mounting pressure on major banks' capital positions; (b) liquidity problems in the global interbank market; and (c) a tightening of credit standards in the face of the global economic recession. The liquidity factor was in full force in 2007, as heightened counterparty risk and the seizing up of securitized funding sources made banks hesitant to lend to each other (World Bank 2008). The impact of this factor seems have eased temporarily, as banks continued to lend both domestically and internally through the first half of 2008. But with the deepening of the global economic recession in the second half of 2008 the credit supply behaviors of international banks changed markedly vis-à-vis both home-country and developing-country borrowers.

Total foreign claims on developing countries held by banks reporting to the BIS are a key measure of international bank activity in developing countries. The amount of such claims declined to $3 trillion in the second half of 2008, a drop of some $500 billion. The decline involved both banks' cross-border lending as well as their lending through local affiliates in developing countries (figure 2.20). Econometric analysis (annex 2B) reveals that although frictions in the interbank money market remain a problem, monetary easing and liquidity injections by major central banks helped to offset the effects of the liquidity squeeze on emerging-market borrowers in the early phase of the crisis. However, as their financial health came under increasing pressure in the last quarter of 2008, banks reduced their exposure to emerging market borrowers, and overall lending fell for the first time in six years.

. . . and prospects for international bank lending remain gloomy

Ongoing problems in the global financial industry are likely to curtail the lending capacity of many major global financial institutions for some time, causing financing shortages to appear even as the decline in global economic activity (chapter 1) cuts corporations' planned investment expenditures and associated financing needs. In addition, the

Figure 2.20 International banks' claims on emerging markets, 2004–08



Source: World Bank staff estimates based on Bank for International Settlements data.

dramatic reversal in investors' risk tolerance has greatly increased the cost of external financing for all but the most creditworthy borrowers.

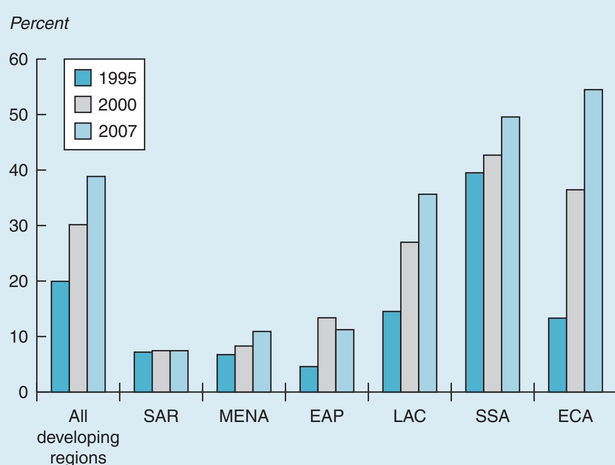
Going forward, significant downside risks remain related to the ability and willingness of financial institutions to lend, particularly across borders. First, the health of the balance sheets of international banks remains as uncertain as the depth and duration of the economic contraction. In the first months of 2009, many international banks continued to announce further losses and write-downs. Additional losses are widely expected to be reported through 2010, a sign that problems in the banking sector are not yet over (IMF 2009). In addition, growing concerns over credit risk and problems with cross-currency and foreign-exchange swap markets are likely to sharpen the so-called home bias in bank lending. In addition, in the interest of improving their capital ratios, banks may prefer to continue limiting their cross-border exposures, which typically involve higher regulatory capital charges to compensate for currency or country risk.

The risk that banks may reduce their support for subsidiaries in developing countries has also grown (box 2.3). Intrabank lending (loans made from a parent bank to a subsidiary or branch) has played a prominent role in bank lending in some countries, particularly those in emerging Europe and Central Asia. This type of flow is believed to have contributed to the relative resilience of bank

Box 2.3 Bank lending in developing countries and the presence of foreign banks

The participation of foreign banks in developing countries' financial systems has increased rapidly in recent years. At the end of 2007, the 910 foreign banks with a presence in developing countries controlled combined assets in excess of $1.2 trillion and accounted for more than 39 percent of total domestic banking assets. Foreign-owned lenders account for a particularly high proportion of local banking assets in three regions—70 percent in several Eastern European countries, and approximately 40 percent in some Latin American and Sub-Saharan countries (see figure). In some countries, such as Peru and Mozambique, their share is almost 100 percent, while in others, such Albania and Croatia, one or two foreign banks control the largest share of the local banking system (World Bank 2008, chapter 3).

Share of banking assets held by foreign banks, by region, 2007



The rising share of foreign banks in many developing countries has been accompanied by robust growth in international claims. Particularly in emerging Europe, a substantial share of bank activity is believed to depend on support from the parent banks, as these have injected funds through their subsidiaries and branches (BIS 2009; World Bank 2008). In 2008, such support protected countries from a sudden cutoff of the credit spigot, but whether it will continue remains uncertain, given the poor health of many international banks.

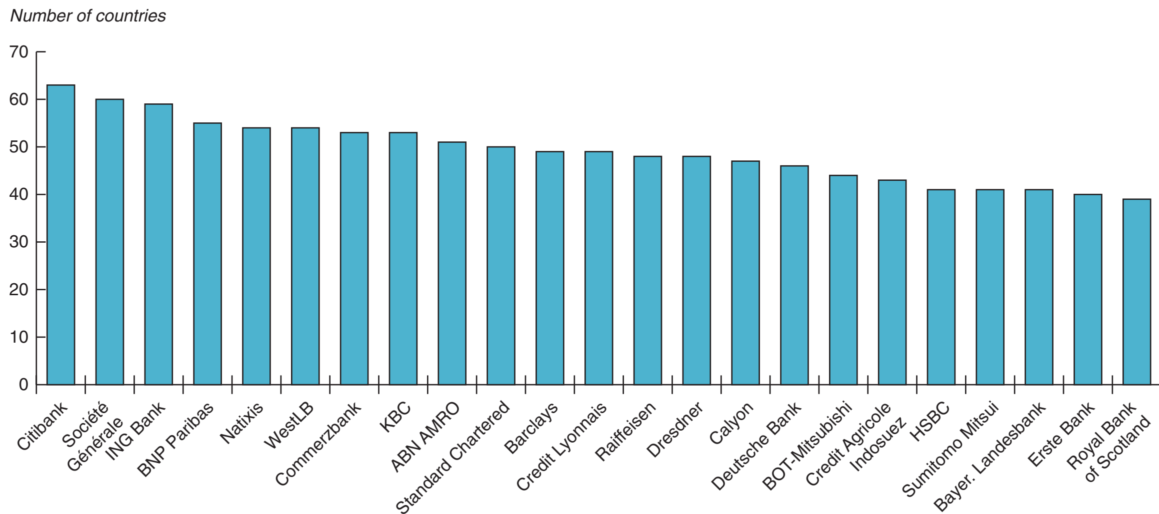
The literature highlights several factors, including home- and host-country conditions, as well as characteristics of the subsidiaries themselves, to explain variations in the level of support that parent banks provide to their subsidiaries (de Haas and van Lelyveld 2006a; Stein 1997). A multinational bank holding company may support subsidiaries with capital and liquidity in cases of significant losses (support effect), but it also tries to allocate capital across all of its subsidiaries depending on their expected risks and returns (substitution effect). Several factors shape the net outcome. Some subsidiaries may be more independent than others, for example (de Haas and van Lelyveld 2006b). Or negative capital shocks in host economies may force banks to reduce their assets to satisfy capital requirements (Van den Heuvel 2002).

In the current crisis, several of these factors are in play. With limited access to international debt markets, many of the subsidiaries of foreign banks have no choice but to rely on their parents for funds. Given the limited funding available also to those parents, however, intrabank loans may fall significantly in certain economies as parents reallocate these funds based on relative growth prospects and credit quality of the countries.

lending to developing countries in 2008. In the current environment, however, where the financial crisis has hit both the home and host countries of international banks, the relation between parent and subsidiary has become much more complex. For example, the deteriorating financial strength of subsidiaries in developing countries—particularly several Eastern European countries that were hit the hardest by the crisis—has taken a toll on the balance sheets of the parent banks, a toll serious enough in some cases to imperil the credit rating of the parent. Any downgrade in creditworthiness would raise the cost of capital for the affected bank.

The growing role of the state in some of the major international banks may affect their operations and cross-border lending practices. Since October 2008, several developed-country governments have injected capital into large international banks to improve their capital ratios in exchange for ownership shares ranging from 10 to 70 percent. For example, the British government now owns 66 percent of both Lloyds and the Royal Bank of Scotland. Similarly, the German government now owns 25 percent of the combined assets of Commerzbank and Dresdner Bank—which Commerzbank acquired last year. In March 2009, Citigroup was still in talks with

Figure 2.21 Major international banks with cross-border lending exposure to at least 30 developing countries, 1993–2007



Source: World Bank staff estimates based on data from Bankscope.

the U.S. government for additional aid in exchange for an additional ownership stake, which, if realized, may raise the government's share in the banking giant to 40 percent. Several of the affected banks had been active in lending to developing countries (figure 2.21). Although no general change in official lending practices has been announced so far, governments tend to encourage banks to lend domestically.[9] Given already limited funds, that tendency may further hamper cross-border lending to developed and developing countries alike.

The reversal of international capital flows to developing countries will have major consequences

The growing integration of the global economy and the increasing importance of private actors in international finance have provided enormous benefits to developing countries, while widening the scope for economic turmoil when global conditions deteriorate. Developing countries are much more dependent on private capital flows today than ever before. The growing dependence has greatly magnified the potential impact of changes in global economic conditions. Thus, even though most developing countries maintain better policies and have stronger institutions than they did at the onset of previous crises, more countries are nevertheless vulnerable to external disruptions.

Hence, the projected sharp decline in international capital flows, together with expected decreases in workers' remittances and other cross-border flows, is likely to oblige developing countries to make major macroeconomic adjustments and to restrict their ability to finance current-account transactions. The narrowing of access to international debt markets will be especially hard on developing-country corporations, some of which may be unable to refinance their obligations. As a result, the incidence of restructuring and bankruptcy among developing-country banks and companies is expected to rise in coming months. While the impact will be widespread, low-income countries and countries with high current-account deficits will have to go through the most serious macroeconomic and social adjustments.

The level and duration of the contraction in capital flows to developing countries, and its overall impact, will depend on how fast international investor confidence is restored, how soon conditions in international financial markets return to normal, and the degree to which international cooperation can mitigate the worst of the damage. The revitalization of the world economy, and its prospects in coming years, will be determined by the success of the national and international policy measures taken to address the present crisis. The importance of international efforts to reverse the deterioration of the global economy is one of the key topics of the next chapter.

Annex 2A: Methodology for assessing trends in foreign direct investment

The forecasts of FDI flows presented in this chapter are based on an econometric model that uses the following explanatory variables: GDP growth rate of the top seven industrial countries, the major suppliers of FDI; the difference between the GDP growth rate of each developing country and that of the G-7 countries (three-year moving average) as a proxy for investors' expectations about excess rates of return in the medium term; the rating of *Institutional Investor* magazine (lagged one year) as a proxy for the investment climate; the price of oil to capture resource-industry-related foreign investment; a volatility factor[10] (lagged one year) as a proxy for global economic uncertainty; and the lagged dependent variable (FDI), representing the persistence of FDI flows over time. In addition, country fixed effects account for the size of the economy and other characteristics. The model uses panel data for 1994–2008 from 34 developing countries that accounted for about 90 percent of FDI flows to developing countries in the last five years. Regression results are summarized in table 2A.1. The model builds on those used in previous editions of Global Development Finance.

Table 2A.1 Regression results of FDI forecasting model, fixed-effects panel regression

Explanatory variable	Coefficient
G-7 growth rate	0.152
	(3.19)***
GDP growth rate – G-7 growth rate (3-year moving average)	0.032
	(3.59)***
Institutional Investor rating (t-1)	0.012
	(2.27)**
Oil price	0.011
	(5.16)***
Volatility factor (t-1)	−0.011
	(3.12)***
FDI (t-1)	0.514
	(9.01)***
Constant	2.618
	(6.43)***
Within R^2	0.63
Overall R^2	0.77
Observations	416

Source: World Bank staff.
Note: Coefficients computed using White heteroskedasticity-consistent standard errors. Statistical significance at the 1% (***) and 5% (**) levels.

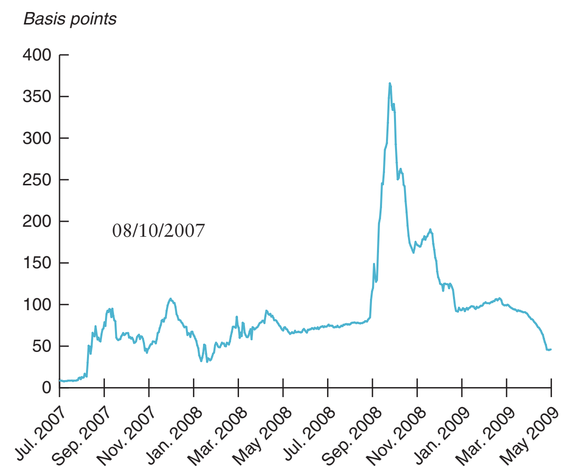
Annex 2B: Liquidity problems, bank solvency, and international bank lending to developing countries

Financial shocks affect lending by international banks to emerging-market borrowers through three major channels: balance-sheet effects, changes in interbank liquidity, and changes in lending standards. To assess the likely impact of each, we specify linear regression models of the flow of credit to emerging economies as a function of variables capturing a particular monetary-policy channel, a lagged dependent variable, and various macroeconomic and institutional control variables. We explore how the effects have differed since the onset of the financial crisis and whether the economic forces shaping capital flows to emerging economies have changed during the current economic turmoil.

The dependent variable is the (log of the) quarterly foreign-bank claims (FC) compiled by the Bank for International Settlements on up to 105 emerging economies from the fourth quarter of 2001 to 2008 (see figure 2.20). Throughout the analysis we distinguish between the precrisis and crisis periods. We date the beginning of the financial crisis to the run-up in the LIBOR-OIS spread in August 2007, which indicated growing liquidity and problems of counterparty risk in the interbank market (figure 2B.1). Accordingly, we create a binary variable (Crisis) that takes the value 1 from the third quarter of 2007 onward and 0 before that time.

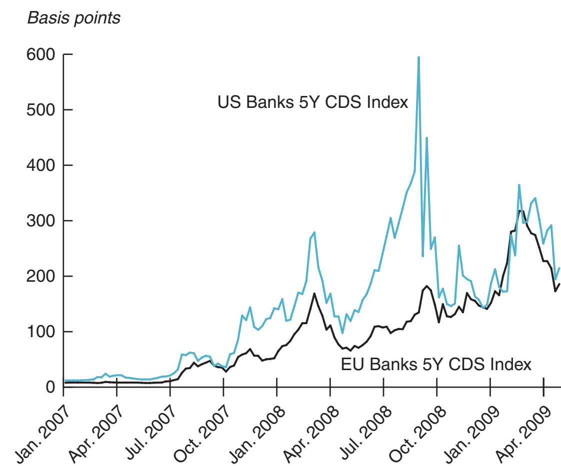
To assess whether the various factors contributing to the crisis also exert differential effects on the provision of credit to developing countries, we further divide the crisis period into two subperiods. In line with figure 2B.2, which shows how widespread bankruptcy fears in the U.S. and European banking sectors caused premiums on credit default swaps to spike during the first quarter of 2008, we conjecture that liquidity factors dominated the early phase of the crisis (up to the second quarter of 2008), whereas solvency issues have since come to the fore in the banking sector. Hence we create binary variables Liq and Solv. Liq takes

Figure 2B.1 Three-month LIBOR-OIS spread, July 2007–April 2009



Source: Bloomberg.

Figure 2B.2 Five-year CDS sector index for banks in the United States and European Union, January 2007–April 2009



Source: Bloomberg.

the value 1 from the third quarter of 2007 to the first quarter of 2008 and 0 at other times. Solv takes the value of 1 from the second quarter of 2008 onward, and 0 before that time. To clarify whether the crisis and conjectured solvency and liquidity effects independently affect credit to emerging economies, we interact the various crisis dummies with our key explanatory variables and their lags. We estimate the various specifications with country fixed effects (FE) and clustered standard errors or regional dummy variables. P-values are reported in parentheses.

To capture the traditional credit channel, we rely on the LIBOR-OIS spread (OIS) as an indicator for the availability of liquidity and for counterparty risk in interbank lending. Similarly, we measure banks' risk tolerance ("risk-taking channel") by the proportion of respondents who report in the Federal Reserve Board's "Senior Loan Officer Opinion Survey on Bank Lending Practices" that their institution has tightened its lending standards for commercial and industrial loans (Tightening).

To investigate the importance of the "balance-sheet channel" for the provision of credit to emerging markets, we use the quarterly average of noncurrent loans (Noncurrent: future problems) as a fraction of outstanding loans, net charge-offs (Charge-offs: past problems) as a fraction of outstanding loans, and the fraction of unprofitable lenders (Unprofit) as a proxy for the health of the global banking system. Given the need to restore bank capitalization to meet international standards, we also use their leverage (Leverage), Tier-I, and total risk-based capital ratio (RBCap) to measure balance-sheet effects. The sample consists of approximately 114 U.S. banks with foreign offices (with small variations by year and quarter through mergers, international expansion, and retrenchment) that hold about 12 percent of all foreign claims on emerging economies. This sample is a good proxy for global institutions that extend credit to borrowers in developing countries. In fact, the monthly correlation between U.S. and European bank credit default swap indexes is 0.904 (figure 2B.2), so that the U.S. data provide excellent instrumental variables for the health of the global banking system.

The results indicate that the lack of interbank lending, as measured by the LIBOR-OIS spread, adversely affects the provision of credit to emerging economies (table 2B.1, specifications 1, 2, and 5). To put this effect into perspective, an increase of 100 basis points in the spread can be expected, according to our results, to reduce the flow of credit to developing countries by 15 percent. The interaction terms suggest that the crisis is primarily responsible for this effect. However, the lagged OIS-Crisis term also reveals how the unprecedented injection of liquidity into the banking system during 2007 has counteracted the global credit retrenchment. For instance, specification 5 shows that the net effect of an increase of 100 basis points in the spread reduces emerging-market lending by only 17 percent over two quarters, although the initial effect suggests a reduction of about 50 percent (specification 5). Taken together, the results are consistent with the conclusion that monetary policy partially offset the effects of the liquidity crisis in 2007 on emerging-market borrowers. By contrast, such measures seem to have failed in 2008, when bank-solvency issues came to the forefront (results are not reported).

The crisis also seems to have affected the state of the lending cycle or, equivalently, banks' willingness to take credit risks as measured by the fraction of banks tightening their lending standards for commercial and industrial (C&I) loans. Before the crisis, lending standards apparently had a negligible economic effect on emerging-market lending. For the crisis period, however, our results are consistent with the view that the global recession has induced lenders to tighten their credit standards, thereby restricting access to global lending for marginal credit risks (an effect known as the "flight to quality"). Specifications 3, 4, and 6 indicate that rising lending standards further exacerbate the impact of the financial crisis: a 10-percentage-point increase in banks tightening their lending standards reduces the flow of credit to developing countries by 4 percent for the crisis period (steady state), for an overall decline of 3.8 percent. Furthermore, the delayed nature of the effect—tighter credit standards tend to take two quarters to filter through to emerging-market lending—bodes ill for the future provision of funds to borrowers in developing countries.

Table 2B.2 summarizes our estimates of the impact of bank performance—that is, the health of global banking as proxied by that of U.S. foreign lenders—on the flow of credit to developing countries. According to the balance-sheet view of monetary-policy transmission, frail financial institutions (as measured by their operating performance)

Table 2B.1 Lending standards, interbank liquidity, and credit to emerging economies

Dependent Var	Log(Foreign Claims)				1st difference log(FC)	
	(1) FE	(2) FE	(3) FE	(4) FE	(5) FE	(6) FE
Lagged log(FC)	0.8133	0.861	0.819	0.8654		
	(0.000)***	(0.000)***	(0.000)***	(0.000)***		
Log(GDP)	0.1674	0.1925	0.2434	0.2243	0.0357	0.0508
	(0.000)***	(0.000)***	(0.000)***	(0.000)***	(0.1200)	(0.008)***
Inflation	0.0023	−0.0497	0.0546	−0.0284	−0.0481	−0.0432
	(0.9790)	(0.5160)	(0.5450)	(0.7100)	(0.5630)	(0.6030)
Growth	−0.0008	−0.0013	0	−0.0009	0.0016	0.0017
	(0.5880)	(0.3390)	(0.9860)	(0.5170)	(0.2440)	(0.2270)
ICRG Composite		−0.0029		−0.0024	0.0004	0.0003
		(0.069)*		(0.1290)	(0.8240)	(0.8440)
OIS spread	−0.0006	0.0038			0.0037	
	(0.8180)	(0.073)*			(0.093)*	
Lagged OIS	−0.0040	−0.0057			−0.0035	
	(0.065)*	(0.002)***			(0.061)*	
OIS*Crisis	−0.0004	−0.005			−0.005	
	(0.8950)	(0.026)**			(0.035)**	
Lag-OIS*Crisis	0.0039	0.0055			0.0033	
	(0.074)*	(0.002)***			(0.074)*	
Volatility of OIS	−0.0006	−0.0005			−0.0003	
	(0.1390)	(0.1100)			(0.3230)	
Lagged volatility	−0.0016	−0.0013			−0.0012	
	(0.000)***	(0.000)***			(0.001)***	
Vol-OIS*Crisis	0.0006	0.0005			0.0003	
	(0.1610)	(0.1190)			(0.3340)	
Lag-vol*Crisis	0.0018	0.0015			0.0014	
	(0.000)***	(0.000)***			(0.000)***	
Tightening			0.0014	0.0021		0.0017
			(0.076)*	(0.002)***		(0.013)**
Lag1-Tight			−0.002	−0.0026		−0.0024
			(0.019)**	(0.000)***		(0.001)***
Lag2-Tight			0.0011	0.0009		0.0009
			(0.014)**	(0.026)**		(0.028)**
Tight*Crisis			0.0019	0		−0.0002
			(0.2250)	(0.9750)		(0.8960)
Lag1-Tight*Crisis			−0.0006	0.0011		0.0007
			(0.7980)	(0.5380)		(0.7100)
Lag2-Tight*Crisis			−0.0048	−0.0047		−0.004
			(0.004)***	(0.000)***		(0.005)***
Constant	−0.0849	−0.532	−0.9551	−0.982	−0.3092	−0.4916
	(0.7480)	(0.026)**	(0.000)***	(0.000)***	(0.2180)	(0.011)**
Observations	2,902	2,297	2,902	2,297	2,291	2,291
Countries	108	85	108	85	85	85
R-squared	0.832	0.905	0.831	0.905	0.036	0.034

Source: World Bank staff estimates.
Note: *, **, *** denote statistical significance at 10%, 5%, and 1%, respectively.

Table 2B.2 U.S. bank performance and credit to emerging economies

Dependent Var			Log(Foreign Claims)			1st difference log(FC)	
	(1) FE	(2) FE	(3) FE	(4) FE	(5) FE	(6) FE	(7) FE
Lagged log(FC)	0.855	0.852	0.856	0.854	0.853		
	(0.000)***	(0.000)***	(0.000)***	(0.000)***	(0.000)***		
Log(GDP)	0.169	0.195	0.185	0.195	0.226	0.023	0.022
	(0.000)***	(0.000)***	(0.000)***	(0.000)***	(0.000)***	(0.3680)	(0.3670)
Inflation	−0.145	−0.123	−0.14	−0.125	−0.101	−0.101	−0.102
	(0.077)*	(0.1500)	(0.097)*	(0.1410)	(0.2330)	(0.2580)	(0.2520)
Growth	−0.001	−0.001	−0.001	−0.001	−0.001	0.002	0.002
	(0.5580)	(0.4650)	(0.4340)	(0.3990)	(0.3780)	(0.2800)	(0.3130)
ICRG Composite	−0.005	−0.005	−0.005	−0.005	−0.005	−0.001	−0.001
	(0.002)***	(0.003)***	(0.004)***	(0.006)***	(0.003)***	(0.4800)	(0.5410)
Noncurrent	−6.32	12.956				1.447	
	(0.2420)	(0.2430)				(0.9090)	
Lag1-Noncur	24.531	−9.501				5.181	
	(0.038)**	(0.6020)				(0.8140)	
Lag2-Noncur	−26.352	−7.508				−9.659	
	(0.000)***	(0.4260)				(0.4040)	
Noncur*Liq		26.543				25.257	
		(0.2750)				(0.3390)	
Lag1-Noncur*Liq		−32.329				−27.108	
		(0.2710)				(0.4850)	
Lag2-Noncur*Liq						−4.289	
						(0.8100)	
Noncur*Solv		−40.295				−23.276	
		(0.010)***				(0.1730)	
Lag1-Noncur* Solv		192.147				177.621	
		(0.024)**				(0.048)**	
Lag2-Noncur* Solv		−175.596				−183.061	
		(0.071)*				(0.072)*	
Charge-offs			0.71	2.486			−2.159
			(0.8710)	(0.5700)			(0.6360)
Lag1-Charge			12.332	11.526			16.594
			(0.028)**	(0.037)**		(0.004)***	
Lag2-Charge			−19.014	−17.497			−16.867
			(0.000)***	(0.000)***		(0.000)***	
Charge-offs*Crisis			40.16				
			(0.000)***				
Lag1-Charge*Crisis			−33.829				
			(0.011)**				
Lag2-Charge*Crisis			−20.083				
			(0.1250)				
Charge-offs*Liq				26.409			22.194
				(0.038)**		(0.1230)	
Lag1-Charge* Liq				−30.156			–29.708
				(0.053)*			(0.094)*
Lag2-Charge* Liq							3.501
							(0.8370)
Charge-offs*Solv				82.188			77.496
				(0.002)***		(0.005)***	
Lag1-Charge* Solv				−32.96			–43.168
				(0.083)*			(0.030)**
Lag2-Charge* Solv				−84.475			–67.461
				(0.011)**		(0.050)*	
Unprofitable					0.363		
					(0.034)**		
Lag1-Unprof					−0.574		
					(0.000)***		
Lag2-Unprof					−0.46		
					(0.000)***		
Unprof*Crisis					−0.547		
					(0.003)***		
Lag1-Unprof*Crisis					0.713		
					(0.001)***		
Lag2-Unprof*Crisis					0.123		
					(0.6200)		
Constant	−0.057	−0.354	−0.287	−0.417	−0.684	−0.07	−0.083
	(0.8060)	(0.2030)	(0.2570)	(0.1040)	(0.008)***	(0.8100)	(0.7590)
Observations	2,214	2,214	2,214	2,214	2,214	2,209	2,209
Countries	85	85	85	85	85	85	85
R-squared	0.900	0.901	0.901	0.901	0.900	0.031	0.037

Source: World Bank staff estimates.
Note: *, **, *** denote statistical significance at 10%, 5%, and 1%, respectively.

hinder the provision of credit to the real economy. The results suggest that the quality of banks' loan portfolios and their general profitability significantly affect their ability to lend to developing countries. For instance, a one-percentage-point increase in noncurrent loans, which indicates future balance-sheet problems, decreases the flow of credit by 5.44 percent (specification 6). The fact that these effects primarily occur from the second quarter of 2008 onward is consistent with the interpretation that bank-solvency issues now dominate not only the financial crisis but also emerging-market lending. We take these findings as evidence that the fundamental economic forces currently shaping global finance are associated with the postulated balance-sheet channel of monetary policy.

To further clarify the economic forces that affect the provision of credit to developing countries since the onset of the financial crisis, we also investigate the direct effect of credit losses. The results reveal that credit charge-offs, indicative of past loan-portfolio problems, depress emerging-market lending, as do drops in the general profitability of the banking sector. Regarding the former, the impact is more evenly distributed across the two crisis subperiods. Our estimates suggest that an increase in charge-offs by 10 basis points reduces the flow of credit to developing countries by 4 percent as a direct consequence of the financial crisis, whereas the noncrisis net effect is economically insignificant. The results for the fraction of unprofitable banks (specification 5) confirm these findings: as profitability in global banking falls, institutions cut back on marginal activities such as lending to developing countries, which naturally reduces the flow of funds to borrowers in such markets.

The recapitalization of banking sectors that suffered dramatic losses in investments and loan portfolios is currently a regulatory priority in many countries. Under pressure from investors and regulators, banks are striving to improve their capitalization through a mixture of new private and public equity injections, complemented by actions to shrink their balance sheets and improve the quality of the assets they hold—for example, by writing down and making provisions for problem loans. These actions further reduce banks' lending activities and narrow the access of emerging-market borrowers to credit. We first assess the effect of bank leverage on the availability of credit to borrowers in developing countries. Specifications 1, 2, and 5 in table 2B.3 provide evidence that emerging economies benefited in recent years from banks' unprecedentedly high leverage. A 10-percentage-point increase in bank leverage raises the flow of credit by about 5 percent. Consistent with the balance-sheet-channel view, leverage does not seem to have played any role during the early liquidity phase of the financial crisis. By contrast, excessive leverage has harmed emerging-market borrowers during the current solvency crisis. When viewed in isolation, leverage during the latter part of 2008 seems actually to have shrunk the flow of credit to emerging markets: during this subperiod, a 10-percentage-point increase in leverage reduces the provision of credit to developing countries by 35 percent, a finding consistent with the view that bank-solvency issues now dominate global financial flows.

Our analysis also gauges the effect of capital adequacy standards on lending to developing countries. A rise in the Tier-I capitalization ratio unsurprisingly appears to reduce credit to such markets. In normal times, an increase by one percentage point in the Tier-I capitalization ratio reduces the flow of credit by 15 percent (specification 6), with the financial crisis further exacerbating this effect. However, these effects clearly depend on the extent of regulatory enforcement of capital-adequacy standards. Risk-based capitalization ratios (specifications 4 and 7) provide a much better gauge of the economic consequences of the banking sector's deleveraging for emerging-market borrowers. A one-percentage-point increase in banks' risk-based capitalization appears to reduce the flow of credit to developing countries by about 10 percent (specification 7), suggesting that restoring financial order to the balance sheets of global banks, a precondition for continued lending in developing countries, may hurt emerging-market borrowers in the short term.

Table 2B.3 U.S. bank capitalization and credit to emerging economies

Dependent Var	Log(Foreign Claims)				1st difference log(FC)		
	(1) FE	(2) FE	(3) FE	(4) FE	(5) FE	(6) FE	(7) FE
Lagged log(FC)	0.858	0.857	0.854	0.855			
	(0.000)***	(0.000)***	(0.000)***	(0.000)***			
Log(GDP)	0.2170	0.2270	0.2110	0.2040	0.044	0.048	0.039
	(0.000)***	(0.000)***	(0.000)***	(0.000)***	(0.021)**	(0.028)**	(0.1220)
Inflation	−0.1	−0.075	−0.097	−0.114	−0.075	−0.072	−0.084
	(0.2300)	(0.3660)	(0.2450)	(0.1780)	(0.3880)	(0.4100)	(0.3450)
Growth	0	−0.001	−0.001	−0.001	0.002	0.002	0.002
	(0.9320)	(0.5490)	(0.6070)	(0.4200)	(0.2690)	(0.2340)	(0.2660)
ICRG Composite	−0.003	−0.004	−0.004	−0.005	−0.001	−0.001	−0.001
	(0.054)*	(0.018)**	(0.013)**	(0.007)***	(0.6230)	(0.7140)	(0.6150)
Leverage	−0.734	−4.899			−8.233		
	(0.9130)	(0.4760)			(0.2510)		
Lag1-Lev	22.754	24.679			26.893		
	(0.007)***	(0.003)***			(0.002)***		
Lag2-Lev	−20.566	−24.046			−26.372		
	(0.001)***	(0.000)***			(0.000)***		
Lev*Crisis	–3.957						
	(0.6030)						
Lag1-Lev*Crisis	−59.158						
	(0.000)***						
Lag2-Lev*Crisis	63.081						
	(0.000)***						
Lev*Liq		−22.28			−16.808		
		(0.2610)			(0.4170)		
Lag1-Lev* Liq		22.663			8.106		
		(0.2480)			(0.7860)		
Lag2-Lev* Liq					8.762		
					(0.6840)		
Lev*Solv		1.56			2.531		
		(0.8520)			(0.7710)		
Lag1-Lev* Solv		−61.591			−64.524		
		(0.000)***			(0.000)***		
Lag2-Lev* Solv		59.4630			61.009		
		(0.000)***			(0.000)***		
TierI			−8.398			−1.018	
			(0.1010)			(0.8500)	
Lag1-TierI			3.467			5.798	
			(0.5630)			(0.3670)	
Lag2-TierI			−18.744			−15.264	
			(0.000)***			(0.007)***	
TierI*Crisis			−15.433				
			(0.085)*				
Lag1-TierI*Crisis			−28.19				
			(0.058)*				
Lag2-TierI*Crisis			42.889				
			(0.000)***				
TierI*Liq						26.072	
						(0.2610)	
Lag1-TierI* Liq						−32.693	
						(0.2190)	
Lag2-TierI* Liq						6.603	
						(0.7360)	
TierI*Solv						−27.261	
						(0.1010)	
Lag1-TierI* Solv						−26.572	
						(0.1750)	
Lag2-TierI* Solv						53.192	
						(0.001)***	
RBCap				−2.634			1.543
				(0.4810)			(0.6950)
Lag1-RBCap				6.005			5.887
				(0.1270)			(0.1610)
Lag2-RBCap				–10.972			–11.012
				(0.001)***			(0.003)***
RBCap* Liq				22.356			13.948
				(0.061)*			(0.2680)
Lag1-RBCap* Liq				–22.189			–16.389
				(0.064)*			(0.2740)

(table continues on next page)

Table 2B.3 U.S. bank capitalization and credit to emerging economies (*continued*)

Dependent Var	Log(Foreign Claims)				1st difference log(FC)		
	(1) FE	(2) FE	(3) FE	(4) FE	(5) FE	(6) FE	(7) FE
Lag2-RBCap* Liq							2.457 (0.8090)
RBCap* Solv				–32.981 (0.008)***			–36.488 (0.005)***
Lag1-RBCap* Solv				–25.88 (0.068)*			–28.253 (0.056)*
Lag2-RBCap* Solv				59.433 (0.000)***			65.042 (0.000)***
Constant	–0.908 (0.052)*	–0.546 (0.2590)	1.466 (0.054)*	0.367 (0.5680)	0.201 (0.6900)	0.532 (0.5440)	0.14 (0.8380)
Observations	2,214	2,214	2,214	2,214	2,209	2,209	2,209
Countries	85	85	85	85	85	85	85
R-squared	0.900	0.901	0.900	0.901	0.038	0.033	0.033

Source: World Bank staff estimates.
Note: *, **, *** denote statistical significance at 10%, 5%, and 1%, respectively.

Annex 2C: Debt Restructuring with Official Creditors

This annex lists official debt restructuring agreements concluded in 2008. Restructuring of intergovernmental loans and officially guaranteed private export credits takes place under the aegis of the Paris Club. These agreements are concluded between the debtor government and representatives of creditor countries. Paris Club treatments are defined individually, by consensus of all creditor countries. Most treatments fall under the following predefined categories, listed by increased degree of concessionality: “Classic terms” represent the standard treatment; “Houston terms” are for highly-indebted lower-middle-income countries; “Naples terms” are for highly-indebted poor countries; and “Cologne terms” are for countries eligible for the Heavily Indebted Poor Countries (HIPC) Initiative. To make the terms effective, debtor countries must sign a bilateral implementing agreement with each creditor.

Agreements with countries

Guinea. On January 23, 2008, Paris Club creditors reached agreement with the government of Guinea to restructure its external public debt, following the IMF’s approval in December of the country’s arrangement under the Poverty Reduction and Growth Facility (PRGF). The agreement, concluded under Cologne terms, consolidated about $300 million in debt, of which $160 million consisted of arrears and late interest. The agreement resulted in the immediate cancellation of $180 million of debt, and the rescheduling of about $120 million. On an exceptional basis, the agreement also deferred until after 2010 the repayment of arrears accumulated by Guinea. These measures would reduce by $378 million all debt-service payments to Paris Club creditors falling due between January 1, 2008, and December 31, 2010.

The Gambia. On January 24, 2008, Paris Club creditors agreed to a debt reduction for The Gambia, which reached its completion point under the enhanced HIPC Initiative in December 2007. As a means of restoring the country’s debt sustainability, the Paris Club decide to cancel debt valued at $11.6 million in nominal terms. The stock of debt owed to Paris Club creditors by The Gambia was estimated at about $40 million in nominal value as of December 1, 2007. The Gambia agreed to allocate the resources freed up by debt relief to priority areas identified in the country’s poverty reduction strategy.

Liberia. The government of Liberia reached its HIPC decision point in March 2008 and entered an agreement with Paris Club creditors in April 2008 to restructure its external public debt. As of January 2008, the stock of debt due to Paris Club creditors by Liberia was estimated to be more than $1.5 billion in nominal terms, of which more than 97 percent consisted of arrears and late interest. Liberia’s agreement with its creditors, under Cologne terms, rescheduled $1.043 billion, of which $1.028 billion comprised arrears and late interest. The agreement also led to immediate cancellation of $254 million in debt and a rescheduling of around $789 million, which will be considered for debt relief when Liberia reaches is HIPC completion point. Several creditors also committed on a bilateral basis to grant additional relief, fully canceling the country’s debt.

Togo. Following the IMF’s approval of a new three-year arrangement under the PRGF in April 2008, Paris Club creditors agreed to a debt-relief package for the government of Togo in June 2008. This agreement consolidated $739 million, canceled $347 million, and rescheduled $392 million under Naples terms, whereby repayment is extended over 40 years with a 16-year grace period. On an exceptional basis, this agreement also required no payments from the country between

April 1, 2008, and March 31, 2011. Paris Club creditors also committed to further debt reduction as soon as Togo successfully reaches its decision point under the enhanced HIPC Initiative.

Djibouti. In October 2008, Paris Club creditors agreed with the government of Djibouti to a restructuring of its external debt. This decision followed the IMF's approval of the country's arrangement under the PRGF on September 17, 2008. This agreement concluded under Houston terms, with exceptional additional measures considering the country's limited capacity for repayment. The agreement consolidated around $76 million in debt, of which $58 million consisted of arrears and late interest. Some $64 million was to be rescheduled and the remaining $12 million was to be deferred. As a result, the country's debt owed to Paris Club creditors was reduced to $19 million from $85 million, a 79 percent reduction.

Republic of Congo. On December 11, 2008, Paris Club creditors agreed with the government of the Republic of Congo to a reduction of its external public debt. This decision followed the IMF's approval (on December 8, 2008) of the country's contract under the PRGF. This agreement was conducted under Cologne terms, and will result in the cancellation of $805 million in debt and the rescheduling of $155 million over the three-year consolidation period. In accordance with Cologne terms, concessional assistance (ODA) is to be repaid over 40 years with a grace period of 16 years. Ninety percent of the commercial debt was to be canceled, with repayment of the remaining 10 percent rescheduled over 23 years with a 6-year grace period. The stock of debt owed to Paris Club creditors by the country as of July 1, 2008, was estimated to be more than $3.4 billion in nominal terms.

Notes

1. Financial distress escalated in the United States and Europe over the course of 2008, beginning with the takeover of Bear Sterns by JP Morgan in March, and culminating by September when several other financial institutions came under stress including American International Group (AIG) and Lehmann Brothers in the United States and Lloyds TSB in the United Kingdom (Global Economic Prospects 2008, page 20).

2. By the end of September 2008, investment banks Bear Stearns and Lehman Brothers had collapsed, Merrill Lynch had been acquired by Bank of America, and Goldman Sachs and Morgan Stanley had become commercial banks.

3. The discussion here is based on quarterly short-term debt data from Bank for International Settlements. Flows are calculated as the change in the debt stock between periods. These numbers might vary from the short-term debt data reported by the World Bank (table 2.1) due to differences in sources for some countries. World Bank Debt Reporting System (DRS) data are obtained, whenever available, directly from country authorities. DRS only reports annual data.

4. In January, Mexican multinational companies Grupo Bimbo (food processing) and Cemex (cement) borrowed $2.3 billion for acquisition and $1.4 billion for refinancing purposes, respectively. Also, there was a $1.4 billion syndicated loan to Russian oil company Rosneft for trade finance purposes.

5. AIG finalized its sale of its credit card and banking assets in Thailand to Bank of Ayudhya. The company received proceeds of about $45 million from the sales but also disclosed that it had also been able to pay off intercompany debt of $495 million with the transaction. http://uk.reuters.com/article/marketsNewsUS/idUKN0852725120090408.

6. Nigeria recently revised upward to $18 billion for 2007 the data it reports to the IMF. This represents a 450 percent increase over inflows for 2005, raising suspicion that the increase may mask the inclusion of other types of private flows, such as trade payments. Our estimates for 2006 and 2007—$5.4 billion and $9.2 billion, respectively—were therefore constructed using data reported for 2005 to the IMF and the growth of remittance inflows reported in a global survey of central banks conducted by the World Bank's Development Prospects Group in mid-2008. The Arab Republic of Egypt reported $7.6 billion in remittances for 2007, a significant increase from 2006.

7. During the Latin American debt crisis of the 1980s the fall in other long-term (and short-term) flows from banks and the bond market was seven times greater that that of FDI. Similarly, during the Mexican debt crisis in 1994, FDI inflows fell by 27 percent and recovered fully by 1997. However, portfolio equity and debt flows fell by 89 percent and 45 percent, respectively, in just one year, from 1994 to 1995. The 1997 currency and banking crisis in East Asia (Indonesia, Korea, Malaysia, the Philippines, and Thailand) saw a drop of 22 percent in net long-term inflows to these countries, while FDI fell by less than 5 percent from 1997 to 1998.

8. For example, Mexican Quimpac canceled its acquisition of Colombian mining company Prodesal because of the financial crisis (http://global.factiva.com/ha/default.aspx). See also http://uk.reuters.com/article/UK_SMALLCAPSRPT/idUKL521661520090105.

9. French banks that tap government assistance have pledged to increase lending by 3–4 percent annually. ING, a Dutch bank, announced on January 26 that it would extend €25 billion ($32 billion) to Dutch businesses and consumers in return for another round of government assistance. http://www.economist.com/displaystory.cfm?story_id=13057265.

10. The market volatility index is derived as the predicted common factor in a factor analysis of eight variables: VIX, US$/euro volatility, US$/yen volatility, US$/sterling volatility, agriculture commodities price index volatility, energy price index volatility, industrial metals price index volatility, and TED spread.

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3

Charting a Course Ahead

THE GLOBAL ECONOMY FACES A crisis of staggering proportions that has reduced confidence in the prospects for growth and depressed economic activity almost everywhere in the world. While recent data indicate that the fall in global production and trade may be slowing, prospects remain uncertain and the potential for a further downturn is not negligible. For developing countries, the breadth and severity of the crisis have underscored the risks of globalization. Over the past 15 years, many of those countries had opened to the world, revamping their macroeconomic policies and their framework for private investment. With expanding opportunities for trade and strong inflows of capital, those improvements made possible a long run of rapid economic growth, accompanied in many places by impressive reductions in poverty. Unfortunately, the channels of integration with the world economy have operated in reverse during the current crisis, as a falloff in demand for developing countries' goods and services and reduced access to international capital markets have sparked a sharp decline in growth and in capital flows to developing countries.

This chapter considers how policy makers in developing countries and the international community more generally can chart a course toward a robust recovery that can be sustained over the long term. We first examine the intense pressures on many corporations in developing countries that are facing heavy refinancing needs under very harsh financing conditions. Private capital flows to developing countries are expected to decline sharply in 2009 and fall short of meeting their external financing needs by a wide margin—estimated at between $352 billion and $635 billion. This discussion highlights the need to expand the lending capacity of international financial institutions, an issue that played a prominent role in the G-20 Leaders' Summit in April, 2009. We then consider a few key issues facing policy makers in developing countries, assessing the scope for expansionary policies at the country level, while stressing the importance of international policy coordination and the need to strengthen the international financial regulatory framework.

The main messages that arise from this analysis are as follows:

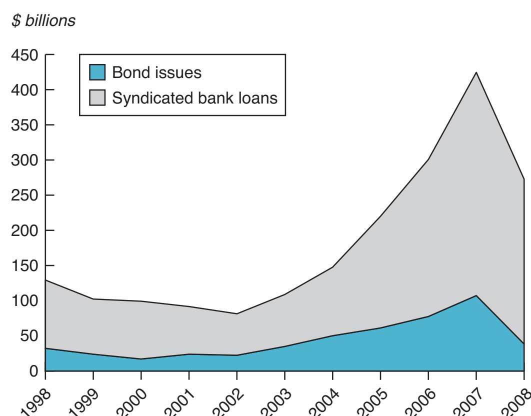
- *Corporations in developing countries face severe financing difficulties.* Unlike most crises over the past three decades, the impact of the current crisis on developing countries has been transmitted primarily through the corporate sector. As firms' reliance on short-term debt has increased, so has the probability of default, particularly in highly leveraged firms. As refunding pressures are building, sources of finance are drying up. Many private firms will be hard-pressed to service their foreign-currency liabilities with revenues earned in sharply devalued domestic currencies. In addition, the financial positions of some developing-country firms that participated in the global expansion of derivatives have been weakened by huge losses on speculative financial instruments. Corporations in countries with well-developed domestic corporate bond markets are better positioned to weather the crisis, as such markets can provide an alternate source of funds when external debt flows cease suddenly. But where foreign investors play a prominent role, domestic bond markets can also be vulnerable to a sudden shift in external financial conditions.

- *Countries with large external financing needs face balance-of-payments crises.* The current crisis has affected the external financing position of virtually all developing countries, although not equally. Countries that have high levels of external debt, large current-account deficits, and inadequate foreign reserve holdings are more likely to encounter difficulties in obtaining the finance they will need to avoid a more severe contraction in growth. Balance-of-payments crises and corporate debt restructurings are particularly likely in countries where the corporate sector accounts for a large share of external borrowing.
- *Low-income countries lack the resources to respond to the crisis.* Most of the resources of international financial institutions are likely to be allocated to high-income emerging markets and middle-income countries that have the ability to repay the loans they receive. Low-income countries, by contrast, face grave economic prospects, especially if their exports, workers' remittances, and foreign direct investment (FDI) fail to recover quickly from the dramatic deterioration in 2009. The amount of development assistance presently available to these countries is inadequate to meet their projected external financing needs. At the same time, given the intense fiscal pressures resulting from the crisis, donor countries will be hard-pressed to increase aid significantly.
- *The potential for expansionary policies varies significantly among developing countries.* Several governments have adopted emergency legislation aimed at raising expenditures and cutting taxes, while automatic stabilizers such as unemployment insurance and income-related transfers have further boosted fiscal expansion. However, the scope for using such policies has varied significantly across countries. Countries that faced excessive inflationary pressures with little fiscal room and insufficient reserve holdings at the onset of the crisis had few viable policy options. Moreover, countries with large external financing needs may find themselves compelled to suppress demand further in order to meet their external obligations.
- *International policy coordination will play an important role in securing a global recovery.* The financial crisis in today's integrated global economy has underlined the importance of coordinating policy so that measures taken in one country do not defeat those taken in another. The economic channels through which nations trade goods and services also serve to propagate the crisis if countries severely restrict imports. A clear danger to coordinated recovery is the politically tempting tactic of protectionism, either in its classic expression (selective trade barriers) or in proposed measures to restrict stimulus spending to domestically produced goods and services.
- *Fault lines in the international financial regulatory framework are in need of major repair.* The main driver of this crisis—excessive risk taking in the financial system—underlines the importance of tighter and more comprehensive supervision and regulation. In a world of global financial institutions, effective control over the financial system can be achieved only through coordinated efforts, because lax regulation in one jurisdiction makes it more difficult for other jurisdictions to enforce more stringent standards. National regulators have privileged access to information on financial institutions operating within their borders. For that reason, they should retain primary responsibility for supervision. But greater international cooperation in sharing information and establishing broad standards for regulation is needed to make national regulators more effective.

Corporations in developing countries face severe financing difficulties

Unlike many other emerging market crises over the past three decades, the impact of the present crisis on developing countries has been transmitted primarily through the corporate sector. Corporate borrowing expanded rapidly during the recent boom in capital flows. External bond issuance and bank borrowing by corporations in developing countries rose from $81 billion in 2002 to $423 billion in 2007, before falling last year to $271 billion as global financial turmoil increased (figure 3.1). Corporations account for the bulk of developing countries' short-term debt (debt with an original maturity of one year or less), which

Figure 3.1 Gross external borrowing by developing country corporations, 1998–2008



Source: Dealogic DCM Analytics and Loan Analytics.

rose to almost 25 percent of total external debt in 2007, compared with just 12 percent in the late 1980s. Corporations' share of total medium- and long-term external debt held by developing countries also reached about 50 percent in 2008, up from only 5 percent in 1989.[1]

Developing countries in all regions participated in the boom in corporate borrowing from external sources (table 3.1). However, Europe and Central Asia accounted for the largest share of the increase, as corporate borrowing shot from $19 billion in 2002 to $197 billion in 2007. South Asia and Sub-Saharan Africa registered the largest percentage increases in corporate borrowing from 2002 to 2007, given that borrowing was minimal prior to the boom. By the standards of these regions, the rise in corporate borrowing in Latin America and the Caribbean and in East Asia and the Pacific was relatively modest. All regions, except the Middle East and North Africa, participated in the 2008 drop in corporate borrowing. Interestingly, despite the presumably higher risk of private versus public sector corporations, the public sector accounted for a larger percentage decline in corporate borrowing; the public sector's share of external corporate borrowing fell from 30 percent in 2007 to 25 percent in 2008.

Refunding pressures are building, as corporate debt falling due in the first half of this year is estimated at $17 billion per month, well above the

Table 3.1 Foreign debt contracted by developing-country corporations, 1998–2008 (billions of dollars)

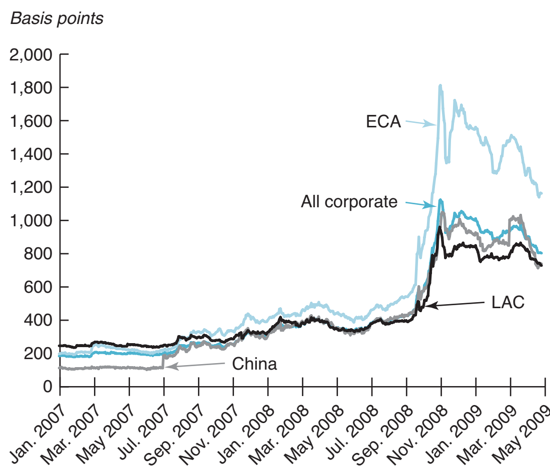
	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008
Total	**107.3**	**86.9**	**99.2**	**91.7**	**81.5**	**108.6**	**147.4**	**219.9**	**300.6**	**423.3**	**271.2**
By instrument											
Bond	32.2	23.9	17.3	23.9	22.6	35.2	50.2	61.4	77.7	107.3	38.5
Bank lending	75.1	63.0	81.9	67.8	59.0	73.4	97.2	158.4	222.9	315.9	232.8
By Region											
LAC	63.4	49.4	57.2	57.1	25.5	38.5	45.6	54.3	88.9	97.1	48.5
EAP	16.2	12.6	12.7	9.6	23.7	21.3	24.7	36.1	42.7	54.2	40.3
ECA	16.5	12.9	18.0	12.8	19.2	30.9	52.6	95.7	122.5	196.9	136.6
SSA	5.2	5.6	6.2	7.4	7.5	8.4	8.6	12.6	20.6	33.5	9.7
MENA	1.7	3.3	2.3	2.6	3.9	6.4	7.5	10.1	6.1	5.6	15.1
SAR	4.3	3.1	2.8	2.3	1.8	3.1	8.5	11.1	19.9	35.9	21.0
By ownership											
Public	38.0	23.5	22.9	26.4	23.9	33.9	43.8	82.4	80.8	126.2	67.3
Private	69.3	63.5	76.3	65.3	57.6	74.7	103.6	137.5	219.8	297.1	203.9
By sector											
Finance	29.4	20.9	23.7	20.5	14.7	24.5	40.2	64.1	92.2	98.2	56.4
Oil & Gas	21.4	13.3	19.8	21.7	23.5	28.2	29.4	61.5	46.2	99.1	60.1
Telecommunications	16.8	14.4	15.5	11.7	9.1	7.6	17.3	19.8	35.3	45.4	19.3
Utility & Energy	13.8	15.2	15.5	10.6	8.0	14.4	7.5	9.5	13.2	24.2	28.1
Metal & Steel	2.9	1.2	2.5	1.6	1.1	3.4	6.6	8.4	12.8	20.0	25.0
Mining	3.9	3.1	2.2	3.0	3.6	4.3	8.4	6.4	30.8	24.6	17.2
Construction/Building	1.8	1.8	4.1	3.5	1.2	1.5	4.2	8.7	14.9	30.9	11.3
Other	17.3	17.0	15.9	19.2	20.4	24.8	33.8	41.4	55.2	80.9	53.9

Source: World Bank staff estimates based on Dealogic Loanware and Bondware.

recent levels of issuance (IIF 2009). Simultaneously, sources of finance are drying up. For example, the hedge funds that made a major contribution to the expansion of the Asian corporate sector in recent years are now attempting to sell their largely illiquid assets (IMF 2009c). In Sub-Saharan Africa, trade finance volumes have declined (in part because of lower demand), while spreads on trade finance transactions have increased from 100–150 basis points over LIBOR to 400 basis points.

At the same time, firms' cost of capital has risen substantially. The global recession cut sharply into the revenues of developing-country firms, raising the risk of corporate debt default, while investors' tolerance for risk waned. Taken together, these factors have raised the cost of capital dramatically, especially for less creditworthy borrowers. Spreads on emerging market corporate bonds, which averaged about 200 basis points in 2007, jumped to more than 1,000 basis points by end-October 2008 (figure 3.2),[2] though they have since declined to below 800 basis points. Corporate bond spreads widened dramatically in mature and emerging markets alike, including China and others in relatively strong positions to withstand the financial repercussions of the crisis. At the same time, the crisis has led to greater differentiation among developing countries, with firms in Europe and Central Asia experiencing much greater increases in spreads than firms in other emerging markets.

Figure 3.2 Spreads on emerging market corporate bonds, February 2007–April 2009



Source: JP Morgan (CEMBI-Global).

These pressures have been exacerbated by huge losses on speculative financial instruments. Many developing-country firms participated in the global expansion of derivatives. In India, for example, the stock market boom was accompanied by futures trading that was at least six times the turnover in spot markets (Sen 2008). Exchanges in developing countries, including Brazil, India, Malaysia, and Mexico, were among the top 10 derivatives exchanges in terms of the number of contracts traded (Basu and Mukhopadhyay 2006). The average daily turnover in over-the-counter derivatives in developing countries increased from $27 billion in 2001 to $99 billion in 2007, or to about 2 percent of the global market (Saxena and Villar 2008).

Most of these instruments were designed to hedge foreign exchange risk in response to several factors: (a) higher demand from firms and households, as rising wealth increased their holdings of foreign assets; (b) the increased exchange rate volatility of more open economies; (c) the more prominent role played by foreign investors; and (d) the experience of the late-1990s crises, when firms and households suffered from large exchange-rate exposure. Many emerging market exporters sought protection against gradual currency appreciation by writing options on their foreign exchange earnings.

"Carry trades" were a common speculative vehicle, with an estimated volume of between $200 billion and $1 trillion in recent years (BIS 2008).[3] These trades kept high-yielding currencies rates (such as the Indonesian rupee, Mexican peso, South African rand, and Brazilian real) at relatively high appreciated levels. However, sudden withdrawals from the affected countries, as investors sought safe havens in U.S. Treasury securities, led to rapid depreciations. Estimates of recent losses by emerging market corporations from their foreign exchange positions exceed $40 billion, with perhaps the largest losses in Brazil (where some 200 firms incurred losses of an estimated $28 billion, according to Marques and Moutinho 2008), Poland (where authorities estimate total losses at $5 billion), and the Republic of Korea (where the government had spent $1.3 billion by January 2009 to stave off bankruptcies of firms with derivative losses). Several commercial banks—for example, Hana Bank (Republic of Korea), Bank Millennium (Poland), Banorte (Mexico), and the government-owned development bank BNDES (Brazil)—also chalked up substantial credit losses as a result of corporate

bankruptcies. The unwinding of these speculative positions, in turn, accentuated the fall in emerging market currencies (for example, in Mexico, according to Nanto 2009), despite cuts in high-income official rates that increased short-term interest differentials in favor of emerging markets.

The case of Korea illustrates the risks of assuming cheap foreign-currency financing. The won/yen exchange rate has been very stable over the past decade, in part because of policy support. Thus firms could generate large profits by borrowing in yen at low interest rates (including issuance of Samurai bonds) and using the proceeds to invest in higher-yielding won-denominated instruments. Moreover, firms reduced the funding costs by assuming so-called KIKO ("kick-in, kick-out") options offered by banks as part of structured products, whereby funding was subsidized in return for the firm writing a put option with unlimited payout in case of a currency depreciation. The firms' rationale for making this bet was that their export receipts would rise in step with any depreciation of the won, enabling them to cover the put option. In turn, banks used these options to cover the protection that they had offered to carry-trade investors. However, the financial crisis simultaneously cut firms' export revenues (as global demand plummeted) and put the won under pressure (because of the flight to quality). As a result, the firms suffered massive losses through these derivative trades (for example, Daewoo reported $1.7 billion in losses from foreign currency derivatives trades in 2008), and the banks then suffered losses when firms could not repay their loans. Eventually a portion of the banks' losses were covered by the government.

The case of Poland illustrates the fallacy of projecting stable exchange rates for EU countries that are expected to adopt the euro. Authorities estimate that 80 percent of nonfinancial firms took on substantial currency exposure through derivative trades, although with a rapid global recovery the resulting losses may eventually be offset by stronger export revenues. For the time being, however, Polish banks have experienced rising nonperforming corporate loans. In addition, about 60 percent of the mortgages issued by Polish banks were denominated in Swiss francs, and the franc has appreciated by 40 percent against the zloty since October 2008. The Polish Financial Supervision Commission estimated that as of February 2009 corporations had lost $5.5 billion from currency derivatives.

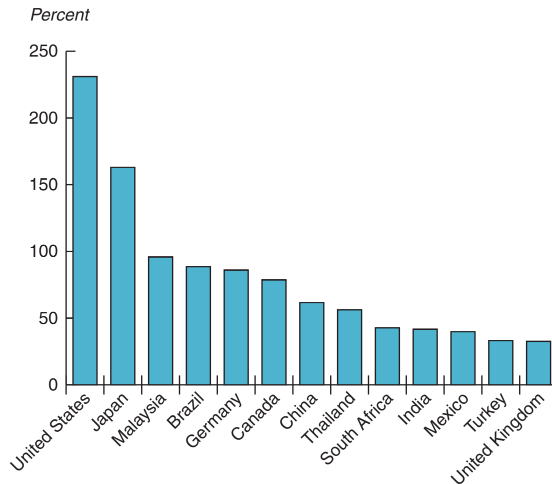
Authorities in some countries have already taken steps to rein in such speculative trades. Some are tightening suitability rules, whereby banks must certify that nonfinancial participants in foreign exchange derivative markets can hedge only their net currency positions. Market participants have also started litigation against banks that offered structured products with an unlimited downside (such as KIKO products in Korea), and several cases are pending in court, creating legal uncertainty as to the enforceability of exotic derivatives contracts. Industry groups are advocating stronger efforts to develop local-currency bond markets to alleviate the pressure to seek foreign financing. Policy makers have stepped up calls for improved surveillance of systemic risks, where the derivatives exposures of corporations will require better monitoring and containment of the very large flows moving through carry trades, as well as the substantial leverage that characterizes such transactions.

Domestic bond markets have helped cushion the impact of the crisis in a few countries

Domestic bond markets have become an important alternate source of funds in major emerging market economies. The dollar value of the outstanding local-currency bonds in 20 developing countries jumped from $2.9 trillion in 2005 to $5.5 trillion by end-June 2008, or to 9 percent of global bond issuance.[4] Reliance on local currency bond markets can help limit mismatches of currencies and maturities in countries affected by the crisis, thus contributing to financial stability. However, just eight countries—Brazil, China, India, Malaysia, Mexico, South Africa, Thailand, and Turkey—accounted for almost 90 percent of local-currency bonds outstanding in June 2008. Relative to the size of these economies, local-currency bond markets have grown to levels comparable to some of the financial centers of the high-income economies (figure 3.3).

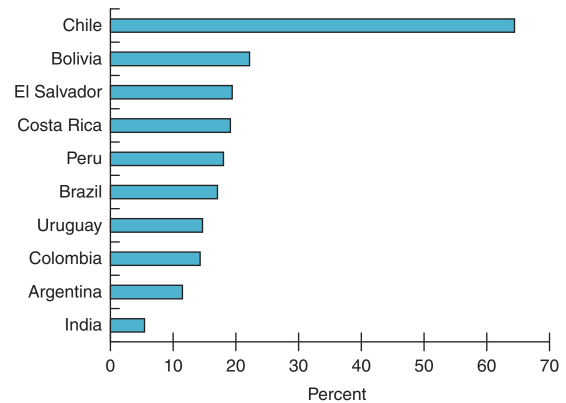
Domestic institutional investors (pension funds, insurance companies, and mutual funds) have been the primary investor base. In some countries (Malaysia and Thailand), domestic bond markets have also attracted retail investors looking for relatively safe instruments with higher yields than bank deposits. The assets managed by domestic institutional investors have grown substantially because of several factors—chief among them are high savings rates (particularly in several East Asian

Figure 3.3 Largest local-currency bond markets, 2007 (percent of GDP)



Sources: BIS and World Bank staff calculations.

Figure 3.4 Pension assets in selected countries as a share of GDP, 2007

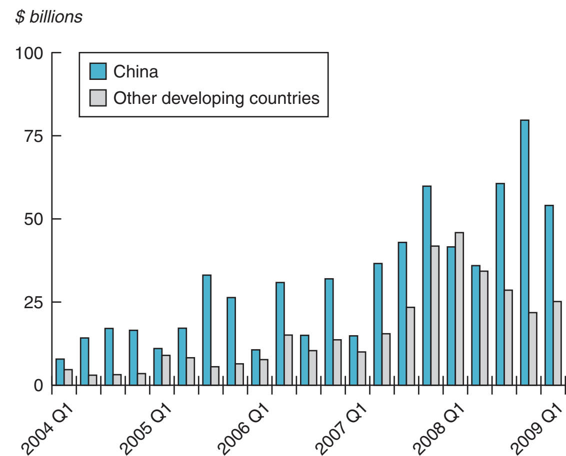


Source: OECD Private Pension Outlook 2008.

countries), pension reforms (Brazil, Chile, Mexico, and Thailand), rapid growth of the insurance industry (China and Thailand), and the expansion of collective-investment schemes, such as mutual funds, in most major emerging markets. Pension funds and insurance companies have long-term liabilities that are best funded by high-quality debt instruments such as long-term government bonds. The volume of pension-fund assets is already significant in many Latin American countries (figure 3.4), and there is potential for substantial growth in such assets in countries such as China, India, Russia, and Thailand. That growth will help develop domestic bond markets in those countries.

Corporations in countries with a well-developed domestic corporate bond market are better positioned to weather the current crisis, especially if they face heavy refinancing needs. In 2008 corporate (financial and nonfinancial) bonds accounted for 29 percent of the total domestic bond market in the 20 developing countries, up from 25 percent in 2007, indicating that the domestic bond market has become an increasingly important source of funding for corporations. There is, however, wide variation across countries. Corporate bonds accounted for more than a third of the total domestic bond market in six countries but were negligible in nine other countries. In the case of Malaysia, the value of outstanding corporate bonds issued in the domestic market ($168 billion in 2008) exceeds the value of government bonds ($110 billion) and the nation's external debt ($66 billion) by a wide margin. China dominates domestic corporate bond issuance in the 20 developing countries, accounting for two-thirds of the total amount issued over the past five years (figure 3.5). Domestic bond issuance by Chinese corporations reached a record high of $80 billion in 2008Q4 amid all the turbulence in international financial markets. By contrast, the volume of issuance by corporations in domestic bond markets of other developing countries declined from record highs reached in early 2008. The difference partly reflects large movements in exchange rates. Currencies

Figure 3.5 Corporate bond issuance in domestic markets, 2004Q1–2009Q1



Source: Dealogic Analytics.

in many of the developing countries with active corporate domestic bond markets (Brazil, India, and Mexico, in particular) depreciated by more than 30 percent against the dollar in 2008, while the Chinese renminbi appreciated by 5 percent.

The deep domestic market for corporate bonds in countries like Brazil, China, Malaysia, Mexico, South Africa, and Thailand will help to attenuate the impact of the crisis. The development of a domestic market for corporate bonds in other countries is limited by several factors, including the small size of corporate bond issues, the lack of a market-based yield curve, incomplete disclosure of accounting information, the small base of domestic investors, and weak corporate governance.

Despite their clear value in expanding the range of options available for governments and corporations to meet their financing needs, domestic bond markets can be vulnerable to a sudden shift in external financial conditions in cases where foreign investors play a prominent role in the market (similar issues are raised with the large foreign bank participation in many emerging markets—box 3.1). Foreign investors account for only about 10 percent of the amount outstanding of bonds issued in the domestic markets of the

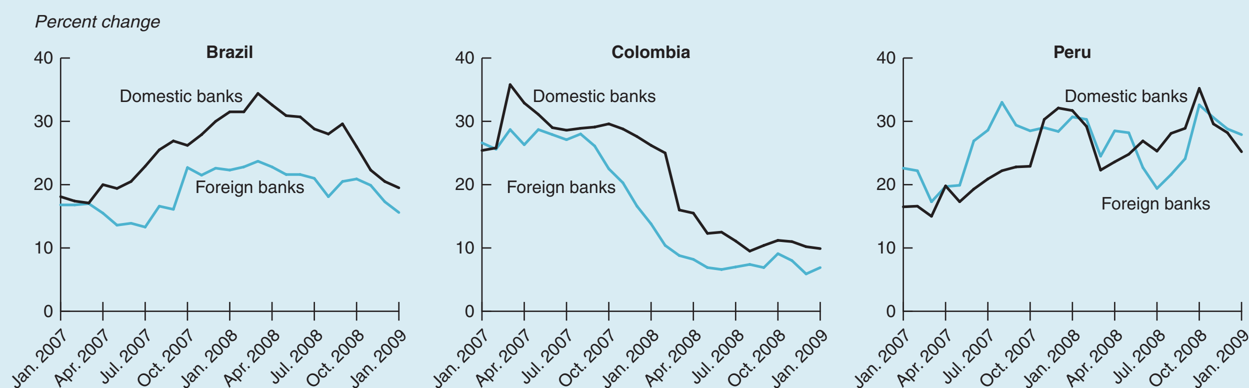
Box 3.1 Foreign bank participation and the financial crisis[a]

Foreign participation is a concern in the domestic banking sector of some developing countries, as foreign affiliates may tend to cut off credit when their parent banks suffer an adverse liquidity shock (Cull and Martinez Peria 2007). The host country in such cases stands to suffer a larger credit contraction than if banks were predominantly owned by domestic investors. Although it is far too soon to come to a reliable conclusion on the impact of foreign bank ownership on developing countries' experience during the financial crisis, preliminary evidence does not support the view that foreign banks' subsidiaries bear an inordinate responsibility for observed contractions in domestic credit.

Evidence gathered for three Latin American countries in which foreign banks have a prominent role suggests that foreign bank subsidiaries and domestic banks responded similarly to the global financial crisis. Foreign banks accounted for 23 percent of total bank lending during 2006–08 in Brazil, 24 percent in Colombia, and 50 percent in Peru. In Brazil, the slowdown in domestic credit creation was modest, and credit creation by domestic banks shrank more from the peak than that of foreign banks (see box figure). In Colombia, the rate of growth in bank lending has been decelerating since 2007, but there is no evidence of a sharper decline in the wake of the financial crisis—if anything, domestic banks reduced credit creation more than did foreign banks. In Peru, the pace of lending by domestic and foreign banks has remained roughly stable since early 2008.

a. For a detailed discussion of this issue see chapter 3 in World Bank (2008).

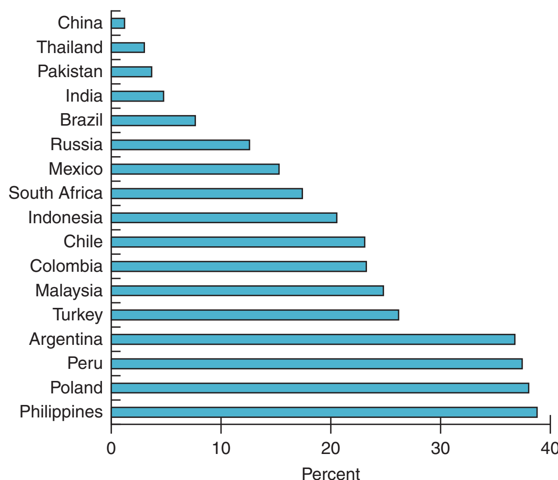
Real credit growth by ownership of banks



Source: World Bank staff estimates based on data from national authorities.

Note: This figure plots the yearly month-to-month growth rate of total by domestic (private) and foreign banks, measured at fixed January 2006 local currency prices.

Figure 3.6 Foreign holdings of domestic bonds, 2007
Share of total



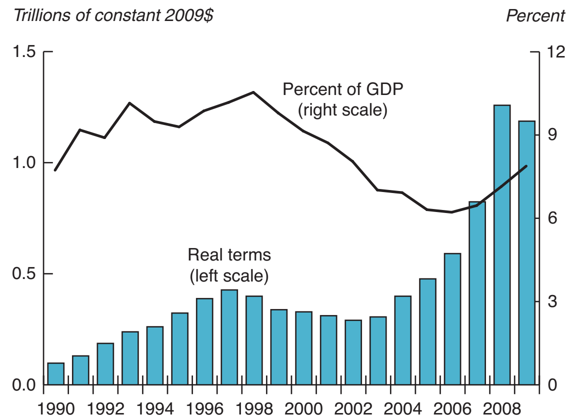
Sources: IMF; BIS; World Bank staff calculations.

20 developing countries for which BIS data are available. However, foreign participation varies widely from country to country. In 2007, foreign investors held more than one-third of the amount outstanding of domestic bonds in Argentina, Peru, Poland, and the Philippines, but less than 5 percent in China, Thailand, Pakistan, and India (figure 3.6).

Countries with large financing needs face balance-of-payments crises

The projected sharp decline in private capital flows follows a long period of increase in developing countries' reliance on external finance. Most countries will require significant capital inflows to meet their external financial needs, defined as the external funds required to finance current-account deficits and make scheduled payments on private debt coming due this year. In 97 of 108 developing countries for which data are available,[5] the total financing needs in 2009 are estimated to be $1 trillion, $600 billion higher than in 2003 in constant 2009 prices (figure 3.7). Strong growth during 2004–06 enabled developing countries' financing needs to decline as a share of GDP, even as the dollar amount rose. However, in the past two years, financing needs have continued

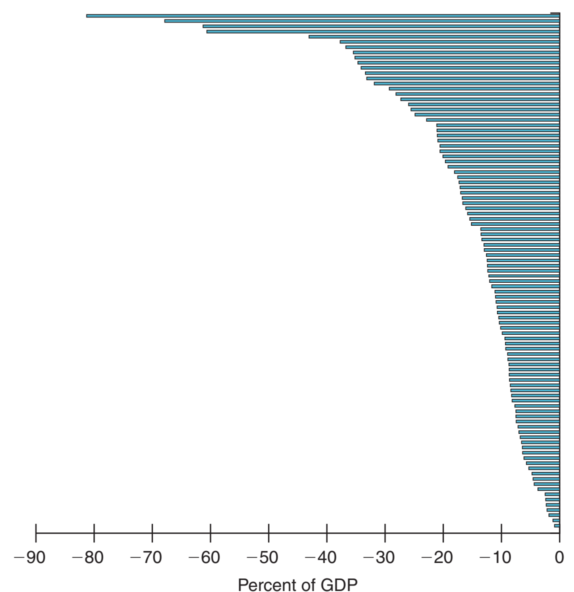
Figure 3.7 External financing needs of developing countries, 1990–2009



Source: World Bank staff estimates.

to expand, while growth is now slowing. The present ratio of financing needs to GDP for the 97 countries is estimated at 7.8 percent, up from 6.2 percent in 2006. External financing needs in 25 of the 98 countries are expected to exceed 20 percent of their GDP (figure 3.8). Overall, external financing needs are projected to decline slightly in constant dollar terms in 2010–11, as developing

Figure 3.8 Estimated external financing needs of 102 developing countries in 2009



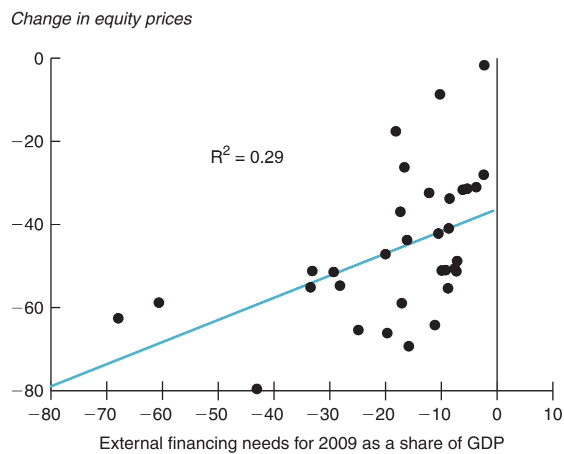
Source: World Bank staff estimates.

countries reduce their current-account deficits and their reliance on short-term debt. Given the anticipated recovery in output, this projection implies that by 2011 external financing needs will fall back to 2006 levels as a share of GDP.

The crisis has had a larger impact on countries with heavy external financing needs

Equity price declines have been larger in countries with heavy external financing (figure 3.9), especially in emerging Europe and Central Asia and other areas where financing gaps loom large. Between August 2008 and February 2009, equity prices (measured in U.S. dollars) fell by around 65 percent in Bulgaria and Latvia, where external financing needs for 2009 are estimated at more than 65 percent of GDP. By contrast, the relationship between equity prices and financing needs is less apparent for countries whose external financing needs are more moderate (less than 20 percent of GDP). Countries that will need a large amount of external financing in 2009 also experienced larger average depreciations in exchange rates in late 2008 (figure 3.10). By contrast, the correlation between external financing needs and the rise in sovereign bond spreads is quite weak (figure 3.11). This illustrates that the financing needs are concentrated in the corporate sector. Sovereign spreads widened the most in countries with impending fiscal pressures or uncertain political situations. For example, sovereign bond spreads widened by more than 1,000 basis points in Ecuador, Pakistan, Sri Lanka, and República Bolivariana de Venezuela, where external financing needs are estimated at less than 15 percent of GDP.

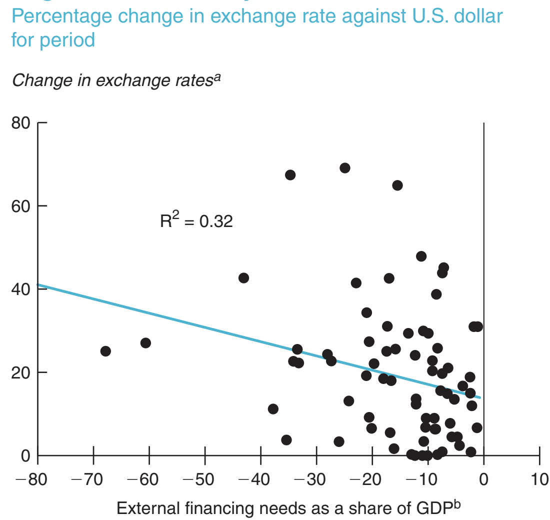
Figure 3.9 Equity price changes versus external financing needs of developing countries, August 2008–February 2009



Sources: MSCI Barra and World Bank staff estimates.

Figure 3.10 Exchange-rate changes and external financing needs in developing countries, August 2008–February 2009

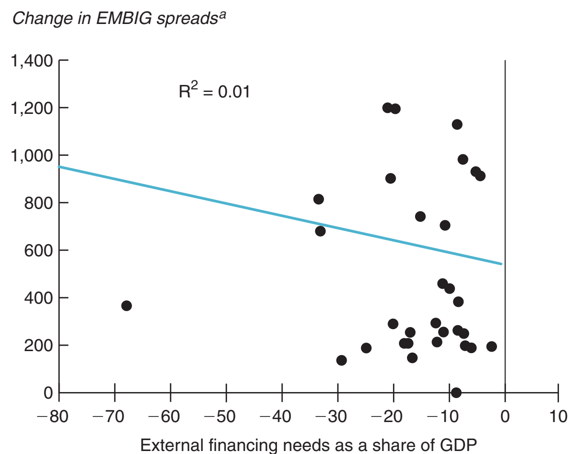
Percentage change in exchange rate against U.S. dollar for period



Sources: Datastream and World Bank staff estimates.

Note: a. Percent change in $ nominal exchange rates between August 2008 and February 2009; increase reflects depreciation
b. Current account balance projected for 2009 and principal repayments on private debt coming due as a ratio to GDP.

Figure 3.11 Change in sovereign bond spreads and external financing needs of developing countries, August 2008–February 2009



Sources: Datastream and World Bank staff estimates.

Note: a. Change (bps) in EMBIG spread between August 2008 and February 2009.

Table 3.2 Estimates of developing countries' external financing needs in 2009

$ billions

	Countries with financing needs	Countries with financing gaps	Countries with no financing gaps
Number of countries	98	59	39
External private debt:	3134	2760	374
Short-term	611	535	76
Medium & long term	2524	2226	298
External financing needs:	−1066	−959	−107
Current account	−224	−217	−7
Principal repayments on private debt	842	742	100
Short-term	611	535	76
Medium & long term	231	207	24
Private sources of external financing:	764	607	157
Net equity flows	169	90	79
Disbursements of private debt	786	691	95
Short-term	562	492	70
Medium & long term	224	199	25
Unidentified outflows	−191	−173	−17
Estimated financing gap:		−352	—

Source: World Bank Debtor Reporting System (DRS) and staff estimates.
Note: n.a. = not applicable.

Many countries will find it very difficult to meet their external financing needs from private sources of capital

Our estimates indicate that equity flows and new disbursements of private debt will not meet external financing needs for 59 of the 98 countries that have such needs, leaving a total financing gap (external finance required after accounting for new loans and investments from private sources) of $352 billion (column two of table 3.2). The 59 countries with a financing gap have financing needs of $0.9 trillion, more than half of which is short-term debt ($535 billion). These 59 countries are projected to receive the bulk of private sources of external financing in 2009 ($607 billion of the $764 billion going to all 98 countries), most of which will take the form of new disbursements of short-term debt ($492 billion). This calculation depends critically on assumptions concerning the rollover rate on private debt coming due (disbursements divided by principal repayments), net equity flows, and unidentified capital outflows. The assumptions underlying the projection are outlined in box 3.2.

We illustrate the sensitivity of our projections to these assumptions by comparing the base- and low-case scenarios outlined in box 3.2. The number of countries with external financing gaps increases from 59 to 69 in the low-case scenario (table 3.3). The 10 additional countries with external financing gaps in the low case have external financing needs of just $47 billion. However, net private capital flows to the 69 countries is much lower compared with the base case. According to these estimates, capital flows from private sources will fall short of meeting developing countries' financing needs in 2009 by between $352 billion to $635 billion.

Table 3.3 Estimated external financing gap in developing countries, 2009

$ billions

	Base case	Low case
Number of countries with ext. fin. gaps:	59	69
External financing needs:[a]	−959	−1,005
Private capital flows	607	371
Equity flows[b]	90	70
Principal repayments on private debt	691	520
Short-term	492	380
Long-term	199	141
Unidentified outflows	−173	−219
External financing gap:	−352	−635

Source: World Bank Debtor Reporting System (DRS) and staff estimates.
Note:
a. Current account balances - principal repayments due on private debt.
b. FDI and portfolio equity inflows less outflows.

Box 3.2 Methodology used to estimate external financing gaps

The purpose of this exercise is to estimate the extent to which capital flows from private sources will meet developing countries' external financing needs in 2009. We first estimate developing countries' external financing needs, defined as the current-account deficit (as projected in chapter 1) plus scheduled principal payments on private debt (based on information in the World Bank's Debtor Reporting System). We compare this estimate to a projection of private capital flows, which includes new loans on private debt, net equity flows, and net unidentified capital outflows. The difference between the estimated financing needs and projected private capital flows is the financing gap, which is reported in table 3.2. Projections of private capital flows in 2009 are discussed in chapter 2.

New loans on private debt. Net private debt flows are projected to decline from $108.5 billion in 2008 to between −$56 billion and −$300 billion in the base- and low-case scenarios. Countries with financing gaps are expected to have more difficulty rolling over their debt than those without financing gaps (countries where financing needs are met by net private capital flows). Moreover, we also assume that private creditors will be more willing to refinance sovereign debt and private debt that is publicly guaranteed. Rollover rates (disbursements of new loans/principal repayments maturing in 2009) underlying the projection are reported in the table below.

Net equity flows are projected to decline from $339 billion in 2008 to between $303 billion and $227 billion in the base- and low-case scenarios. These figures include both inflows and outflows of net foreign direct investment and portfolio equity flows.

Unidentified capital outflows. A definition of and historical data for "unidentified capital outflows" are provided in chapter 2. Briefly, this is a balancing item that is equal to the difference between the current-account deficit and all identified capital-account transactions, on the one hand, and the change in reserves, on the other. A portion of this balancing item represents private capital transactions that are not reported to the authorities. Another portion represents inconsistencies within the balance-of-payments reporting system. The magnitude of unidentified capital outflows is expected to decline substantially in 2009 as residents of developing countries drawdown foreign assets held abroad. For example, residents of developing countries reduced their deposits at BIS-reporting banks abroad by over $300 billion (18 percent) over the course of 2008. Many transactions of this nature are not fully recorded. We assume that unidentified capital outflows fall from $658 billion in 2008 to $281 billion in the base case scenario and $340 billion in the low case.

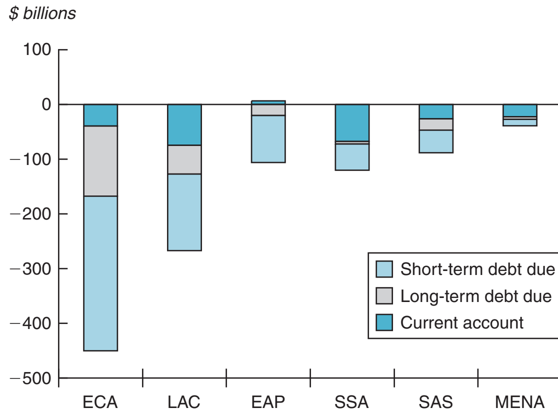
Rollover rates on private debt coming due

Percent

	Base case		Low case	
	Countries with financing gaps	Countries without financing gaps	Countries with financing gaps	Countries without financing gaps
Short-term	92	100	65	100
Medium & long term				
Public and publicly guaranteed (PPG)	129	150	85	100
Private non-guaranteed (PNG)	86	100	55	70

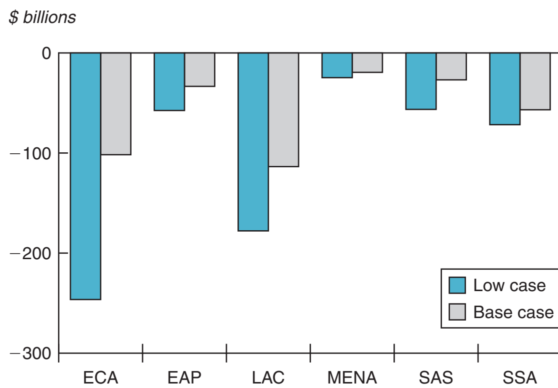
The underlying nature of financing needs varies widely across regions. In Sub-Saharan Africa, current-account deficits are the major item requiring external financing, while in the other regions principal repayments (on short-term debt in particular) account for the bulk of financing needs (figure 3.12). The estimated financing gaps in regions with high volumes of short-term debt coming due (notably Europe and Central Asia and Latin America) are quite sensitive to the different rollover rates assumed in the two scenarios (figure 3.13). The estimated financing gap for emerging Europe and Central Asia varies by $145 billion from the base- to low-case scenarios, compared with a variation of just $15 billion for Sub-Saharan Africa. A similar result holds when the estimated financing gap is broken down by income classification. The estimated financing gap for the upper-middle-income countries varies by $192 billion, compared with just $11 billion for low-income countries.

Figure 3.12 External financing needs in 2009, by region



Source: World Bank staff estimates.

Figure 3.13 External financing gaps in 2009, by region and under alternative scenarios



Source: World Bank staff estimates.

Reserves are unlikely to be sufficient to meet financing gaps

Some countries will be able to rely on reserves built up over the past few years to help meet their external financing gap. However, many countries already have drawn down their reserves significantly, as described later in this chapter. Remaining reserves fall short of the estimated external financing gap for 2009 in 9 countries in the base-case scenario and 13 countries in the low case. Further reductions of reserves in those and other countries could increase the risk of interruptions in international payments.

Financing from official sources is limited

Our estimates of the financing gap do not take into account capital flows from official sources, since the aim of the exercise is to gauge how much financing from official sources would be required to meet countries' external financing needs after taking into account projections of financing from private sources.

Most low-income countries depend heavily on official sources to meet their external financing needs. Our projections indicate that net private capital flows will be insufficient to meet the external financing needs of 30 of the 40 low-income countries for which data are available. If official capital flows to those 30 countries were to remain at the average levels observed in 2007–08, they would cover the entire external financing gap in just two of the 30 countries in the base-case scenario and not a single country in the low case.

Thus many countries will need substantially more official finance to close their financing gap, and the official community is responding. In response to the crisis, net official lending jumped to $20.4 billion in 2008 (including assistance from the International Monetary Fund, IMF) after five years in which repayments exceeded disbursements (table 3.4). Net lending by official creditors was negative over the past five years because improved financial conditions in developing countries had reduced demand for multilateral lending and facilitated repayments (and prepayments) to the Paris

Table 3.4 Net official flows, 2002–08
$ billions

	2002	2003	2004	2005	2006	2007	2008[e]
World Bank	−0.3	−0.5	1.6	2.8	−0.4	4.9	7.1
IMF	14.1	2.5	−14.7	−40.1	−26.7	−5.1	10.9
Other official	−8.7	−13.3	−12.8	−34.0	−43.8	0.2	2.4
Total	5.1	−11.3	−25.9	−71.3	−70.9	0.0	20.4

Source: World Bank Debtor Reporting System; IMF.
Note: e = estimate.

Club. The drop in lending also reflected the growing importance of grants from the International Development Association (IDA), which is not included in the net lending data.[6] Amortization payments to official creditors (including the IMF) fell from $130 billion in 2006 to $55 billion in 2008, while purchases from the IMF jumped to $14 billion (compared with $2 billion in 2007 and $4 billion in 2006). Three-quarters of the purchases came in the fourth quarter in response to the slump in economic activity and the freezing of credit in industrial countries. Developing countries entering into standby arrangements with the IMF in the fourth quarter of 2008 included Hungary ($15.7 billion), Latvia ($2.4 billion), Pakistan ($7.6 billion), Seychelles ($26 million), and Ukraine ($16.4 billion). In March 2009, Romania negotiated a $17.5 billion package from the IMF.

The IMF has overhauled its lending framework, creating a new flexible credit line and doubling access limits for all borrowers. Mexico became the first country to access the new flexible credit line with a $47 billion precautionary arrangement approved in April 2009. Poland and Colombia have also arranged precautionary credit lines of $20.5 billion and $10.4 billion, respectively.

The international community has taken major steps to enhance the lending capacity of the IMF. In April 2009 the G-20 leaders endorsed an expansion of the IMF's lending capacity from $250 billion to $750 billion (initially to be financed through bilateral loans from member countries and later through an expanded and more flexible scheme known as New Arrangements to Borrow), along with an allocation to members of special drawing rights (SDR) equivalent to $250 billion and urgent ratification of the Fourth Amendment, which would result in an additional SDR allocation of $34 billion to some members. These SDR measures, if implemented, would enable member countries to draw on their share of the total $284 billion. Furthermore, the G-20 leaders also pledged to provide resources to finance $250 billion in trade through 2011.

Since September 2008, multilateral development banks (MDBs, listed in table 3.5) have acted to lessen the impact of the global liquidity crisis on developing countries, especially low-income countries. As of April 2009, the MDBs had collectively committed $88 billion in funding to developing countries to deal with the fallout from the global financial crisis (table 3.5). The commitments cover a broad range of areas, including development policy loans, trade finance, political insurance, and equity investment funds for bank restructuring in emerging market countries. A substantial portion of the total (or $73 billion) came in the form of development policy loans aimed at providing liquidity support to emerging market countries. While the total support for trade finance was just $13 billion, the impact of the resources committed is expected to be much greater. For example, the

Table 3.5 Multilateral development banks' planned 2009–11 financial response to the crisis, as of April 2009
$ billions

Name of institution	Lending	Equity investment	Trade finance: Guarantee	Trade finance: Liquidity facility	Political risk insurance	Total
Asian Development Bank	5.7		0.9			6.6
African Development Bank				1.0		1.0
European Bank for Reconstruction and Development	1.4		1.0			2.4
Inter-American Development Bank	6.0		1.0	6.0		13.0
World Bank Group	60.0	1.0	2.0	1.0	1.0	65.0
IBRD	60.0					60.0
IFC		1.0	2.0	1.0		4.0
MIGA					1.0	1.0
Total MDBs	**73.1**	**1.0**	**4.9**	**8.0**	**1.0**	**88.0**

Sources: World Bank staff estimates based on several sources, including MDBs' press releases.
Note: The amount in this table represents announced increases over the pre-crisis level, and does not include the multiplier or leveraging effects of such new initiatives.

Box 3.3 The response of international financial institutions to the trade finance contraction following the crisis

The World Bank Group responded to alleviate the impact on developing countries of the sudden evaporation of trade finance following the bankruptcy of Lehman Brothers in September 2008. That response, like those of other international financial institutions (IFIs), has been aimed at the global level as well as the country level. At the global level, the IFIs worked closely with the World Trade Organization to address finance issues. The World Bank Group, acting through the International Finance Corporation (IFC), doubled the Global Trade Finance Program (GTFP)[a] from $1.5 billion to $3 billion. Under the GTFP, IFC guarantees a percentage of the exposure that international banks incur when they confirm letters of credit, book acceptances, or purchase trade-related notes issued or guaranteed by local banks. The liquidity crisis of 2008 has dramatically increased the demand for IFC's facility, as actors in major emerging markets find it increasingly difficult to obtain trade finance from traditional banking sources.

Up to now, IFC has focused on providing guarantees to participating banks (issuing and confirming). However, in collaboration with other multilateral development banks, bilateral organizations, export credit agencies, and several large banks, in March 2009, IFC created a Global Trade Liquidity Program (GTLP) of up to $5 billion to meet participating banks' growing demand for liquidity. The GTLP is estimated to be able to support around $48 billion of developing-country trade over three years.

In addition to IFC, the European Bank for Reconstruction and Development, the Asian Development Bank, and the Inter-American Development Bank have been active in trade facilitation efforts. The EBRD program began in 1999; ADB's was launched in 2003. In addition to providing guarantees to banks, the EBRD extends to banks short-term loans that are on-lent to local companies to provide the working capital necessary to fulfill foreign trade contracts. During this crisis, ADB and IADB have increased the size of their facilities to $1 billion each. EBRD has increased its facility from €800 million to €1.5 billion.

a. IFC's GTFP became operational in 2005.

new IFC's Global Trade Liquidity Program initiative of $5.0 billion (including $4 billion from other MDBs and bilateral agencies) is expected to support up to $48 billion in trade (box 3.3).

The strong financial position of the International Bank for Reconstruction and Development (IBRD) on the eve of the crisis allowed it to respond quickly and substantially to developing countries' requests for financial assistance. Loan commitments are expected to reach $35 billion in the current fiscal year (ending June 30, 2009), compared with $13.5 billion for the previous year. And net lending may rise from near zero over the past few years (mainly reflecting some borrowing countries' decisions to repay IBRD loans earlier than scheduled) to $15–20 billion over the next three years. Since the last months of 2008 the World Bank Group, of which the IBRD is a part, has taken various steps to assist developing countries in dealing with the global financial crisis. In December 2008, the Bank Group's International Development Association (IDA) launched a $2 billion Financial Crisis Response Fast-Track Facility to speed up grants and long-term, interest-free loans to help the world's poorest countries cope with the impact of the global financial crisis. On the private sector front, the International Finance Corporation (IFC) in December 2008 launched a global equity fund to recapitalize distressed banks, with $1 billion provided by the IFC and $2 billion by Japan. The IFC also created an infrastructure crisis facility to provide rollover financing to help recapitalize existing, viable, privately funded infrastructure projects facing financial distress, with $300 million provided by the IFC and $1.5 billion from other sources. In addition, the IFC took steps through its trade finance facilitation program to ease access to trade credit by developing-country firms. Similarly, the Multilateral Investment Guarantee Agency, another part of the World Bank Group, is providing guarantees of up to $1 billion to foreign banks to help inject liquidity and bolster confidence in the financial systems of Russia, Ukraine, and Eastern European countries. The response of other development banks is largely synchronized with the actions of the World Bank Group.

Table 3.6 Total assets and equity of the major MDBs, 2007
$ billions

	Asset	Capital
Asian Development Bank	69.5	14.3
African Development Bank	12.1	4.7
European Bank for Reconstruction and Development	46.1	13.9
Inter-American Development Bank	69.9	20.4
World Bank Group	248.5	53.8
of which		
IBRD	207.9	39.8
IFC	40.6	14.0
Total MDBs	**446.1**	**107.1**

Source: Financial statement of each institution in its 2008 Annual Report.

Facing capital constraints, many MDBs have sought capital increases to enable them to respond more effectively to the requirements of their member countries. The participants in the G-20 meeting held in April 2009 committed to review the adequacy of the capital resources of all MDBs to provide appropriate increase in funding to mitigate the impact of the crisis (see table 3.6 for MDBs' capital and assets, as of 2007). The G-20 endorsed a 200 percent general capital increase for the Asian Development Bank (ADB) and agreed to review the need for capital increases at the Inter-American Development Bank, the African Development Bank, and the European Bank for Reconstruction and Development. The ADB's Board of Governors agreed to triple ADB's capital base from $55 billion to $165 billion, substantially increasing its support to countries affected by the global downturn. The ADB plans to increase its lending assistance by more than $10 billion in 2009–10, bringing total ADB assistance for these two years to about $32 billion, up from about $22 billion in 2007–08. The ADB will establish—pending approval from its board of directors—a $3 billion fund (the Countercyclical Support Facility) to support fiscal spending by member countries needed to overcome the crisis. It is crucial for multilateral agencies to be adequately capitalized to increase their ability to respond to this and future crises and to meet the funding requirements of the developing countries.

Despite these efforts, commitments are not yet sufficient to cover developing countries' financing gaps. Furthermore commitments to an SDR allocation have not historically been followed by swift ratification by national governments. For example, regarding the last SDR issuance dating from 1997, as of April 1, 2009, 131 members representing 77.68 percent of the total voting power had accepted the Fourth Amendment, falling short of the required 85 percent.[7] Moreover, a third of the pledged money is to come from direct lending from member governments. Some governments already have made this money available, but others have yet to do so. Therefore it is not clear that all of the money will be available immediately. And while the total amount of funds committed would be sufficient to cover our estimate of developing countries' financing gaps in 2009, disbursing all of this money this year would leave nothing available if difficult financing conditions persist into 2010, not an unlikely scenario.

The inability to meet financing needs could have grave economic consequences

The previous discussion has shown that for many developing countries, the availability of reserves, private external finance, and official support is unlikely to be sufficient to cover their current account deficits and principal repayments on outstanding debt. These countries will be faced with a difficult choice. They could postpone debt service payments, either by delaying government debt service or imposing capital control on private borrowers. Alternatively (or in combination), they could impose restrictive fiscal and monetary policies (perhaps in conjunction with capital controls) to the point where the fall in import demand sufficiently reduces external financial requirements.[8]

None of these options is palatable. Efforts to renegotiate external debt service payments, or outright defaults, are likely to impair access to international capital markets for some time to come, and could result in interruptions in payments systems if creditors attempt to attach the country's foreign exchange holdings. Reducing economic activity through higher interest rates or an improved fiscal balance in the midst of a global recession could have grave implications for welfare and poverty reduction. Using capital controls to attain either of these ends has the added disadvantage of impairing the efficiency of production and encouraging corruption. While many developing countries have

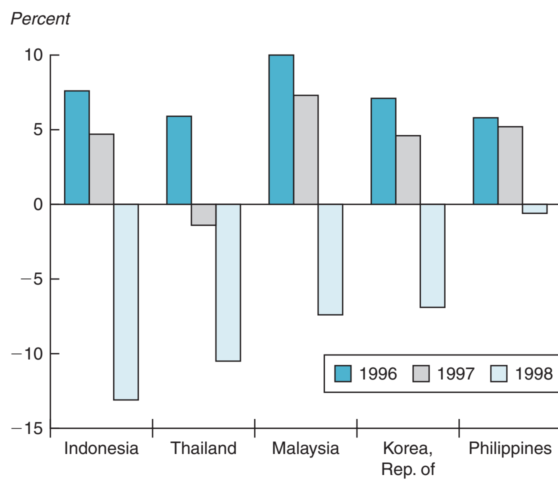
controls on capital account transactions, most permit foreign exchange outflows for current account transactions or for the purpose of repaying debt. Extending capital controls to these activities risks gravely undermining both the functioning of the economy and the credibility of government policies. Countries that encounter external financing constraints run the risk of going through an even more painful adjustment process because a further depreciation in the real exchange rate and steeper contraction in growth would be required to bring about an abrupt improvement in the current account. Both channels would be particularly painful at the current juncture, when GDP growth in developing countries with financing needs is already forecast to decline to 1.7 percent in 2009, down sharply from 4.7 percent in 2008, and in many of those countries substantial exchange-rate depreciations have already reduced real purchasing power. In short, many governments will face a difficult choice between imposing credit controls, postponing payments on their external debt, and going through an even more painful economic adjustment process.

This dilemma is well illustrated by the experience of East Asian economies during the financial crisis of the late 1990s, when high levels of capital flight forced the most affected countries into sharp exchange rate depreciations and restrictive macroeconomic policies to reduce demand, inducing severe recessions (figure 3.14) that reversed some of the hard-earned gains in poverty reduction attained in earlier years. In the current context of stagnant global export demand and the large overhang of corporate foreign debt, the real economy costs associated with the process of adjustment to external financing gaps would be very high, as would be the costs of large-scale corporate debt insolvency and restructuring. Such costs would vary across countries, depending on their foreign debt exposure, local capital market development, and the exchange rate regime.

Many low-income countries may be unable to meet their external financing needs

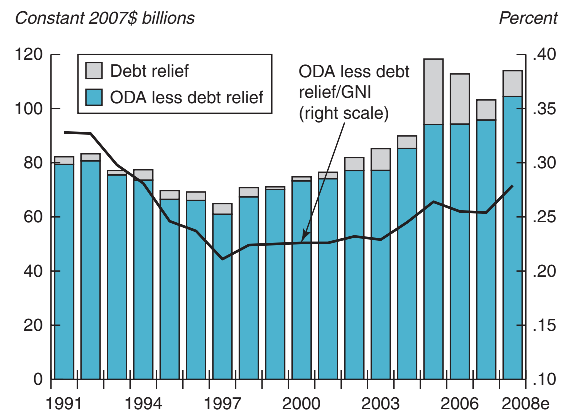
Many low-income countries will face particular difficulties in obtaining sufficient finance. Recognizing this, the G-20 leaders agreed to provide an additional $6 billion in concessional and flexible IMF financing for low-income countries over the next 2 to 3 years. Nevertheless, their historical reliance on official development assistance (ODA) is likely to be accentuated as export revenues and other sources of capital recede in 2009, while the prospects for substantial, additional ODA are not favorable. ODA disbursements by the 22 member countries of the Development Assistance Committee did rise to $114 billion last year, up $10.5 billion (10.2 percent) from 2007 (figure 3.15), but the sharp rise in industrial countries' fiscal deficits is likely to constrain further increases. Recent forecasts from the OECD envision a rise in the

Figure 3.14 Real GDP growth in five Asian countries, 1996–98



Source: World Bank staff estimates.

Figure 3.15 Net ODA disbursements by DAC donors, 1991–2008



Source: OECD Development Assistance Committee.
Note: e = estimate.

aggregate deficit of its member countries from 2.4 percent of GDP in 2008 to about 4 percent in 2009–10. And these forecasts are subject to constant revision, as spending plans remain in flux and revenue estimates extremely uncertain.[9]

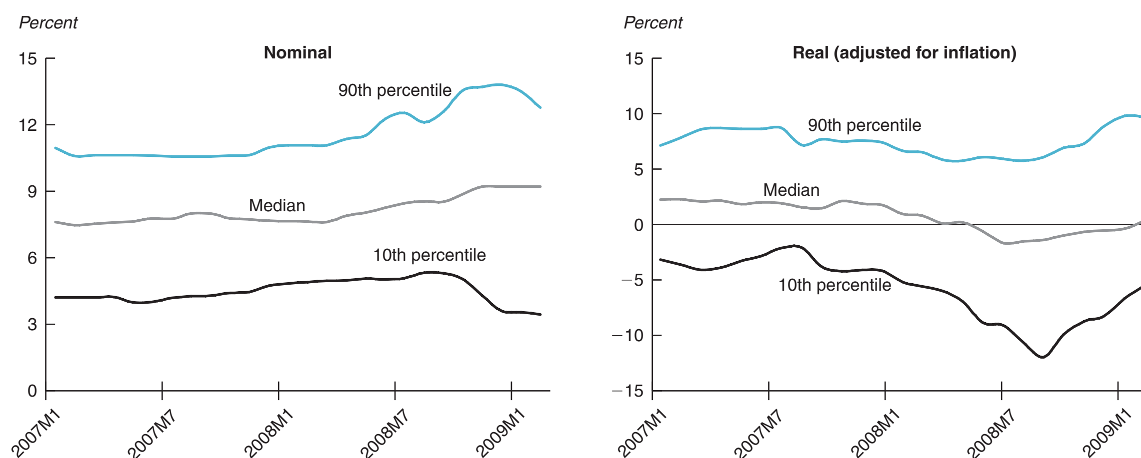
It is likely that expenditures not directly connected to domestic growth will come under increasing scrutiny, especially in Greece, Ireland, and Spain, where sharp increases in debt levels have resulted in warnings about bond ratings.[10] The intense pressures stemming from the sharp downturn in global growth will make it politically difficult for donors to meet their ODA commitments, even though such commitments are small relative to their fiscal revenues and expenditures. The 22 DAC member countries would have to enhance their net ODA disbursements by an average annual rate of 7.0 percent in 2009–10 in order to meet their existing commitments. Although such an objective might sound modest, net ODA disbursements were augmented at an average annual rate of only 6.7 percent over the past five years when growth was robust and fiscal pressures were limited.

The potential for expansionary policies varies significantly among developing countries

Policy responses in several developing countries have focused on short-term measures to support demand, including an easing of monetary conditions, drawdowns of reserves, and expansionary fiscal policies. However, developing countries differ greatly in their ability to use such policies to support demand. As noted in the previous section, the many countries with large financing gaps may find themselves compelled to suppress demand further to meet their external obligations, or risk the difficult-to-estimate but potentially severe consequences of default. Other countries, by contrast, retain some space for expansionary policies to compensate for the reduction in external demand and in private external finance.

Monetary policy. There is some evidence that monetary policy is easing in many developing countries. The median policy interest rate for 22 major developing countries increased over the course of 2008 in response to rising inflation and in the context of a generalized belief that developing economies would remain largely decoupled from the crisis unfolding in mature markets. Nevertheless, in most countries policy rates did not rise as fast as inflation, indicating some easing of monetary conditions. The perceptions of partial immunity from the crisis were dispelled by the sharp decline in global economic activity in late 2008. Now, about half of the 22 developing countries are well into an easing cycle aimed at supporting aggregate demand (figure 3.16). For example, policy rates in China, India, and Turkey declined by more than 2 percentage points from August 2008 to February 2009. Some countries—essentially those experiencing severe balance-of-payments

Figure 3.16 Policy interest rates in developing countries, January 2007–March 2009



Source: Datastream.
Note: Policy interest rates minus year-on-year change in headline consumer price index.

outflows and exchange-rate pressures—have raised policy rates, including Russia (2 percentage points), Pakistan (1.25 percentage points), and Hungary (1 percentage point).

The challenges of monetary policy vary widely across developing countries. In their decisions to limit interest-rate reductions, various central banks have cited the potential for additional currency weakness, greater inflation, and rising inflationary expectations. Several of these countries may have space remaining for additional monetary easing, in part because inflationary expectations are declining in many countries in Latin America and Asia. But monetary policy can have only a limited and temporary effect on real exchange rates relative to underlying fundamentals such as declines in export demand and in the terms of trade, which clearly have been the main drivers of exchange-rate depreciation in most emerging markets.

A more acute dilemma faces many central banks in Central Europe and the countries of the former Soviet Union. There, financing gaps tend to be wide, and support for aggregate demand (through lower policy rates) needs to be balanced against the risks of capital outflows and the resulting damage to the balance sheets of banks, firms, and households. Heavy external borrowing earlier in the decade has created significant currency mismatches in the region, with the result that further exchange rate depreciation could threaten the solvency of many financial institutions and corporate borrowers whose earnings come in local currency. This perspective suggests that, despite weakening aggregate demand, this group of countries has very little room for rate cuts. In some cases, rate increases may be needed to stem capital outflows.

For countries with fixed or quasi-fixed exchange-rate regimes, the scope for independent monetary policy depends on the degree to which the capital account has been liberalized (in practice as well as on paper). For countries running current surpluses or maintaining large reserves, some easing of monetary policy would be appropriate. However, for those experiencing unsustainable declines in reserves, such easing would not be appropriate. Here, too, rate hikes might be necessary. These countries may need to consider introducing more flexibility into their exchange-rate regimes in order to gain more freedom for monetary policy. Where this path is taken, it will be necessary to establish a credible medium-term monetary policy anchor to replace the fixed exchange rate.

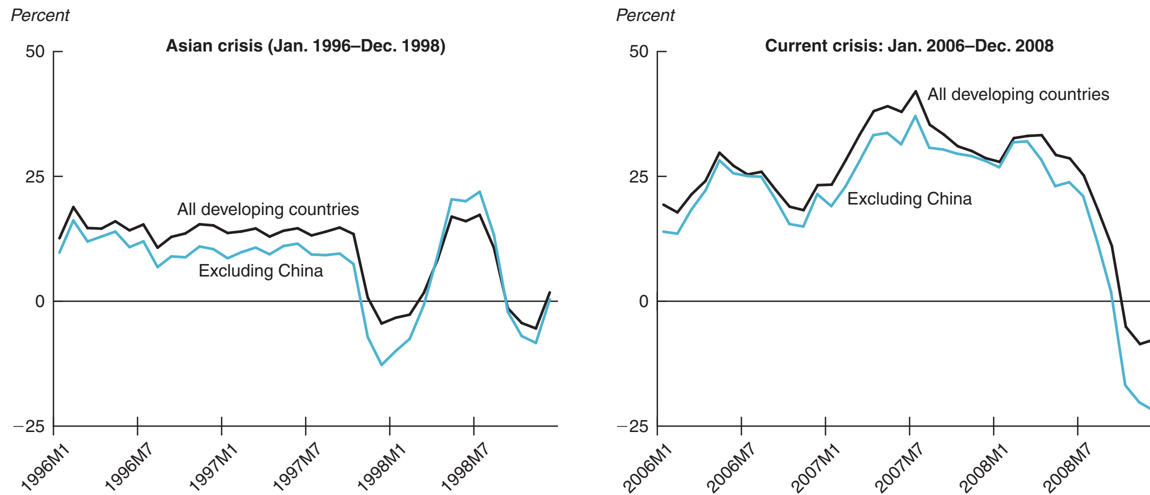
Like many industrial countries, a few developing countries have taken extraordinary financial steps to support credit markets. For example, Mexico and Russia have provided guarantees of bank debt to maintain credit market access; Indonesia and Russia have expanded deposit guarantees to avoid runs; central banks in Brazil, Indonesia, and Mexico have provided new liquidity facilities; and Brazil, the Republic of Korea and Mexico have entered into swap lines with the U.S. Federal Reserve to relieve pressures that emerged in settling cross-border claims. These liabilities will need to be carefully managed, and steps to unwind some of these actions may be necessary as economies recover.

Drawdowns of reserves. Several developing countries (Belarus, Ecuador, Malaysia, Pakistan, Poland, and Russia) have drawn down their foreign reserve holdings to mitigate the impact of the current crisis. Until the crisis intensified in late 2008, developing countries' reserves had expanded rapidly, growing at an average rate of more than 25 percent (figure 3.17). But reserve holdings dropped sharply in late 2008, declining by 8 percent over the latter half of the year (or by 22 percent if one excludes China, which accounts for more than 40 percent of all reserves held by developing countries).

A reduction in foreign reserves on this scale is unprecedented. Reserve growth averaged around 14 percent until the Asian crisis began in mid-1997, declining to –4.5 percent by the end of the year. Reserve growth subsequently recovered to more than 15 percent by mid-1998, only to decline to –5.5 percent by year's end in the wake of the Russian debt crisis in August 1998. Furthermore, the current wave of reserve depletion has been more widespread than in previous episodes. Over the latter half of 2008, reserves fell by more than 10 percent in one-third of developing countries, with declines exceeding 25 percent in the six countries listed above. During the Asian crisis, reserves fell more than 10 percent in just one in eight developing countries, with declines exceeding 25 percent in just two countries.

The appreciation of the dollar against other major currencies has been an important reason for the decline in reserve holdings measured in U.S. dollars. The importance for each country of the reduction in the dollar value of its reserve holdings

Figure 3.17 Growth of foreign reserves in developing countries, 1996–98 and 2006–08



Source: IMF International Financial Statistics.

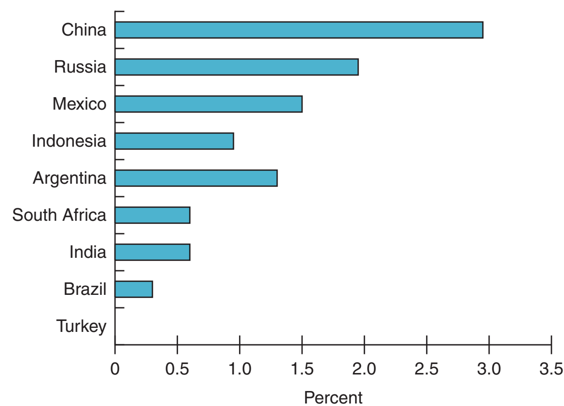
is affected by the share of its foreign exchange liabilities that are denominated in dollars.

Fiscal stimulus. Several developing-country governments have announced plans to support aggregate demand and reduce job losses through fiscal stimulus. The IMF has evaluated the impact of such measures on the fiscal accounts of developing countries that are members of the G-20. These estimates, based on announcements as of mid-February 2009, cover 2009–10, because expenditures programmed in this year may not be disbursed until one or two years down the road (IMF 2009a). As a proportion of GDP, the largest packages to date (calculated by averaging the ratio of fiscal stimulus to GDP over 2009–10) are those of China (2.9 percent), Russia (2.0 percent), and Mexico (1.5 percent), with the smallest measures among the G-20 developing countries being taken by India (0.5 percent), Brazil (0.3 percent), and Turkey (0 percent) (figure 3.18).[11]

The factors that explain these differences include the extent of automatic stabilizers and the amount of "fiscal space" available in each country, both of which vary widely from one country to another. For example, China's relatively low deficit, low level of public debt, and low interest rates before the onset of the crisis leave it in a comparatively favorable position to increase the nation's fiscal deficit. But other countries are saddled with higher levels of public debt (India) or higher interest rates (Brazil and Turkey), making it more difficult for them to finance larger deficits.

Figure 3.18 Fiscal stimulus measures by G-20 developing countries

Average percent of GDP, 2009–10

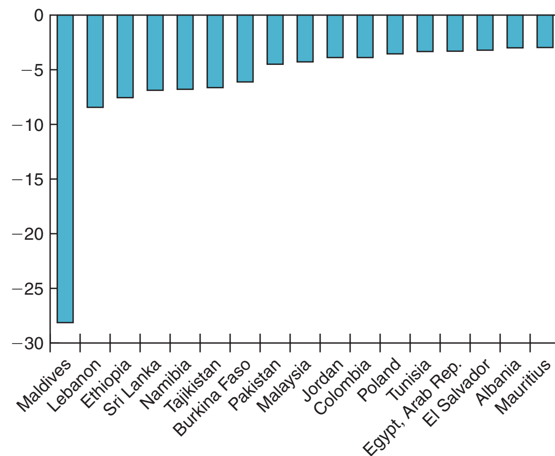


Source: IMF, Global Economic Update, March 26, 2009.

The financial crisis also will lead to a deterioration of developing countries' fiscal accounts through several channels over which governments lack immediate control—chief among them automatic stabilizers, reductions in tax revenues (driven by declines in equity prices, housing prices, and financial sector profits), decreased revenues from commodity sales, and rising risk premiums on government debt. The IMF estimates that fiscal deficits in the G-20 developing countries from these nondiscretionary channels will be about 3 percent of GDP in 2009 (IMF 2009a).

Figure 3.19 Developing countries with fiscal deficits exceeding 3 percent of GDP at the onset of the financial crisis

Percentage of GDP; most recent value



Source: World Bank.

The lack of fiscal space poses a particularly serious challenge for many developing countries, including many small low-income countries that lack significant local capital markets and where the monetization of large fiscal deficits could lead to inflation and capital outflows. Either of those results would exacerbate, rather than ameliorate, economic weakness. Seventeen developing countries were running relatively large fiscal deficits at the onset of the financial crisis (figure 3.19)—they are not likely to be able to undertake further fiscal measures to support demand.

Unless further external assistance is provided from official sources, those emerging market and developing countries that have cramped fiscal space will have to carefully prioritize their spending so that they achieve an appropriate balance between protecting vulnerable groups while preserving the components of government spending that are likely to have the greatest direct and indirect effect on growth, and poverty reduction.

The financial crisis has increased the importance of policy coordination

The breadth and severity of the financial crisis underline the importance of cooperative efforts by both high-income and developing countries to foster recovery and establish a more efficient international framework to support long-term growth. Opportunities for cooperation should be sought in four broad categories:

- Fiscal and monetary policies
- Stronger international financial regulations to improve transparency and avoid excessive risks that threaten stability
- Greater resources for supranational financial institutions
- A more substantial role for developing countries in shaping the global financial order.

Coordination of fiscal and monetary policy in advanced countries will continue to play a prominent role in the short term

Since the onset of the crisis, central banks in the industrial countries have worked in concert to support economic activity through massive lending and sharp reductions in interest rates. By April 2009, the Federal Reserve's interest rate target had been lowered to a range of 0–0.25 percent, and the Bank of Canada's and the Bank of England's to 0.5 percent. The European Central Bank's rate stood at 1.0 percent. With the zero bound on interest rates fast approaching, central banks have turned to "quantitative easing"—expanding the money supply directly through purchases of various securities—to provide further monetary stimulus. The Federal Reserve increased swap facilities for other central banks whose commercial banks needed access to dollar liquidity, extended the term of existing facilities, widened the scope of acceptable collateral, and broadened the scope of institutions (including investment banks) that could access Federal Reserve lending. Other central banks—including the Bank of Canada, the Bank of England, the European Central Bank, and the Swiss National Bank—also expanded their liquidity provisions and coordinated their announcements of the extended facilities. To support commercial banks, governments have purchased impaired assets, expanded guarantees, and injected capital. Most recently, the Bank of England and the Federal Reserve purchased long-term government bonds in an attempt to lower long-term rates and encourage purchases of corporate bonds.

In a few instances, the absence of further coordination has led to problems. When Ireland initially guaranteed the deposits of domestic banks

only, the move provoked runs on branches of foreign banks operating in the country. Ireland later extended the guarantee to all banks operating in Ireland, and other European countries also widened the scope of their deposit insurance.

These policy measures have begun to ease liquidity conditions in global interbank markets, with the LIBOR (London interbank offered rate) and other key lending rates declining since late-September (although they are still hovering well above pre-crisis levels). The same policies, however, will present a significant challenge over the medium term. The Bank of England and the Federal Reserve have greatly expanded their balance sheets, taking on exposure to a wide range of risky assets. This exposure will present the monetary authorities with a delicate balancing act once signs of a recovery are confirmed. Withdrawing liquidity from the financial system prematurely runs the risk of stalling the recovery before it gets fully engaged; waiting too long runs the risk that the excess liquidity could ignite inflationary pressures. The implications of explicit sovereign guarantees of commercial banks' assets and liabilities, and the potential for substantial contingent liabilities associated with corporations deemed "too big to fail," have yet to be fully appreciated and assessed. Government commitments will have to be financed, if not through taxation, then through the issuance of debt obligations. As the fiscal implications of such commitments are factored in, interest-rate expectations will adjust upward, raising the cost of capital for all borrowers, including those in developing countries. Also, the extensive state intervention in virtually all aspects of banking—including funding, loan portfolio, and compensation and dividend policies—will need to be managed effectively to avoid impairing these institutions' efficiency.

In addition to monetary action, several countries also have undertaken fiscal expansion to spur recovery (see the previous section of this chapter and chapter 1). While the case for fiscal policy coordination is weak in normal times—because countries normally face very different challenges and priorities—it is called for today, because all countries are facing the same prospect of inadequate global demand. Stimulating aggregate demand through fiscal expansion is in everyone's interest at the moment, but each country will be reluctant to undertake it on the necessary scale because some of the expansionary effects will spill over to other countries, and because any one country acting alone—even the United States—may reasonably fear that increases in government debt will cause investors to lose confidence in that country's fiscal sustainability and so withdraw financing. These constraints can be lessened only by a firm and credible commitment to global coordination of fiscal expansion.

Governments' willingness to coordinate their policies also can help reestablish confidence by ruling out beggar-thy-neighbor responses to the crisis. The danger that special interests will use trade policy to protect particular industries is especially acute in a downturn. In this context, recent proposals in the United States and elsewhere to require that funds appropriated for fiscal stimulus must be spent exclusively on domestically produced goods and services are extremely worrisome. A joint international commitment to maintaining open markets for goods and services, such as that highlighted at the G-20 Leaders' Summit in April 2009, must be a central feature of governments' policy responses.

Reform of the international financial system is a top priority over the medium term

The financial crisis and ensuing global economic downturn have raised fundamental questions about the role of financial markets in the global economy and triggered demands for equally fundamental structural reforms to prevent a crisis of such severity from recurring (see box 3.4 for a discussion of the link between the financial origins of the crisis and the economic downturn).[12] But significant reform of the global financial system is inconceivable without policy coordination. Although globalization of markets and industries has multiplied the policy links among countries, the institutional mechanisms for coordinating those policies have not kept pace. Those institutional mechanisms will now have to catch up fast.

At their April summit, the G-20 leaders announced an ambitious reform agenda aimed at preventing the excesses that characterized the latest period of overlending and excessive risk taking, along with several concrete initiatives designed to strengthen the international financial system. A durable revival of economic activity

Box 3.4 The origins of the financial crisis

Over the past six years, the global economy has witnessed a classic boom-and-bust cycle, with asset prices far outstripping fundamental values in the boom and then crashing, ushering in the most severe global recession since the 1930s.

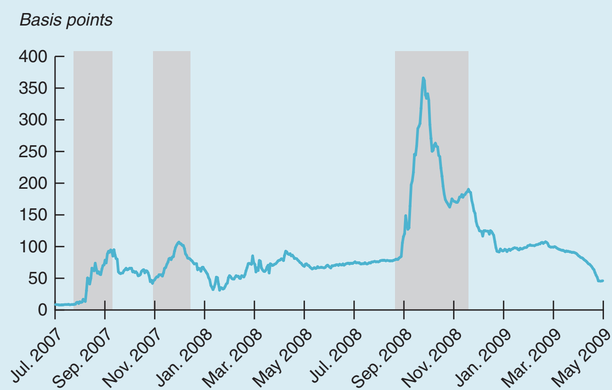
The boom. The collapse of financial markets and the global recession had their roots in the 2003–07 boom, when global growth averaged about 5 percent (its highest sustained rate since the 1970s) and equity markets and commodity prices surged. The decline in risk-free interest rates (the U.S. Federal funds rate fell from 6 percent in early 2001 to 1 percent by mid-2003) precipitated a search for yield that sharply increased the demand for more risky assets. For example, one-year adjustable U.S. mortgage rates fell from 7.25 percent in late 2000 to 3.5 percent in mid-2004, while capital flows to developing countries reached record levels and spreads on emerging-market bonds narrowed sharply (see chapter 2). The boom was facilitated by financial innovations, including the explosion in securitized instruments and structured financial products (particularly collateralized debt obligations), and was marked by a sharp increase in leverage throughout major financial systems.

Monetary authorities were initially reluctant to reduce asset-price inflation through tighter credit for fear of choking off the economic recovery. At the same time, regulators failed to rein in the rise in financial sector leverage, for several reasons. Rising asset prices and opaque derivative instruments masked the risks confronting banks' capital positions. A growing share of maturity transformation (formerly dominated by banks) was undertaken by the "shadow banking system" through banks' off-balance-sheet transactions or by institutions (such as investment banks) that were not subject to the same level of regulation as deposit-holding institutions. Moreover, regulators had increased their reliance on banks' own evaluation of their capital positions, which often failed to adequately reflect systemic risks.

The financial meltdown. The first crack in rising global asset prices came in the U.S. housing sector. The Case-Shiller index of U.S. housing prices nearly doubled from the first quarter of 2000 to the second quarter of 2006, fed by the growing involvement of purchasers with low credit scores and by increasing levels of debt finance predicated on ever-increasing prices. As housing prices turned downwards in 2006, the most over-extended borrowers defaulted on their loans and/or unloaded their houses on the market, further depressing prices and leading to more sales and foreclosures, in a downward spiral that has reduced U.S. housing prices by more than a third from the peak.

While the decline in U.S. housing prices had been anticipated (see, for example, Shiller 2006), the financial consequences were surprising. A number of financial institutions in major financial centers (notably the United States, the United Kingdom, Germany, France, the Netherlands, Australia, and Canada) reported large losses on U.S. subprime mortgage assets, sparking a sell-off of assets to meet margin calls and redemption orders in the case of some hedge funds. Write-downs on credit losses prompted individual banks to sell assets to restore capital ratios, which in the aggregate further reduced asset values and thus worsened capital ratios. Investors became more concerned over both the likely extent of losses on high-risk investments and the exposure of financial institutions, resulting in a flight to safety (U.S. Treasuries and bank deposits subject to expanded guarantees) that severely depressed equity

Spread between U.S. dollar London Interbank Offer Rate and the overnight index swap rate



now hinges on working out detailed financial reforms in the following areas:

- Governments must widen the scope of financial regulation and supervision across institutions and financial instruments. The origination and propagation of complex financial instruments must be monitored and regulated; markets for those instruments must be transparent.
- All institutions—banks and nonbanks alike—whose failure would compromise the functioning of the entire financial system must be regulated. None should be able to avoid regulation through affiliates or off-balance-sheet

prices and raised yields on most investments. High-yield corporate bond issues plummeted, the asset-backed commercial paper market collapsed, and short-term money markets experienced massive outflows.

The collapse in asset values was greater and more destructive than expected. The mathematical models used to evaluate highly complex derivative instruments tended not to reflect low-probability events, such as the systemic collapse that actually occurred. Moreover, financial innovations had increased the procyclical nature of asset price changes.[a] The asset-price collapse had a severe impact on banks because (contrary to one theory about the virtues of securitization) they had failed to offload much of the risks of securitized transactions, or for reputational reasons felt compelled to reabsorb distressed Structured Investment Vehicles onto their balance sheets as the crisis worsened.

The size of market disruptions can be seen in the unprecedented rise in the spread between the London Interbank Offer Rate and the overnight index swap rate, an indicator of market liquidity and risk. (See box figure, in particular the shaded sections, which reflect the initial realization of large losses on U.S. subprime mortgage assets, the suspension of redemptions on some investment funds by Bear Stearns and BNP Paribas, and the U.K. rescue of Northern Rock in the summer of 2007; the announcement of large write-downs by UBS and Lehman Brothers in December 2007; and the extreme financial turbulence initiated by the collapse of Lehman, U. S. government conservatorship of Fannie Mae and Freddie Mac, and government intervention in the American International Group in the fall of 2008.)

The impact. The crisis in financial markets, coupled with self-reinforcing cyclical adjustments, precipitated a sharp decline in economic activity in industrial countries. Firms that had traditionally relied on commercial paper and money markets to finance working capital experienced a sharp decline in access to finance. While bank lending did not decline markedly, credit generated by the shadow banking system collapsed. The impact of the initial credit crunch was exacerbated by cutbacks by firms determined to avoid massive losses in an uncertain environment. As time went on, falling demand reduced profits and employment throughout high-income economies. And households faced with massive wealth losses (on the order of $15 trillion in the U.S. housing and financial markets alone-Weller and Lynch 2009) and uncertain employment prospects sharply increased savings, further depressing economic activity. The severity of the ensuing recession is discussed in chapter 1.

Initially, many emerging markets appeared to enjoy some measure of insulation from the crisis in industrial countries, owing to improved policies that limited foreign currency borrowing, encouraged the development of local bond markets, reduced inflation and fiscal deficits, and increased international reserves. However, over time the serious implications of the crisis for growth in developing countries have become clear. The crisis has been transmitted to developing countries through several channels: the value of developing countries' overseas financial assets have declined, in part through private-sector losses on derivative transactions; developing countries' access to foreign bank lending, international capital markets, and foreign direct investment has deteriorated markedly; and the volumes and prices of their exports have plunged. Those likely to suffer the greatest impact are low-income countries that are dependent on commodity exports, countries with large current account deficits, and countries that have built up large stocks of foreign currency debt.

a. This occurred because of increased participation by institutions with fixed rules for asset sales based on changes in credit ratings (e.g., insurance companies), increased reliance on market value or credit ratings to trigger asset sales (e.g., provisions for the sale of junior classes of SIV holders to protect senior classes), and arrangements that increased collateral requirements as the credit ratings of counterparties fell (FSA 2009).

holdings. In keeping with the widening of the financial safety net in the United States from commercial banks to broker-dealers and investment banks, all of the latter must also come under the regulatory umbrella.

- Incentives must be revised to diminish short-run risk taking. In particular, regulators should revise the Basel II capital requirements to better reflect underlying risks and to minimize the procyclicality of regulation.[13] Banks also must be required to maintain adequate liquidity. The originators of complex instruments should retain some exposure to them, so that they have a continuing incentive to monitor the underlying risks. Without necessarily becoming the object of regulation, the compensation paid by financial-sector firms should be based on longer-term performance, not just the current year's return.
- Regulators also need to strengthen the reporting requirements applicable to institutions that are deemed not to be systemically important

(hedge funds, for example) and to scrutinize the activities of the agencies that rate the creditworthiness of firms and governments.

The measures that need to be taken vary from country to country, because not all countries experienced various regulatory failures to the same extent. Clearly, the initial problems related to subprime mortgage markets and their securitizations arose in the United States, and some of the needed reforms are specific to that country, including reforms related to the coordination of regulatory responsibilities at the federal level and between the states and various federal agencies. However, other countries also experienced a housing bubble and overlending by their banks, and lax regulation helped permit their purchases of U.S. mortgage-backed securities without adequately accounting for risks.

In the current era of globalized financial markets, national regulation can become ineffective if not backed up by international policy coordination. At present, inadequate regulation in one country can have major repercussions in others. Lack of coordination on minimum standards may lead to "regulatory arbitrage," as banks shift activities to the country where regulation is most accommodating. The prospect of such arbitrage may induce each country to avoid imposing a competitive disadvantage on its own banks through too-stringent regulation. By contrast, an agreement by all financial center countries to impose minimum standards would offset the incentive to adopt regulatory laxity. And the increased confidence that may be expected from financial reform may be further enhanced by evidence that countries share the same perspective on the required changes. A first step in this direction was taken at the G-20 summit in London. Moreover, the increased scope of central bank regulation and supervision, along with the expansion of the lender-of-last-resort function to global nonbank financial institutions, will require increased cooperation.[14]

Although the task of designing and implementing reforms to strengthen financial markets and regulatory regimes cannot end with national regulators, it must begin with them. The actions of - national regulators, which have the best access to information on their own financial institutions, must be strengthened and harmonized—and not superseded by a shifting of responsibility to an international body. Shoring up the roles of the Bank for International Settlements and the Financial Stability Forum in sharing information and identifying international best practice would be a useful way of supporting more effective national regulation.

The willingness to harmonize regulatory reform is likely to be influenced by the stage of the financial crisis. While the present state of the financial arena provides a keen incentive for harmonization, regulatory cooperation is resisted in normal times as countries seek to protect or advance the competitive advantage of the financial firms located within their territory. However, the incentive for cooperation among national regulators changes with shifts in the tradeoff that regulators face between safeguarding national competitiveness and promoting financial stability. A downward shock to confidence in financial stability makes increased regulation desirable and provides an incentive for regulators to harmonize, because only by doing so can they avoid jeopardizing the international competitiveness of their financial sectors. The most propitious time for action is during a crisis.

Annex 3A provides a formal model of regulatory coordination, in which policy is chosen optimally by each country to maximize an objective function that includes both maintaining competitiveness and promoting financial stability. The model suggests that the gains from coordination may be largest when there is a large common shock to confidence. Thus, it may be important to seize the initiative while the current crisis prevails, because a return to normal times may remove the incentives to regulate adequately at the national level and to coordinate regulation optimally at the international level. In the limiting case where financial stability is a global public good that is not differentiated across countries, each country will want others to take action—each will want to be a free rider. In these circumstances it will be especially important to put in place global mechanisms to strengthen regulation, because otherwise no country will provide adequate regulation. In the past, agreement among the hosts of the major financial centers—principally the United States and the United Kingdom, with the support of Japan—has ensured some measure of global regulation (Masson and Pattison 2009), but the dispersion and globalization of financial centers have weakened this discipline.

Recent initiatives adopted by the G-20 countries to strengthen international frameworks for prudential regulation are unlikely to have a major impact on the short-term prospects for capital flows to developing countries. The G-20 leaders agreed to leave the international standard for minimum capital adequacy unchanged until recovery is assured. Guidelines for harmonization of the definition of capital are to be produced by the end of 2009, and the Basel Committee on Banking Supervision is expected to make recommendations on capital adequacy levels in 2010. The recommendations are likely to include raising minimum regulatory levels for capital, enhancing the overall quality of capital reserves, and developing a global framework for promoting stronger liquidity buffers. Regulatory changes along such lines, however necessary and desirable they may be, will temporarily reduce the lending capacity of international financial institutions—until the new requirements are fully absorbed by the system. This means that cross-border bank lending may be more subdued during the recovery phase, compared with previous episodes.

There is also a risk that measures undertaken to promote standardization of credit derivatives markets, and to increase their resilience, could shrink the investor base for some segments of the emerging market asset class. Requiring all transactions to be channeled through central clearing exchanges could make it more difficult for investors to purchase less-liquid derivative contracts, such as credit default swaps for sovereign and corporate debt that is not widely traded. Over-the-counter derivative contracts are more suitable for thinly traded assets, but they carry the cost of higher counterparty risk.

Measures taken to recapitalize commercial banks with public funds have introduced pressures to force banks to concentrate their lending in the domestic market at the expense of cross-border lending—the so-called home bias in lending practices. Given the severity of present economic conditions, political pressures along these lines could spread widely throughout the financial system, curtailing the supply of private debt flows to developing countries.

Confidence in the international financial system must be restored

On a final note, it is important to recognize how the severity of the current crisis has undermined confidence in the international financial system (annex 3B). Many economic and financial indicators have exhibited unprecedented declines, moving us into uncharted territory in several respects. Uncertainty surrounding the outlook remains at an all-time high, suggesting that a nascent global recovery will be vulnerable to after-shocks of the present crisis and may not survive any marked deterioration in financial conditions. The ability of the international community to take cooperative action in a timely manner and to make meaningful progress on the key areas outlined above would go a long way in restoring confidence.

Annex 3A: Modeling the benefits of a coordinated regulatory response to common shocks to confidence

This annex develops a formal model of regulatory coordination, in which policy is chosen optimally by each country to maximize an objective function that includes both maintaining competitiveness and promoting financial stability. The model suggests that the gains from coordination may be largest when there is a large common shock to confidence.

Technically, let us consider a formal model patterned after the informal discussion of these issues by Singer (2001), in which the objective function of national regulators depends on improving the competitiveness of the country's financial firms as well as promoting financial stability (which Singer calls "confidence"). We will assume that the stringency of regulation, R, affects both variables: in a two-country world, competitiveness C is proportional to the difference in regulation, while stability S in both countries depends directly on the country's own regulation but also on the other country's (but with a weight less than one). Formally, for countries $i = 1, 2$, (and $j = 2, 1$, the foreign country):

$$C_i = \alpha\,(R_j - R_i) \tag{3.1}$$

$$S_i = R_i + \gamma R_j - u_i \tag{3.2}$$

$$U_i = C_i - \beta\,(S_i - S^*)^2 \tag{3.3}$$

where S^* is some target level of financial stability that is subject to a (negative) confidence shock. The regulator's utility function, equation 3.3, is linear in competitiveness, but quadratic in financial stability because the regulator internalizes the inefficiencies that result from overregulation: there is an optimal amount of stability. The justification for the coefficient γ in equation 3.2, with $0 < \gamma < 1$, is that a country's regulation has a comparative advantage in furthering its own country financial stability, presumably because some financial services are not traded. A perfectly globalized world for finance, which we consider later below, would set $\gamma = 1$.

Let us consider the optimal amount of regulation for each economy, first when each economy chooses it independently (that is, under a Nash equilibrium) and second when all economies cooperate in choosing a common level of regulation to maximize joint utility.

The Nash equilibrium: independent regulation

Here, each country maximizes equation 3.3 subject to equations 3.1 and 3.2. The first-order conditions yield

$$R_i = -\gamma\,R_j + u_i + S^* - \frac{\alpha}{\beta} \tag{3.4}$$

Solving the two countries' reaction functions together gives

$$R_i = \frac{1}{1+\gamma}\left(S^* - \frac{\alpha}{\beta}\right) + \frac{1}{1-\gamma^2}\left(u_i - \gamma u_j\right) \tag{3.5}$$

Note that if the two countries' confidence shocks are equal, $u_i = u_j = u$, then equation 3.5 simplifies to

$$R_i = \frac{1}{1+\gamma}\left(S^* - \frac{\alpha}{\beta} + u\right) \tag{3.6}$$

It can be seen that regulation is lower by an amount that depends on the negative effect of regulation on competitiveness (α) and inversely on the weight of stability in the objective function (β), while also being affected by the impact of foreign regulation on stability (γ).

The cooperative equilibrium: joint decision making

Suppose instead that the two countries collaborate and jointly choose regulation to maximize an equally weighted average of their two utility functions. In this case, they maximize utility U with

respect to both countries' regulation $R = R_1 = R_2$ where utility is given by

$$U = U_1 + U_2 = C_1 + C_2 - \beta(S_1 - S^*)^2 - \beta(S_2 - S^*)^2 \quad (3.7)$$

Solving for R gives an expression for optimal regulation:

$$R = \frac{1}{1+\gamma} S^* + \frac{1}{1+\gamma} \frac{u_1 + u_2}{2} \quad (3.8)$$

Note that equation 3.8 is very similar to equation 3.5, but it is not reduced by the objective of gaining a competitive advantage over the other country and it depends on the average shock to confidence. The cooperative equilibrium leads to *greater* regulation on average, because each country knows that it need not worry about the other country's attempt to become more competitive.

Let us consider in some detail the case of identical shocks. If the two countries' confidence shocks are the same, then 3.8 simplifies to

$$R = \frac{1}{1+\gamma} \left(S^* + u\right) \quad (3.9)$$

which again is similar to equation 3.6 but with the omission of a negative term that reduces the amount of regulation in both countries. Thus, a Nash equilibrium results in a suboptimal amount of regulation. The cooperative equilibrium produces higher welfare in both countries by providing greater regulation—*if* the two countries can agree to cooperate and not to try to gain a competitive advantage over the other. Doing so is self-defeating, because in the Nash equilibrium both countries adopt the same policies, with the result that neither succeeds in becoming more competitive relative to the other. The gain in utility from cooperation can be written as $\Delta U_i = U_i^C - U_i^N$, where U_i^C and U_i^N are the utilities of country $\boldsymbol{i}$ evaluated at Nash and cooperative equilibriums. When $u_i = u_j$

$$\Delta U_i = \frac{\alpha^2}{4\beta} \quad (3.10)$$

Thus, when the shocks to confidence are identical, the gains from coordination are always positive and are independent of the shock itself. The shock is completely offset by the coordinated policies, which achieve the goal S^* for financial stability as well as maintaining equal competitive positions. For the general case when $u_i \neq u_j$ the solution is ambiguous (Dailami and Masson 2009).

Globalization

The case of increased globalization can be studied by letting $\gamma \rightarrow 1$. In the limiting case, with a common shock $\boldsymbol{u}$ to confidence, the first-order conditions become indeterminate. In the case of independent (Nash) policies, the first-order conditions are given by

$$R_1 = -R_2 + u + S^* - \left(\frac{\alpha}{\beta}\right) \quad (3.11)$$

and

$$R_2 = -R_1 + u + S^* - \left(\frac{\alpha}{\beta}\right) \quad (3.12)$$

These two equations cannot be solved for individual values of R_1, R_2, only for their sum. Doing so implies that the total of regulation $R_1 + R_2$ is set optimally at a point that trades off financial stability for competitiveness. But this can be done through any arbitrary sharing of the regulatory burden. Given this indeterminacy, countries would no doubt prefer that the other country did the regulating. In these circumstances, harmonization would be necessary to rule out a downward spiral of deregulation.

Annex 3B: A framework for measuring investor confidence

Restoring confidence is a crucial step in repairing financial markets and lifting the global economy out of recession. How to measure confidence, however, and how to go about restoring it, are complex. This annex describes a framework for gauging changes in investor confidence that have potentially important market consequences. Confidence in markets, institutions, and financial strategies depends on investors' beliefs about the trends and dynamics of market expectations, the effect of policy on economic fundamentals (including the paths of employment, trade, housing prices, and industrial production), and fallible human judgment.

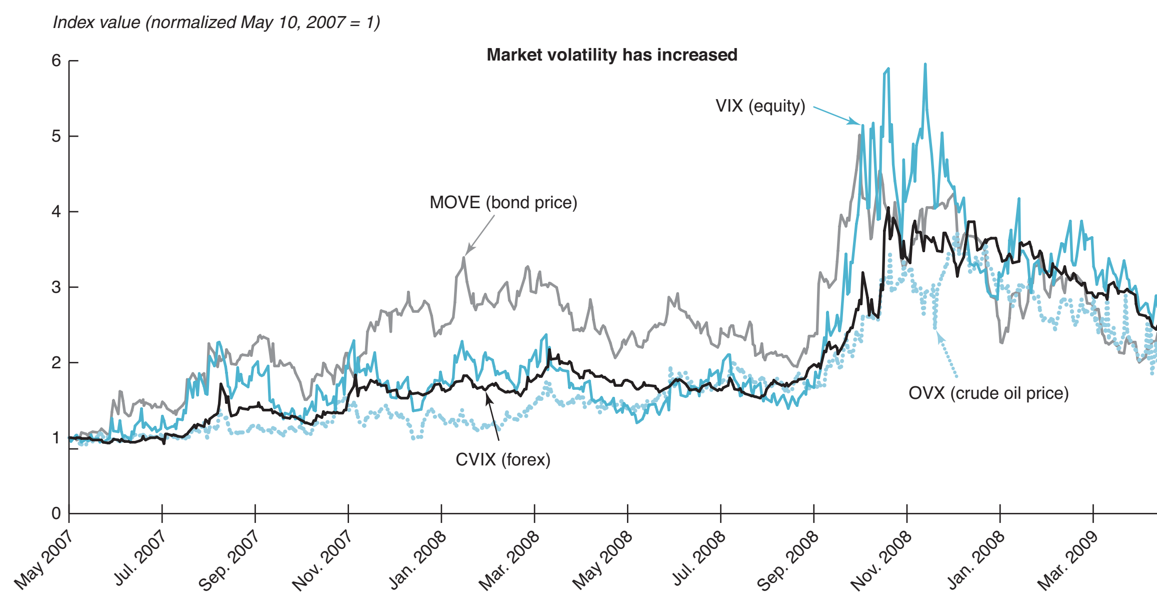
Drawing on insights from three strands of literature—behavioral finance (Thaler 1985, 1987; Loewenstein and Elster 1992; Nisbett and Ross 1980), investor sentiment (Barberis, Shleifer, and Vishny 1997; Froot, O'Connell, and Seasholes 2001; Froot and Ramadorai 2008), and market reaction to macroeconomic news (Balduzzi 2001; Brandt and Kavajecz 2004; Goldberg and Leonard 2003)—we postulate four dimensions of investor confidence: *market volatility, market performance, macroeconomic news,* and *government responses*. We deal with each in turn.

Volatility. First, investor sentiment is strongly influenced by abnormal volatility in the marketplace, particularly when it spans several asset classes, signaling an overall climate of uncertainty and risk aversion. In recent months, global equity, credit, commodity, and foreign exchange markets all have shown record volatility (figure 3A.1).

Investment performance. Second, investors' confidence is related to the performance of their investments, as measured by wealth creation or destruction. The contraction of financial wealth that has occurred during the current crisis is greater than any since the Great Depression.

Macroeconomic indicators. Third, investors and traders typically look at a broad array of macroeconomic reports that provide insights into

Figure 3A.1 Record volatility in the global equity, credit, commodity, and foreign exchange markets, May 2007–April 2009



Source: Bloomberg.

economic fundamentals and shape perceptions of the future state of the economy. Relevant data series include monthly payrolls, industrial production, sales and trade data, personal income, and housing starts. These data typically lag behind the financial data, but throughout 2008 and into 2009 the one-sided stream of negative economic news had a dramatic impact on confidence.

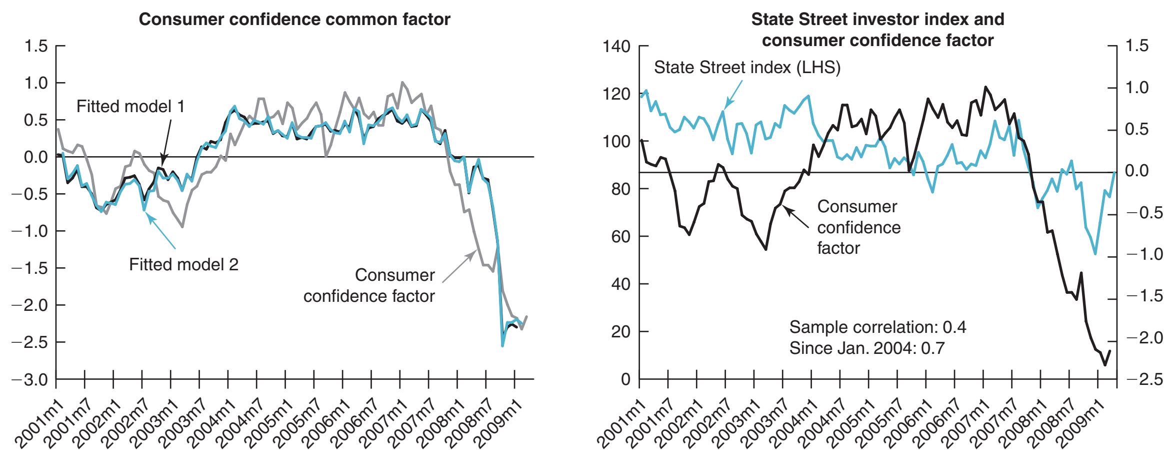
Government policy pronouncements. Fourth, market participants and traders pay close attention to the stance of government policy makers and continually assess the credibility of their words and actions. Governments can influence investors' confidence in many ways: through macroeconomic policy (for example, by easing monetary policy or providing fiscal stimulus), through regulatory policy, and through other legislative actions that can strengthen transparency and enhance corporate financial disclosure and integrity (for example, actions taken by the U.S. government in the aftermath of the Enron and Worldcom accounting scandals).

A variety of market- and survey-based indicators are used to track and report consumer confidence, investor sentiment, and business confidence concerning the future course of markets and the economy at large. A well-established market-based index of investor confidence is provided by State Street Global Markets. It is based on measurements of institutional investors' holdings of risky assets, particularly equities (www.statestreet.com/investorconfidenceindex). The more investors are willing to allocate assets to equities, the theory goes, the greater their risk appetite and confidence. An alternative proxy for confidence used in the literature (Qiu and Welch 2004) is a measure of consumer sentiment or confidence. It provides a survey-based measure of sentiment and has the additional advantage of offering comparable data on a regular basis for several countries.

We use both market- and survey-based proxies to gauge investors' confidence, combining them with measures of consumer confidence in Canada, Germany, Japan, the United Kingdom, and the United States to extract a common global index, using the well-established method of principal component analysis. This composite index is closely correlated with State Street's index of investor confidence (figure 3A.2), revealing that generally optimistic or pessimistic views about the economy translate into views on equity market conditions, and vice versa.

The two approaches to measuring confidence generally confirm that investors care about market volatility, the macroeconomic environment, and the performance of equity markets, as vindicated by the econometric results reported in table 3A.1. They also suggest that restoring investor confidence is a prerequisite for consumer sentiment and a change in aggregate demand.

Figure 3A.2 Correlation of authors' composite global index of consumer confidence with State Street index of investor confidence



Source: Dailami and Masson 2009.

Table 3A.1 Evidence that investors' confidence is shaped by a combination of factors

Dependent variable: consumer confidence factor
$CC = \alpha + \beta_1 \times Volatility + \beta_2 \times Macro + \beta_3 \times Equities$

	Model 1	Model 2
Volatility factor	−0.273*** (0.056)	−0.301*** (0.059)
Macro environment factor	0.233*** (0.056)	
Macro environment factor (t − 1)		0.237*** (0.051)
MSCI Developed World	0.012*** (0.003)	0.013*** (0.003)
Constant	−0.050 (0.042)	−0.069* (0.040)
Observations	97	97
R-squared	0.72	0.75

Source: World Bank staff.
Note: The dependent variable in the table is a common factor of consumer confidence indexes from Canada, Germany, Japan, the United Kingdom, and the United States. Volatility is the monthly average of the predicted daily common volatility of eight variables: VIX, US$/euro, US$/yen, US$/sterling, agriculture commodities price index, energy price index, industrial metals price index, and the TED spread. The macroeconomic environment factor is the predicted common factor across industrial production, employment, and export growth rates (year-on-year) in Germany, Japan, the United Kingdom, and the United States. Equity market growth is represented by the change (year-on-year) in the MSCI for developed economies. The estimation sample covers the period from January 2001 to January 2009.

Notes

1. This calculation is based on data from the World Bank Debtor Reporting System (DRS) comparing private nonguaranteed debt and public and publicly-guaranteed debt. For a more detailed discussion of the globalization of corporate financing in developing countries see World Bank (2007).

2. The JP Morgan index (CEMBI-Global) includes corporate bond spreads in 20 emerging market economies, four of which are high-income countries: Hong Kong, Israel, Singapore, and Taiwan (China).

3. Carry trades are transactions where investors borrow in low-yielding currencies—mainly the Japanese yen, U.S. dollar, or Swiss franc—and invest the proceeds, often enhanced by leverage, into high-yielding currencies such as Australian and New Zealand dollars, the British pound, the Korean won, the Indonesian rupee, the Brazilian real, the Mexican peso, or the South African rand.

4. Comprehensive data on domestic bond markets are not available for most developing countries. The BIS reports data on domestic debt securities in just 20 developing countries.

5. Current-account surpluses exceed principal repayments on maturing debt in the other 11 countries for which data are available.

6. IDA is the part of the World Bank that assists the poorest countries.

7. Legislation containing the Fourth Amendment is currently under consideration in the U.S. Congress.

8. Capital controls could reduce the effective demand for imports by imposing government rationing of foreign exchange.

9. For example, in March the U.S. Congressional Budget Office estimated the deficit for fiscal 2009 (October to September) at about $1.8 trillion, or 13 percent of U.S. GDP much greater than the December OECD forecast of less than 7 percent. The $1 trillion toxic asset removal plan announced on March 23 by the Obama administration will further increase the deficit for 2009 and beyond.

10. ODA expenditures that are tied to domestic producers may boost the demand for local products and thus be more favored than general ODA.

11. China and South Africa introduced stimulus measures in 2008.

12. Several wide-ranging studies have argued that the laxity of financial regulation and inadequacies in the management of financial institutions were major contributors to the crisis. See, for instance, IIF (2008), the Group of Thirty (2009), and Brunnermeier and others (2009).

13. Capital requirements tend not to be binding in an upturn, because asset valuations are high and risk assessments optimistic, with the opposite occurring in a downturn. However, regulation should be more stringent in the upturn than in the downturn.

14. Buiter (2007) characterizes this expanded central bank role as "market maker of last resort." Pervasive securitization implies that stability in bank-based lending is not sufficient to ensure even the basic functioning of the financial system.

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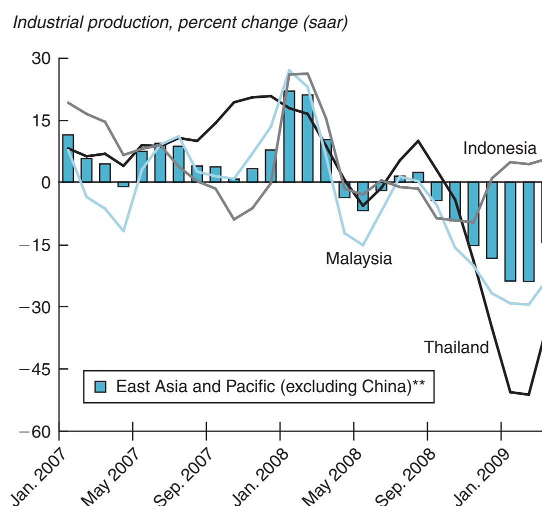
Appendix: Regional Outlooks

East Asia and Pacific

Recent Developments

Amid a sharp slowdown in global demand and a sudden stop in capital flows, growth in developing East Asia and Pacific slowed to 8 percent in 2008 from a record high 11.4 percent in 2007. The steep drop occurred despite policy easing and other measures taken by the authorities in most countries to support activity. With exports sharply down, companies moved to cut production and investment, while households have curbed consumption amid rising layoffs and economic uncertainty. Countries more dependent on exports, especially on single products or single markets, have seen activity fall faster and, in general, harder. Growth began slowing in most countries in the second quarter of 2008 and weakened sharply by the fourth, when all newly industrialized economies (NIEs) including Hong Kong, China; the Republic of Korea; Singapore; and Taiwan, China, were in recession and output was contracting in Malaysia, the Philippines, and Thailand, measured in seasonally adjusted annual growth terms (saar). The pace of economic expansion slumped further during the first quarter of 2009, with GDP in several NIEs falling at double-digit rates, and growth in the developing region slumping to 3.5 percent (saar). Still, high-frequency indicators, such as manufacturing production, suggested that the pace of decline was beginning to moderate (figure A.1).

Figure A.1 East Asia and Pacific production dropped sharply but shows signs of bottoming out



Source: World Bank data through Thomson Datastream.

Note: **Recent production data for China has been distorted by vagaries of timing of the Chinese New Year—yielding difficulties in seasonally adjusting the data for presentation.

China remains a brighter spot within the region and the global economy, amid signs that the fall off in economic activity may be reaching a bottom there. The country is weathering the financial and economic crisis better than many others because it does not rely on external financing, its banks have been largely unscathed by the international financial turmoil, and it has the fiscal and macroeconomic space to implement forceful stimulus measures. A large government investment program, equivalent to 12 percent of 2008 GDP, was announced in late 2008. And combined with monetary easing and other measures, domestic demand appears to be bottoming out, partly offsetting weak external demand and the effects of earlier efforts to combat overheating. Real GDP growth eased to a 10-year low 6.1 percent in the first quarter of 2009 (year-on-year) from 9 percent for 2008 as a whole and a record 13 percent in 2007.

Indonesia's slowdown came relatively late and, so far, has been more moderate than that of many other countries in the region. Though the expansion of all components of GDP slowed in late 2008, growth for the year amounted to 6.1 percent, a pace little changed from 2007. But further decline in exports and slower consumption and investment spending caused growth to fade to 4.4 percent in the first quarter of 2009 (year-on-year). In Thailand, contracting foreign demand combined with the impact of political uncertainty weighed heavily on economic activity, transforming the slow expansion of early 2008 into contraction by the fourth quarter at a sharp 22 percent pace (saar), while output continued to decline at a 7.3 percent annualized pace during the first quarter of 2009.

Cambodia experienced the sharpest growth slowdown in developing East Asia and Pacific. Exports, most of which are garments shipped to the United States, have suffered badly, as has construction after a sharp downward correction in housing prices, as well as lending and tourism. Real GDP growth slowed to 6.7 percent in 2008 following 10.2 percent gains in 2007. In contrast, Vietnam's growth slowed by much less in 2008 as the government tackled the threat of an overheating domestic economy decisively starting in late 2007. In response to the first shock of the current crisis, the authorities shifted emphasis from growth to stabilization in March 2008. By November 2008, they shifted once more to supporting economic activity through large interest rate reductions, injections of liquidity, and a fiscal stimulus package. The slowdown in growth was limited to 6.2 percent in 2008 from 8.5 percent in 2007.

Facilitated by declining inflation (consumer prices have eased substantially across East Asia as the food and fuel hikes of 2007–08 had more-than fully unwound by mid-2009), and in response to weakening economic activity and the impacts of the international financial crisis, monetary authorities in many countries have cut key policy interest rates and employed other measures to help sustain domestic liquidity and the availability of credit. Against a background of sound banking systems in most countries, these measures have ensured that liquidity in local currency has remained broadly adequate, and interbank rates have declined or remained stable. Policy actions included reductions in key central bank policy rates in all middle-income countries and Vietnam, cuts in rates for minimum required reserves (China, Indonesia for dollar deposits, Malaysia, the Philippines, and Vietnam), increases in rates paid on required reserves (Indonesia and Vietnam), and extensions of the coverage and maturity of central bank obligations. The central bank of China also added to liquidity by redeeming local-currency assets earlier. Several countries also extended their deposit guarantee schemes to cover most or all deposits.

The middle-income countries of East Asia are actively using fiscal policy to boost domestic demand. The stimulus packages in aggregate are equivalent to 3.6 percent of regional GDP, with the measures to be implemented in 2009 amounting to another 1.7 percent of GDP and most of the remainder to be delivered in 2010. The role of automatic stabilizers is smaller in East Asia than in other regions, leaving the deterioration of fiscal balances broadly in line with that of the more developed countries. Nonetheless, the developing countries of East Asia have been more forceful than other groups in delivering support to economic activity.

All middle-income countries have introduced discretionary fiscal stimulus packages. The low-income countries, typically with limited or no fiscal space and weak or limited absorptive and administrative capacity, have been working to obtain a boost in external aid to create room for additional outlays. Discretionary cuts in tax rates and increases in spending have combined with lower revenues in line with weaker growth and declining commodity prices to increase fiscal deficits throughout the region. The largest increases have been in China and Thailand, countries considered to have the largest available fiscal space. There are substantial variations across fiscal packages, notably in the size, in the share of tax cuts versus expenditure increases or other measures, and in whether the proposals target just 2009 or 2009–2010. The packages in China and the Philippines incorporate measures to be financed by both the public and private sectors. In contrast, the package in Malaysia includes sizable credit guarantees and equity investments that do not add to the public sector deficit.

Capital inflows diminish in 2008. Amid the surge and decline in commodity prices and the sharp contraction in trade during late 2008, current account balances improved only in China and

Malaysia, both countries with surpluses, and in the Lao People's Democratic Republic, a country with a large deficit. In China, the surplus rose further in 2008 in dollar terms, while monthly outcomes climbed to record highs late in the year as a sharp decline in trade took firmer hold, but weakened relative to GDP to about 10 percent. In Lao PDR, commodity exports rose briskly in 2008 and despite the decline in prices, outstripped the increase in exports in value terms. While the full-year external shortfall worsened modestly in Vietnam to about 10 percent of GDP, determined policy measures to combat overheating have succeeded in cooling the economy and have contributed to a shift in recent months from a trade deficit to a surplus. In contrast to these developments, current account balances worsened in the rest of the region. For the developing countries of East Asia, the aggregate current account surplus decreased from 9.5 percent of GDP in 2007 to 8.1 percent for 2008; but when China is excluded these figures shift dramatically to a surplus of 5.2 and 2.8 percent of GDP.

Global demand for developing-country assets decreased amid increased risk aversion, ongoing deleveraging, and weaker growth prospects, causing capital flows to countries in the region to weaken substantially. After peaking in 2007, net capital flows to East Asia and Pacific began slowing in early 2008 before shifting to outflows during the second quarter in Malaysia and the NIEs; and in the later part of the year in China and Indonesia. For the region as a whole, a notable softening in portfolio equity flows, bond issuance and bank borrowing was in evidence in 2008, while FDI retained a relatively firm tone on average, increasing by $10 billion in the year to $185 billion. Excluding official flows, resident lending abroad, and errors and omissions items, private capital flows to the region fell from about $280 billion in 2007 to $203 billion in 2008 (table A.1).

Nonresidents continued to sell equities, and in the second half of 2008, shifted to selling debt securities and selectively withdrawing bank deposits held with domestic banks. Inflows of foreign direct investment slowed sharply in the second half of 2008, as companies completed projects that had already been started but delayed new commitments and new construction. In some countries, earlier agreed projects were cancelled, notably in real estate development, mining, and manufacturing. Lending by foreign banks also slowed sharply during the year. Repayments to foreign banks began

Table A.1 Net capital flows to East Asia and Pacific
$ billions

Indicator	2002	2003	2004	2005	2006	2007	2008p
Current account balance	53.9	70.3	88.4	174.9	282.6	387.9	396.9
as % of GDP	*2.7*	*3.1*	*3.4*	*5.8*	*8.3*	*9.5*	*8.1*
Net private and official inflows	53.0	74.7	125.0	184.7	196.5	278.3	201.2
Net private inflows	60.7	81.9	130.2	187.6	206.0	281.2	203.0
Net equity inflows	63.2	69.3	89.6	130.1	161.4	210.5	192.5
Net FDI inflows	59.4	56.8	70.3	104.4	105.2	175.3	185.1
Net portfolio equity inflows	3.8	12.5	19.3	25.7	56.2	35.2	7.4
Net debt flows	−10.2	5.4	35.4	54.6	35.1	67.8	8.7
Official creditors	−7.7	−7.2	−5.2	−2.9	−9.5	−2.9	−1.8
World Bank	−1.7	−1.5	−1.9	−0.6	−0.4	−0.3	1.2
IMF	−2.7	−0.5	−1.6	−1.6	−8.5	0.0	0.0
Other official	−3.3	−5.2	−1.7	−0.7	−0.6	−2.6	−3.0
Private creditors	−2.5	12.6	40.6	57.5	44.6	70.7	10.5
Net M-L term debt flows	−12.4	−9.7	7.9	12.1	15.4	28.1	16.2
Bonds	0.1	1.8	9.6	12.1	5.6	2.3	2.2
Banks	−10.2	−8.4	0.4	2.0	11.4	26.2	14.0
Other private	−2.3	−3.1	−2.1	−2.0	−1.6	−0.4	0.0
Net short-term debt flows	9.9	22.3	32.7	45.4	29.2	42.6	−5.7
Balancing item[a]	−17.5	−7.7	23.4	−143.3	−187.1	−130.8	−170.2
Change in reserves (− = increase)	−89.4	−137.3	−236.8	−216.3	−291.9	−535.4	−427.9
Workers' remittances	29.5	35.4	39.2	46.7	53.0	65.3	69.6

Source: World Bank.
Note:
p = projected.
a. Combination of errors and omissions and net acquisition of foreign assets (including FDI) by developing countries.

during the second and third quarters, limiting full-year inflows to less than $20 billion. The countries with the largest bank repayments in 2008 were the Republic of Korea ($17 billion), Malaysia ($13 billion), and China ($9 billion).

Outlook

Weaker exports and slower expansion in domestic demand are set to slow real GDP growth in developing East Asia to 5 percent in 2009 from 8 percent in 2008, despite determined fiscal and monetary easing. Sluggishness in domestic demand reflects slower growth or declining investment spending by the private sector that is only partly offset by stronger government investment outlays in the middle-income countries. At the same time, household spending falters as precautionary savings balances are built, amid rising unemployment and slower wage increases (table A.2).

Thanks to China, growth in developing East Asia and the Pacific will be the fastest among the world's regions. The region's contribution to global GDP will remain the largest, equal in dollar terms to the sum of the contributions from the other three regions with positive impacts: South Asia, the Middle East and North Africa, and Sub-Saharan Africa. Given that developing East Asia's nominal GDP is barely a tenth of global output, however, the region's contribution to incremental global GDP will only partially offset the collapse in output in developed countries. If China is excluded, however, developing East Asia's performance is expected to be lackluster. The reason lies in the openness of the economies in the region and the tight production networks organized to serve the markets in the United States (and to a lesser extent Japan). But just as these structural characteristics have pulled down the growth performance of these countries during the global downturn, they will serve to support their performance once global growth resumes.

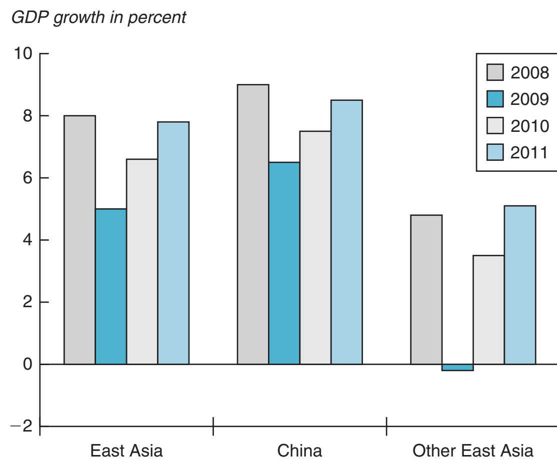
Developments in the region in 2009 will be influenced heavily by China (figure A.2). The slump in global demand will cause China's exports to fall this year, the first decline in decades. Nonetheless, a large monetary and fiscal stimulus should help partly offset the decline in exports and contain the slowdown in growth, projected at 6.5 percent for 2009 as a whole, down from 9 percent in 2008. With growth below potential, excess capacity is likely to restrain market-based investment and result in downward pressure on prices, following

Table A.2 East Asia and Pacific forecast summary
annual percent change unless indicated otherwise

					Forecast		
Indicator	1995–2005[a]	2006	2007	2008	2009	2010	2011
GDP at market prices (2000 $)[b]	7.4	9.8	11.4	8.0	5.0	6.6	7.8
GDP per capita (units in $)	6.3	8.9	10.5	7.2	4.2	5.8	7.0
PPP GDP[c]	7.3	9.7	11.3	8.0	5.0	6.6	7.8
Private consumption	5.9	7.1	9.5	6.5	5.0	5.7	7.1
Public consumption	8.3	8.2	10.4	9.9	9.8	9.5	8.3
Fixed investment	7.9	8.8	9.5	8.3	11.5	6.8	7.5
Exports, GNFS[d]	12.7	19.0	15.3	9.7	−8.7	5.1	8.7
Imports, GNFS[d]	9.8	12.6	11.0	11.8	−2.9	4.6	8.6
Net exports, contribution to growth	1.1	4.3	3.7	0.5	−3.6	0.7	0.9
Current account bal/GDP (%)	2.2	8.3	9.5	8.1	7.5	6.7	5.8
GDP deflator (median, LCU)	5.9	1.3	1.8	6.4	6.0	2.5	2.2
Fiscal balance/GDP (%)	−1.7	−0.6	0.3	−0.9	−3.9	−4.6	−3.8
Memo items: GDP							
East Asia excluding China	3.5	5.7	6.2	4.8	−0.2	3.5	5.1
China	9.1	11.1	13.0	9.0	6.5	7.5	8.5
Indonesia	2.7	5.5	6.3	6.1	3.5	5.0	6.0
Thailand	2.7	5.3	4.9	2.7	−3.2	2.2	3.1

Source: World Bank.
Note:
a. Growth rates over intervals are compound average; growth contributions, ratios and the GDP deflator are averages.
b. GDP measured in constant 2000 U.S. dollars.
c. GDP measured at PPP exchange rates.
d. Exports and imports of goods and non-factor services.

Figure A.2 China is key to East Asian prospects



Source: World Bank.

several months of month-on-month declines in the consumer price index. Even so, China will still grow faster than most other countries in the world in 2009, including all countries in developing East Asia. Indeed, excluding China, GDP in the region is seen to decline by 0.2 percent in 2009, the slowest since the crisis of the late 1990s.

In Malaysia and Thailand, among the region's other middle-income countries, output is projected to contract in 2009 due to a drop in exports and investment. In Malaysia, real GDP is projected to fall by 4.4 percent, a result of high and undiversified dependence on exports of electronics, oil, and crude palm oil, all of which are falling sharply, coupled with its relatively small domestic market. In Thailand a slump in exports, exacerbated by heightened political uncertainty, is set to cause output to contract at a 3.2 percent rate, following the slowest expansion in developing East Asia during 2008. Some of the low-income countries are hardest hit by the crisis. The deceleration in growth in Mongolia has been particularly swift, as the collapse in commodity export prices exposed an unsustainable fiscal situation with little saving from the commodity boom of 2007–08 and oversized and untargeted social transfers. Whereas other major commodity exporters let their currencies depreciate as terms of trade deteriorated, the Mongolian authorities defended the currency peg to the U.S. dollar, leading to a substantial loss of foreign exchange reserves that ultimately forced a sharp adjustment.

Looking beyond 2009, scope for faster recovery in the region will be helped by China but will ultimately depend on the pace of recovery in the advanced economies. Even under the assumption that a pickup in growth in developed countries begins in 2010, a sizable output gap will remain for several years, including high unemployment and weak consumption and imports, sustaining downward pressure on prices for manufactured products. A pickup in 2010, moreover, is likely to be relatively subdued, at 6.6 percent, up from the 5 percent trough of 2009, as consumers in developed countries adjust to lower wealth levels and banks complete the deleveraging process. Prospects for lower global growth—contrasted with the average of the past decade—increase the importance of China's rebalancing its growth pattern, by moving away from reliance on export-led manufacturing, boosting the role of services, and stimulating domestic consumption and, inevitably, imports.

Risks and uncertainties

The projections outlined in this report are surrounded by extreme uncertainties. While recovery among developed countries from most recessions has been relatively swift, an analysis of previous recessions in advanced economies suggests that when accompanied by a credit crunch, housing crisis, and equity bust, they tend to last twice as long and are deeper than other "normal" recessions. Further, while investment usually picked up strongly in past recoveries once inventories were exhausted, recovery from the current global recession may be more subdued because of the substantial destruction of wealth and ongoing deleveraging in financial systems around the world. Continued problems in commercial banks or even renewed financial market tensions could delay recovery further and lead to another year of stagnating or even contracting global growth. Finally, even when recovery begins, the pace of pickup is more likely to be subdued as global imbalances are gradually resolved (table A.3). The low case scenario presented in chapter 1 of this report highlights growth in East Asia and Pacific registering 4.2 percent in 2009, easing further into 2010 to 3.9 percent before a stronger revival sets in during 2011 at 7.5 percent (see table 1.10 in chapter 1).

Table A.3 East Asia and Pacific country forecasts
annual percent change unless indicated otherwise

Country/indicator	1995–2005[a]	2006	2007	2008	Forecast 2009	2010	2011
Cambodia							
GDP at market prices (2000 $)[b]	8.3	10.8	10.2	6.7	1.0	3.0	5.0
Current account bal/GDP (%)	−4.6	−4.7	−6.0	−6.6	0.3	−0.5	−1.5
China							
GDP at market prices (2000 $)[b]	9.1	11.1	13.0	9.0	6.5	7.5	8.5
Current account bal/GDP (%)	2.6	9.5	11.0	9.8	9.3	8.3	7.2
Fiji							
GDP at market prices (2000 $)[b]	2.3	3.6	−6.6	1.2	−2.5	2.0	2.5
Current account bal/GDP (%)	−4.8	−7.5	−37.7	−44.3	−22.1	−25.5	−29.0
Indonesia							
GDP at market prices (2000 $)[b]	2.7	5.5	6.3	6.1	3.5	5.0	6.0
Current account bal/GDP (%)	1.5	2.9	2.4	0.1	−2.5	−2.7	−2.6
Lao PDR							
GDP at market prices (2000 $)[b]	6.2	8.1	7.9	6.9	5.0	8.0	8.0
Current account bal/GDP (%)	−9.2	1.5	2.7	−0.4	1.2	1.0	1.2
Malaysia							
GDP at market prices (2000 $)[b]	4.6	5.9	6.2	4.6	−4.4	2.2	5.3
Current account bal/GDP (%)	6.7	17.1	16.6	19.7	11.6	11.6	10.4
Papua New Guinea							
GDP at market prices (2000 $)[b]	0.7	2.6	6.2	5.8	3.5	5.0	5.5
Current account bal/GDP (%)	3.0	14.6	17.5	18.7	5.6	3.6	1.2
Philippines							
GDP at market prices (2000 $)[b]	4.2	5.4	7.2	4.6	−0.5	2.4	4.5
Current account bal/GDP (%)	−1.4	5.0	5.9	3.3	2.2	1.6	2.5
Thailand							
GDP at market prices (2000 $)[b]	2.7	5.3	4.9	2.7	−3.2	2.2	3.1
Current account bal/GDP (%)	1.9	1.1	6.5	0.1	3.8	3.6	3.4
Vanuatu							
GDP at market prices (2000 $)[b]	1.5	7.2	5.0	4.5	−2.5	3.5	5.0
Current account bal/GDP (%)	−9.8	−17.6	−12.4	−17.0	−12.0	−12.5	−14.2
Vietnam							
GDP at market prices (2000 $)[b]	7.2	8.2	8.5	6.2	3.5	5.0	7.0
Current account bal/GDP (%)	−2.4	−0.3	−9.1	−11.4	−14.9	−14.5	−14.3

Source: World Bank.
Note:
In the current very volatile global environment, World Bank forecasts are frequently updated based on new information and changing assumptions. Moreover, the confidence intervals around these point forecasts are larger than usual. As a result, the projections presented here may differ from those contained in other Bank documents, even if basic assessments of countries' prospects do not significantly differ at any given moment in time.

American Samoa, Micronesia, Fed. Sts., Kiribati, Marshall Islands, Myanmar, Mongolia, N. Mariana Islands, Palau, Korea, Dem. Rep., Solomon Islands, Timor-Leste, Tonga are not forecast owing to data limitations.
a. Growth rates over intervals are compound average; growth contributions, ratios and the GDP deflator are averages.
b. GDP measured in constant 2000 U.S. dollars.

Europe and Central Asia

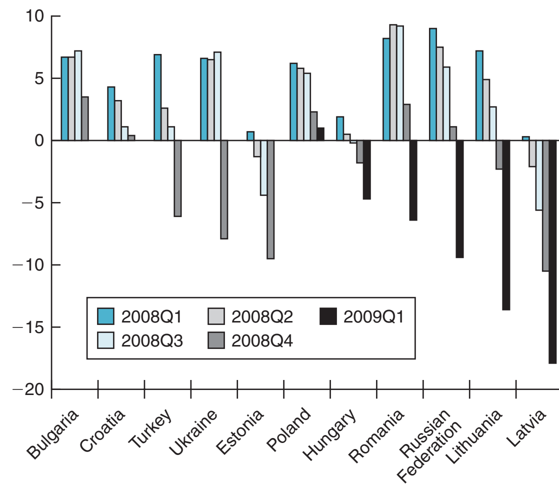
Recent developments

Among developing regions, Europe and Central Asia has been hit the hardest by the global economic and financial crisis. For several countries, a combination of international support, adjustment programs, and perhaps even private sector debt restructuring will be needed to avoid large-scale defaults. After years of growth over 6 percent, real GDP growth in the region slowed to 4 percent in 2008 and is expected to drop 4.7 percent in 2009, driven by a collapse in capital inflows, a sharp deterioration in terms of trade, and contraction in both domestic and external demand.

The robust domestic demand that supported growth throughout 2007 and through the first three quarters of 2008 began to wane at the height of the crisis in September 2008. High levels of foreign-currency denominated private sector and household debt, rising unemployment, and broadening recession in trade partner countries contributed to

Figure A.3 Output declined rapidly in the fourth quarter of 2008

Real GDP, percent change year on year



Source: NIA; national sources.

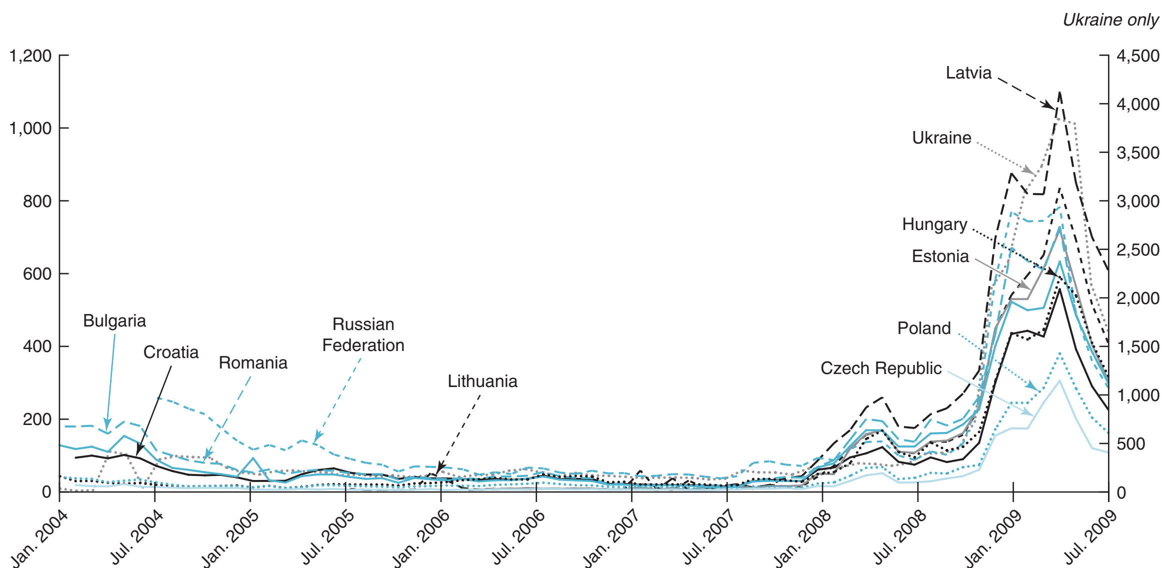
dramatic declines in GDP in several countries in the fourth quarter of 2008. The Baltic states of Estonia and Latvia suffered the most adverse impact with GDP falling by 9.5 and 10.5 percent relative to a year earlier, with other emerging markets such as Turkey and Ukraine also recording negative growth. In several countries with data available for the first quarter of 2009, output deteriorated further on a year-on-year basis. Economic activity continued to shrink in Hungary (−4.7 percent), Lithuania (−13.6 percent), and Latvia (−17.9 percent), while Romania and Russia stepped for the first time into negative growth territory (−6.4 and −9.4 percent, respectively). Poland, the only economy to show resilience, posted a modest GDP increase of 1 percent (figure A.3).

Unlike Latin America and the Caribbean and East Asia and Pacific, Europe and Central Asia entered the global financial crisis highly dependent on foreign capital inflows. For example, Hungary had been sustaining twin deficits (on the current account and the government budget) for several years, while Romania had been accumulating high levels of private sector foreign debt to finance booming domestic demand. As the financial crisis took hold in September 2008, key growth determinants for the region started to deteriorate rapidly, unveiling deep vulnerabilities. Surging commodity prices, which had spurred growth among commodity exporters in the first half of 2008 spiraled downward, external markets began to collapse, and capital flows reversed owing to heightened investor risk aversion. As a consequence, growth rates between 2007 and 2008 decelerated from 8.8 percent to 6 percent in private consumption and from 19.3 percent to 7.7 percent in investment activity. Weak domestic demand and investment contributed to a slowing in import growth to 9 percent in 2008 from 18.8 percent in 2007, while stress in the external markets reduced growth in exports of goods and services to 3.8 percent from 7.7 percent.

The most vulnerable group of countries within the broader region, Central and Eastern Europe (CEE), received shocks through several channels simultaneously. In the capital markets, external financing continued to decline, with total gross capital inflows (syndicated bank lending, bond issuance, and equity initial public offerings) plummeting from $56.6 billion in the second quarter of 2008 to a meager $3.9 billion in the first quarter of 2009. At the same time, spreads for government borrowing on international markets, a key measure of credit risk, widened to unprecedented levels. Between September 2008 and March 2009, spreads on sovereign five-year credit-default swaps increased from a range of 68 to 270 basis points to 381 to 1,100 basis points. Vulnerabilities in the banking sector and a general increase in the risk aversion toward emerging markets affected to different degrees each of the countries in the region. In Bulgaria and Romania spreads almost tripled, while in Croatia, Lithuania, and Poland spreads widened by five times or more their levels in mid-2008 (figure A.4). As market sentiment started to improve, credit-default swap rates eased in April and May but continued to hover above pre-crisis levels.

The drying-up of capital was amplified by adverse developments in the product markets, where record growth prior to the financial crisis had been supported by large trade flows with the Euro Area. Rapidly shrinking consumer demand and investment spending across major West European partners quickly resulted in a sharp contraction in trade. In the last quarter of 2008, real exports contracted by 2 percent in Poland (year-on-year), by 3 percent in Croatia, and by 6 percent in Bulgaria and Latvia. Turkish exports declined the most, by 8 percent, on the basis of falling demand for its manufactured goods.

Figure A.4 Financial crisis increased the price of risk
Spreads on selected five-year sovereign credit default swaps



Source: Thomson Datastream–CMA.

The decline in both capital inflows and exports caused double-digit contractions in industrial production at the beginning of 2009 across a range of countries. In the first quarter of 2009, industrial production fell by 10 percent in Croatia (year-on-year), by 11 percent in Poland, by 12 percent in Romania, by 18 percent in Bulgaria, by 22 percent in Turkey, and by 24 percent in Latvia. In the first quarter of 2009, Turkey posted a contraction of 51 percent in the number of automobiles produced relative to the first quarter of 2008. Poland's industrial production of motor vehicles also fell by more than 25 percent, though fueled to a large extent by slack domestic demand. The Romanian auto industry, regarded as one of the most vulnerable in the region, benefited from the scrap-car program that boosted sales of new cars in Germany. Car exports rose by 62 percent in the first quarter of 2009 compensating for a 51 percent decrease in domestic sales of new cars during the first four months.

In the labor markets, the crisis has reduced personal income due to rising unemployment at home and abroad, with the latter leading to lower workers' remittance inflows. Over 10 percent of GDP in Albania and 5 percent in Romania and Bulgaria came from migrant remittances[1] in 2007. With many migrant workers employed in the European sectors hardest hit by recession (such as household work, construction, and agriculture), receipts of remittances in the CEE region increased by only 5 percent in 2008, compared with 21 percent in the previous year. Lagging the first signs of decline in the real economy, unemployment in the CEE region rose in February-March by one percentage point over the average rate prevailing in the first half of 2008.

Pressures on the current account and financial distress triggered a sequence of borrowing from the International Monetary Fund (IMF). Hungary (which already had graduated from the group of middle-income countries) and Latvia were among the first to turn to the IMF in 2008, contracting loans of $18.1 billion. Serbia followed soon after, with a $530 million standby agreement targeted at maintaining market confidence in its economy. In March, Romania had to turn to the IMF for a loan of $17 billion after the national currency had lost about 20 percent of its value relative to the euro over the previous 12 months. At the beginning of April, Poland took advantage of a $20.5 billion flexible credit line from the IMF—a precautionary facility for countries with sound economic fundamentals—to boost its foreign currency reserves.

Despite the initial resilience shown within the Commonwealth of Independent States (CIS), the group has not been spared by the global meltdown. The sharp decline in international oil prices in the second half of 2008 adversely affected hydrocarbons producers, particularly the oil-exporting countries of Azerbaijan, Kazakhstan, and especially the Russian Federation. In Russia, formerly the region's engine of growth, the collapse of oil revenues caused GDP to decline at an annualized rate (saar) of 6.9 percent in the fourth quarter of 2008 and at a shocking 30.6 percent pace in the first quarter of 2009, bringing the level of GDP 9.4 percent lower than its level a year earlier.

In all CIS countries, dependence on external financing exacerbated the adverse impact of falling commodity prices. A general deterioration in investor confidence toward emerging markets widened across the region, hitting Kazakhstan, Russia, and Ukraine particularly hard. In Ukraine, spreads on five-year credit-default swaps increased from 443 basis points in September 2008 to a record high of 3,795 basis points in April 2009. In addition to the economic slowdown and financial turmoil, investors' concerns regarding Ukraine were increased by political difficulties in implementing a sequence of measures necessary to secure disbursements under an IMF stabilization loan agreement. Gross capital inflows to the CIS area fell by 39 percent in 2008, after surging by 84 percent in the previous year. In the first quarter of 2009, flows to all member countries fell to zero with the exception of Russia (which brought a $500 million bond to market and secured a syndicated bank loan of $1.35 billion) and Ukraine (which had a $7 million equity issuance) (table A.4).

The CIS area also suffered a decline in remittances, a major source of revenue for the low-income economies in the group. In 2007, international remittance receipts were the equivalent of 46 percent of GDP in Tajikistan, 28 percent in the Kyrgyz Republic, and 34 percent in Moldova. In Moldova, more than 35 percent of the population lived in remittance-receiving households in 2008.[2] With oil revenue–driven growth slowing in Russia, the advance in total remittance receipts for the CIS region decelerated dramatically to 7 percent in 2008 compared with record growth of 75 percent in 2007. Surging unemployment in Russia, which reached 10 percent in April 2009 (compared with 5.9 percent a year earlier),

Table A.4 Net capital flows to Europe and Central Asia
$ billions

Indicator	2002	2003	2004	2005	2006	2007	2008p
Current account balance	18.9	14.7	26.7	44.2	25.1	−34.1	−11.6
as % of GDP	*1.9*	*1.2*	*1.7*	*2.2*	*1.1*	*−1.1*	*−0.3*
Net private and official inflows	46.5	83.4	124.1	156.3	279.0	465.8	255.8
Net private inflows	43.7	89.3	134.3	192.1	311.3	471.4	250.5
Net equity inflows	22.0	31.2	59.1	70.8	125.4	180.8	162.4
Net FDI inflows	18.5	30.5	55.5	62.8	114.9	154.4	170.8
Net portfolio equity inflows	3.5	0.7	3.6	8.0	10.5	26.4	−8.4
Net debt flows	24.5	52.2	65.0	85.5	153.6	285.0	93.4
Official creditors	2.8	−5.9	−10.2	−35.8	−32.3	−5.6	5.3
World Bank	1.1	−0.4	0.5	−0.5	0.4	0.0	0.8
IMF	4.7	−1.9	−5.9	−9.8	−5.8	−5.0	7.0
Other official	−3.0	−3.6	−4.8	−25.5	−26.9	−0.6	−2.5
Private creditors	21.7	58.1	75.2	121.3	185.9	290.6	88.1
Net M-L term debt flows	17.0	24.2	54.8	101.0	131.2	189.3	93.8
Bonds	4.7	9.7	19.4	27.5	31.8	58.2	17.6
Banks	13.8	14.9	36.7	74.6	100.2	132.1	77.2
Other private	−1.5	−0.4	−1.3	−1.1	−0.8	−1.0	−1.0
Net short-term debt flows	4.7	33.9	20.4	20.3	54.7	101.3	−5.7
Balancing item[a]	−34.5	−45.4	−78.9	−110.0	−127.7	−194.7	−307.9
Change in reserves (− = increase)	−30.9	−52.8	−71.9	−90.6	−176.4	−237.1	63.8
Workers' remittances	13.7	15.5	22.2	31.2	38.3	50.4	53.1

Source: World Bank.
Note:
p = projected.
a. Combination of errors and omissions and net acquisition of foreign assets (including FDI) by developing countries.

forced hundreds of migrant workers to return to their home countries.[3] In an attempt to cushion severe external shocks from sharply falling remittances, Tajikistan, the region's poorest country, turned to the IMF in April for a $116 million loan under the Poverty Reduction and Growth Facility.

Outlook

The aftershocks from the initial crisis in global financial and product markets will continue to exact a painful toll on the growth outlook across Europe and Central Asia. As many countries are facing large balance-of-payments difficulties and in some cases unavoidable adjustments to the real side of their economies, the region will see the sharpest contraction among all developing regions (table A.5). Aggregate GDP is expected to contract by 4.7 percent in 2009 but recover to reach still-subdued growth of 1.6 percent as markets begin to thaw by 2010.

In Central and Eastern Europe, GDP is expected to decline by 1.6 percent and remain almost flat through 2010 as many economies in the region recover slowly from the crisis. The sharpest downturn will be felt in the Baltic states, as Latvia struggles to weather its sharp decline in GDP during 2008 and as the falloff in private consumption widens in Lithuania. Latvia's GDP is projected to fall 13 percent in 2009, while Lithuania's GDP appears set to contract by 10 percent. Despite relatively strong fundamentals, Poland will not remain unscathed. GDP is anticipated to grow by just 0.5 percent in 2009 as the country continues to be exposed to spillover effects through trade flows and financial vulnerabilities given the large presence of foreign-owned institutions in its banking system.

The CIS area is expected to face a deep recession in 2009, with real GDP contracting by 6.2 percent from growth of 8.6 percent in 2007 and 5.6 percent in 2008. The slowdown stems to a considerable extent from the projected 42 percent decline in international energy prices in 2009 (relative to the 2008 average). For the group of CIS oil-exporting countries, the decline in terms of trade

Table A.5 Europe and Central Asia forecast summary

annual percent change unless indicated otherwise

					Forecast		
Indicator	1995–2005[a]	2006	2007	2008	2009	2010	2011
GDP at market prices (2000 $)[b]	4.1	7.5	6.9	4.0	−4.7	1.6	3.3
GDP per capita (units in $)	4.1	7.5	6.9	4.0	−4.7	1.6	3.2
PPP GDP[c]	4.0	7.7	7.3	4.4	−5.3	1.8	3.2
Private consumption	4.8	7.5	8.8	6.0	−3.9	2.0	3.8
Public consumption	2.3	5.1	4.8	4.0	1.0	1.6	3.0
Fixed investment	5.1	16.0	19.3	7.7	−19.5	0.4	3.0
Exports, GNFS[d]	7.9	8.3	7.7	3.8	−6.2	3.2	5.1
Imports, GNFS[d]	8.8	14.3	18.8	9.0	−12.0	2.9	5.5
Net exports, contribution to growth	−0.2	−2.4	−4.9	−2.7	3.4	−0.1	−0.5
Current account bal/GDP (%)	0.8	0.9	−1.3	−0.4	−1.2	−0.5	−0.5
GDP deflator (median, LCU)	17.2	8.9	8.8	12.3	2.1	5.0	5.0
Fiscal balance/GDP (%)	−3.1	3.2	1.6	0.7	−5.9	−4.1	−3.0
Memo items: GDP							
Transition countries	4.1	6.8	5.7	2.8	−3.5	1.0	3.1
Central and Eastern Europe	3.9	6.6	6.7	4.6	−1.6	0.6	3.2
Commonwealth of Independent States	4.1	8.5	8.6	5.6	−6.2	2.5	3.5
Russia	3.9	7.7	8.1	5.6	−7.5	2.5	3.0
Turkey	4.3	6.9	4.7	1.1	−5.5	1.5	3.0
Poland	4.3	6.2	6.7	4.8	−0.5	0.9	3.5

Source: World Bank.
Note:
a. Growth rates over intervals are compound average; growth contributions, ratios and the GDP deflator are averages.
b. GDP measured in constant 2000 U.S. dollars.
c. GDP measured at PPP exchange rates.
d. Exports and imports of goods and non-factor services.

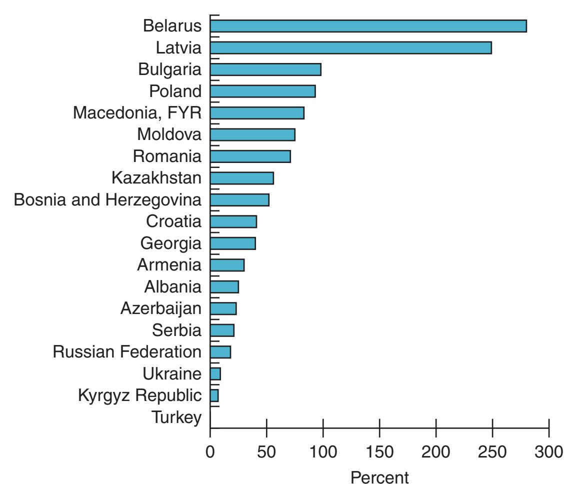
represents a loss of some 7.9 percent of their 2008 GDP. In Russia, the combination of declines in industrial output, soaring unemployment, and flight of foreign capital is expected to reduce GDP by 7.5 percent, sending damaging waves throughout the whole of the CIS through intraregional trade flows and transfers. Remittances to the broader CIS region are expected to decline for the first time in a decade, by 25 percent. The small oil-importing countries in the CIS will be the most affected owing to their close economic ties with Russia. GDP is expected to fall by 6 percent in Armenia, by 3.3 percent in Belarus, and by 3 in Moldova.

Financing requirements across the region are projected to remain substantial, due in part to large current-account deficits. The prolonged credit crunch, untamed recession in the Euro Area, and sharp contraction in Russia will continue to put pressure on current accounts in a number of countries. Two economies that are likely to maintain large surpluses are Azerbaijan and Uzbekistan, which in 2008 generated record double-digit surpluses in net exports of 38 percent of GDP and 16.2 percent of GDP, respectively. In 2009, Azerbaijan's current account surplus is projected to shrink to 10.3 percent of GDP, and Uzbekistan's to 11.8 percent of GDP. Russia is also expected to post a current account surplus of 2.4 percent of GDP as the fast rate of ruble depreciation has slowed imports considerably. In other countries, the sharp fall in exports of goods and services will be offset by contraction in imports through adjustments to the real side of the economy. However, these offsetting effects will not be enough to reverse persistent deficits in current-account balances. Overall in Europe and Central Asia, the current account deficit will widen from 0.4 percent of GDP in 2008 to 1.2 percent in 2009.

The region's large external financing requirements in 2009 also reflect the more than $283 billion in short-term debt coming due.[4] Among the countries with high short-term debt levels, only Russia could foot the bill from reserves or its current-account surplus if external finance were not forthcoming. As of February 2009, Belarus, Bulgaria, and Latvia held insufficient international reserves to cover debt coming due in 2009 (figure A.5). Kazakhstan, the Former Yugoslav Republic of Macedonia, Moldova, Poland,

Figure A.5 High short-term debt to total reserves ratios in Europe and Central Asia

Projected short-term debt due in 2009 (percent of reserves in February 2009)



Sources: International Financial Statistics; Bank for International Settlements; World Bank staff calculations.

Romania, and Bulgaria had short-term debt levels above 50 percent of their reserves. So far, rollover of short-term debt has not proved to be the problem initially feared—in part because of moral suasion exercised by domestic and international authorities on lending banks.

With the sharp fall-off in capital flows, tight capital markets, and large borrowing requirements, financing gaps[5] in the region could be as high as $102 billion, or 3.7 percent of GDP in 2009. For those countries that lack large foreign currency reserves, the gap will have to be bridged either through capital flows from official sources or through internal adjustment. Between September 2008 and May 2009, nine countries reached agreements with the IMF for a total of $55.8 billion in assistance,[6] with additional funds being channeled through the World Bank, the European Commission, and several other donors. Lithuania and Turkey are exploring similar options and might contract stabilization packages from the IMF in 2009.

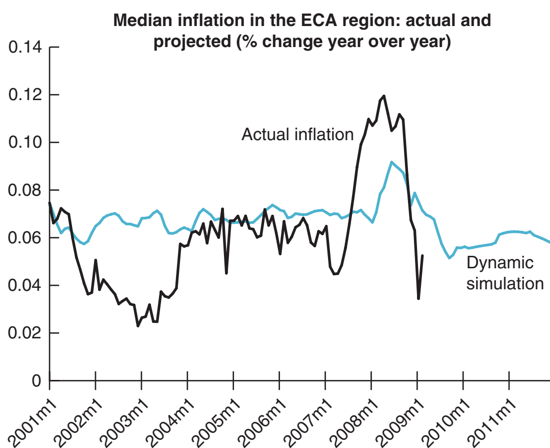
Although the surge in international official flows has offered some temporary relief, international assistance alone cannot make up for the sharp contraction in private capital flows, and many countries in the region are undergoing painful

cuts in domestic demand as part of the adjustment process. Current account deficits in five countries in the region are projected to fall by 5 percent of GDP or more. In countries with floating exchange rates, some of the adjustment will occur through depreciation but at the cost of higher debt for private firms and households with loans denominated in foreign currency. The currencies of several countries are expected to depreciate further during 2009. In countries with more rigid exchange rate and/or monetary policy response, the adjustment will have to take place through a sharp contraction in imports and, thus, in domestic demand.

In the second half of 2008, inflationary trends across the region were gradually replaced by disinflationary pressures from fast-declining international energy and commodity prices (figure A.6). Lower agricultural prices favored by improved weather conditions and weaker domestic demand also contributed to this development. Projections for 2009 indicate that the region as a whole will see a widening in the output gap, from output exceeding long-term potential by 8.4 percent in 2008 to output below potential by 2.4 percent in 2009, which will put downward pressure on prices.[7] The most affected will be countries in the CIS, where output exceeded sustainable levels by 1.2 percent in 2008 but is projected to be below potential by 11.1 percent in 2009. However, in a number of countries the effect of slowing activity on domestic prices will be offset by downward pressures on local currencies. This is particularly the case for net oil exporters and for those countries that face large current account imbalances. Econometric estimation of the behavior of headline inflation in response to changes in internationally traded dollar-denominated commodity prices also suggests that the median inflation rate for the region will stabilize within a 5.4 percent to 6.3 percent band through 2010.

Overall, average fiscal positions across the region are expected to deteriorate further in 2009, to an average deficit of 5.9 percent of GDP, compared to surpluses of 1.6 percent in 2007 and 0.7 percent in 2008.

Figure A.6 Lower commodity prices should see inflation decline



Source: World Bank.

Risks and uncertainties

Risks to the outlook for the region remain skewed to the downside (table A.6). In the short term, a worsening in financial constraints and commercial bank lending carries a high liquidity risk, which could increase pressures on the balance of payments in several countries. The rapid expansion of foreign currency borrowing in the years before the crisis means that many such loans could become nonperforming were domestic currencies to depreciate sharply against the currency of the loan. This in turn could threaten the solvency of banks in ways that have yet to emerge—posing further challenges for policy makers. The currencies of Russia and Kazakhstan have already depreciated, after initial attempts to defend the exchange rates through massive drawdown on reserves. Other countries with large current-account and/or government deficits and relatively rigid exchange rate regimes may be at particular risk of such a scenario.

High levels of short-term debt also expose many countries in the region to rollover risk. So far this risk has not materialized. But the predominance of foreign-owned banks in Central and Eastern Europe (foreign-owned lenders predominantly headquartered in Austria, Greece, Italy, and Sweden account for 70 percent of local banking assets in several countries)[8] could expose countries in the region to a sharp reduction in access to foreign capital if parent banks in high-income countries are forced to scale back lending in the region as they seek to bolster their own balance sheets.

Table A.6 Europe and Central Asia country forecasts

annual percent change unless indicated otherwise

Country/indicator	1995–2005[a]	2006	2007	2008	Forecast 2009	2010	2011
Albania							
GDP at market prices (2000 $)[b]	5.4	5.0	6.0	6.0	1.5	2.0	3.0
Current account bal/GDP (%)	−5.5	−7.3	−8.4	−12.4	−10.7	−8.9	−8.1
Armenia							
GDP at market prices (2000 $)[b]	8.6	13.3	13.8	6.8	−6.0	−2.0	1.0
Current account bal/GDP (%)	−11.7	−1.8	−6.7	−12.2	−12.1	−10.3	−6.5
Azerbaijan							
GDP at market prices (2000 $)[b]	10.2	34.5	25.0	10.8	3.3	5.2	9.0
Current account bal/GDP (%)	−16.6	17.7	29.5	38.0	10.3	15.5	19.0
Belarus							
GDP at market prices (2000 $)[b]	6.9	10.0	8.6	10.0	−3.3	2.6	4.4
Current account bal/GDP (%)	−3.2	−3.9	−6.7	−8.7	−7.8	−5.7	−3.6
Bulgaria							
GDP at market prices (2000 $)[b]	2.2	6.3	6.2	6.0	−1.5	1.5	3.0
Current account bal/GDP (%)	−3.6	−17.9	−23.6	−23.1	−14.1	−10.8	−8.7
Croatia							
GDP at market prices (2000 $)[b]	4.1	4.8	5.4	2.3	−3.0	0.3	3.0
Current account bal/GDP (%)	−3.5	−7.7	−8.6	−10.5	−7.6	−5.6	−6.4
Georgia							
GDP at market prices (2000 $)[b]	6.6	9.4	12.3	2.2	1.0	2.0	4.0
Current account bal/GDP (%)	−8.1	−16.2	−22.0	−22.5	−19.6	−16.8	−15.5
Kazakhstan							
GDP at market prices (2000 $)[b]	6.4	10.7	8.2	3.0	−1.5	1.5	3.0
Current account bal/GDP (%)	−2.3	−2.5	−7.9	5.5	−8.4	−7.8	−6.3
Kyrgyz Republic							
GDP at market prices (2000 $)[b]	4.7	2.7	7.4	6.6	0.5	2.5	3.5
Current account bal/GDP (%)	−10.2	−11.0	−7.1	−6.8	−6.0	−7.2	−7.8
Lithuania							
GDP at market prices (2000 $)[b]	6.0	7.7	8.9	3.0	−10.0	−2.5	2.5
Current account bal/GDP (%)	−7.9	−10.8	−14.3	−11.3	−5.0	−3.0	−1.8
Latvia							
GDP at market prices (2000 $)[b]	6.9	12.2	9.9	−4.6	−13.0	−3.0	2.6
Current account bal/GDP (%)	−7.5	−22.7	−21.8	−12.5	−6.6	−4.2	−3.9
Moldova							
GDP at market prices (2000 $)[b]	2.3	4.8	3.0	7.0	−3.0	2.0	4.0
Current account bal/GDP (%)	−7.9	−11.3	−16.7	−17.8	−12.1	−10.1	−9.3
Macedonia, FYR							
GDP at market prices (2000 $)[b]	2.2	4.0	5.1	4.9	−1.2	1.0	2.0
Current account bal/GDP (%)	−5.5	−0.4	−8.2	−13.8	−11.6	−11.4	−11.7
Poland							
GDP at market prices (2000 $)[b]	4.3	6.2	6.7	4.8	0.5	0.9	3.5
Current account bal/GDP (%)	−3.3	−2.8	−5.0	−5.6	−4.3	−4.0	−3.7
Romania							
GDP at market prices (2000 $)[b]	2.1	7.7	6.0	7.1	−4.0	0.5	2.5
Current account bal/GDP (%)	−5.8	−10.5	−13.7	−12.4	−8.4	−7.5	−8.7
Russian Federation							
GDP at market prices (2000 $)[b]	3.9	7.7	8.1	5.6	−7.5	2.5	3.0
Current account bal/GDP (%)	7.6	9.5	6.0	6.0	2.4	3.0	3.2
Turkey							
GDP at market prices (2000 $)[b]	4.3	6.9	4.7	1.1	−5.5	1.5	3.0
Current account bal/GDP (%)	−1.4	−6.0	−5.9	−5.6	−1.9	−1.9	−2.0

(Continues)

Table A.6 (*Continued*)
annual percent change unless indicated otherwise

Country/indicator	1995–2005[a]	2006	2007	2008	Forecast 2009	2010	2011
Ukraine							
GDP at market prices (2000 $)[b]	2.7	7.3	7.9	2.1	−9.0	1.0	3.5
Current account bal/GDP (%)	2.7	−1.5	−4.2	−7.5	0.1	1.0	−0.8
Uzbekistan							
GDP at market prices (2000 $)[b]	4.6	7.3	9.5	9.0	4.5	5.0	6.5
Current account bal/GDP (%)	3.3	14.4	13.3	16.2	11.8	15.2	13.6

Source: World Bank.
Note:
In the current very volatile global environment, World Bank forecasts are frequently updated based on new information and changing assumptions. Moreover, the confidence intervals around these point forecasts are larger than usual. As a result, the projections presented here may differ from those contained in other Bank documents, even if basic assessments of countries' prospects do not significantly differ at any given moment in time.
Bosnia and Herzegovina, Montenegro, Serbia, and Turkmenistan are not forecast owing to data limitations.
a. Growth rates over intervals are compound average; growth contributions, ratios and the GDP deflator are averages.
b. GDP measured in constant 2000 U.S. dollars.

Latin America and the Caribbean

Recent developments

Almost six years of improving current account positions (figure A.7, panel a), marked terms-of-trade gains (panel b), declines in public external debt relative to output (panel c), expansions in international reserves (panel d), and financial sector reforms have strengthened the ability of many countries in Latin America and the Caribbean to weather external shocks. Nevertheless, the region has not been immune to the global increase in risk aversion and fall in external demand resulting from the financial crisis and growth has declined sharply in virtually all countries in the region.

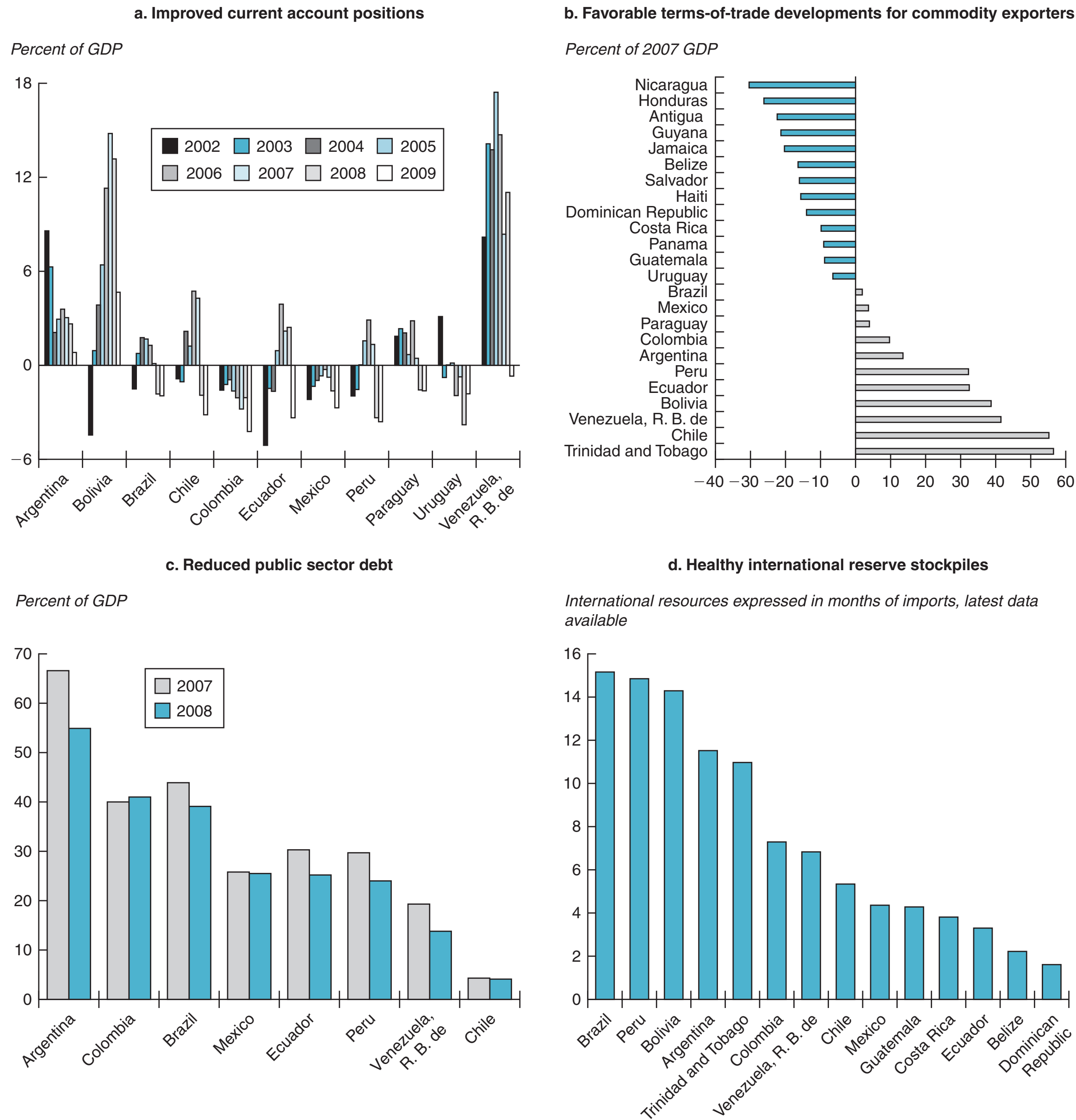
Inflows of external capital from private sources dropped sharply during 2008, and countries experienced massive capital outflows in the last quarter of the year (for example, Brazil's recorded portfolio outflows shifted by $30 billion, and Mexico's by almost $11 billion, from the preceding year). Secondary-market spreads on both sovereign and corporate bonds jumped (figure A.8). Domestic lending rates to the private sector rose by almost 1,400 basis points in Argentina, 530 basis points in Brazil, 521 basis points in Chile, and 379 basis points in Paraguay between September and November 2008, but have come down since. Domestic financial market are deeper and play a bigger role in overall financial intermediation today contrasted with the crisis periods of 15–20 years ago.

The drop in external finance was compounded by plummeting trade in goods and services. During the fourth quarter of 2008, constant-price exports fell by almost 14 percent in Costa Rica, by over 10 percent in Argentina, 8 percent in Mexico, and almost 7 percent in Brazil and República Bolivariana de Venezuela, (figure A.9, panel a). The fall in commodity prices depressed commodity exporters' terms of trade, while providing some relief to oil-importing countries (panel b). However, for the region as a whole, the fall in commodity prices between July 2008 and May 2009 reduced incomes by an estimated 2.2 percent of GDP. Workers' remittances fell as host countries entered recession: between the first quarter of 2008 and the first quarter of 2009, remittances to Guatemala declined by 5.9 percent, to Mexico by 4.9 percent, to Panama by 6.3 percent, and to Colombia by 11.6 percent. El Salvador, Jamaica, Honduras, Haiti, and Guyana, where remittances exceed 15 percent of GDP, were also adversely affected. Tourism receipts also declined sharply; for example, the number of non-resident tourists in the Dominican Republic fell 5 percent in the first quarter (year-on-year).

Heightened uncertainty about the length and depth of the crisis, increased risk aversion on the part of international investors, and a drying up of finance caused a steep slowdown in growth of fixed investment spending in the fourth quarter of 2008 (figure A.10, panel a). In Chile, the year-on-year growth of investment fell from 29.9 percent

Figure A.7 Improved initial conditions are helping Latin America and the Caribbean weather the crisis

Terms of trade impact from changes in international prices between January 2002 and December 2007



Source: World Bank.

in the third quarter of 2008 to 10.4 percent in the fourth quarter; in Brazil it slowed from 19.7 percent to 3.9 percent, and in Argentina from 8.6 percent to minus 2.6 percent. In Mexico and Colombia, investment stagnated. Private consumption slowed or fell in most economies. Declines in net trade and decelerating investment and consumption meant a dramatic worsening of GDP growth in the fourth quarter of the year, ranging from a 1.6 percent fall in Mexico, to gains of 1.2 percent in Brazil, 0.3 percent in Argentina, and 0.2 percent in Chile (panel b).

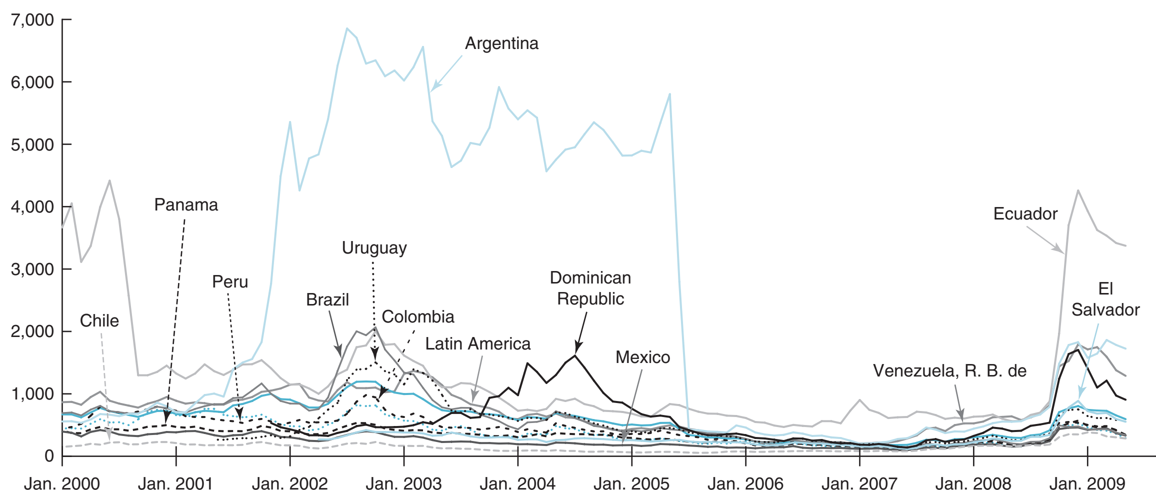
Table A.7 Net capital flows to Latin America and the Caribbean

$ billions

Indicator	2002	2003	2004	2005	2006	2007	2008p
Current account balance	−15.7	7.7	19.9	33.5	47.0	15.4	−27.1
as % of GDP	*−0.9*	*0.4*	*1.0*	*1.4*	*1.6*	*0.4*	*−0.7*
Net private and official inflows	38.0	61.8	59.9	81.7	64.8	215.1	130.9
Net private inflows	25.6	57.0	70.0	112.9	85.0	215.9	127.2
Net equity inflows	54.4	45.6	64.3	83.0	82.8	137.1	118.3
Net FDI inflows	53.0	42.3	64.9	70.8	71.6	107.5	124.8
Net portfolio equity inflows	1.4	3.3	−0.6	12.2	11.2	29.6	−6.5
Net debt flows	−16.4	16.2	−4.4	−1.3	−18.0	78.0	12.6
Official creditors	12.4	4.8	−10.1	−31.2	−20.2	−0.8	3.7
World Bank	−0.6	−0.4	−1.0	−0.7	−3.4	−0.1	2.4
IMF	11.9	5.6	−6.3	−27.6	−12.1	0.0	0.0
Other official	1.1	−0.4	−2.8	−2.9	−4.7	−0.7	1.3
Private creditors	−28.8	11.4	5.7	29.9	2.2	78.8	8.9
Net M-L term debt flows	−8.5	9.1	0.2	14.1	3.2	45.7	11.6
Bonds	−0.8	11.0	−0.5	15.6	−16.2	8.7	−9.4
Banks	−6.2	−1.4	0.8	−1.4	19.9	37.0	21.8
Other private	−1.5	−0.5	−0.1	−0.1	−0.5	0.0	−0.8
Net short-term debt flows	−20.3	2.3	5.5	15.8	−1.0	33.1	−2.7
Balancing item[a]	−20.7	−35.4	−55.6	−82.2	−58.5	−96.3	−55.3
Change in reserves (− = increase)	−1.7	−34.1	−24.3	−33.1	−53.4	−134.2	−48.5
Workers' remittances	27.9	36.6	43.3	50.1	59.2	63.1	63.3

Source: World Bank.
Note:
p = projected.
a. Combination of errors and omissions and net acquisition of foreign assets (including FDI) by developing countries.

Figure A.8 EMBI sovereign spreads surged as the crisis shook investors' confidence



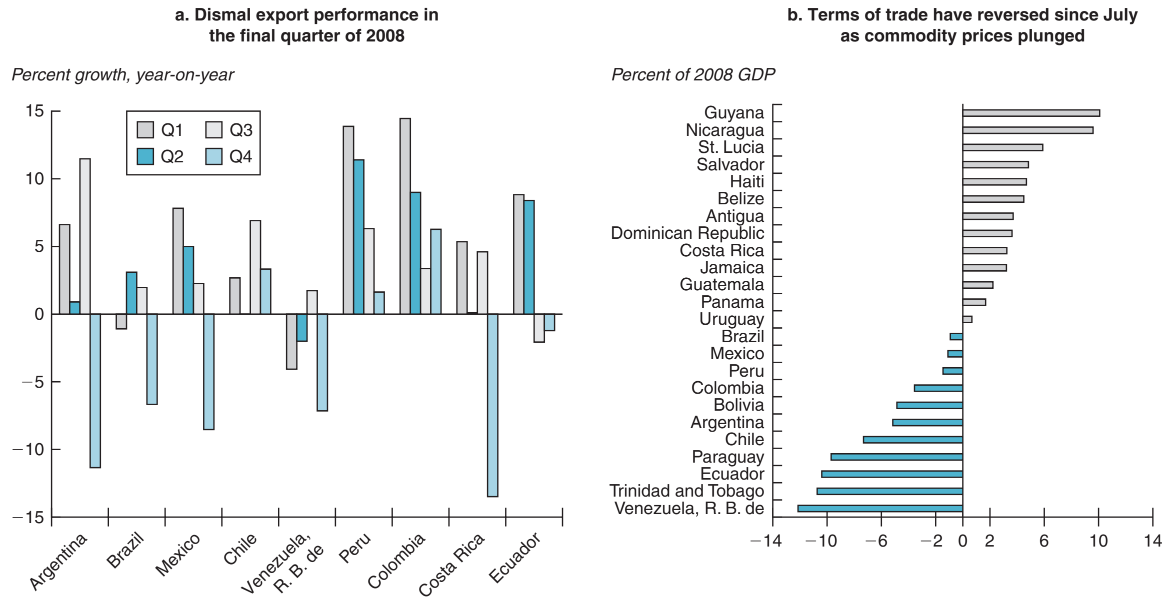
Source: JP Morgan.

The policy response

Several regional governments undertook countercyclical fiscal policies to fight the recession. And some central banks moved quickly to reduce interest rates. For example, from January through May of 2009, central banks in Chile and Brazil cut interest rates by 700 and 350 basis points, respectively. Most countries with high inflation initially took a cautious approach to monetary expansion. Since March, however, deteriorating

Figure A.9 Economic conditions in Latin America and the Caribbean have deteriorated sharply

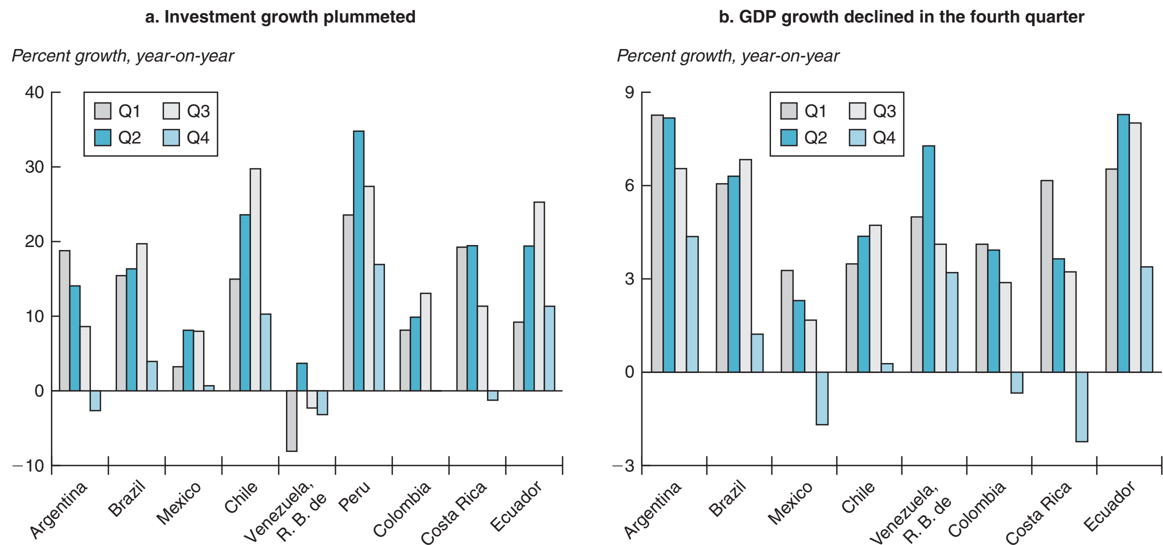
Terms of trade impact from changes in international prices between July 2008 and March 2009



Source: World Bank.

economic conditions have spurred a dramatic shift to aggressive interest rate cuts in Colombia (300 basis points), Mexico (225 basis points), and Peru (225 basis points). Most governments announced increased spending on infrastructure, reduced taxes, increased subsidies, or some combination of these measures. In Colombia the fiscal stimulus for 2009 is estimated at 4.5 percent of GDP; in Peru, about 3 percent; in Mexico, about 1.5 percent; in Argentina, 1.3 percent; and in Brazil, 0.4 percent. Including the recession-induced impact on tax revenues, automatic stabilizers, and other factors, the

Figure A.10 Sharply weaker investment growth has contributed to GDP slowdown



Source: World Bank.

Source: World Bank.

region's fiscal balance is projected to deteriorate by 2.7 percent of GDP in 2009.

Countries with flexible exchange rates, in particular those reliant on commodity exports or tightly integrated with the U.S. economy, absorbed part of the shock through significant exchange rate depreciation. Virtually all countries with some exchange rate flexibility (in the region and elsewhere in the world) experienced a sharp depreciation against the U.S. dollar with investors' flight to safety. However, the extent of the depreciation against other trading partners was more modest. Of the 18 regional countries with current data on effective exchange rates, only three experienced a nominal effective depreciation of more than 10 percent from August 2008 to March 2009. Some countries intervened to stabilize currencies and saw a dwindling of reserves; international reserves excluding gold fell by $12 billion (12.5 percent) in Mexico, $2.9 billion (8.6 percent) in Peru, and $10.4 billion (5 percent) in Brazil between September and December 2008.

Outlook

Regional GDP is projected to fall by 2.2 percent in 2009, with uncertainty regarding the timing and strength of the recovery (table A.8). Weak exports, tight credit conditions and significant excess capacity are expected to cause fixed investment to fall by 10.1 percent. Rising unemployment and difficulty in obtaining consumer finance will continue to take a toll on private consumption, which is forecast to fall by 0.9 percent in 2009. Net exports are anticipated to add 0.8 percentage points to growth, as imports fall by 9.0 percent. The import contraction would be even greater, if changes in reserves or higher official flows were not available to finance deterioration in current-account balances (figure A.11). GDP growth is expected to recover to 2 percent by 2010, or less than 1 percent in per capita terms.

Brazil is more resilient to external demand shocks than many other economies in the region, given the smaller share of trade in its overall GDP,

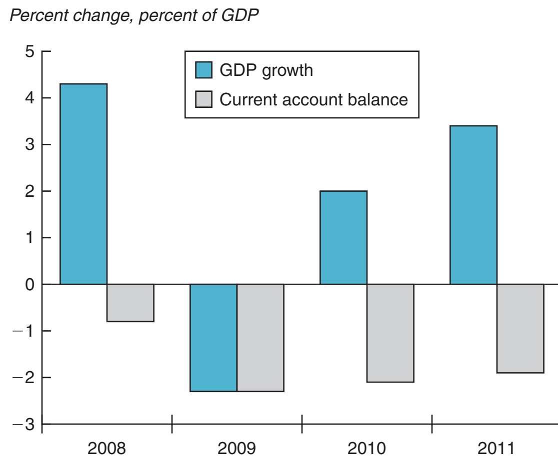
Table A.8 Latin America and the Caribbean forecast summary

annual percent change unless indicated otherwise

					Forecast		
Indicator	1995–2005[a]	2006	2007	2008	2009	2010	2011
GDP at market prices (2000 $)[b]	2.8	5.6	5.8	4.2	−2.2	2.0	3.3
GDP per capita (units in $)	1.3	4.2	4.4	2.9	−3.4	0.7	2.1
PPP GDP[c]	2.8	5.5	5.9	4.4	−2.0	2.0	3.4
Private consumption	3.1	6.4	4.0	4.6	−0.9	2.3	3.5
Public consumption	2.1	4.5	3.5	4.4	3.1	3.3	3.0
Fixed investment	3.5	13.5	21.3	11.6	−10.1	0.8	4.4
Exports, GNFS[d]	6.4	7.3	5.0	1.6	−7.7	2.3	5.1
Imports, GNFS[d]	6.6	14.2	12.2	8.8	−9.0	2.9	5.9
Net exports, contribution to growth	0.1	−1.6	−1.9	−2.0	0.8	−0.3	−0.5
Current account bal/GDP (%)	−1.7	1.6	0.4	−0.7	−2.3	−2.1	−1.9
GDP deflator (median, LCU)	7.1	6.8	4.5	7.9	10.7	6.0	6.1
Fiscal balance/GDP (%)	0.4	1.4	1.2	0.3	−2.4	−1.6	−0.6
Memo items: GDP							
LAC excluding Argentina	2.9	5.1	5.3	3.8	−2.4	2.0	3.6
Central America	3.6	5.0	3.7	1.7	−5.0	1.7	3.1
Caribbean	4.4	8.7	5.9	3.5	−0.1	2.3	4.6
Brazil	2.4	3.7	5.7	5.1	−1.1	2.5	4.1
Mexico	3.6	4.8	3.3	1.4	−5.8	1.7	3.0
Argentina	2.3	8.5	8.7	6.8	−1.5	1.9	2.1

Source: World Bank.
Note:
a. Growth rates over intervals are compound average; growth contributions, ratios and the GDP deflator are averages.
b. GDP measured in constant 2000 U.S. dollars.
c. GDP measured at PPP exchange rates.
d. Exports and imports of goods and non-factor services.

Figure A.11 Output and current account balances will deteriorate in 2009, improving only modestly in 2010



Source: World Bank.

and has somewhat more room for monetary expansionary policies. Output is projected to contract by 1.1 percent in 2009 (after growth of 5.1 percent in 2008) and to bounce back to 2.5 percent in 2010 as external demand recovers and credit growth resumes, and as domestic demand remains resilient.

Declining exports and remittance receipts (the result of close links with the U.S. market) are expected to lower Mexico's GDP by more than 5.5 percent in 2009, after a decline of an estimated 8 percent in the first quarter. The outbreak of influenza A (H1N1), which reduced tourism and led to the closure of nonessential business from March through May 5, is estimated to have reduced annual growth by 0.8 percentage points. In 2010, the projected 1.8 percent recovery in U.S. GDP is expected to facilitate an expansion of 1.7 percent in Mexico.

Sharply weaker domestic demand and falling exports are expected to lower Argentina's GDP by 1.5 percent in 2009. In addition to reduced export volumes (particularly the impact of lower Brazilian demand on the auto sector), lower commodity prices, tight credit conditions, and the worst drought in seven decades will cut into exports. Unsustainable government policies are likely to further undermine investment, already suffering as a result of the global economic and financial crises. The economy is projected to expand 1.9 percent in 2010, boosted by stronger external demand and a return to more normal agricultural output.

In Chile, output is expected to fall by 0.4 percent in 2009, compared with 3.2 percent growth in 2008, as key exports (such as copper) decline sharply and fixed investment falls by 11.7 percent (table A.9). The cancellation of several private projects is expected to depress imports. The economy is projected to expand by 2.7 percent in 2010, boosted by a moderate recovery in external demand and higher commodity prices.

Colombia's economy is likely to contract for the first time since 1999 (by 0.7 percent), as exports and investment plunge, while widening current-account and fiscal deficits limit the space for countercyclical policies. Output growth may recover to 1.8 percent in 2010 with higher external demand.

In other economies, growth in Peru is expected to decelerate to around 3 percent from a very strong 9.8 percent in 2008. The economy of the República Bolivariana de Venezuela has weakened markedly with the decline in oil prices and macroeconomic mismanagement and is the only regional economy expected to continue to contract in 2010.

In Caribbean countries the number of tourists and tourism revenues are expected to be affected, undermining private consumption, and also affecting government revenues substantially. Moreover, tourism-related construction will stall as occupancy rates decline. Output in the Caribbean economies is expected to remain flat in 2009, compared to 3.5 percent growth in 2008, before rising to a below-trend 2.3 percent in 2010.

Countries in Central America will be hit hard, as in many economies, remittances account for a significant share of GDP. Declining remittances will have marked consequences for private consumption and investment, and the group's economy is likely to contract by 5 percent, after a disappointing 1.7 percent advance in 2008, before returning to a similar pace in 2010 (1.7 percent).

Risks and uncertainties

Perhaps the principal danger facing the economies of Latin America and the Caribbean is a deeper and more prolonged recession in advanced economies than presently anticipated. Further reductions in external demand would mean lower export revenues, while further deleveraging in high-income country banks would make it more

Table A.9 Latin America and the Caribbean country forecasts

annual percent change unless indicated otherwise

Country/indicator	1995–2005[a]	2006	2007	2008	Forecast 2009	2010	2011
Argentina							
GDP at market prices (2000 $)[b]	2.3	8.5	8.7	6.8	−1.5	1.9	2.1
Current account bal/GDP (%)	−0.2	3.6	3.0	2.6	1.0	0.9	1.0
Belize							
GDP at market prices (2000 $)[b]	5.6	4.7	1.2	3.0	1.1	2.3	2.9
Current account bal/GDP (%)	−12.1	−2.1	−4.0	−10.7	−6.1	−5.4	−5.2
Bolivia							
GDP at market prices (2000 $)[b]	3.3	4.8	4.6	5.8	1.8	2.6	4.1
Current account bal/GDP (%)	−3.0	11.3	13.3	12.1	−1.4	−0.1	−0.2
Brazil							
GDP at market prices (2000 $)[b]	2.4	3.7	5.7	5.1	−1.1	2.5	4.1
Current account bal/GDP (%)	−2.0	1.3	0.1	−1.8	−1.9	−2.2	−2.4
Chile							
GDP at market prices (2000 $)[b]	4.2	4.3	4.7	3.2	−0.4	2.7	3.6
Current account bal/GDP (%)	−1.5	4.7	4.3	−1.9	−3.2	−2.9	−2.0
Colombia							
GDP at market prices (2000 $)[b]	2.1	6.8	7.5	2.5	−0.7	1.8	4.0
Current account bal/GDP (%)	−2.3	−2.1	−2.8	−2.1	−4.2	−4.3	−3.4
Costa Rica							
GDP at market prices (2000 $)[b]	4.5	8.2	7.8	2.7	−0.6	1.8	3.1
Current account bal/GDP (%)	−4.0	−4.5	−6.3	−8.8	−5.5	−5.1	−5.3
Dominica							
GDP at market prices (2000 $)[b]	3.1	4.0	0.9	3.1	−2.5	1.3	3.3
Current account bal/GDP (%)	−19.8	−17.1	−28.2	−37.3	−25.3	−27.4	−27.1
Dominican Republic							
GDP at market prices (2000 $)[b]	5.6	10.7	8.5	5.0	−0.5	2.3	5.0
Current account bal/GDP (%)	−1.0	−4.1	−5.6	−10.9	−6.0	−5.8	−3.4
Ecuador							
GDP at market prices (2000 $)[b]	3.2	3.9	2.5	6.5	−2.6	1.8	3.1
Current account bal/GDP (%)	−1.4	3.9	2.2	2.4	−3.4	−2.3	−1.3
El Salvador							
GDP at market prices (2000 $)[b]	2.7	4.2	4.7	2.5	−1.0	0.6	2.3
Current account bal/GDP (%)	−2.5	−3.6	−5.5	−7.2	−2.8	−4.0	−5.0
Guatemala							
GDP at market prices (2000 $)[b]	3.5	5.1	6.3	3.8	0.6	2.2	4.0
Current account bal/GDP (%)	−4.9	−4.9	−5.4	−4.8	−4.4	−4.5	−3.1
Guyana							
GDP at market prices (2000 $)[b]	1.7	5.1	5.4	4.2	1.8	3.2	4.7
Current account bal/GDP (%)	−9.4	−17.9	−18.5	−20.3	−18.4	−16.7	−16.4
Honduras							
GDP at market prices (2000 $)[b]	3.8	6.4	6.3	4.0	0.8	2.1	3.5
Current account bal/GDP (%)	−6.6	−4.7	−11.6	−14.1	−8.2	−8.6	−7.2
Haiti							
GDP at market prices (2000 $)[b]	0.9	2.3	3.2	1.4	−0.2	1.6	2.8
Current account bal/GDP (%)	−3.7	−9.0	−7.9	−9.6	−7.9	−7.6	−7.8
Jamaica							
GDP at market prices (2000 $)[b]	0.8	2.7	1.4	−1.4	−2.6	0.4	2.3
Current account bal/GDP (%)	−6.2	−10.8	−14.9	−15.6	−12.7	−11.0	−8.4
Mexico							
GDP at market prices (2000 $)[b]	3.6	4.8	3.3	1.4	−5.8	1.7	3.0
Current account bal/GDP (%)	−1.9	−0.3	−0.8	−1.6	−2.7	−2.6	−2.3
Nicaragua							
GDP at market prices (2000 $)[b]	4.1	3.7	3.2	2.8	−0.3	1.3	2.1
Current account bal/GDP (%)	−20.2	−12.8	−19.0	−22.7	−15.2	−11.8	−9.9
Panama							
GDP at market prices (2000 $)[b]	4.5	8.5	11.5	9.2	1.3	2.8	5.2
Current account bal/GDP (%)	−5.3	−3.1	−7.3	−12.1	−10.2	−11.1	−11.3

Table A.9 (*Continued*)

Country/indicator	1995–2005[a]	2006	2007	2008	Forecast 2009	2010	2011
Peru							
GDP at market prices (2000 $)[b]	3.3	7.6	9.0	9.8	3.0	4.3	6.0
Current account bal/GDP (%)	−3.3	2.9	1.3	−3.3	−3.6	−3.3	−2.9
Paraguay							
GDP at market prices (2000 $)[b]	1.2	4.3	6.8	5.8	−0.9	1.8	3.0
Current account bal/GDP (%)	−1.5	2.8	0.7	−1.4	−2.0	−1.7	−0.7
St. Lucia							
GDP at market prices (2000 $)[b]	2.6	5.0	3.2	2.4	−1.4	1.7	3.0
Current account bal/GDP (%)	−13.8	−32.7	−31.4	−32.0	−26.1	−26.4	−25.8
St. Vincent and the Grenadines							
GDP at market prices (2000 $)[b]	4.2	6.9	6.7	2.3	−1.0	2.1	2.8
Current account bal/GDP (%)	−18.3	−24.3	−26.4	−27.9	−23.4	−23.0	−23.3
Uruguay							
GDP at market prices (2000 $)[b]	1.5	7.0	7.6	8.9	0.8	2.3	3.4
Current account bal/GDP (%)	−1.0	−1.9	−0.8	−3.8	−1.8	−2.2	−2.4
Venezuela, RB							
GDP at market prices (2000 $)[b]	1.6	10.3	8.4	4.8	−2.2	−1.4	1.2
Current account bal/GDP (%)	7.5	14.7	8.8	12.0	−0.8	1.2	1.2

Source: World Bank.
Note:
In the current very volatile global environment, World Bank forecasts are frequently updated based on new information and changing assumptions. Moreover, the confidence intervals around these point forecasts are larger than usual. As a result, the projections presented here may differ from those contained in other Bank documents, even if basic assessments of countries' prospects do not significantly differ at any given moment in time.
Barbados, Cuba, Grenada, and Suriname are not forecast owing to data limitations.
a. Growth rates over intervals are compound average; growth contributions, ratios and the GDP deflator are averages.
b. GDP measured in constant 2000 U.S. dollars.

difficult for countries to roll over short-term debt (the region's external financing needs are estimated at $268 billion in 2009). Several countries would be faced with the choice between even greater contractions in domestic demand to reduce imports to financeable levels or defaulting on external debt service obligations, with potentially severe implications for future access to finance.

Even with the anticipated recovery in advanced economies, foreign banks are expected to remain risk averse and reluctant to lend for a sustained period of time, while bond issuances to finance fiscal deficits in high-income countries could crowd out borrowing by both governments and the private sector in developing countries. The extent of the decline in foreign investors' appetite for claims on regional economies and the size of high-income government borrowing are particularly difficult to anticipate.

The risk of protectionism has also increased. As unemployment rises, governments are more likely to adopt politically motivated protectionist measures that will attract retaliatory measures, potentially igniting a trade war. Already, domestic purchase provisions of some stimulus packages and other measures indicate the growing risk of competitive trade restrictions.

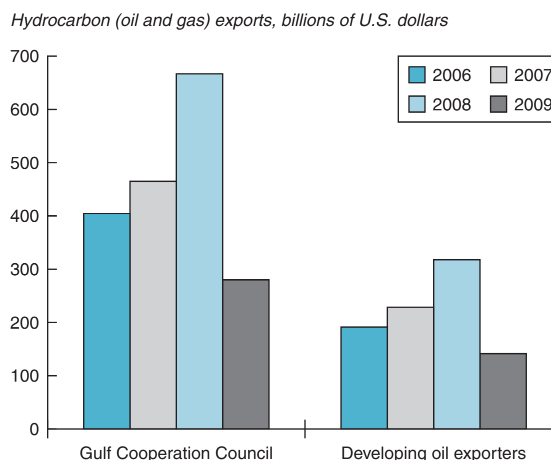
The risk of an A(H1N1) flu pandemic remains. Fortunately this flu, which has already had a sharp negative output in Mexico, is less virulent than initially feared. Moreover, its rate of spread has diminished as both Northern and Southern hemispheres have exited their respective flu seasons. Nevertheless, when flu season returns H1N1 is likely to re-emerge. Should it do so in a more deadly form, the costs associated with mortality, illness, and absenteeism, and efforts to avoid infection could shave off more than 1 percent of GDP in countries affected. In the event of a pandemic, economies that rely heavily on tourism, would be severely affected.

Finally, the steps taken to contain the crisis raise the risk of macroeconomic instability in the longer term. Public debt has increased sharply, a result of fiscal stimulus packages and declines in

government revenues from plummeting commodity prices and lower domestic activity. Substantial monetary easing also raises the risk of building up inflationary pressures in the future if central banks fail to appropriately retract monetary stimulus as the output gap narrows. Borrowing costs for Argentina, Ecuador, and the República Bolivariana de Venezuela have already increased sharply due to concerns over potential debt service interruptions.

Figure A.12 Middle East and North Africa oil revenues hit hard by global recession in 2009

Hydrocarbon (oil and gas) exports, billions of U.S. dollars



Source: IEA; OPEC; national agencies; World Bank.

The Middle East and North Africa

Recent Developments

GDP among the developing countries of the Middle East and North Africa region registered a strong 6 percent gain during 2008, on the back of surging oil revenues during the year's first half, continued robust non-oil export performance for the diversified economies, and favorable flows of remittances, tourism receipts and foreign direct investment (FDI).[9] These conditions were not to persist however, and the onset of the financial crisis in the United States during September 2008 began to exact a toll on regional growth into year-end 2008 and 2009. GDP is anticipated to almost halve to 3.1 percent during 2009 as the real-side effects of the crisis take firmer hold, and a return to average growth for the region (near 4.5 percent) is not expected before 2011. In the interim, those elements which supported growth over the last five years are anticipated to unwind: oil prices are projected to rise only modestly, averaging $66 in 2011; the European export market will remain flaccid; and slowing of services receipts and remittances will exact a toll on growth for both developing oil exporters and the more diversified economies of the region.

Initially, the developing countries of the Middle East and North Africa region were less directly affected by the financial crisis than those of many other developing regions. The biggest direct effect from the crisis was the acceleration in the decline of oil prices. That decline of about 65 percent from near $150/bbl to near $60/bbl at present has radically reduced government revenues among developing-country oil exporters, and especially for the high-income Gulf Cooperation Council (GCC) exporters. These economies include Bahrain, Kuwait, Oman, Qatar, Saudi Arabia and the United Arab Emirates (figure A.12). Over recent years, these countries have become a key source of investment financing (through FDI and other flows) as well as remittances for the diversified developing economies of the region. The dampening of these income and investment flows is an important element contributing to the slowdown in regional growth.

For the GCC in aggregate, oil and gas revenues dropped from $670 billion in 2008 to an estimated $280 billion during 2009—a massive decline equivalent to 38 percent of the group's GDP. Revenues for the developing oil exporters of the region, including Algeria, the Islamic Republic of Iran, Iraq, the Syrian Arab Republic, and the Republic of Yemen declined from $320 billion to an estimated $140 billion, equivalent to 28 percent of GDP. Such severe revenue declines, against continuation of expenditures at a fairly rapid pace, has caused fiscal balances in a number of oil exporters to go into deficit. As a result, the public sector's capacity to mitigate some of the adverse consequences of the crisis through targeted stimulus packages, and other measures, has been reduced.

The financial elements of the global crisis have already taken a toll on the region, particularly through equity markets—affecting the cost of capital for firms and inducing a large-scale loss of wealth for households and institutions. Some estimates suggest that GCC sovereign wealth funds

lost 27 percent of their value in the 12 months ending December 2008, with losses as high as 40 percent among those funds heavily allocated to emerging markets and private equity placements.[10]

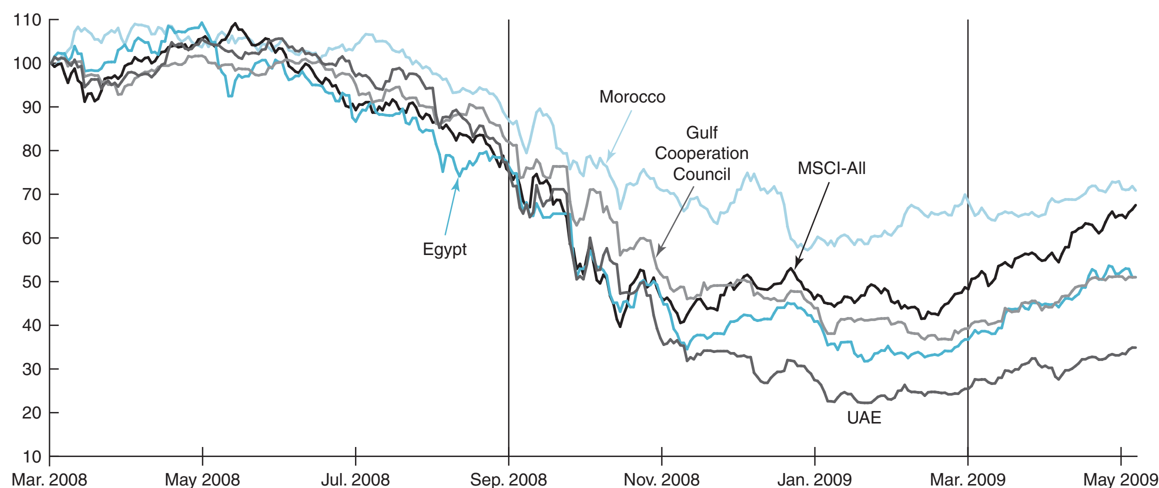
GCC equity prices in dollar terms dropped by some 58 percent between September 15, 2008 and March 12, 2009 (a period during which virtually all bourses registered sharp declines). Over the same period, equity prices in UAE plummeted by 70 percent, contrasted with a decline of 55 percent for all emerging markets (figure A.13). Since mid-March 2009, a global stock market rally has set in, grounded in improved expectations for the health of the international banking system (in the wake of the G-20 London Summit and following measures undertaken by the U.S. Treasury). Middle East and North African equities have participated in the upturn, with the GCC index gaining 37 percent through end-May, contrasted with a 52 percent increase in the MSCI-all market index over the period. The moderate gains for regional bourses are nonetheless indicative of improving confidence in the potential for the global economy to recover sooner rather than later.

The banking sector in the region has weathered the crisis relatively well, in part because of limited direct exposure to subprime mortgages and related asset-backed securities. However, a Kuwaiti bank suffered significant losses in late 2008 from trading in currency derivatives. In response, many banks across the region tightened lending standards, and, in some countries, reduced lending directly. The impact of the crisis on investment firms in the region is less clear, mainly because of data unavailability. However, anecdotal evidence suggests that some firms may have run into financial difficulties due to maturity mismatches on their balance sheets. As elsewhere, access to external financing has become more difficult and borrowing spreads increased for countries in the region following the eruption of the crisis. Most countries did not need to borrow during the latter part of 2008 because they had generally favorable balance of payments positions and access to alternative sources of financing, such as remittances, FDI, tourism receipts, foreign aid, and international reserves.

Table A.10 highlights the general financial health of the developing region over the period since 2005, when higher oil prices, generally favorable terms of trade and export market growth began to move current account surplus positions into double-digit shares of regional GDP. Net additions to reserves accumulated to more-than $140 billion over the period, as aggregate current account surplus positions were complemented by increasing inflows of FDI, which rose from $7 billion during 2004 to $25 billion in 2006

Figure A.13 Middle East and North Africa bourses hit hard at the worst of financial crisis

Equity indexes, March 2008 = 100 (U.S. dollar terms)



Source: Morgan-Stanley.

Table A.10 Net capital flows to the Middle East and North Africa
$ billions

Indicator	2002	2003	2004	2005	2006	2007	2008p
Current account balance	6.1	22.4	38.3	59.9	93.1	80.7	97.6
as % of GDP	*1.6*	*5.3*	*7.9*	*10.9*	*16.3*	*13.0*	*13.0*
Net private and official inflows	7.7	9.8	12.1	15.8	13.4	21.6	23.3
Net private inflows	9.8	11.9	15.8	19.1	24.7	21.0	23.3
Net equity inflows	4.2	7.8	7.6	16.5	26.0	22.1	24.5
Net FDI inflows	4.7	7.6	6.9	14.1	25.0	24.2	22.5
Net portfolio equity inflows	−0.5	0.2	0.7	2.4	1.0	−2.1	2.0
Net debt flows	3.5	2.0	4.5	−0.7	−12.6	−0.5	−1.2
Official creditors	−2.1	−2.1	−3.7	−3.3	−11.3	0.6	0.0
World Bank	−0.2	−0.3	−0.6	0.0	−0.8	1.0	−0.2
IMF	−0.3	−0.6	−0.5	−0.7	−0.2	−0.1	−0.1
Other official	−1.6	−1.2	−2.6	−2.6	−10.3	−0.3	0.3
Private creditors	5.6	4.1	8.2	2.6	−1.3	−1.1	−1.2
Net M-L term debt flows	5.4	0.8	2.6	2.8	−1.6	−1.8	−0.8
Bonds	5.2	0.7	2.8	2.5	0.8	0.1	−0.6
Banks	0.3	−0.5	−0.2	1.1	−1.3	−0.5	1.4
Other private	−0.1	0.6	0.0	−0.8	−1.1	−1.4	−1.6
Net short-term debt flows	0.2	3.3	5.6	−0.2	0.3	0.7	−0.4
Balancing item[a]	−2.5	−10.4	−36.1	−55.3	−70.2	−58.7	−78.3
Change in reserves (− = increase)	−11.3	−21.7	−14.2	−20.3	−36.3	−43.6	−42.6
Workers' remittances	15.2	20.4	23.0	24.3	25.7	31.3	33.7

Source: World Bank.
Note:
p = projected.
a. Combination of errors and omissions and net acquisition of foreign assets (including FDI) by developing countries.

(or 4.5 percent of GDP). FDI was increasingly sourced from the GCC countries and targeted at a wide range of infrastructure, real-estate and industrial projects across the region, from Morocco to Jordan. As global financial conditions began to deteriorate during 2008, FDI flows receded to a still-high $22.5 billion. However, worker remittances (bottom panel of table A.10) continued to increase, helping to support reserve accumulation at a substantial $43 billion pace in the year.

The collapse in global industrial activity as well as investment and consumer outlays during the fourth quarter of 2008 and first quarter of 2009 cut sharply into demand for oil. World crude oil demand fell a hefty 3.7 percent between the final quarter of 2008 and the first of 2009, standing more than 3 million barrels per day (mb/d) lower than a year earlier. For 2009 as a whole, oil demand is anticipated to decline by 2.16 mb/d with continuing large falloffs in high-income countries and only moderate gains across developing countries. Oil producers in the Middle East and North Africa region have responded quickly by reducing supply in an effort to support prices at a tenable "floor level."

Output among the GCC exporters has been trimmed by some 10.6 percent (year-over-year) over the course of the last months of 2008 through May 2009, led by large cutbacks in Kuwait (14 percent) and Saudi Arabia (12.7 percent). Production has been reined in by the developing exporters of the region, with Algerian output declining 11 percent and that of the Islamic Republic of Iran by 7 percent. This development alone will reduce growth in the oil economies of these countries by substantial margins in 2009, carrying overall GDP growth lower by an average of some 5 percentage points compared with 2008. Both Saudi Arabia and Kuwait are projected to slip into recession during 2009, with growth for all exporters falling from 6.2 percent in 2008 to 2 percent in 2009. Spillovers from this development to the diversified group of economies are anticipated to be widespread and adverse, running the scope from reduced FDI inflows to lower remittances and reduced tourism from the Gulf to other countries in the region (earlier a quickly increasing trend).

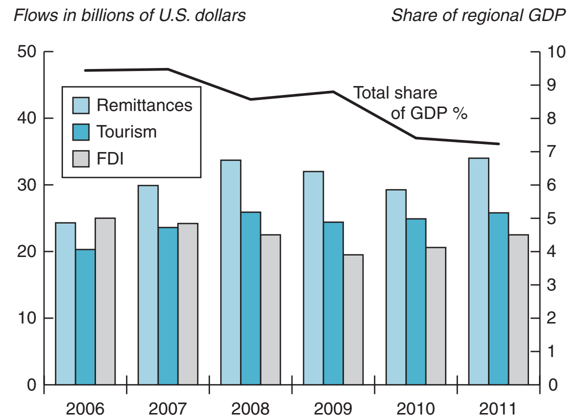
For the more diversified economies, export volumes and values have declined by as much as

35 percent in nominal terms since September 2008. A key determinant for this development is the collapse of import demand in the Euro Area (as well as the United States). For example French import volume declined 19 percent during the first quarter of 2009 on the heels of a 12 percent contraction in the previous quarter (saar). Exports from Morocco dropped 45 percent from September 2008 through February 2009, from Tunisia 31 percent, and from Jordan 18.4 percent. However, industrial production has held up better than in most other developing regions, with output over the same period down by some 5 percent in most countries in the Middle East and North Africa compared with 15 or more percent for the world as a whole. For example, Egyptian production stood 30 percent above year –earlier levels in November 2008 while in Jordan it was 26 percent higher in January 2009 than a year before. As more recent data become available, they will undoubtedly show substantial deterioration for countries with important trade links to Europe.

Countries such as Egypt, Morocco, Tunisia, Jordan and Lebanon derive both balance of payments support and needed domestic income through exports of services, notably tourism and business services, remittance receipts from workers abroad (largely from Europe and the GCC countries), and more recently, strong FDI flows, which have helped to underpin and catalyze domestic private and public capital expenditures. Such flows amount to substantial proportions of GDP for these countries. In Egypt, for example, total flows represented 18.7 percent of GDP in 2007, of which remittances 5.7 percent, tourism 5.5 percent, and FDI 7.6 percent. Given the current global and regional economic environment, these income and investment flows are slated to decline both in absolute terms and as a share of GDP, with negative consequences for current-account deficits and domestic demand (figure A.14).

A large number of countries within the region suffered heavily from the food and fuel crisis which preceded the onset of the global financial crisis. The Middle East and North Africa is the world's largest net food importing region. As food, notably grains prices escalated at a record pace over 2006 to mid-2008, and oil prices moved up, while terms of trade for countries oil-importing

Figure A.14 Remittances, FDI and tourism revenues decline as a share of GDP



Sources: World Bank; United Nations; IMF.

countries in the region such as Morocco, Tunisia, Lebanon, Jordan and Egypt plummeted. Inflation moved into double digits in several countries linked to the food and fuel price increases, and authorities undertook measures to offset the more adverse effects on the poor, including increased subsidies, measures to boost incomes through higher civil service wages, and finally a move-up in interest rates in a number of countries to counter the inflationary impulse. One brighter aspect of the current conjuncture is that inflation rates across the region are easing, as the gains in both food and fuel prices unwind, serving to boost the purchasing power of consumers. For example, Tunisian CPI inflation softened to 3.1 percent in February 2009 (year-on-year) from 4.9 percent during 2008, Jordan's to 1.5 percent from 14.9 percent, while Saudi Arabian inflation has dropped to 6 percent from 10 percent in 2008.

Outlook

GDP growth for the developing countries in the region is projected to halve from 6 percent in 2008 to 3.1 percent in 2009 (table A.11). For the broadly geographic region, including the GCC countries, the slowdown is expected to be still more pronounced, shifting from growth of 5.6 percent in 2008 to gains of just 1.6 percent in 2009, largely reflecting the sharp decline in oil output (see Memo items to table A.11).

Table A.11 Middle East and North Africa forecast summary

annual percent change unless indicated otherwise

Indicator	1995–2005[a]	2006	2007	2008	Forecast 2009	2010	2011
GDP at market prices (2000 $)[b]	4.4	5.3	5.4	6.0	3.1	3.8	4.6
GDP per capita (units in $)	2.7	3.5	3.6	4.2	1.3	2.1	2.9
PPP GDP[c]	4.5	5.3	5.5	6.1	3.0	3.6	4.4
Private consumption	4.1	5.8	6.1	7.2	2.8	4.0	4.9
Public consumption	3.4	4.2	3.1	6.6	8.6	7.6	6.8
Fixed investment	6.3	1.2	23.3	19.7	3.8	6.0	7.5
Exports, GNFS[d]	5.1	7.3	8.2	7.6	−2.0	2.9	5.1
Imports, GNFS[d]	5.8	7.8	19.5	18.2	0.6	5.4	7.1
Net exports, contribution to growth	−0.4	−0.5	−4.2	−4.7	−0.9	−1.5	−1.6
Current account bal/GDP (%)	2.9	16.3	13.0	13.0	−1.6	−1.5	−1.8
GDP deflator (median, LCU)	5.2	3.8	4.4	16.9	4.8	9.8	7.6
Fiscal balance/GDP (%)	5.0	−2.7	−0.5	−1.5	−5.4	−3.6	−3.5
Memo items: GDP							
MENA Geographic Region[e]	4.1	4.8	4.9	5.6	1.6	3.5	4.4
Selected GCC Countries[f]	3.6	4.0	4.0	4.9	-0.5	3.0	4.3
Egypt	4.4	6.8	7.1	7.2	3.8	4.2	5.0
Iran	4.8	5.7	6.2	6.9	2.5	3.0	4.0
Algeria	4.0	1.8	3.0	3.0	2.2	3.5	4.0

Source: World Bank.
Note:
a. Growth rates over intervals are compound average; growth contributions, ratios and the GDP deflator are averages.
b. GDP measured in constant 2000 U.S. dollars.
c. GDP measured at PPP exchange rates.
d. Exports and imports of goods and non-factor services.
e. Geographic region includes high-income countries: Bahrain, Kuwait, Oman and Saudi Arabia.
f. Selected GCC Countries: Bahrain, Kuwait, Oman and Saudi Arabia.

Across countries in the region, the extent of the slowdown is expected to vary depending on trade links to Europe (falling export market growth), reliance on oil revenues, and initial fiscal and external account positions. Oil exporters with large populations (Algeria, the Islamic Republic of Iran, and the Syrian Arab Republic) are much more fiscally constrained than oil exporters with smaller populations; as a result these countries entered the crisis with significantly weaker fiscal and external positions. Governments, like Algeria, with sufficient international reserves or large sovereign wealth funds are using fiscal policy to cushion the downturn, while others with limited resources (such as the Islamic Republic of Iran) have responded to the crisis and declining revenues by reducing government spending pro-cyclically. Growth in these countries is projected to decline, with total output growth decelerating in Algeria from 3 percent in 2008 to 2.2 percent in 2009, and from 6.9 percent to 2.5 percent in the Islamic Republic of Iran.

The projected weak recovery in global demand for oil is expected to restrain the recovery in these countries, with growth increasing only gradually to 3.0–3.5 percent in 2010 and to 4 percent by 2011. Because of the sharp falloff in oil prices, current account balances are projected to deteriorate sharply among developing oil exporters from 23.8 percent of GDP in 2008 to 3.5 percent by 2011.

Prospects for several of the more diversified economies of the region, including Jordan and Lebanon, are dependent on remittances, FDI flows, tourism, and foreign aid, and therefore their prospects will depend on those of the Gulf States and to a lesser extent those of the international donor community. Growth in this group of countries is projected to decline from a relatively robust 5.6 percent in 2008 to 3.9 percent in 2009 (table A.12). Within this group, Lebanon and Jordan entered the crisis with weak macroeconomic positions—high debt, and current account and fiscal deficits. GDP growth in both countries is projected to slow by more than 3 percentage points in 2009. Reduced remittances, FDI, and tourism are expected to weigh heavily on external balances in both countries, especially given

Table A.12 Middle East and North Africa country forecasts
annual percent change unless indicated otherwise

Country/indicator	1995–2005[a]	2006	2007	2008	Forecast 2009	2010	2011
Algeria							
GDP at market prices (2000 $)[b]	4.0	1.8	3.0	3.0	2.2	3.5	4.0
Current account bal/GDP (%)	8.2	49.0	35.8	37.3	4.1	−0.9	−4.6
Egypt, Arab Rep.							
GDP at market prices (2000 $)[b]	4.4	6.8	7.1	7.2	3.8	4.2	5.0
Current account bal/GDP (%)	0.4	2.4	0.3	−6.5	−6.1	−5.8	−5.3
Iran, Islamic Rep.							
GDP at market prices (2000 $)[b]	4.8	5.7	6.2	6.9	2.5	3.0	4.0
Current account bal/GDP (%)	7.2	28.6	28.9	37.4	5.9	7.4	7.2
Jordan							
GDP at market prices (2000 $)[b]	4.7	6.3	6.6	5.5	2.5	3.5	4.5
Current account bal/GDP (%)	0.0	−11.3	−17.0	−27.5	−10.1	−10.3	−10.4
Lebanon							
GDP at market prices (2000 $)[b]	3.3	−0.6	7.5	6.5	2.5	4.5	5.0
Current account bal/GDP (%)	−19.5	−5.4	−8.0	−14.7	−6.1	−5.4	−4.8
Morocco							
GDP at market prices (2000 $)[b]	4.4	8.0	2.2	6.4	3.2	4.5	5.5
Current account bal/GDP (%)	0.7	2.0	−0.3	−6.1	−2.4	−2.7	−2.5
Syrian Arab Republic							
GDP at market prices (2000 $)[b]	3.2	5.1	4.2	5.2	3.0	3.5	4.5
Current account bal/GDP (%)	3.0	2.5	2.1	0.9	−7.7	−6.9	−6.7
Tunisia							
GDP at market prices (2000 $)[b]	5.0	5.5	6.3	4.5	3.0	4.0	5.0
Current account bal/GDP (%)	−3.0	−2.0	−2.6	−5.4	−4.7	−3.3	−1.6
Yemen, Rep.							
GDP at market prices (2000 $)[b]	4.9	3.2	3.0	4.0	7.7	5.0	4.0
Current account bal/GDP (%)	3.1	1.2	−8.0	−6.5	−9.2	−3.4	−1.0

Source: World Bank.
Note:
In the current very volatile global environment, World Bank forecasts are frequently updated based on new information and changing assumptions. Moreover, the confidence intervals around these point forecasts are larger than usual. As a result, the projections presented here may differ from those contained in other Bank documents, even if basic assessments of countries' prospects do not significantly differ at any given moment in time.
Djibouti, Iraq, Libya, and West Bank and Gaza are not forecast owing to data limitations.
a. Growth rates over intervals are compound average; growth contributions, ratios and the GDP deflator are averages.
b. GDP measured in constant 2000 U.S. dollars.

expected reductions in capital flows. Current accounts in the two countries in 2008 represented 15 and 27 percent of GDP, respectively. Lower oil prices and a forced reduction in imports caused by the lack of available external financing are expected to bring those deficits down by more than 10 percent in each country in 2009.

The Republic of Yemen is projected to buck the global trend for slower growth in 2009 with the coming on-stream of new liquid natural gas (LNG) plants. In Djibouti, the operation of a new port facility by Dubai World and spending by foreign military bases is projected to provide a cushion and prevent a sharp decline in GDP growth. The diversified countries of North Africa (Egypt, Morocco, and Tunisia) entered the crisis with relatively good macroeconomic positions and have experienced limited fallout in their own financial systems. However, the real-side of the crisis has been keenly felt, because of their close trade and financial ties to high-income Europe and their reliance on European tourism and remittance flows. In Egypt, fourth-quarter GDP expanded by only 4.1 percent in 2008 compared with 7.7 percent a year earlier; monthly job creation fell by 30 percent and foreign investment flows by 48 percent. Reflecting the continuation of these trends into the rest of the year, GDP is projected to slow by 3 percentage points or more in Egypt and Morocco, with the former's GDP

growth easing to 3.8 percent from 7.2 percent in 2008, and Moroccan output down from 6.4 percent to 3.2 percent in 2009.

Prospects for recovery in the developing countries in the Middle East and North Africa will depend importantly on the strength of the eventual revival of growth in Europe and in the GCC countries. Continued weakness in the price of oil, the persistent drag of global finance, weak remittance flows, and strong negative wealth effects from falling real-estate and equity prices in the region are all projected to restrain recovery. GDP is expected to increase by 3.8 percent in 2010 and 4.6 percent by 2011, but because of the amplitude of the slowdown already experienced, unemployment and spare capacity, especially in the oil sector, will continue to be issues even at the end of the forecast period. This general pattern is expected to be mirrored in both the resource-rich and resource-poor countries of the region, with the recovery still more muted among the oil exporters.

Risks and uncertainties

In many respects, the risks going forward for countries in the region are the same as for the global economy. On the downside is the worrying risk that instead of a slow recovery, as projected in the baseline, the recession lasts significantly longer and is associated with secondary crises in countries with large current account deficits (see chapter 1). Although many countries in the Middle East and North Africa region would be affected negatively by a further drying up of foreign capital flows, weaker exports, and remittances, Jordan and Lebanon—two countries with large current-account deficits—face the largest risk of a balance-of-payments crisis in a protracted recession scenario. Should a lack of access to foreign exchange form a binding constraint and official assistance and remittance flows are unable to fill the gap, the countries could be forced into a very painful restructuring process accompanied by large currency depreciation and a reduction in domestic demand in order to restore external balance. Inevitably, this would lead to much higher unemployment and increased social tensions. Other countries in the region would be less dramatically affected by a prolonged recession scenario. Weaker trade flows, lower remittances, and tourism receipts would likely extend the growth recession further in the region and result in an even larger buildup in spare capacity.

The outlook for global energy demand and world oil prices is another key risk for the region. In the baseline, energy demand is projected to remain low and oil prices are unlikely to increase much beyond current levels. With recent OPEC production cuts and with Saudi Arabia's increase in its production capacity to 12.5 million barrels a day (thanks to recent investment), there is sufficient slack to absorb any decline in supply that might be caused by unanticipated supply disruptions in other markets.

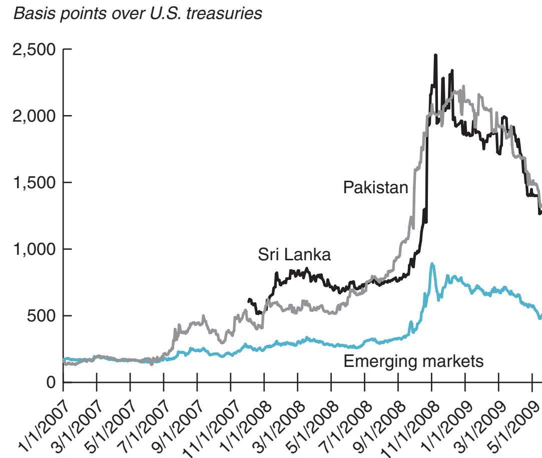
South Asia

Recent developments

Amid the onset of the global crisis in September 2008, GDP growth in South Asia registered a relatively resilient 7.1 percent in 2008, albeit down significantly from the robust 8.7 percent outturn of 2007, on a calendar-year basis. This 1.6 percentage point falloff in growth compares favorably with the 3.4 and 2.9 percentage point declines in the East Asia and Pacific and Europe and Central Asia regions. South Asia's economies have been cushioned somewhat from the real-side effects of the crisis because exports represent a relatively small share of the region's GDP and because their financial market integration is limited. Production is less specialized in manufacturing or natural resources—sectors that have been hit particularly hard by the crisis. Real incomes and consumer demand in the region have been bolstered by the collapse in global commodity prices, notably that of oil. However, employment of migrant workers and remittances inflows to the region are facing strong headwinds in the wake of the fall-off in activity in high-income host countries. A number of economies have been forced to undertake sharp adjustment measures to address macroeconomic imbalances, which has led to a slowdown in domestic demand. Pakistan faced a balance-of-payments crisis in the second half of 2008, eventually reaching an agreement with the IMF toward the end of the year. Sri Lanka—currently in discussion with the IMF on a stand-by facility (as of end-May)—and the Maldives are also struggling with large imbalances, especially so in the Maldives where the current account deficit surged to 53 percent of GDP and the fiscal deficit increased to 14 percent of GDP.

The immediate impact of the crisis on the South Asian economy was most apparent in financial markets, although the banking sector was relatively unscathed—given the region's minimal exposure to toxic assets and the limited presence of foreign commercial and investment banks. Stock markets were buffeted largely in line with global equities, especially through the end of 2008. Since that time, equity markets in the region have stabilized, with some bourses posting gains as of the end of May 2009. Stock markets in India, for example, advanced in April and May, with a surge following recent elections that boosted market sentiment and underpinned expectations of an accelerated reform program and greater openness to foreign investors. Markets in Bangladesh witnessed less extreme volatility than other regional stock markets, as its equity market is not highly capitalized, trading is thin, and foreign participation is low (2.5 percent of total assets are held by foreign investors). Regional bond markets also suffered from the sharp deterioration in investor sentiment and widespread deleveraging by commercial banks in developed countries, which resulted in a withdrawal of investment funds from emerging markets in the fall of 2008. Bond spreads surged for sovereigns in the region, and spreads for emerging market corporate borrowers effectively barred them from the market—notably for Pakistan and Sri Lanka. As global markets have begun to thaw, and after Pakistan and Sri Lanka began to work with the IMF on stabilization packages, spreads have narrowed significantly. As of late May 2009, spreads had declined to 1,298 basis points in Pakistan and 957 points in Sri Lanka from 2,221 and 2,455 in December and October of 2008, respectively. Nonetheless, spreads remain substantially above the emerging market average of 473 basis points (figure A.15).

Figure A.15 JP Morgan Emerging Market Bond Index (EMBI), stripped spreads



Source: JP Morgan.

Gross capital inflows—international syndicated bank lending, equity placements, and bond issuance—to South Asia had surged in recent years, but collapsed in the aftermath of the crisis. Flows to South Asia fell by 29 percent in 2008, among the sharpest declines posted among developing regions. In the first quarter of 2009, inflows to Bangladesh, Pakistan, and Sri Lanka fell to zero, while in India they were extremely subdued, down 64 percent relative to inflows recorded during the first quarter of 2008. In India, gross inflows were primarily composed of bank loans, with a trickling of equity inflows for the first quarter of 2009. Gross financial flows posted a recovery in India during April and May, as international investor confidence improved on early indications of a recovery for global growth and on expectations that the country is well-placed to benefit from an eventual turnaround. Markets have also reacted positively to the decisive election outcomes.

Capital inflows, including recent record-high FDI inflows, had become a significant source of finance for the rapid rise in regional investment (particularly for corporate capital expenditures in India) and a key driver of regional GDP growth over recent years (table A.13). As a consequence, their reversal has contributed to a sharp falloff in regional investment growth. For example, in Pakistan, FDI represented 13.4 percent of gross domestic investment in 2007 but has since declined by more than half, sapping badly needed capital for investment programs. In India, FDI inflows fell from 4.6 percent of gross domestic investment in the third quarter of 2008 to only 0.7 percent during the fourth quarter of the year. In contrast, in Bangladesh, FDI has been relatively resilient. Despite the crisis, inflows between July 2008 and February 2009 were twice as high as in the previous year and are projected to reach 1.4 percent of GDP in the current fiscal year.

On a net basis, total private and official capital flows to the region contracted by one-third

Table A.13 Net capital flows to South Asia

$ billions

Indicator	2002	2003	2004	2005	2006	2007	2008p
Current account balance	11.4	12.5	−1.0	−12.4	−16.6	−20.5	−59.1
as % of GDP	*1.8*	*1.6*	*−0.1*	*−1.2*	*−1.5*	*−1.5*	*−3.9*
Net private and official inflows	7.4	13.8	25.4	28.6	76.6	116.5	77.0
Net private inflows	9.7	15.5	24.3	25.4	71.9	112.5	66.5
Net equity inflows	7.7	13.4	16.8	22.7	33.6	66.0	65.5
Net FDI inflows	6.7	5.4	7.8	10.3	23.2	29.9	47.5
Net portfolio equity inflows	1.0	8.0	9.0	12.4	10.4	36.1	18.0
Net debt flows	−0.3	0.4	8.6	5.9	43.0	50.5	11.5
Official creditors	−2.3	−1.7	1.1	3.2	4.7	4.0	10.5
World Bank	−1.0	−0.1	2.1	2.3	1.9	1.9	1.4
IMF	0.1	−0.1	−0.3	0.0	−0.1	−0.1	3.2
Other official	−1.4	−1.5	−0.7	0.9	2.9	2.2	5.9
Private creditors	2.0	2.1	7.5	2.7	38.3	46.5	1.0
Net M-L term debt flows	0.2	1.4	4.9	1.1	20.3	27.2	1.8
Bonds	−0.7	−3.1	4.1	−2.9	4.3	9.5	1.5
Banks	1.0	4.5	1.1	4.1	16.0	17.7	5.9
Other private	−0.1	0.0	−0.3	−0.1	0.0	0.0	−5.6
Net short-term debt flows	1.8	0.7	2.6	1.6	18.0	19.3	−0.8
Balancing item[a]	8.2	9.6	3.0	−10.4	−19.8	5.0	−44.8
Change in reserves (− = increase)	−27.0	−35.9	−27.3	−5.8	−40.2	−101.0	27.0
Workers' remittances	24.1	30.4	28.7	33.1	39.6	52.1	66.0

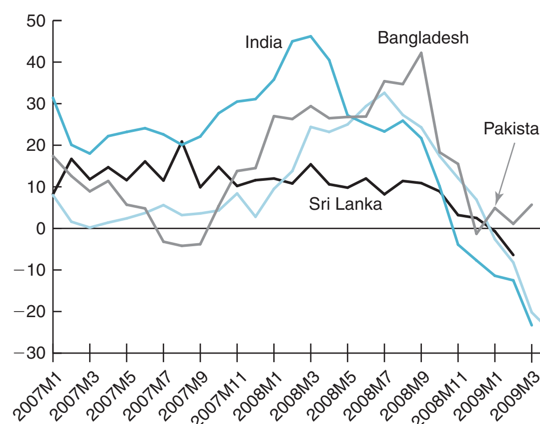
Source: World Bank.
Note:
p = projected.
a. Combination of errors and omissions and net acquisition of foreign assets (including FDI) by developing countries.

in 2008 from a record-high $116.5 billion in 2007. The contraction was led by a halving of portfolio equity inflows plunging private creditor bond issuance and syndicated bank loans, which contracted 84 percent and 67 percent, respectively. In contrast, during 2008, net FDI inflows grew 59 percent, coming to represent nearly two-thirds of total net inflows. This sharp increase in net FDI inflows was driven by surges in FDI to India and Pakistan—largely accumulated prior to the onset of the crisis—which registered gains of 52 percent and 59 percent, respectively.

Although less immediate than the transmission to the financial sector, the crisis has also had a severe impact on trade flows (figure A.16). This has become increasingly evident as the collapse in demand—most pronounced among the high-income countries—led to a falloff in exports that has become more pervasive across the global economy in the first quarter of 2009. In the six months through March 2009, regional merchandise exports in dollar terms fell by one-third from August 2008 pre-crisis levels. This stands in stark contrast to the 17 percent boom in export growth posted in the six months through March 2008. In India, Pakistan, and Sri Lanka, exports are contracting at double-digit annual rates (seasonally adjusted), down 33 percent, 27.5 percent (both as of March 2009), and 11.6 percent (as of February), respectively. In Bangladesh, exports averaged 3 percent annualized growth during the three months through January 2009, down from a peak of 72 percent in July 2008. Regional merchandise

Figure A.16 South Asian exports, values

3mma, y/y percent change



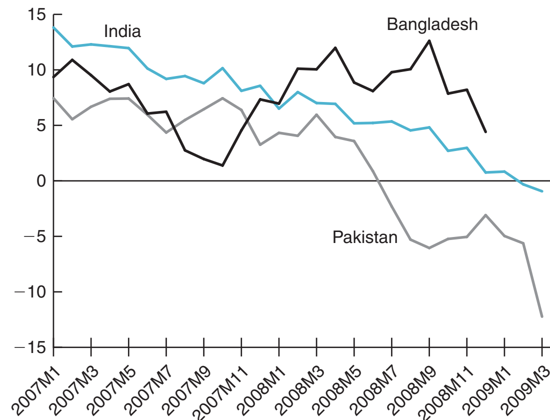
Source: World Bank.

imports have also contracted sharply, reflecting weakening domestic demand and the steep fall in international commodity prices, particularly oil. In the six months through March 2009, regional merchandise import values fell 30 percent from August 2008 pre-crisis levels, contracting just slightly less than the 33 percent recorded for exports over the same period. As the level of imports is significantly larger than exports in most countries, this has led to a general improvement in trade balances.

The marked deterioration in investor confidence, collapse in capital flows and plummeting external demand and trade are translating into a significant falloff in industrial production. High frequency data for South Asia (where available) show a decidedly sharp slowdown—if not outright contraction—in economic activity in recent months. Industrial production in India was down 2.4 percent in March 2009 from a year earlier and in Pakistan it was down 20.6 percent. In India, industrial activity has been generally trending downward since late 2006, recording a halving of growth to 4.4 percent in 2008, compared with outturns of 10 percent growth in both 2006 and 2007. In Pakistan, industrial production has posted negative readings since July 2008, now down 23 percent on an annualized basis as of March 2009, from an expansion of 5.5 percent during 2007. In Bangladesh, manufacturing output has slowed markedly, falling to 2.8 percent in December (year-on-year). During the fourth quarter of 2008, production slowed to 4.4 percent, nearly one-third the 12.6 percent pace recorded in the preceding quarter (figure A.17).

Figure A.17 Industrial production in South Asia

3-month moving average, y/y % change, seasonally adjusted



Sources: World Bank; Thomson Datastream.

Reflecting the collapse in food and fuel prices since the recent peak in mid-2008 and falling domestic demand, regional inflationary pressures have subsided and disinflation is evident across the region. Indeed, at one extreme, Afghanistan recently registered sharp deflation of 9.7 percent at an annual rate in April 2009. This compares with a recent high rate of inflation of 47.8 percent in May 2008 and reflects a sharp fall of food prices, as agricultural output has rebounded dramatically following the severe drought of last year.[11] Elsewhere in the region, the path of disinflation is particularly marked in Sri Lanka, where the consumer price index has come down by 25 percentage points since a recent peak in June 2008, reaching an annual rate of 3.3 percent in May 2009. Disinflationary pressures are less pronounced elsewhere in the region, although also clearly evident. In India, wholesale producer prices moderated sharply (reaching close to a zero annual rate in March), although consumer price inflation has proven more sticky downward (at just below 10 percent in March). In Bangladesh, inflation moderated to 5 percent in March 2009, down from a recent peak of 10.8 percent in August 2008. In the Maldives, inflation has also eased significantly to 11.2 percent in March, compared with a year ago, down from over 17 percent in July 2008. In Pakistan, notably, inflationary pressures have proven more stubborn. While the consumer price index in Pakistan is down by a marked 8 percentage points since August 2008, it remains in double digits at an annual rate of 17.2 percent in March 2009—among the highest rates in the world. Inflation in Nepal also remains at double-digit rates (14.4 percent as of March), with limited pass-through to consumers of lower international commodity prices.

In the immediate aftermath of the crisis, remittance inflows to South Asia rebounded. However, this was an apparently temporary phenomenon, because migrant workers who have lost foreign jobs are reported to be returning to their home countries with accumulated savings. More recently, remittance inflows have begun to dwindle, if not contract. For example, in Bangladesh,

although remittance inflows have continued to grow, the rate of increase has declined sharply from an annual rate of 50 percent pace in August 2008 to only 9.6 percent in April 2009. In Sri Lanka, net remittances inflows declined 3.8 percent in March 2009 over a year ago, posting the fifth consecutive month of decline (on the heels of an 18 percent decline in February)—compared with over 22 percent annual growth rate for the third quarter of 2008.

Tourism, a key source of foreign exchange and economic growth in a number of regional economies, has also been negatively affected by the global crisis. In Bhutan, where tourism recently contributed 7 percent to GDP growth, tourist arrivals declined 37.8 percent (year-on-year) in March 2009, compared with growth of 40 percent in 2008. In the Maldives, tourism activity, which represents over one-third of GDP, has declined by about 10 percent. In Sri Lanka, the recently ended civil war contributed to an 11 percent fall in tourist arrivals during 2008. In Nepal, tourist arrivals are mixed, shrinking 17.6 percent in March 2009 over the previous year and growing 15.8 percent in April. Until recently, tourism revenues in Nepal were rising rapidly, up to 2.3 percent of GDP in fiscal 2007/08 (through June 2008), roughly double the outturn of the previous year on the improved security situation and emerging political stability.

The policy response by regional governments to the slowdown has been mixed. Most countries have relied on monetary measures, because fiscal space is highly constrained. Monetary policy has been eased in line with significantly lower inflationary pressures in most countries. In some cases, central banks rapidly introduced cuts to their benchmark rates after the credit crunch took hold in September 2008. Regional exchange rate policies have also shifted (notably in India, and more recently in Sri Lanka), where countries relatively quickly shifted from defending their currencies to a posture of conserving international reserve holdings. Currencies across the region depreciated against the dollar—a pattern evident across most developing countries—with international investors shifting to 'safe-haven' assets. Against a trade-weighted basket of currencies, in nominal terms, the extent of depreciation was more modest. For example, the Indian rupee depreciated by close to 20 percent against the US dollar from August 2008 to March 2009, but by only 6.6 percent against the trade-weighted basket of currencies over the same period. Adjusting for inflation rates across trade partners, the pattern is more mixed. For instance, the real effective exchange rates (REER) for the Indian rupee depreciated close to 9 percent between August 2008 and March 2009. In contrast, whereas Pakistan's rupee depreciated by 13.5 percent from August 2008 to March 2009 against the US dollar, the REER for the Pakistani rupee appreciated by just over 9 percent over the same period—in part reflecting its significantly higher inflationary pressures compared with its trade partners.

Among developing regions, South Asia entered the crisis with the least fiscal space. Before the onset of the crisis, general government fiscal deficits exceeded 5 percent of GDP in India, Pakistan, and Sri Lanka, and in the Maldives it exceeded 10 percent. In Bangladesh the deficit represented close to 4 percent of GDP. Despite limited resources, India, and Bangladesh have introduced fiscal stimulus packages to support domestic demand. In India, where fiscal policy had already become much more expansionary before the crisis, the government introduced a fiscal stimulus package in late 2008. The fiscal 2008/09 stimulus measures, geared at boosting demand, are equal to about 3.5 percent of India's GDP. As a consequence, the public sector deficit is projected to have increased from 5.8 percent of GDP in 2007 to 9.8 percent in 2008 and to over 12 percent as of early-2009. In Bangladesh, the government announced a stimulus package in late-April 2009, focused on providing assistance to the export sector, remittance flows, the annual development program, and investment projects. For the final quarter of fiscal 2008/09 ending in June 2009, stimulus spending from the package comes to 34 billion taka (or about 0.7 percent of 2007/08 GDP).

Meanwhile, in the Maldives, where the deficit has surged to an estimated 14 percent of GDP, the government is facing a fiscal crisis. The problem began building in 2005 in the aftermath of the December 2004 tsunami; as the government hiked outlays for reconstruction, many recurrent expenditures were increasingly unrelated to the reconstruction effort. While less extreme, fiscal pressures in Sri Lanka are also rising, in this case because of a steep decline in tax revenue. During the first two

Table A.14 South Asia forecast summary

annual percent change unless indicated otherwise

Indicator	1995–2005[a]	2006	2007	2008	Forecast 2009	2010	2011
GDP at market prices (2000 $)[b]	6.0	9.0	8.4	6.1	4.6	7.0	7.8
GDP in calendar year basis[c]	6.1	9.3	8.7	7.1	5.5	7.1	7.7
GDP per capita (units in $)	4.1	7.3	6.8	4.6	3.2	5.7	6.4
PPP GDP[c]	6.0	9.1	8.5	6.1	4.6	7.1	7.8
Private consumption	4.7	6.3	7.3	3.8	3.7	5.6	6.3
Public consumption	4.9	10.4	6.3	17.5	8.9	4.7	4.0
Fixed investment	8.0	14.7	13.6	11.4	6.3	10.6	11.5
Exports, GNFS[d]	10.9	17.4	8.1	10.4	−2.6	7.1	10.8
Imports, GNFS[d]	10.5	22.4	8.0	15.2	0.4	6.9	9.5
Net exports, contribution to growth	−0.2	−1.8	−0.4	−1.7	−0.7	−0.4	−0.4
Current account bal/GDP (%)	−0.6	−1.5	−1.5	−3.9	−1.7	−2.4	−2.5
GDP deflator (median, LCU)	6.3	6.7	7.8	12.0	9.7	5.1	5.5
Fiscal balance/GDP (%)	−7.7	−5.6	−6.4	−8.9	−10.9	−11.3	−9.2
Memo items: GDP							
South Asia excluding India	4.5	6.8	6.3	5.9	2.6	3.4	4.8
India	6.4	9.7	9.0	6.1	5.1	8.0	8.5
Pakistan	4.1	6.9	6.4	5.8	1.0	2.5	4.5
Bangladesh	5.3	6.6	6.4	6.2	5.0	4.5	5.0

Source: World Bank.
Note:
National income and product account data refer to fiscal years (FY) for the South Asian countries with the exception of Sri Lanka, which reports in calendar year (CY). The fiscal year runs from July 1 through June 30 in Bangladesh and Pakistan, from July 16 through July 15 in Nepal, and April 1 through March 31 in India. Due to reporting practices, Bangladesh, Nepal and Pakistan report FY2007/08 data in CY2008, while India reports FY2007/08 in CY2007.
a. Growth rates over intervals are compound average; growth contributions, ratios and the GDP deflator are averages.
b. GDP measured in constant 2000 U.S. dollars.
c. GDP measured at PPP exchange rates.
d. Exports and imports of goods and non-factor services.

months of 2009, customs revenues are estimated to have shrunk by an annual rate of 50 percent.

The government of Pakistan is pursuing fiscal consolidation under the new IMF program reached in November 2008, with the burden of adjustment falling primarily on expenditures. As of December 2008 (halfway through the fiscal year), the government is on track to reduce the deficit to 4.3 percent of GDP from 7.4 percent a year earlier. Nepal is also bucking the trend of growing deficits and is actually expected to register a budget surplus, attributable to improved tax receipts (up 38 percent) and reduced capital expenditures.

Outlook

The outlook for regional growth remains highly uncertain, given the synchronized nature of the slowdown in growth across the globe. There are significant uncertainties tied to potential negative feedback loops between the real and financial sectors within and among countries and about how massive swings in commodity prices and exchange rate will ultimately affect different industries.

In the baseline scenario of a deep global recession followed by a slower-than-normal recovery, GDP growth in South Asia is projected to slow sharply to 5.5 percent in 2009, compared with 7.1 percent in 2008, on a calendar-year basis (table A.14). This compares favorably with the deceleration in growth of 4.7 percentage points projected for all developing countries and especially with Europe and Central Asia, Latin America and the Caribbean, and the OECD economies where output is projected to decline. All components of demand are being hit, with investment growth in particular being compressed by a contraction in external demand—with world trade projected to contract 10 percent in 2009. Private consumption is projected to decelerate in the wake of job losses, weaker remittance inflows, and heightened uncertainty. Government consumption is also projected to ease significantly, as a result of falling revenues and higher borrowing costs.

The regional fiscal balance is projected to deteriorate in 2009 to a deficit of 10.9 percent of GDP from an estimated 8.9 percent in 2008. On the expenditure side, higher borrowing costs will also come into play. Interest payments represent over 20 percent of total outlays for South Asia, by far the highest share among developing regions. India, Pakistan, and Sri Lanka are most vulnerable in this respect, with interest payments accounting for 20 percent, 26.3 percent, and nearly 29 percent of central government expenditures, respectively. On the revenue side, the collapse in trade activity is disproportionately hitting the revenue stream because taxes on international trade represent nearly 15 percent of revenues for the region, more than double the share for developing countries as a group. Bangladesh and the Maldives are particularly reliant on taxes on trade, which represent 33 percent and 30 percent of their total revenues, respectively.

In response to the collapse in external demand, regional exports of goods and services are projected to contract in 2009. All export categories are facing downward pressures; information technology industries (India) are considered especially vulnerable to the downturn in financial sector activity, and textile exports (Bangladesh, Pakistan, Sri Lanka) and tourism (Bhutan, Maldives, Nepal, and Sri Lanka) are vulnerable to cuts in discretionary spending. However, the regional current account deficit is projected to shrink to 1.7 percent of GDP in 2009 from 3.9 percent in 2008 because import expenditures are projected to slow sharply with weaker domestic demand growth, given the projected improvement in the terms of trade.

Weak economic conditions in high-income countries are projected to reduce remittances in labor-exporting countries in 2009. For example, foreign employment of Bangladeshi workers declined 27.4 percent in the eight months ending March 2009, compared with the same period in the preceding year. Inevitably this decline will result in a significant downward adjustment in remittance inflows to the country over the coming period. Although remittances are typically countercyclical—expatriates tend to send more money to their country of origin in times of need—the synchronized character of the global recession has made them procyclical. They represent a key supply of foreign exchange for regional economies—equivalent to 18 percent of GDP in Nepal, and 9 percent in both Bangladesh and Sri Lanka (2007), 4 percent in Pakistan, and 3 percent in India. In dollar terms, India received $27 billion in remittance inflows 2007, the highest level of inflows among developing countries. In Pakistan, remittances are estimated to have covered 47 percent of the surging current account deficit in fiscal year 2007/08.

Given the region's strong underlying growth dynamics, the negative impacts of the crisis are expected to begin to unwind in 2010 and 2011, with a projected rebound in GDP growth to 7.1 percent and 7.7 percent, respectively (table A.15). The relatively rapid recovery in regional activity to close to potential output growth comes despite the weak recovery projected elsewhere and reflects the lagged impact of recent monetary policy easing—with some potential for further interest rate cuts. Fiscal stimulus measures, where they are being pursued, should also provide a boost to household income and spending. Nevertheless, given the extent of the slowdown already absorbed, over the forecast period GDP growth will persist below the 8.3 percent average outturn in the five years through 2007.

Risks and uncertainties

Given the recent extremely high degree of volatility and massive shifts in demand across global markets, the outlook remains highly uncertain, particularly with respect to the timing of negative impacts and the rebound in activity. On the upside, some industries could benefit from shifts to lower-cost providers, such as for low-end textiles (Bangladesh) and outsourcing (India). In India, the reform agenda of the newly elected government has already improved investor sentiment and could yield an even stronger recovery in investment demand. In Sri Lanka, the recent end of the decades old civil war has buoyed domestic sentiment, which could also provide a fillip to growth and stronger than envisioned outcomes. A recovery of global growth that is stronger and more rapid than currently anticipated would support higher growth outcomes for South Asia, primarily through stronger external demand leading to higher export growth, and an improved risk appetite translating into higher capital inflows.

Although such upside outcomes are possible, downside risks are more pronounced. More negative growth outturns could be driven by a deeper

Table A.15 South Asia country forecasts
annual percent change unless indicated otherwise

					Forecast		
Country/indicator	1995–2005[a]	2006	2007	2008	2009	2010	2011
Bangladesh							
GDP at market prices (2000 $)[b]	5.3	6.6	6.4	6.2	5.0	4.5	5.0
Current account bal/GDP (%)	−0.6	2.0	1.2	0.9	0.9	0.6	0.4
India							
GDP at market prices (2000 $)[b]	6.4	9.7	9.0	6.1	5.1	8.0	8.5
Current account bal/GDP (%)	−0.4	−1.0	−1.0	−3.4	−1.4	−2.3	−2.5
Nepal							
GDP at market prices (2000 $)[b]	4.1	2.8	3.2	4.7	3.0	3.5	4.0
Current account bal/GDP (%)	−3.5	0.0	−2.6	1.1	2.5	2.0	1.3
Pakistan							
GDP at market prices (2000 $)[b]	4.1	6.9	6.4	5.8	1.0	2.5	4.5
Current account bal/GDP (%)	−1.1	−5.4	−5.8	−8.4	−5.2	−4.5	−4.3
Sri Lanka							
GDP at market prices (2000 $)[b]	4.5	7.7	6.8	6.0	2.5	4.0	5.5
Current account bal/GDP (%)	−3.2	−5.7	−4.5	−9.3	−3.6	−3.8	−3.7
Memo items: GDP on calendar year basis							
South Asia	6.1	9.3	8.7	7.1	5.5	7.1	7.7
Bangladesh	5.0	6.3	6.5	6.3	5.6	4.7	4.8
India	6.6	9.9	9.3	7.3	5.9	8.1	8.5
Nepal	3.9	3.0	3.0	4.0	3.8	3.3	3.8
Pakistan	3.7	7.3	6.6	6.1	3.3	1.8	3.5

Source: World Bank.
Note:
In the current very volatile global environment, World Bank forecasts are frequently updated based on new information and changing assumptions. Moreover, the confidence intervals around these point forecasts are larger than usual. As a result, the projections presented here may differ from those contained in other Bank documents, even if basic assessments of countries' prospects do not significantly differ at any given moment in time.

Afghanistan, Bhutan, Maldives are not forecast owing to data limitations.

National income and product account data refer to fiscal years (FY) for the South Asian countries with the exception of Sri Lanka, which reports in calendar year (CY). The fiscal year runs from July 1 through June 30 in Bangladesh and Pakistan, from July 16 through July 15 in Nepal, and April 1 through March 31 in India. Due to reporting practices, Bangladesh, Nepal and Pakistan report FY2007/08 data in CY2008, while India reports FY2007/08 in CY2007.

GDP figures are presented in calendar years (CY) based on quarterly history for India. For Bangladesh, Nepal and Pakistan, CY data is calculated taking the average growth over the two fiscal year periods to provide an approximation of CY activity.

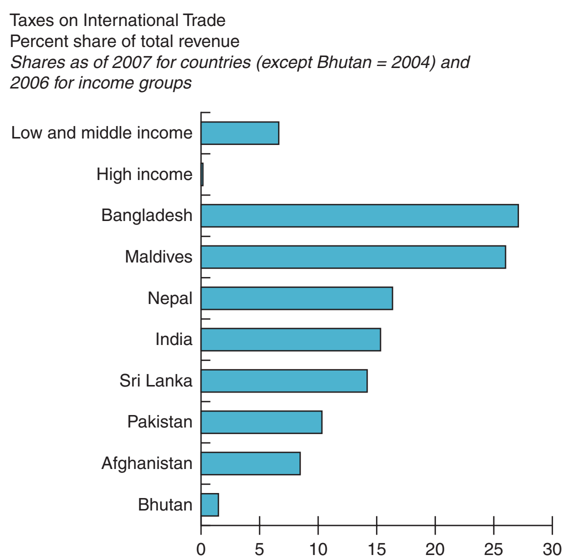
a. Growth rates over intervals are compound average; growth contributions, ratios and the GDP deflator are averages.
b. GDP measured in constant 2000 U.S. dollars.

and more protracted global recession as outlined in chapter 1. This would lead to weaker external demand and a slower rebound in investment growth in South Asia. A protracted global recession would translate into a sharper decline in remittances than forecast, where Bangladesh, Nepal, and Sri Lanka, in particular, would be vulnerable. Additionally, in such a scenario, foreign assistance could be curbed, as high-income countries face their own mounting fiscal pressures. Afghanistan, in particular, would be exposed to significantly reduced aid flows, where aid accounts for two-thirds of central government expenditures. However, given its geopolitical importance, a falloff appears unlikely. Reduced aid would force a further contraction in fiscal spending especially in countries like Bangladesh, Pakistan, and Sri Lanka, where aid represents 21, 9, and 9 percent of central government expenditures.

On the domestic front, downside risks are tied in particular to the region's large fiscal obligations and relatively high reliance on taxes on trade and large subsidy programs, both of which would lead to heightened fiscal pressures in the event of a protracted global recession (figure A.18). Ongoing budgetary pressures are also likely to lead to cuts in development spending. Large fiscal deficits also represent a threat to long-term growth, weighing on potential output by crowding out private investment through the increased call on capital by the public sector (by foreign and domestic agents) and higher interest rates. Growing public sector obligations also are likely to translate into increased debt

Figure A.18 Government revenue in South Asia is very dependent on trade

Taxes on International Trade
Percent share of total revenue
Shares as of 2007 for countries (except Bhutan = 2004) and 2006 for income groups



Source: World Bank.

ratios, raising the risk of default. Central government debt represents 85 percent of GDP in Sri Lanka, over 70 percent in Bhutan, and close to 55 percent in India, the Maldives, and Pakistan.

With slower growth outturns and rising unemployment, higher poverty is a significant political, humanitarian and economic risk. South Asia's social protection spending is less developed than in East Asia and the Pacific and the Middle East and North Africa where social insurance spending represents 2.9 percent and 3 percent of GDP, respectively. In South Asia it is less than half that amount at 1.4 percent.

Separately, security threats, civil strife, and political uncertainties remain of concern across much of the region.

Sub-Saharan Africa

Recent developments

Although many countries in Sub-Saharan Africa have only weak links to international financial markets and relatively small manufacturing sectors, the financial crisis had immediate consequences for countries in Sub-Saharan Africa. Output and incomes in the region have been negatively affected by falling commodity prices, falling volume demand for metal and mineral exports, and declining remittances and tourism.

Partly because of increased uncertainty and the generalized flight to quality that immediately followed the outbreak of the crisis, but also because lower commodity prices have reduced the attractiveness of private investment in the region, capital flows to the region declined sharply (table A.16). Some $5.7 billion in portfolio investment left South Africa during the fourth quarter of 2008, up from a $1 billion outflow in the third quarter. In Uganda the outflow was much smaller—$119 million—but contrasted even more sharply with a $9 million inflow in the third quarter of 2008. In South Africa, foreign direct investment fell to 3.3 billion rand in the fourth quarter from 22.4 billion rand in the third quarter.

The same factors that precipitated the reversal in capital flows also saw borrowing costs rise sharply for those few countries in the region that have access to international bond markets. Initially, sovereign spreads jumped as high as 1,900 basis points in the case of Ghana, but have since declined (figure A.19). Nevertheless, sovereign spreads for Ghana and Gabon remain between 220 and 375 basis points above their pre-September 15th level. For South Africa, spreads remain 50 basis points higher. Partly as a result of sharp increases in external borrowing costs and unwillingness to lend, many countries and firms postponed issuing new bonds, with emerging frontier economies in the region being the most affected. While official assistance to the region has increased, the additional aid has not been sufficient to close the widening financing gap. For the region as a whole the financing gap is expected to lie between $30 billion and $45 billion in 2009 (see chapter 3).

Responding to the outflow of capital, currencies of countries in the region depreciated sharply against the dollar, as did those of virtually every other country in the world, with the average depreciation in countries in the region amounting to 25 percent. However, on a trade-weighted basis the depreciations were milder, precisely because all countries depreciated. Of the countries with available data only Lesotho, South Africa, and Zambia depreciated by 10 percent or more.

The rapid drop in global demand for industrial products accelerated the decline in global commodity prices (see chapter 1). For African

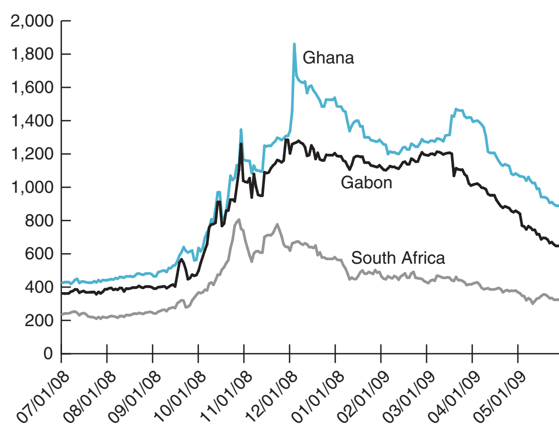
Table A.16 Net capital flows to Sub-Saharan Africa

$ billions

Indicator	2002	2003	2004	2005	2006	2007	2008p
Current account balance	−6.2	−9.2	−1.0	6.4	6.9	−23.2	−18.7
as % of GDP	*−1.7*	*−2.1*	*−0.2*	*1.0*	*1.0*	*−2.7*	*−1.9*
Net private and official inflows	9.6	15.0	23.2	31.8	38.0	60.4	38.7
Net private inflows	6.9	13.5	20.9	32.8	40.3	55.5	35.9
Net equity inflows	9.8	13.6	16.6	24.2	33.5	42.1	35.6
Net FDI inflows	10.2	12.9	9.9	16.8	18.5	28.6	32.4
Net portfolio equity inflows	−0.4	0.7	6.7	7.4	15.0	13.5	3.2
Net debt flows	−0.2	1.4	6.6	7.6	4.5	18.3	3.1
Official creditors	2.7	1.5	2.3	−1.0	−2.3	4.9	2.8
World Bank	2.2	2.2	2.5	2.4	2.0	2.4	1.7
IMF	0.5	0.0	−0.1	−0.4	−0.1	0.1	0.7
Other official	0.0	−0.7	−0.1	−3.0	−4.2	2.4	0.4
Private creditors	−2.9	−0.1	4.3	8.6	6.8	13.4	0.3
Net M-L term debt flows	−1.1	0.9	2.7	4.9	−2.1	7.9	1.3
Bonds	1.5	0.4	0.6	1.3	0.3	6.6	−1.0
Banks	−1.9	1.2	2.4	3.8	−1.7	1.9	2.7
Other private	−0.7	−0.7	−0.3	−0.2	−0.7	−0.6	−0.4
Net short-term debt flows	−1.8	−1.0	1.6	3.7	8.9	5.5	−1.0
Balancing item[a]	−3.2	−2.0	−0.6	−18.6	−13.2	−11.0	−0.9
Change in reserves (− = increase)	−0.2	−3.8	−21.7	−19.5	−31.7	−26.1	−19.0
Workers' remittances	5.0	6.0	8.0	9.4	12.9	18.6	19.8

Source: World Bank.
Note:
p = projected.
a. Combination of errors and omissions and net acquisition of foreign assets (including FDI) by developing countries.

Figure A.19 Bond spreads in Sub-Saharan Africa widened sharply in the wake of the global financial crisis



Source: JP Morgan-Chase.

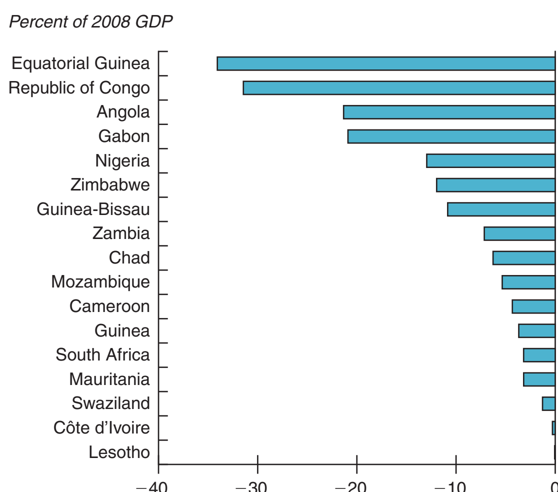
commodity exporters, these lower prices represented a significant loss in incomes and induced a sharp deterioration in their current account positions. For oil importers, however, lower fuel prices represented a favorable terms-of-trade development. Overall, the terms of trade deteriorated in 18 of 44 countries in the region between July 2008 and May 2009, with income losses in excess of 10 percent of GDP in 7 of them (figure A.20). Another 26 countries recorded improved terms of trade, largely because of lower fuel prices. Particularly strong gains came in countries such as Cape Verde, Eritrea, Seychelles, and Togo that rely heavily on oil imports to satisfy domestic demand.

Weaker economic conditions in high-income countries have also negatively affected remittances and tourism, two important sources of foreign currency for countries in Sub-Saharan Africa. Tourism revenues weakened in the final quarter of 2008 and in the first few months of 2009, and remittances are projected to decline by some 4.4 percent in 2009.

Despite currency depreciations (which tend to increase the price of imported goods), inflation in more than half of the countries in the region for which data are available decelerated by more than 2 percentage points between September 2008 and March 2009, mainly because of falling oil prices. Internationally traded food prices have also declined, but food prices in individual countries have responded with a lag, and year-over-year measures of food inflation remain high in many countries.

Figure A.20 Terms of trade losses since July have been significant in some countries as commodity prices plunged

Terms of trade impact of changes in international prices between July 2008 and May 2009



Source: World Bank.

For countries in west Africa, both overall inflation and food inflation came down sharply. For example in Côte d'Ivoire, consumer price inflation decelerated to bel\ow 4 percent in March (year-on-year) from almost 9.6 percent in September, as food inflation eased to 5.4 percent from close to 15 percent. Similarly in Mali, consumer price inflation diminished to 5.4 percent from 12.3 percent as food inflation eased to 6.4 percent from a peak of 17.5 percent in July.

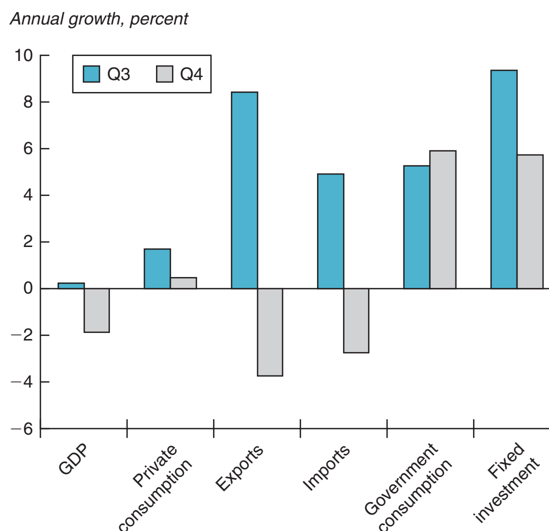
Food price inflation accelerated or remained high in many east African countries, including Kenya, Rwanda, Tanzania, and Uganda. In Ethiopia, food price inflation slowed sharply to 26.5 percent in March from 80 percent in September, bringing overall inflation down to 23.7 percent from 60 percent.

In southern Africa, food inflation remains above 20 percent in Botswana, keeping overall inflation high at 11.7 percent. In Zambia food inflation contributed 7.9 percentage points to the 14.7 percent inflation rate in May. In South Africa, overall inflation also remains high at more than 8 percent, pushed by a 15.7 percent surge in food and nonalcoholic beverage prices that contributed 2.4 percentage points to overall inflation in January 2009 and by rising housing and utility costs that contributed a similar amount to headline inflation.

The credit squeeze, coupled with a rapid drop in consumer and investor confidence, was reflected in a quick decline both in world demand for the exports of African countries and in domestic demand for investment and for consumer durable goods. The fall in investment activity was especially pronounced in extractive industries, both because of reduced commodity prices and because of reliance on external financing sources. The sharpest decline was recorded in spending on durable goods (transport equipment in particular). In South Africa, growth in investment activity more than halved to 3 percent (on a seasonally adjusted annual rate) from 7.3 percent, mainly because of government restraint. Private sector investment (mainly reflecting mining sector activity) continued to expand at a brisk 2.9 percent pace, about the same rate as in the third quarter.

In South Africa, tighter credit conditions and rising interest rates coupled with increasing unemployment have been reflected in declining consumer confidence. This, together with cuts in consumer wealth due to falling house and equity prices yielded a 2.7 percent (saar) contraction in household consumption expenditure in the fourth quarter of 2008 (figure A.21). This followed a

Figure A.21 External trade and private consumption deteriorated markedly in the fourth quarter of 2008 in South Africa



Source: South Africa Reserve Bank.

0.9 percent contraction the previous quarter and marked the first time since 1992 that consumer spending contracted for two consecutive quarters.

The sharp decline in global trade during the fourth quarter of 2008 and into 2009 was reflected in much weaker export growth or outright contraction for Sub-Saharan African countries, in particular for countries with large mining operations like Botswana, Namibia, and Zambia. In South Africa, merchandise exports declined 6.3 percent in the fourth quarter (year-on-year).

Weak demand, especially for durables and cars, caused industrial output to fall in many countries. Industrial production fell by an annualized 22.1 percent in the first quarter in South Africa, while in Angola it fell by more than10 percent between September 2008 and January 2009. Mining sectors also contracted markedly as external demand plunged. In South Africa the mining sector contracted at an annualized 32.8 percent pace in the first quarter. In Zambia weaker demand for copper led to mine closures. In Namibia and Botswana (long a star performer in the region), low demand for diamonds forced mine closures, leading to sharp declines in fourth-quarter output. In Lesotho, the contraction in the U.S. economy has badly affected the manufacturing sector, which benefited under the African Growth and Opportunity Act in previous years. Exports from Lesotho, Namibia, and Swaziland were also hit hard by the contraction in South Africa, which resulted in a reduction in workers' remittances that accounted for 30 percent of GDP in 2008 in the case of Lesotho.

In Mozambique, the rehabilitation of roads and bridges continues to be a major growth stimulus for the country's secondary sector; construction output accelerated to 20.1 percent, from 18.7 percent (year-on-year) in the second quarter of 2008. However, the sharp fall in aluminum prices and in demand from the auto sector is cutting into industrial output. Côte d'Ivoire continued its economic recovery in 2008, with growth accelerating to 2.5 percent from 1.5 percent previously, pushed by a strong rebound in the construction, food output, and telecommunications sectors. Other countries in the West Africa Economic and Monetary Union recorded an acceleration in growth, helped by improved weather conditions that bolstered output in the primary sectors, as well as by improvements in sociopolitical conditions in Côte d'Ivoire. Some fragile countries are continuing to enjoy a peace dividend.

Fiscal balances in oil-importing countries deteriorated during the course of 2008 as governments took a series of measures to delay the pass-through to domestic prices of higher prices for food and fuel imports in the first half of the year. The fiscal costs of these policies may have averaged 1 percent of GDP in 2008.[12] Sharply falling activity beginning in the fourth quarter of the year led to a further deterioration in fiscal balances, as falling industrial and trade activity and declining commodity prices disproportionately affect the formal sectors from which most tax revenues derive. The deterioration in fiscal positions in oil-importing countries averaged 1.1 percent of GDP and is now limiting the fiscal space for countercyclical policies. In Ghana, expansionary fiscal policy in an election year caused the budget deficit net of grants to almost double. Despite rising non-oil budget deficits, the fiscal positions of oil-exporting countries improved by about 3 percent of GDP in 2008, boosted by high oil prices. However, the sharp decline in oil prices is now undermining government revenues in oil-exporting countries. For example, tax revenues in Nigeria were well below the government's target in the first quarter of 2009, reducing the space for fiscal stimulus.

Current account positions in oil-importing countries other than South Africa deteriorated by 3.4 percent of their GDP in 2008 as a result of terms-of-trade losses, sharp drops in exports in the last quarter of 2008, lower remittances, declining tourism revenues, and lower aid inflows. Despite lower oil prices in the second half of 2008, oil exporters in the region saw their current account surpluses improve by 2.6 percentage points to 6.2 percent of their GDP. In South Africa, the current account deficit narrowed to 5.8 percent of GDP in the fourth quarter of 2008, from 7.8 percent of GDP in the previous quarter, as the trade deficit almost halved.

Outlook

Growth in Sub-Saharan Africa is expected to decelerate markedly in 2009, to 1.0 percent from an estimated 4.8 percent in 2008. GDP in South Africa will actually contract by 1.5 percent (table A.17). Growth in oil-importing countries other than South Africa is projected to decelerate to 2.7 percent from an estimated 5.3 percent in 2008, while

Table A.17 Sub-Saharan Africa forecast summary
annual percent change unless indicated otherwise

Indicator	1995–2005[a]	2006	2007	2008	Forecast 2009	2010	2011
GDP at market prices (2000 $)[b]	3.9	6.0	6.2	4.8	1.0	3.7	5.2
GDP per capita (units in $)	1.3	3.5	3.8	2.8	−0.9	1.8	3.2
PPP GDP[c]	3.9	6.3	6.6	5.1	1.1	3.9	5.4
Private consumption	2.7	6.5	7.1	3.3	0.8	3.5	4.7
Public consumption	5.3	6.0	6.2	5.8	5.5	6.1	5.8
Fixed investment	7.4	18.7	20.5	12.4	−2.6	3.9	7.7
Exports, GNFS[d]	4.8	5.1	4.1	4.7	−3.2	4.2	6.4
Imports, GNFS[d]	6.2	12.7	11.9	6.6	−3.0	4.7	7.3
Net exports, contribution to growth	−0.4	−2.9	−3.2	−1.2	0.2	−0.6	−0.9
Current account bal/GDP (%)	−1.8	1.0	−2.7	−1.9	−8.1	−7.0	−6.2
GDP deflator (median, LCU)	7.3	7.7	7.3	10.2	5.5	5.0	4.5
Fiscal balance/GDP (%)	−3.0	1.5	−0.8	0.5	−5.0	−3.4	−1.9
Memo items: GDP							
SSA excluding South Africa	4.5	6.2	7.0	5.9	2.4	4.3	5.7
Oil exporters	4.4	7.1	7.9	6.3	2.2	4.4	6.3
CFA countries	4.1	2.2	3.5	4.2	2.3	3.6	4.8
South Africa	3.3	5.3	5.1	3.1	−1.5	2.6	4.1
Nigeria	4.6	6.2	6.3	5.3	2.9	3.6	5.6
Kenya	2.9	6.1	7.1	1.7	2.6	3.4	4.9

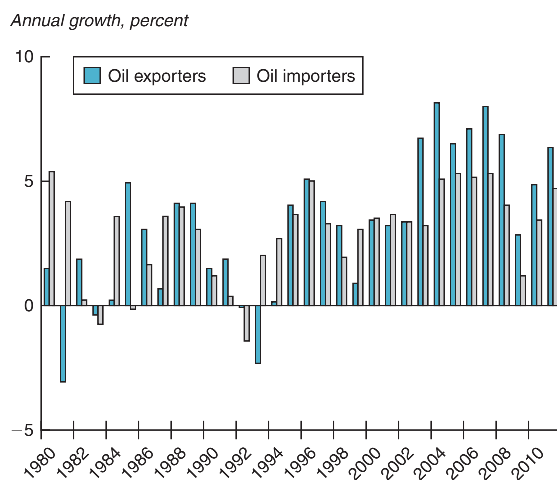
Source: World Bank.
Note:
a. Growth rates over intervals are compound average; growth contributions, ratios and the GDP deflator are averages.
b. GDP measured in constant 2000 U.S. dollars.
c. GDP measured at PPP exchange rates.
d. Exports and imports of goods and non-factor services.

for regional oil exporters growth is expected to ease to 2.2 percent, down sharply from the robust 6.3 percent pace in 2008 (figure A.22).

Much of the decline in growth for 2009 reflects the sharp deceleration in investment and

Figure A.22 Economic growth decelerated abruptly in 2009 to the lowest level in almost a decade in Sub-Saharan Africa

Annual growth, percent



Source: World Bank.

consumption activity that has already occurred, and growth should strengthen in most countries during the second half of 2009. The projected recovery is expected to be relatively slow, partly because of a muted recovery in global export demand, but also because mounting unemployment, lower incomes, and continued financial sector weakness will prevent consumer and investment demand from rebounding quickly. Government spending, although projected to rise, is not expected to have a major offsetting influence on domestic demand, except perhaps in oil-exporting countries where fiscal surpluses provide additional scope for a more expansionary course. Indeed, in many oil-importing countries automatic stabilizers are small given the small share of government revenues in total GDP, and the fiscal space for discretionary spending is limited by tight financing conditions.

Some of the biggest slowdowns are projected to occur in smaller open economies like Botswana, Mauritius, and Seychelles. In Botswana, contraction in mining output is expected to cause an 8 percent decline in overall GDP, while Seychelles' economy will contract by more than 10 percent.

Côte d'Ivoire is expected to buck the trend toward growth deceleration, because growth is slowly returning after several years of conflict-induced slowdown. GDP is projected to accelerate slightly in 2009, as exports rise, and construction, food production, and government spending on basic infrastructure, poverty reduction, and other post-conflict needs will make significant contributions to growth.

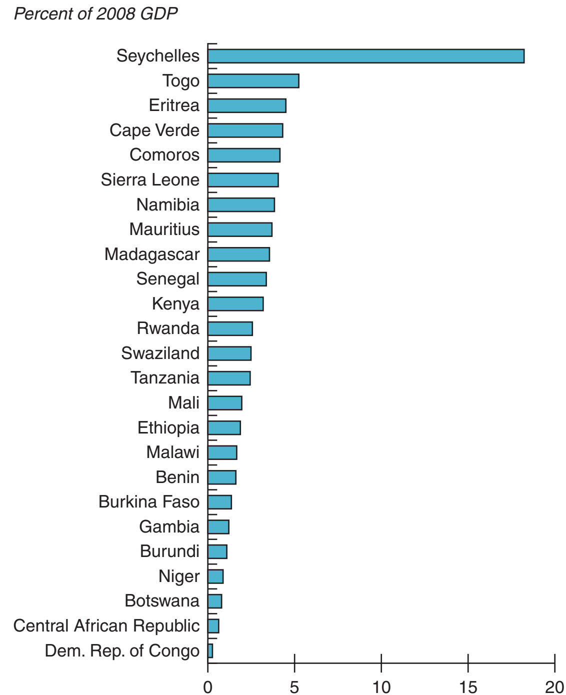
Current account positions in oil-exporting countries are expected to deteriorate sharply due to lower commodity prices in 2009. These will cause large swings in trade balances, only partially offset by profit repatriation by oil companies (figure A.23). Oil-importing countries in the region stand to gain from lower prices for imported fuel, although lower remittances, services revenues, and current transfer inflows will keep the current account balances at relatively high levels (figure A.24).

Current transfers to the region are projected to weaken further, as remittances and aid flows suffer. In Ghana, for example, net official transfers averaged $17.6 million in the last two quarters compared to $223.5 million in the first half of the year. In Uganda, current official transfers were down 7.8 percent year-on-year in the last quarter of 2008. Globally, remittances, which in Sub-Saharan Africa were equal to about two-thirds of FDI and about half of ODA in 2008, are projected to decline by about 4.4 percent in 2009, before recovering in 2010. Countries like Lesotho, Sierra Leone, Cape Verde, Senegal, and Togo, where remittances account for more than 8 percent of GDP will suffer the most.

Fiscal balances throughout the region are projected to weaken further in 2009 due to low activity levels. While output growth will pick up in 2010 and 2011, the slow pace of the recovery will mean that spare capacity, heightened unemployment and weak government revenues will continue to characterize the economic situation throughout the projection period. Oil exporting countries will see their fiscal balances turn to deficits in 2009, to the tune of 4.0 percent of their GDP, as oil prices are markedly lower and as export volumes decline. Meanwhile in oil importing countries fiscal deficits will rise by 2.5 percentage points to close to 6 percent of GDP in 2009, before narrowing moderately over the next two years.

Figure A.24 Terms of trade gains expected among oil-importing countries in 2009

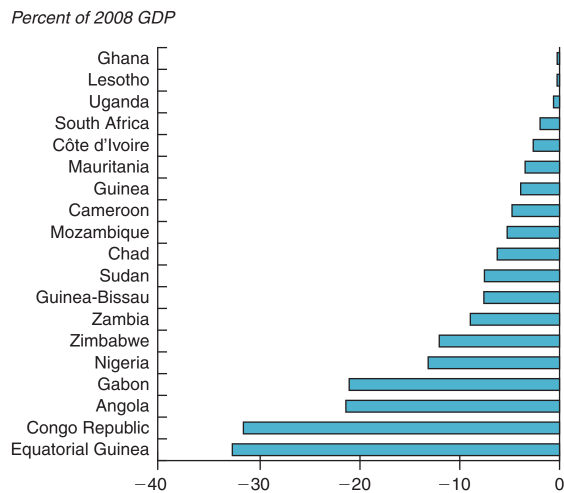
Estimated terms of trade impact from changes in international prices between 2008 and 2009



Source: World Bank.

Figure A.23 Large terms of trade losses expected in countries exporting minerals and oil

Estimated terms of trade impact from changes in international prices between 2008 and 2009



Source: World Bank.

Prospects for 2010 and 2011 are for a slow recovery in Sub-Saharan Africa with growth picking up to about 3.7 percent in 2010 and 5.2 percent in 2011, as both domestic and external demand begin to recover. The overall pattern is similar for both oil-exporting and oil-importing countries (excluding South Africa), with growth in 2010 projected to reach 4.4 percent for each group, accelerating to 6.3 percent and 5.2 percent in 2011, respectively (table A.18).

The recovery in South Africa should follow a similar profile as for the rest of the continent, with output projected to increase by 2.6 percent in 2010 and by 4.1 percent in 2011, as weak financial conditions and excess capacity in many sectors mitigate against a sharp rebound in either investment or consumption. In Nigeria, one of the countries in Africa hit the hardest by the global financial crisis, the banking system is under stress, with some estimates suggesting as much as half of bank capital ($10 billion) is tied up in questionable assets.[13] Credit conditions are therefore expected to be particularly tight there and will likely further undermine growth in the non-oil sector. Only higher government spending is projected to prevent the economy from sliding even further.

Risks and uncertainties

The risks for the Sub-Saharan Africa region are heavily tilted to the downside. A deeper and prolonged global recession would slow the recovery in external demand, prevent a recovery in commodity prices, and further depress tourism revenues, remittances, aid, and private capital flows. Such a scenario (described in chapter 1) would imply additional widening of the output gap in the region by about 3 percentage points and a continuation of recession-like conditions beyond the projection period.

Sharp contractions in remittances and official aid flows also represent a risk for the region because many Sub-Saharan countries depend heavily

Table A.18 Sub-Saharan Africa country forecasts

annual percent change unless indicated otherwise

					Forecast		
Country/indicator	1995–2005[a]	2006	2007	2008	2009	2010	2011
Angola							
GDP at market prices (2000 $)[b]	8.3	18.6	23.4	14.3	−1.9	6.5	10.7
Current account bal/GDP (%)	−2.4	16.9	15.3	19.4	−5.8	−0.1	2.2
Benin							
GDP at market prices (2000 $)[b]	4.6	3.8	4.6	4.9	2.9	3.7	5.5
Current account bal/GDP (%)	−7.2	−7.1	−10.9	−12.3	−10.7	−9.9	−9.1
Botswana							
GDP at market prices (2000 $)[b]	6.9	3.4	3.8	3.0	−8.0	4.8	3.1
Current account bal/GDP (%)	8.1	18.0	18.0	5.2	−7.7	−2.5	−2.2
Burkina Faso							
GDP at market prices (2000 $)[b]	5.2	5.5	4.0	4.7	3.6	4.8	5.9
Current account bal/GDP (%)	−10.1	−13.1	−13.6	−14.5	−13.9	−13.4	−13.8
Burundi							
GDP at market prices (2000 $)[b]	1.0	5.1	3.6	4.4	2.6	3.7	5.1
Current account bal/GDP (%)	−10.8	−35.9	−29.6	−33.3	−27.8	−26.6	−26.0
Cape Verde							
GDP at market prices (2000 $)[b]	5.2	10.7	7.8	5.9	3.8	4.4	5.4
Current account bal/GDP (%)	−10.0	−3.4	−13.4	−17.8	−19.2	−17.9	−18.4
Cameroon							
GDP at market prices (2000 $)[b]	4.2	3.2	3.3	3.9	2.0	2.7	3.5
Current account bal/GDP (%)	−3.5	−0.8	−5.0	−1.2	−6.1	−5.6	−5.1
Central African Republic							
GDP at market prices (2000 $)[b]	0.7	4.0	4.2	3.4	2.7	3.4	4.3
Current account bal/GDP (%)	−4.4	−7.6	−8.5	−9.0	−7.7	−8.0	−8.3
Chad							
GDP at market prices (2000 $)[b]	8.6	0.2	0.2	0.2	0.4	2.1	3.0
Current account bal/GDP (%)	−24.2	−7.2	−11.5	−9.0	−11.5	−9.7	−10.2

(*Continues*)

Table A.18 (*Continued*)

annual percent change unless indicated otherwise

					Forecast		
Country/indicator	1995–2005[a]	2006	2007	2008	2009	2010	2011
Comoros							
GDP at market prices (2000 $)[b]	2.1	1.2	−1.0	0.6	0.2	2.1	2.5
Current account bal/GDP (%)	−6.3	−5.5	−8.1	−12.9	−8.4	−9.6	−10.8
Congo, Dem. Rep.							
GDP at market prices (2000 $)[b]	−0.1	5.6	6.3	7.1	3.0	5.3	7.1
Current account bal/GDP (%)	−1.3	−9.8	−12.2	−19.8	−27.9	−27.9	−27.3
Congo, Rep.							
GDP at market prices (2000 $)[b]	3.4	6.2	−1.6	6.1	7.4	9.7	10.7
Current account bal/GDP (%)	−2.2	1.7	−25.4	−6.4	−17.7	−6.4	−0.0
Côte d'Ivoire							
GDP at market prices (2000 $)[b]	1.5	−0.3	1.5	2.5	3.1	4.2	4.9
Current account bal/GDP (%)	−0.2	2.8	1.0	0.9	0.7	−1.6	−3.2
Eritrea							
GDP at market prices (2000 $)[b]	2.6	−1.0	1.3	1.2	1.7	4.2	4.4
Current account bal/GDP (%)	−14.7	−24.1	−17.8	−18.2	−9.3	−8.6	−8.2
Ethiopia							
GDP at market prices (2000 $)[b]	5.5	10.9	11.5	11.1	6.0	7.0	7.3
Current account bal/GDP (%)	−3.3	−12.0	−10.0	−10.5	−9.9	−9.4	−8.6
Gabon							
GDP at market prices (2000 $)[b]	1.0	1.2	5.6	3.0	0.2	2.3	3.5
Current account bal/GDP (%)	10.6	15.6	16.2	16.8	−2.4	−1.6	−0.2
Gambia, The							
GDP at market prices (2000 $)[b]	4.2	6.5	7.0	5.3	4.5	5.1	5.4
Current account bal/GDP (%)	−5.3	−14.2	−12.1	−15.2	−15.8	−16.2	−16.3
Ghana							
GDP at market prices (2000 $)[b]	4.7	6.4	6.1	7.1	4.1	4.6	5.4
Current account bal/GDP (%)	−5.4	−8.1	−14.3	−20.5	−14.1	−13.7	−14.5
Guinea							
GDP at market prices (2000 $)[b]	3.7	2.2	1.8	3.0	2.0	2.6	4.8
Current account bal/GDP (%)	−4.8	−1.8	−6.8	−10.3	−5.7	−4.4	−3.5
Guinea-Bissau							
GDP at market prices (2000 $)[b]	−0.3	1.8	2.7	2.9	2.1	3.4	3.4
Current account bal/GDP (%)	−13.4	−19.1	−10.0	−12.9	−16.5	−15.1	−15.1
Kenya							
GDP at market prices (2000 $)[b]	2.9	6.1	7.1	1.7	2.6	3.4	4.9
Current account bal/GDP (%)	−7.5	−2.0	−4.7	−6.8	−4.8	−5.0	−4.5
Lesotho							
GDP at market prices (2000 $)[b]	3.0	7.2	4.9	4.1	0.9	2.2	3.6
Current account bal/GDP (%)	−20.6	4.4	−8.4	−17.0	−16.4	−16.9	−16.7
Madagascar							
GDP at market prices (2000 $)[b]	3.1	4.9	6.5	6.0	3.5	4.8	6.2
Current account bal/GDP (%)	−8.6	−9.6	−14.0	−20.6	−13.8	−13.0	−11.4
Malawi							
GDP at market prices (2000 $)[b]	2.4	7.9	7.4	6.9	6.6	5.6	4.6
Current account bal/GDP (%)	−5.7	−16.7	−15.5	−17.5	−13.5	−13.4	−12.2
Mali							
GDP at market prices (2000 $)[b]	5.8	5.3	4.3	5.0	3.7	5.1	5.3
Current account bal/GDP (%)	−8.7	−5.7	−8.3	−9.9	−8.3	−10.2	−11.3
Mauritania							
GDP at market prices (2000 $)[b]	4.3	11.7	1.0	2.2	2.7	4.1	5.0
Current account bal/GDP (%)	−6.3	2.8	−7.0	−11.0	−11.4	−16.2	−16.4
Mauritius							
GDP at market prices (2000 $)[b]	4.8	3.5	4.2	5.8	2.4	2.8	3.7
Current account bal/GDP (%)	0.1	−9.5	−8.4	−8.8	−10.0	−10.9	−8.4
Mozambique							
GDP at market prices (2000 $)[b]	8.0	8.0	7.0	6.4	4.5	4.9	5.9
Current account bal/GDP (%)	−15.1	−11.3	−16.1	−19.3	−19.7	−16.0	−11.5
Namibia							

(*Continues*)

Table A.18 Sub-Saharan Africa country forecasts (*Continued*)

annual percent change unless indicated otherwise

Country/indicator	1995–2005[a]	2006	2007	2008	Forecast 2009	2010	2011
GDP at market prices (2000 $)[b]	4.1	2.9	5.9	2.7	−1.7	2.1	3.3
Current account bal/GDP (%)	3.2	3.6	−2.3	−10.6	−11.8	−10.5	−10.9
Niger							
GDP at market prices (2000 $)[b]	3.5	5.2	3.2	6.9	3.6	4.9	5.3
Current account bal/GDP (%)	−7.1	−8.6	−10.0	−13.3	−16.3	−15.9	−16.6
Nigeria							
GDP at market prices (2000 $)[b]	4.6	6.2	6.3	5.3	2.9	3.6	5.6
Current account bal/GDP (%)	5.4	20.6	4.7	6.1	−8.7	−6.2	−4.6
Rwanda							
GDP at market prices (2000 $)[b]	8.3	7.2	7.9	8.4	5.1	5.5	5.8
Current account bal/GDP (%)	−4.1	−12.3	−12.7	−17.6	−13.4	−13.2	−12.9
Senegal							
GDP at market prices (2000 $)[b]	4.4	2.3	4.8	4.5	3.1	3.8	5.0
Current account bal/GDP (%)	−5.7	−9.4	−10.0	−12.2	−13.6	−13.8	−14.3
Seychelles							
GDP at market prices (2000 $)[b]	2.2	5.3	8.3	0.1	−10.5	2.7	3.7
Current account bal/GDP (%)	−13.8	−18.7	−22.2	−32.0	−29.7	−24.0	−20.4
Sierra Leone							
GDP at market prices (2000 $)[b]	4.5	7.4	6.5	5.8	4.0	5.5	6.5
Current account bal/GDP (%)	−12.4	−9.5	−8.0	−11.2	−6.6	−6.9	−7.6
South Africa							
GDP at market prices (2000 $)[b]	3.3	5.3	5.1	3.1	−1.5	2.6	4.1
Current account bal/GDP (%)	−1.7	−6.6	−7.2	−7.4	−6.1	−6.4	−5.9
Sudan							
GDP at market prices (2000 $)[b]	6.2	11.3	10.2	6.1	4.1	5.3	6.2
Current account bal/GDP (%)	−6.6	−14.3	−5.9	−4.4	−7.5	−6.6	−5.7
Swaziland							
GDP at market prices (2000 $)[b]	1.9	2.8	2.4	2.2	0.8	1.2	1.5
Current account bal/GDP (%)	−1.0	−14.0	−21.3	−27.4	−23.2	−22.7	−22.3
Tanzania							
GDP at market prices (2000 $)[b]	5.4	6.7	7.1	7.5	4.8	5.5	6.4
Current account bal/GDP (%)	−6.3	−8.3	−11.1	−12.0	−10.0	−10.3	−10.9
Togo							
GDP at market prices (2000 $)[b]	3.3	4.1	2.0	0.8	2.2	2.4	3.3
Current account bal/GDP (%)	−10.7	−9.9	−7.5	−9.6	−9.3	−9.8	−9.5
Uganda							
GDP at market prices (2000 $)[b]	6.1	10.8	8.6	9.5	5.0	5.6	6.6
Current account bal/GDP (%)	−7.0	−7.1	−6.9	−7.7	−9.5	−9.3	−9.4
Zambia							
GDP at market prices (2000 $)[b]	3.8	6.2	6.3	6.0	3.0	4.9	5.5
Current account bal/GDP (%)	−12.8	−0.7	−6.1	−9.8	−11.5	−12.5	−12.0
Zimbabwe							
GDP at market prices (2000 $)[b]	−2.4	−4.2	−6.3	−4.9	−4.6	−3.1	−2.1
Current account bal/GDP (%)	0.5	30.7	42.1	28.3	16.3	13.5	15.6

Source: World Bank.
Note:
In the current very volatile global environment, World Bank forecasts are frequently updated based on new information and changing assumptions. Moreover, the confidence intervals around these point forecasts are larger than usual. As a result, the projections presented here may differ from those contained in other Bank documents, even if basic assessments of countries' prospects do not significantly differ at any given moment in time.

Liberia, Mayotte, Somalia, and São Tome and Principe are not forecast owing to data limitations.

a. Growth rates over intervals are compound average; growth contributions, ratios and the GDP deflator are averages.
b. GDP measured in constant 2000 U.S. dollars.

on aid flows for budget support and because remittances represent an important cushion against poverty. The shortfalls in aid would intensify the fiscal problems, limiting further the fiscal space for countercyclical policies at a time when they are especially needed.

An uncertainty clouding the medium term derives from the sharp increase in developed-country borrowing following the crisis and the possibility that such borrowing crowds frontier economies in the region out of international capital markets, leaving countries with the large external financing needs such as Ghana, Kenya, Mauritius, Nigeria, South Africa, and Tanzania vulnerable.

Among countries with relatively developed financial markets,[14] the sharp slowdown (or even outright contraction in economic activity) could result in a big increase in the number of nonperforming loans—especially in countries where credit to domestic commodity exporters represents a large share of total credit extended. This in turn may require government support to financial institutions and depositors adding further pressures on government finances.

Plummeting government revenues heighten the risk of large increases in public debt to unsustainable levels. This will have long-term consequences for growth, causing interest rates to rise, crowding out the private sector, and undermining long-term growth potential. This risk should be balanced against the acute need for fiscal stimulus in the short term to help boost domestic demand and safeguard growth at a time of extremely weak external demand. It is very important that at a time of scarce resources, spending undertaken by governments be the most efficient in terms of supporting growth, addressing bottle-necks, and increasing long-run productivity.

Notes

1. Migrant remittances are defined as the sum of workers' remittances, compensation of employees, and migrant transfers.

2. International Organization for Migration 2008 survey.

3. *Migrants return home to Tajikistan,* BBC, April 28, 2009.

4. Short-term debt due in 2009 is calculated based on the Bank of International Settlements reporting system and data released in May 2009.

5. In consistency with the methodology explained in chapter 3, the financing gap is defined as the difference between total external financing requirements (current-account deficit plus scheduled principal payments on both short-term and long-term private debt coming due in the year) and private capital flows (new loans on private debt, net equity flows, and net unidentified capital outflows).

6. Georgia, which signed a $740 million stand-by agreement in September 2008, is excluded from this total because the package was mainly targeted at helping economic recovery after the Russian war.

7. The output gap is defined as the difference between the actual and potential GDP as a share of the potential GDP in a given year.

8. See GDF 2008, chapter 3.

9. The low- and middle income countries of the Middle East and North Africa region include Algeria, the Arab Republic of Egypt, the Islamic Republic of Iran, Jordan, Lebanon, Morocco, the Syrian Arab Republic, Tunisia, and the Republic of Yemen. Several developing economies are not covered in this report due to data insufficiencies, including Djibouti, Iraq, Libya and the West Bank and Gaza. High-income economies of the broader geographic region, including Gulf Cooperation Council (GCC) members Bahrain, Kuwait, Oman, and Saudi Arabia are covered in this report under the category of "other high-income countries," but the importance of GCC developments for the broader economic region should be underscored. Among the GCC, insufficient data exits for inclusion of Qatar and the United Arab Emirates.

10. Council on Foreign Relations (2009).

11. Wheat production in Afghanistan is projected to rise by 40–50 percent over 2008, given improved weather conditions, and the UN Food and Agriculture Organization has reported that the country is likely to be self-sufficient in wheat this year.

12. *International Monetary Fund,* Regional Economic Outlook Sub-Saharan Africa, April 2009.

13. Estimate of Eurasia Group. According to Bank of America Corp., banks have provided at least 1 trillion naira ($6.8 billion) of margin loans.

14. African countries with more developed financial markets are Botswana, Cape Verde, Ghana, Kenya, Mauritius, Mozambique, Namibia, Nigeria, Seychelles, South Africa, Tanzania, Uganda.

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