

Global Economic Prospects

Fiscal Headwinds and Recovery

Main Analysis

Summer 2010

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Global Economic Prospects Summer 2010: Fiscal Headwinds and Recovery

Key messages

- Market nervousness concerning the fiscal positions of several European high-income countries poses a new challenge for the world economy. This arises as the recovery is transitioning toward a more mature phase during which the influence of rebound factors (such as fiscal stimulus) fades, and GDP gains will increasingly depend on private investment and consumption.
- So far evolving financial developments in Europe have had limited effects on financial conditions in developing countries. Although global equity markets dropped between 8 and 17 percent, there has been little fallout on most developing-country risk premia. And despite a sharp deceleration in bond flows in May, year-to-date capital flows to developing countries during the first 5 months of 2010 are up 90 percent from the same period in 2009.
- Little real-side data is available to evaluate the impact of the European fiscal/debt crisis on economic activity. Existing data suggests that through the end of March, the recovery remained robust in most developing and developed countries, with the exception of high-income Europe where it has stagnated.
- Assuming that measures in place prevent today's market nervousness from slowing the normalization of bank-lending, and that a default or restructuring of European sovereign debt is avoided, global GDP is projected to increase by 3.3 percent in 2010 and 2011, and by 3.5 percent in 2012. Private capital flows to developing countries are projected to increase from 2.7 percent of their GDP in 2009 to 3.2 percent in 2012 (Table 1). Reflecting stronger productivity growth, and less-pronounced headwinds than in high-income countries, GDP in developing countries is expected to grow by 6.2, 6.0, and 6.0 percent in 2010, 2011 and 2012. This is more than twice as quickly as in high-income countries, where growth is projected to strengthen from 2.3 percent this year to 2.7 percent in 2012.
- However, should current uncertainty regarding developments in Europe persist, outturns could be weaker. A high probability alternative baseline, characterized by an accelerated tightening of fiscal policy across high-income countries, would see a more muted recovery, with global GDP expanding by 3.1 percent in 2010 and by 2.9 and 3.2 in 2011 and 2012. The easing of momentum would be concentrated in high-income countries, where GDP might rise 2.1, 1.9, and 2.2 percent during each of the three years. Under these conditions growth in developing countries could average 5.9 percent during the projection period.
- Deeper and more widespread effects might arise if the situation causes investors to become significantly more risk averse; or in a less likely scenario, if there is a major crisis of confidence, prompted by (or causing) a default or major restructuring of high-income sovereign European debt.
 - Simulations suggest that an increase in risk aversion that caused long-term yields on U.S. government bonds to rise by 100 basis points could slow global growth by 0.5 percentage points.
 - A serious loss of confidence in the debt of five EU countries combining high fiscal deficits and high government debts that led to a freezing-up of credit in those countries could cause GDP growth to slow by as much as 2.4 percent in 2011—pushing high-income countries into recession.

- A default or major restructuring among the EU-5 (Greece, Ireland, Italy, Portugal and Spain) could threaten the solvency of several banks outside the EU-5, with potentially far-reaching consequences for the global financial system.
- Because of significant presence of EU-5 banks, international capital flows to Europe and Central Asia and to a lesser extent to Latin America and the Caribbean might be seriously affected in the event of a default or restructuring of high-income sovereign debt.
- To ensure longer-term sustainability, fiscal policy in many high-income countries needs to be tightened sharply over the next several years. Although politically difficult, a policy that favors a more aggressive reining-in of deficits will, by reducing high-income country borrowing costs, favor medium-term growth in both developing and high-income countries.
- Limited fiscal space in low-income countries means that if official development assistance were to decline, policymakers in low-income countries could be forced to cut growth enhancing infrastructure and human capital investments. As a result, the number of people living on \$2 or less per day in 2020 could be higher by as much as 79 million.

So far, the fall-out from the high-income European debt crisis has been contained.

Concerns about the sustainability of Greece's fiscal position spilled over into global financial markets in early May 2010. Although there was a sharp increase in risk premia and a steep decline in stock markets worldwide, there are only limited indications of contagion – at least so far.¹

Following the announcement of a €750 billion, or nearly \$1 trillion aid package by the European Union, the International Monetary Fund, and the European Central Bank, the initial sharp uptick in the price of credit default swaps (CDSs) on the sovereign debt of select European countries receded before rebounding partially in the following weeks (Figure 1). LIBOR-OIS spreads have increased to 32 basis points, suggesting that commercial banks are concerned that the ability of counterparties to repay even short loans might be affected by a default or restructuring of high-income sovereign debt. Moreover, anecdotal evidence suggests that some European banks are having trouble getting funding. Nevertheless, LIBOR-OIS spreads remain well below the values observed during the initial phases of the sub-prime crisis, and suggest that for the moment, markets are not overly concerned.

The credit ratings of most developing country sovereigns have not been affected by the crisis. Since the end of April, though May 24, the credit ratings of 5 countries (Azerbaijan, Bolivia, Nicaragua, Panama and Ukraine) have been upgraded, and none have been downgraded. For the year to date, there have been 22 upgrades and only 4 downgrades. EMBI spreads for major developing countries, after rising much less than in September 2008 (Figure 1 bottom panel), have declined again and are only a little higher than in January 2010 (less than 10 basis points in the case of Brazil and Russia, and 27 and 40 basis points in the case of South Africa and Turkey). Indeed, a recently developed index of the deterioration in financial conditions² for a sample of 60 countries (31 high-income, 27 middle-income, and 2 low-income countries), shows that as of early June 2010, only 8 of the 23 countries displaying relative deterioration in market conditions since March 31st were developing countries. Four of the 8 countries where the deterioration in the aggregate index exceeded 0.5 were developing countries. However, in two cases, the deterioration reflected rising interest rates following a tightening of monetary policy in response to improving economic conditions, rather than a reaction to the situation in Greece.

Table 1. The global outlook in summary
(percentage change from previous year, except interest rates and oil price)

	2008	2009e	2010f	2011f	2012f
<i>Global Conditions</i>					
World Trade Volume (GNFS)	3.2	-11.6	11.2	6.8	7.2
Consumer Prices					
G-7 Countries ^{1,2}	3.1	-0.2	1.5	1.6	1.8
United States	3.8	-0.3	2.0	2.2	2.4
Commodity Prices (USD terms)					
Non-oil commodities	0.0	-21.6	16.8	-4.0	-5.4
Oil Price (US\$ per barrel) ³	97.0	61.8	78.1	74.6	73.9
Oil price (percent change)	36.4	-36.3	26.4	-4.5	-0.9
Manufactures unit export value ⁴	5.9	-4.9	0.0	-3.7	0.0
Interest Rates					
\$, 6-month (percent)	3.2	1.2	0.8	2.2	2.2
€, 6-month (percent)	4.8	1.5	1.0	1.5	2.8
<i>International capital flows to developing countries (% of GDP)</i>					
Developing countries					
Net private and official inflows	4.7	3.4			
Net private inflows (equity + debt)	4.3	2.7	3.0	3.1	3.2
East Asia and Pacific	3.1	2.2	2.1	2.2	2.5
Europe and Central Asia	7.8	2.6	4.0	4.2	4.1
Latin America and Caribbean	4.0	3.0	3.5	3.2	3.3
Middle East and N. Africa	1.9	1.8	2.5	2.8	2.6
South Asia	3.6	3.9	3.4	3.2	3.4
Sub-Saharan Africa	3.0	4.0	3.6	3.8	4.2
<i>Real GDP growth⁵</i>					
World					
Memo item: World (PPP weights) ⁶	1.7	-2.1	3.3	3.3	3.5
High income	1.3	-0.4	4.2	4.0	4.3
OECD Countries	0.4	-3.3	2.3	2.4	2.7
Euro Area	0.3	-3.4	2.2	2.3	2.6
Japan	0.4	-4.1	0.7	1.3	1.8
United States	-1.2	-5.2	2.5	2.1	2.2
Non-OECD countries	0.4	-2.4	3.3	2.9	3.0
Developing countries	3.0	-1.7	4.2	4.2	4.5
East Asia and Pacific	5.7	1.7	6.2	6.0	6.0
China	8.5	7.1	8.7	7.8	7.7
Indonesia	9.6	8.7	9.5	8.5	8.2
Thailand	6.0	4.5	5.9	6.2	6.3
Malaysia	2.5	-2.3	6.2	4.0	5.0
Europe and Central Asia	4.2	-5.3	4.1	4.2	4.5
Russia	5.6	-7.9	4.5	4.8	4.7
Turkey	0.7	-4.7	6.3	4.2	4.7
Poland	4.8	1.7	3.0	3.7	4.0
Latin America and Caribbean	4.1	-2.3	4.5	4.1	4.2
Brazil	5.1	-0.2	6.4	4.5	4.1
Mexico	1.8	-6.5	4.3	4.0	4.2
Argentina	7.0	-1.2	4.8	3.4	4.4
Middle East and N. Africa	4.2	3.2	4.0	4.3	4.5
Egypt ⁷	7.2	4.7	5.0	5.5	5.7
Iran ⁷	2.3	1.8	3.0	3.2	3.2
Algeria	2.4	2.1	4.6	4.1	4.3
South Asia	4.9	7.1	7.5	8.0	7.7
India ^{7,8}	5.1	7.7	8.2	8.7	8.2
Pakistan ⁷	2.0	3.7	3.0	4.0	4.5
Bangladesh ⁷	6.2	5.7	5.5	5.8	6.1
Sub-Saharan Africa	5.0	1.6	4.5	5.1	5.4
South Africa	3.7	-1.8	3.1	3.4	3.9
Nigeria	5.3	5.6	6.1	5.7	6.4
Kenya	1.7	2.6	4.0	4.9	5.4
<i>Memorandum items</i>					
Developing countries					
excluding transition countries	5.7	3.0	6.6	6.2	6.2
excluding China and India	4.3	-1.8	4.5	4.4	4.6

Source: World Bank. □

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

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

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

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

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

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

6. Calculated using 2005 PPP weights.

7. In keeping with national practice, data for Egypt, 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.

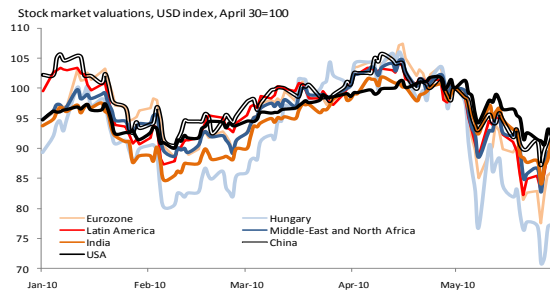
8. Real GDP at market prices. Growth rates calculated using real GDP at factor cost, which are customarily reported in India, tend to be higher and are, for 2008-12:

6.7, 7.4, 8.5, 9.0, and 8.5 percent – see Table B5.4 in the regional annex and the South Asia Economic Update (<http://go.worldbank.org/6BU9N0AZM0>) for more detail.

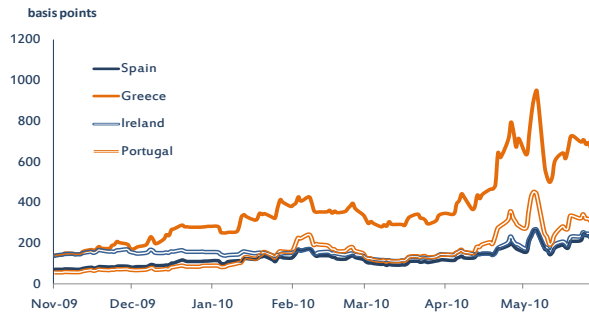
While market conditions have improved—the size of the EU/IMF rescue package (close to \$1 trillion); the magnitude of the initial market reaction to the possibility of a Greek default and

eventual contagion; and continued volatility, are indications of the fragility of the financial situation. As discussed in the risks section below, a further episode of market uncertainty

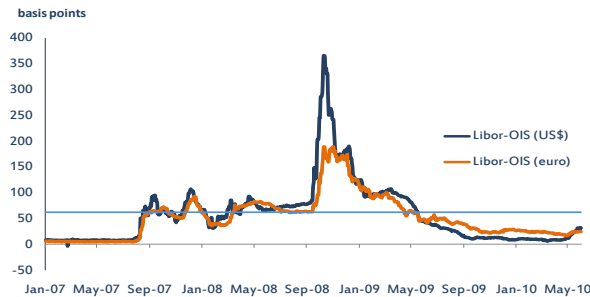
Figure 1. Limited signs of contagion crisis so far
Stock market valuations worldwide have been affected



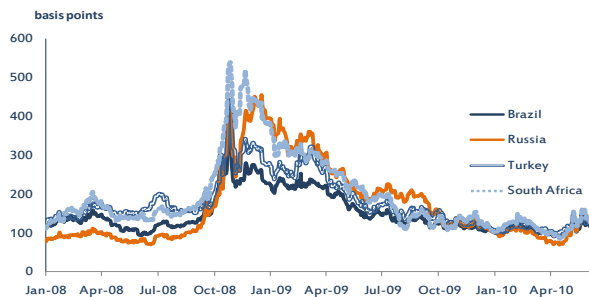
Greek anxieties spread to other euro-zone economies with precarious fiscal positions, but markets are calmed by the EU package



Funding cost pressures up— but well below the average of early stages of sub-prime crisis



Spreads have returned to close to earlier levels



Source: World Bank, Datastream, Bloomberg

could entail serious consequences for growth in both high-income and developing countries.

Stock markets worldwide lost between 8 and 17 percent in May, with losses generally larger in high-income Europe and developing Europe than in markets further removed from Greece. Moreover, data for May indicate a significant decline in capital inflows toward developing countries (Table 2), although year-to-date flows are 90 percent higher than in 2009. Most of the decline was concentrated in bond issuance by developing countries, with more modest declines in bank-lending and equity flows. Although it is difficult to determine with precision to what extent this reflects a normal seasonal decline in flows, or a temporary reduction in issuance prompted by elevated spreads at the beginning of the month,³ these developments could signal a further tightening of capital markets.

Table 2. A sharp fall of in bond issues in May

\$ billion	2008		2009		2010					
	Q1	Total	Q1	Total	Q1	Jan	Feb	Mar	Apr	May
Total	103	390	48	353	104	41	17	47	45	15
Bonds	12	65	18	115	48	21	5	21	26	3
Banks	71	257	22	129	30	12	5	13	8	6
Equity	20	68	8	109	26	7	7	12	11	6
Lat. America	19	90	21	137	31	9	4	17	15	3
Bonds	5	20	10	62	19	8	2	10	9	0
E. Europe	36	157	6	72	26	13	2	10	14	2
Bonds	2	35	4	33	17	7	1	8	11	1
Asia	38	98	18	122	38	16	7	15	11	10
Bonds	3	7	5	16	9	7	2	0.3	3	2
Others	11	45	3	22	10	2	3	5	4	1

Source: World Bank, Dealogic.

The recent bout of market nervousness arose as the recovery is moving into a more mature phase characterized by significant headwinds

Financial markets in developing and high-income countries have staged a remarkable recovery from the worst of the crisis. Notwithstanding recent turmoil, interbank lending rates and developing country bond spreads have returned to close-to-normal levels; stock markets in high-income and emerging

economies have recovered much of the value they lost, and most developing-country currencies have regained their pre-crisis levels against the dollar, with some having appreciated. The real-side of the global economy is also recovering. In the first quarter of 2010, global industrial production was expanding at an 11 percent annualized pace (Figure 2), while merchandise trade, was growing even more briskly (20 percent annualized pace). Still the level of industrial production remains 10 percent or more below potential in many developing countries and unemployment is high.

While the downturn and recovery of the global economy was remarkable for both its depth and its similarity across countries, the recovery is now more than a year old and its character is changing. Bounce-back factors (including the deep inventory cycle, and the growth impetus from fiscal and monetary stimulus) that contributed to very rapid quarterly growth rates are fading. Increasingly, the pace of the recovery at the national and regional level will depend on the extent to which private-sector activity recovers, and measures taken to address longer-term structural factors (including fiscal sustainability, banking-sector restructuring, and underlying productivity).

Fiscal policy poses challenges

Medium-term prospects for both high-income

and developing countries face serious headwinds. High-income countries will continue to be plagued by weak financial sectors, waning growth effects from fiscal and monetary stimulus, and an increasingly pressing need to set public finances on a sustainable path.

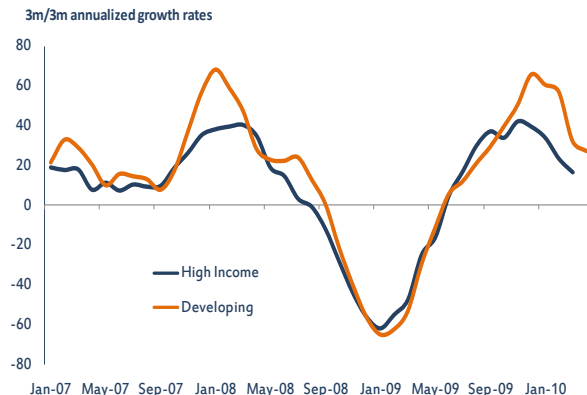
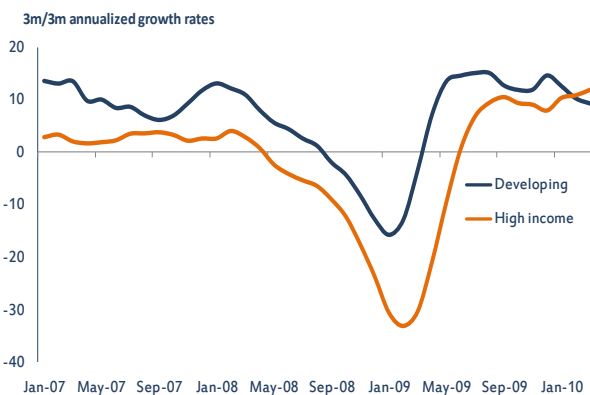
The need to tighten fiscal policy extends well beyond those countries most in the headlines, and the immediate challenge of unwinding the crisis-related stimulus measures that were put into place. This is a problem for many high-income countries, where fiscal deficits and debt to GDP ratios have reached unsustainable levels. The G-7's debt is expected by the IMF to reach more than 113 percent of the group's GDP in 2010 (Figure 3), a level not seen since 1950. Bringing debt levels down will be more challenging now than earlier because, in contrast with the war-related debt of the 1950s, today's debt reflects ongoing demands on government coffers that are likely to grow as pension and health liabilities expand with aging populations. The IMF (2010) estimates that high-income countries will need to cut government spending (or raise revenues) by 8.8 percent of GDP for a 20 year period in order to bring debt levels down to 60 percent of GDP by 2030.

The need to unwind stimulus measures among developing countries is generally less pressing; because both fiscal deficits and debt-to-GDP

Figure 2. The real-side recovery is showing some signs of maturing

Industrial production is growing rapidly

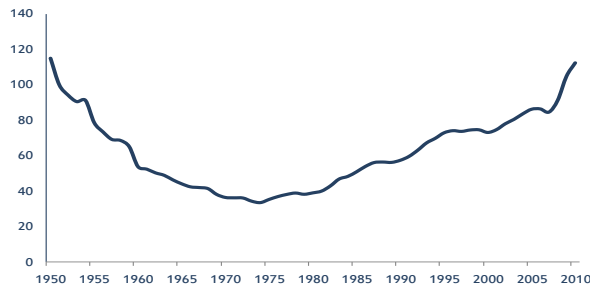
Trade is recovering at very rapid rates



Source: World Bank

Figure 3. G-7 debt is close to post-war highs

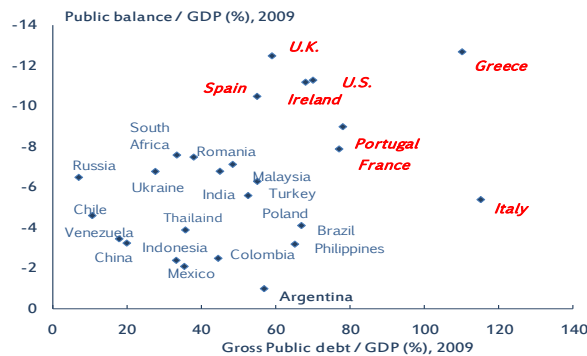
Gross public debt as a % of GDP



Source: IMF

ratios are much lower (Figure 4). Overall, general government deficits as a percent of GDP in developing countries have increased by 4.5 percentage points between 2007 (before the crisis) and 2009. Due to binding financing constraints facing low-income countries, their deficits increased by only 1.3 percentage points of GDP.

Figure 4. Most developing countries are not beset by concerns about fiscal sustainability



Sources: JPMorgan; Barclays Capital; World Bank

Several developing countries do face fiscal challenges, including India whose fiscal deficit is estimated to have reached 9.5 percent of GDP in 2009/10, and whose debt represents 77 percent of its GDP. Recognizing the challenge, the government has announced a medium-term adjustment path, which is expected to reduce India's debt-to-GDP ratio to at most 68 percent of GDP by FY2014/15. China also put in place a large stimulus package, but its finances are on a firmer footing, so there is less urgency to

unwinding stimulus (although overheating could be a strong macroeconomic argument for doing so).

Lower tax and commodity revenues, weaker aid flows, and more competition for global savings could squeeze government and private-sector investment...

Developing countries, particularly low-income countries that rely on official development assistance (ODA) for budgetary support, could come under severe pressure if the crisis results in reduced aid flows. So far, the crisis has caused government deficits in low-income countries to increase by an average of 1.3 percent of GDP, suggesting that many were able to take advantage of relatively good fiscal positions, and ample reserves going into the crisis to buffer its effects on spending. However, the initial cushions have been exhausted, and the ability of low-income countries to maintain spending in the face of a slow recovery is unclear – especially if, as is likely, ODA declines in coming years.

Extrapolating from trends in aid flows during previous recessions from 1977 through 2007—and given the extent of fiscal consolidation and lower potential output faced by donor countries—recent research (Dang, Knack, Rogers, 2009) suggests that ODA could fall by as much as 20 to 25 percent in the current crisis, and that it could take about a decade for flows to recover. This probably represents a worst-case scenario, and aid flows are unlikely to fall so much this time around. Nevertheless, aid flows will likely be tighter than in the past. Indeed, though bilateral aid did increase modestly in real terms during 2009 (Figure 5), it has fallen short of commitments and is declining as a share of recipient GDP.

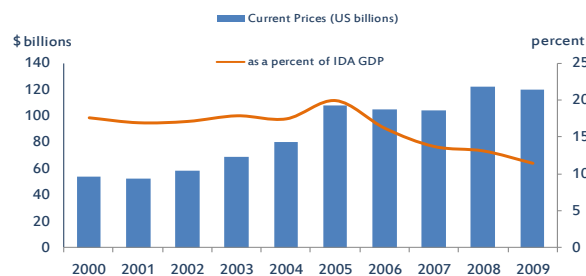
In addition to potentially weaker aid flows, ongoing restructuring in the international financial sector implies significantly less and more expensive financial capital for developing countries for years to come (Table 3). Private capital flows to developing countries are

projected to recover only modestly from \$454 billion (2.7 percent of GDP) in 2009 to \$771 billion (3.2 percent of GDP) by 2012 (Figure 6).

If the rebound in net capital flows remains muted as expected, there is a real risk that many of the private firms that borrowed heavily internationally in the boom period will not be

Figure 5. Official assistance is declining as a share of recipient GDP

Net ODA donors 2000-2009



Sources: World Bank; OECD

able to rollover their loans, potentially generating a second-round region-specific crisis. For example, in Kazakhstan, Latvia, Lithuania, and Ukraine, where the repayment on corporate external debt is anticipated to exceed 8 percent of GDP in 2010.

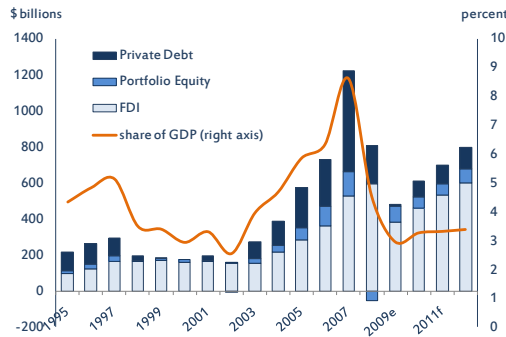
Increased borrowing of high-income sovereigns on international capital markets will increase demands on global savings, raise borrowing costs and potentially crowd-out developing country borrowers. Already in 2009, the G-3 issued 5-times more bonds than they did in each of 2005 and 2006. The group's total draw on global saving exceeded \$2.5 trillion—more than 7-times the net capital flows to developing countries in that year. Partly as a consequence of this increased borrowing and also because the Federal Reserve has stopped purchasing U.S. long-term corporate bonds and residential mortgages, long-term yields on U.S. treasury securities had been rising, though with the onset of the Greek crisis they have eased in response to “safe-haven” inflows (Figure 7).

Table 3. Net International capital flows to developing countries

\$ billions	2005	2006	2007	2008	2009e	2010f	2011f	2012f
Net private and official inflows	501.8	659.8	1222.8	780.5	523.5			
Net private inflows (equity+debt)	573.3	732.1	1223.7	752.4	454.0	589.5	670.2	770.8
Net equity inflows	349.9	469.0	663.8	536.5	445.9	497.5	564.2	652.8
..Net FDI inflows	281.1	363.2	528.4	593.6	358.3	438.0	501.0	575.0
..Net portfolio equity inflows	68.8	105.8	135.4	-57.1	87.5	59.5	63.2	77.8
Net debt flows	151.9	190.8	559.0	244.0	77.6			
..Official creditors	-71.5	-72.3	-0.9	28.1	69.5			
....World Bank	2.7	-0.5	4.8	7.1	21.1			
....IMF	-40.2	-26.7	-5.1	10.8	27.5			
....Other official	-34.0	-45.1	-0.6	10.2	20.9			
..Private creditors	223.4	263.1	559.9	215.9	8.1	92.0	106.0	118.0
....Net M-L term debt flows	137.8	168.3	315.4	228.6	-2.7			
.....Bonds	56.8	31.7	87.4	15.0	54.8			
.....Banks	85.8	141.5	231.0	217.2	-52.9			
.....Other private	-4.8	-4.9	-3.0	-3.6	-4.6			
....Net short-term debt flows	85.6	94.8	244.5	-12.7	10.8			
Balancing item	-414.1	-446.5	-617.9	-808.4	-292.9			
Change in reserves (= increase)	-393.6	-643.5	-1081	-439.0	-561.0			
Memorandum items								
Net FDI outflows	61.6	130.5	148.7	207.5	153.9	210.0	250.0	275.0
Workers' remittances	193.0	235.0	290.0	336.0	316.0	335.0	359.0	
As a percent of GDP (%)								
Net private and official inflows	5.03	5.59	8.45	4.51	3.09			
Net private inflows (equity+debt)	5.74	6.21	8.46	4.35	2.68	3.02	3.05	3.15
..Net FDI inflows	2.82	3.08	3.65	3.43	2.12	2.24	2.28	2.35
..Net portfolio equity inflows	0.69	0.90	0.94	-0.33	0.52	0.30	0.29	0.32
..Private creditors	1.5	1.6	3.9	1.4	0.5	0.5	0.5	0.5

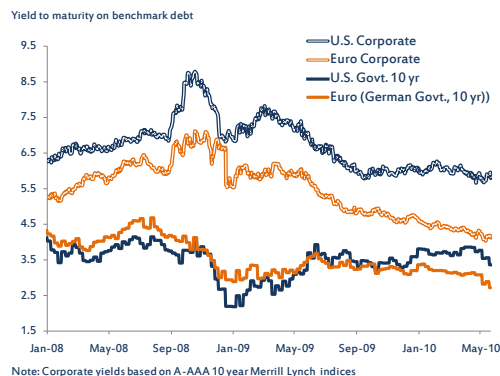
Source: World Bank.

Figure 6. Net private capital inflows will stage a modest recovery



Source: World Bank.

Figure 7. Long-term corporate yields have held relatively steady even as flight-to-safety causes U.S. and German government bonds to fall



Source: Bloomberg.

Weaker aid flows could translate into slower growth and increased poverty over the long-term

The economic impact on long-term growth in developing countries of a forced pullback from growth-enhancing infrastructure and human-capital investment due to lower fiscal revenues, weaker ODA, and sluggish capital flows, are difficult to gauge, as are the effects on private sector growth of tighter

financial sector regulations, and increased competition for capital from high-income sovereigns. *Global Economic Prospects: Crisis, Finance and Growth* (World Bank, 2010) estimated that just the latter two factors could reduce developing country growth rates by between 0.2 and 0.7 percent for a period of 5 to 7 years.

Although the effects on trend growth of a deterioration in financing conditions, or in the capacity of developing countries to invest in their future production, may appear small, their cumulative impact on poverty and poverty reduction could be large. Even a relatively small 0.5 percentage point decline in the rate of growth of potential output in low income countries would—over a 10 year period— increase the number of people living on \$2 dollars per day or less, by as much as 79 million (Table 4).

Medium-term prospects are for a modest recovery, with global growth dependent on prospects for developing countries

Overall, global GDP is expected to expand by 3.3 percent in 2010 and 2011, rising somewhat thereafter to 3.5 percent in 2012 (see earlier Table 1). Reflecting much higher productivity and population growth, the economies of the developing world are expected to grow by about 6 percent in all three years, while high-income country growth is limited to 2.3 percent in 2010 and 2.4 and 2.7 percent in 2011 and 2012 respectively. Because of these large growth differentials, developing countries will be a major source of global growth (Figure 8). Close to half of the increase in global

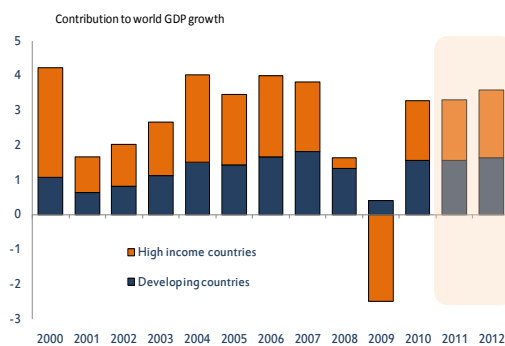
Table 4. A 0.5 percentage point decrease in the rate of growth could increase poverty by 79 million in the long term

Region	Impact on poverty of a 0.5 percent decline in growth as of 2015			
	Poverty Line \$1.25		Poverty Line \$2.00	
	Change in head count	Change in head count	Change in head count	Change in head count
	millions	% points	millions	% points
East Asia and Pacific	4.1	0.2	12.9	0.7
Europe and Central Asia	0.4	0.1	1.4	0.3
Latin America and Caribbean	0.8	0.1	3.0	0.6
Middle East and North Africa	0.3	0.1	1.4	0.6
South Asia	10.0	0.7	30.1	2.1
Sub-Saharan Africa	6.7	1.0	7.6	1.1
Developing Countries	22.4	0.4	56.4	1.0

Region	Impact on poverty of a 0.5 percent decline in growth as of 2020			
	Poverty Line \$1.25		Poverty Line \$2.00	
	Change in head count	Change in head count	Change in head count	Change in head count
	millions	% points	millions	% points
East Asia and Pacific	1.0	0.7	14.1	0.78
Europe and Central Asia	0.4	0.3	1.7	0.37
Latin America and Caribbean	1.6	0.6	3.2	0.59
Middle East and North Africa	0.5	0.6	2.1	0.89
South Asia	9.3	2.1	42.5	2.95
Sub-Saharan Africa	13.5	1.1	15.3	2.30
Developing Countries	26.3	0.4	78.8	1.4

Source: World Bank

Figure 8. Almost half of global growth is due to increased demand in developing countries



Source: World Bank

demand in each of 2010 through 2012 will come from developing countries, and their rapidly rising imports will be responsible for more than 40 percent of

the increase in global exports.

High-income countries

Growth in the *United States* is expected to remain strong in the second and third quarters of 2010, with growth of 3.3 percent for the year as a whole (see Table 1). GDP gains are projected to ease in 2011 to 2.9 percent, reflecting both a gradual tightening of fiscal policy and an end to the boost to growth from stock-building. *Japanese* growth is anticipated to rebound to 2.5 percent in 2010, but to slow thereafter to 2.1 percent. On balance, growth in the Euro area is forecast to remain weak at 0.7 percent in 2010, with some strengthening to 1.3 and 1.8 percent in 2011 and 2012 respectively. However over the medium to long(er) terms, trend growth in high-income Europe will trail that of the United States (and *ex fortiori* developing countries), principally because of slower working-age population growth, but also because of the large fiscal adjustments that countries in the region will begin, and the region's heavier reliance on banking (as opposed to bonds or stock markets) to finance private-sector investment.⁴

Developing countries

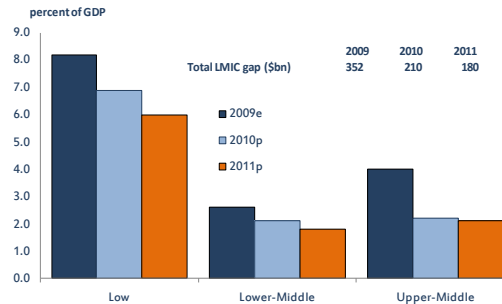
Developing country growth is projected to pick up from an estimated 1.7 percent in 2009 to around 6 percent in each of 2010, 2011 and 2012. The apparent steadiness of growth in each of these years belies an anticipated slowing of growth in China, the largest developing economy (from 9.5 in 2010 to 8.5 percent in 2011), as the fiscal stimulus put in place in 2009 begins to be unwound. Excluding China and India, developing country GDP is projected to increase by 4.5, 4.4, and 4.6 percent in

2010, 2011, and 2012 respectively.

High external financing needs in a time of sharp retrenchment in capital flows led to significant current account adjustments and slower growth in several developing countries during 2009. As a consequence, financing needs are forecast to decline from \$1.2 to \$1.1 trillion in 2010. Most of the decline in 2010 is due to reductions in current account deficits forced on developing countries by a 40 percent decline in international capital flows during 2009. Current account balances in deficit countries were almost halved from -\$283 to -\$128 billion in 2009. In several developing countries in Europe and Central Asia, deficits narrowed by more than 50 percent. Medium and long term debt coming due declined somewhat, thereby reducing financing requirements, but short-term debt has increased – leading to an overall rise in scheduled debt repayments. Based on the assumption that current account deficits remain at their 2009 levels as a percent of GDP, the total external financing needs of developing countries is projected to be on the order of \$1.1 trillion for 2010 through 2012.

Private capital flows to developing countries are forecast to recover modestly from \$454 billion (2.7 percent of GDP) in 2009 to \$771 billion (3.2 percent of GDP) by 2012 (see above). As a result, the ex-ante estimates of the financing gap will halve to \$180 billion by 2012 from \$352 billion in 2009. As a share of GDP, the decline in the financing gap is expected to be most marked for the upper-middle-income countries 1.5 percent and low income countries 1.3 percent (Figure 9).⁵ The financial markets annex provides more detail on recent developments.

Figure 9. Nevertheless external financing gaps will persist



Source: World Bank DEC Prospects Group staff estimates

The **East Asia and Pacific** region fared relatively well during the recession. The region is expected to grow by 8.7 percent in 2010 and 7.8 and 7.7 percent in 2011 and 2012. East Asia has benefitted from close links with China, which led the regional (and global) recovery. However, the earlier strong momentum in regional exports and production is waning, and output gaps are closing rapidly. Coupled with strong capital inflows and rising liquidity, this may put pressure on both goods and asset price inflation. Reflecting these factors, regional and Chinese growth are projected to slow to an average 7.8 and 8.4 percent respectively over 2011 to 2012 (see also the Regional Annex to this Report).

The recovery in **Europe and Central Asian** countries is the least advanced among developing regions, with industrial activity still some 11 percent below January 2008 levels, with GDP continuing to decline in several countries during the fourth quarter of 2009. Regional demand remains hobbled by large household foreign-currency debt obligations and significant negative wealth effects due to the earlier collapse

in real estate and equity markets. The compression in remittances inflows remains a challenge for smaller economies.

Economies in the region that weathered the crisis relatively well (Poland) are projected to rebound more strongly, supported by a return of capital inflows and global trade normalization. But countries that faced the crisis with unsustainable domestic booms - characterized by large current account deficits - (Bulgaria, Latvia, Lithuania) and those with vulnerable private or public balance sheets (Hungary, Romania) are expected to recover more slowly, due to limited room for policy maneuver. Overall, growth is forecast to average 4.5 percent over 2011-2012, compared with an average 7 percent during the boom years. Despite the recovery in growth rates, the large loss of output in 2009 means that even in 2012 many economies in the region will continue to be characterized by high unemployment and large quantities of spare capacity.

The recovery in **Latin America and the Caribbean**, a region dominated by middle-income countries and commodity exporters, entered a strong cyclical rebound during the second half of 2009, benefitting from a robust rebound in external demand, renewed capital inflows, higher commodity prices (see Box 1), a turn in the inventory cycle, and a significant boost to domestic demand from substantial monetary and fiscal stimulus. After contracting by an estimated 2.3 percent in 2009, output in the region is forecasted to expand by around 4.3 percent over the projection period, somewhat slower than during the boom period.

The outlook for the **Middle East and North Africa** region will continue to be driven by oil prices and economic activity in the European Union (the region's main trade partner). The oil price collapse at the onset of the financial crisis together with OPEC production restraints significantly reduced oil revenues, cut into intra-regional FDI flows, remittances and tourism receipts. However, exports are showing signs of life, with a gradual increase in oil revenues and a pick-up in goods shipments (the latter bound to Europe). Though headwinds from Europe places regional growth at some risk, recovery is anticipated to strengthen, with growth firming from 4.0 percent this year to 4.3 and 4.5 percent in 2011 and 2012 respectively.

GDP in **South Asia** has benefitted from stimulus measures (notably in India, and to a lesser extent in Bangladesh and Sri Lanka), relatively robust remittance inflows, which continued to expand (in contrast to declines elsewhere), and the recovery in global demand.

The region also benefitted from relatively resilient capital inflows, which increased as a share of GDP—from 3.6 percent in 2008 to 3.9 percent in 2009—and was supported by long-standing capital account restrictions. A combination of slower global growth, tighter financial conditions and a consolidation of fiscal policy in some countries in the region is expected to cause growth to average 8.4 percent over 2010-2012, compared with the pre-crisis rate of 9.2 percent in 2007 (calendar year basis).

Sub-Saharan Africa weathered the global crisis better than previous, milder economic cycles. In part this is because

the hardest hit global markets (consumer durables and investment goods) are relatively small sectors in the region. At the same time, the region's limited financial integration, normally a negative factor, diminished the size of the initial shock. GDP growth for the region—is expected to continue to strengthen slowly, driven by higher commodity prices and stronger external demand. Overall the region is forecast to grow by 4.5, 5.1 and 5.4 percent respectively over 2010 – 2012, up from an estimated 1.6 percent gain in 2009.

Box 1. Recent developments and prospects for commodity markets

Commodity prices started to rebound in early 2009 and into 2010 as the global recovery intensified. Increased demand from China, significant production cuts (metals and oil), and some weather-related factors (agriculture) contributed to higher prices. By the end of April 2010, energy prices were up 80 percent from the lows in February 2009, while metal prices more than doubled. Agricultural prices increased by 20 percent over this period, with most of the gains in raw materials, e.g. rubber and cotton. Food prices rose just 7 percent on generally abundant global supplies. Mainly reflecting the gains already recorded, non-energy commodity prices are projected to increase 16.8 percent in 2010, before declining in 2011-12.

Prices for industrial commodities fell sharply during May in the wake of the Euro debt crisis, on concerns about economic growth and commodity demand. Industrial commodities fell most, with oil prices plunging nearly \$20/bbl to \$68/bbl, and a number of metals prices fell more than 20 percent from their mid-April highs. Among agriculture commodities, only rubber prices recorded a large decline, reflecting the plunge in the price of oil. Commodity prices appeared to stabilize at end-May, but uncertainty about demand remains.

After five consecutive quarters of decline, world oil demand rose in the final quarter of

2009, led by strong demand in China—up 1.3 mb/d or 17 percent (year-on-year). Nevertheless, global supplies are ample. Following previous production cuts to support prices, OPEC's spare capacity has increased to around 6.5 mb/d, roughly the same level as in 2002 when oil prices were \$25/bbl. Moreover, inventories in the U.S. and in Europe are high. Over the medium term, oil demand is expected to grow only slowly – about 1.5 percent per annum, while non-OPEC oil supplies should continue to rise modestly, by about 0.5 percent a year, while OPEC countries continue to develop additional capacity. As a result, markets should remain well supplied. While prices are expected to average \$75/bbl in real terms in the long run, they are likely to remain volatile, reflecting the inherent difficulties associated with OPEC's efforts to guide global prices through supply management. The tragic oil spill in the Gulf of Mexico has not affected oil production, but will likely have a long-term impact on the industry in terms of regulation and costs.

China has been the primary driver of metal demand during this decade. Its consumption of main base metals (aluminum, copper, lead, nickel, tin and zinc) rose on average by 17 percent per year, while demand in the rest of the world fell 1.1 percent per year. China imported large volumes of metals in 2009, much of which went into private and government controlled stocks, which propelled prices higher. Demand in 2010 is starting to recover outside of China, and over the next two years, metals prices are expected to continue to rise moderately as the global recovery progresses and metal demand expands. However, prices are not expected to rise substantially, because of the large idle capacity in many sectors that can be profitably brought back into production at current prices. However, in some areas industry will have to contend with declining ore grades, environmental and land rehabilitation, as well as water, energy and labor pressures, which may result in upward pressure on prices.

Agricultural prices have rebounded less

strongly than energy and metals, having increased 27 percent from their December 2008 trough. The gains have been centered in specific (mostly tropical) commodities. Edible oil prices gained 28 percent while grain prices have fallen 8 percent. Fertilizer prices, a key input into agriculture, especially in grain production, moderated and have declined by about two thirds since the record highs of the third quarter of 2008. Among other commodities, coffee (arabica) prices increased 46 percent due to strong demand and a weather-induced supply shortfall in Colombia, while cocoa prices are up 33 percent largely because of Côte d'Ivoire's difficulty in supplying the global market. Rice production shortfalls in India and the Philippines during 2009 put upward pressure on prices, but good prospects for the current crop have helped lower prices in May 2010 to their lowest level in 27 months. Overall agricultural markets, especially grains, appear to be well-supplied and are likely to remain so over the forecast period. Food commodity prices are projected to be marginally higher in 2010 compared with 2009, but to decline by 3 and 1 percent in 2011 and 2012 respectively.

See the Commodity annex for more on recent developments and forecasts.

A slower-growth alternative baseline

The uncertainty emanating from Europe and as yet unknown policy reactions to the volatility that erupted in May, makes projecting short-term growth particularly difficult. Increased equity market volatility may lead investors to hold back on investment projects or cause consumers to delay durable goods purchases, potentially slowing growth and even leading to a double dip recession in selected countries. By the same token, how policy reacts to the current situation will also affect prospects. The rapid rise in the price of

CDSs for highly indebted high-income countries, and the potential for reduced market access for these countries, may prompt both them and other governments to speed up fiscal consolidation programs. Table 5 presents an alternative baseline that is consistent with a more constrained lending environment, more cautious investment and consumer behavior, and with governments assumed to speed up fiscal consolidation efforts by half the amount required to bring debt to GDP ratios to 60 percent of GDP by 2030 (see IMF, 2010).

In this alternative baseline scenario, global growth expands between 0.2 (2010) and 0.4 (2011 and 2012) percentage points slower than in the primary base case (Table 1, earlier). Most of the slower growth is explained by a weaker expansion in high-income countries, where GDP is projected to grow by 2.1, 1.9 and 2.2 percent in 2010 through 2012—lower by 0.1, and 0.5 points of growth over the period. The more constrained environment also affects growth in developing countries, but to a lesser extent – in part because only a few countries are assumed to implement sharper fiscal consolidation. The weaker growth in this scenario slows the pace of the expansion in global trade, and results in a somewhat lower price for commodities and lower inflation. Because the slowdown is concentrated in high-income countries, the share of developing countries contribution to global growth rises from 47 to 50 percent.

The expected confirmation of developing countries as a major growth pole does not mean that their prospects are divorced from those in high-income countries. To the contrary, slower

growth in high-income countries will imply slower growth than might have otherwise been expected in developing countries in the short-term. Moreover, their long-term growth prospects are intimately tied to those of high-income countries. Failure to deal with high-income indebtedness could deprive developing countries of healthy markets for their goods. And, increasing developing-country borrowing costs and sharper competition for global savings—due to persistent debt problems in high-income countries—could cut into developing-country investment and growth.

Table 5 A slower growth baseline
(percentage change from previous year)

	2008	2009e	2010f	2011f	2012f
World	1.7	-2.1	3.1	2.9	3.2
High income	0.4	-3.3	2.1	1.9	2.2
OECD Countries	0.3	-3.4	2.0	1.9	2.1
Euro Area	0.4	-4.1	0.5	0.9	1.5
Japan	-1.2	-5.2	2.2	1.4	1.5
United States	0.4	-2.4	3.0	2.3	2.5
Non-OECD countries	3.0	-1.7	4.1	4.1	4.4
Developing countries	5.7	1.7	6.1	5.7	5.8
East Asia and Pacific	8.5	7.1	8.6	7.5	7.4
Europe and Central Asia	4.2	-5.3	4.0	4.1	4.3
Latin America and Caribbean	4.1	-2.3	4.4	3.9	4.0
Middle East and N. Africa	4.2	3.2	4.0	4.2	4.4
South Asia	4.9	7.1	7.3	7.8	7.5
Sub-Saharan Africa	5.0	1.6	4.4	4.9	5.2

Source: World Bank.

e = estimate; f = forecast.

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

2. Calculated using 2005 PPP weights.

Potential impacts for developing countries from the sovereign debt crisis in Europe

Although a gradual, smooth resolution of the fiscal issues in high-income Europe is the most likely scenario,

should a disorderly adjustment occur, it could have serious consequences for both high-income and developing countries. But even in the absence of a disorderly adjustment, developing countries and regions with close trade and financial connections to highly-indebted high-income countries, may face important repercussions.

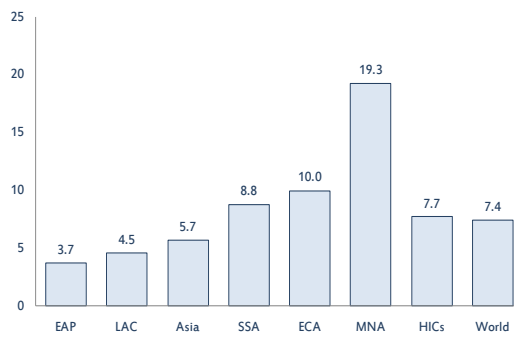
The Middle-East and North Africa, Europe and Central Asia and Sub-Saharan Africa regions have the closest trade ties with the heavily-indebted high-income European countries (EU-5) that are most likely to undergo a significant fiscal contraction (Figure 10). At the country level, these economies account for 20 percent or more of the exports of Albania, Azerbaijan, Cameroon, Cape Verde, Morocco, Tunisia, and Namibia. How hard these developing countries are hit, will depend on the extent of the fiscal contraction initiated, and how successful they are in shifting sales to other markets.

According to IMF (2010) fiscal consolidations, ranging between 9.2 (Greece) and 4.1 (Italy) percent of GDP, need to be implemented between 2010 and 2020 if these countries are to bring debt-to-GDP levels down to 60 percent by 2030. There is precedent for such large cuts in spending, but achieving them will require significant political sacrifices.⁶

Also at risk are countries whose financial sectors are closely linked to these highly indebted countries. Albania, Bulgaria, Romania, and Serbia are economies that have benefitted in the past from heavy capital inflows from Greek financial institutions. Similarly, banks in Portugal and Spain are an important source of finance in Latin

Figure 10 Developing regions with high trade exposure to heavily indebted European economies

Share of Greece, Italy, Portugal, and Spain in Exports, percent

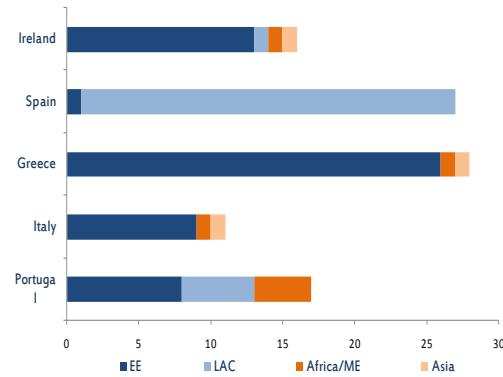


Sources: World Bank, UN-COMTRADE.

America. Overall, the public and private sectors in Latin America have borrowed some \$320 billion or 8 percent of GDP, while those in emerging Europe owe some \$400 billion or 13 percent of GDP. And, Spanish banks own over 25 percent of bank capital in Mexico, Chile, and Peru. Portuguese banks are also important in African countries such as Angola and Mozambique. Beyond banking, FDI flows may also be affected, in particular to Latin America—12 percent of FDI flows to Brazil in 2009 came from Spain and Portugal. Should banks in the EU-5 be forced to re-capitalize or retrench, capital flows to the developing regions noted could contract heavily, potentially imposing further significant cuts to domestic demand—particularly among those that still have large external financing needs.

Figure 11 Outstanding claims of banks in heavily-indebted European countries on developing countries

% of lender's GDP percent



Source: BIS

The global consequences of a default or major restructuring could be far reaching

A crisis of confidence, a default or major restructuring of EU-5 debt could have serious consequences for the global economy, both because of the large-scale recession that the directly affected countries are likely to enter into, but also because of the potential knock-on effects of the default on the financial health of creditor banks elsewhere in the globe.

The scenario outlined in Table 6, which takes as a starting point the slower growth baseline, illustrates the potential impacts on GDP, if a failure to take forceful action to restore fiscal policy onto a sustainable path were to increase investors' risk aversion towards economies with high debts.⁷ In this scenario, increased risk aversion is assumed to cause the yield on 10 year U.S. government bonds to rise by 100 basis points and that of other sovereigns depending upon the degree of their

indebtedness.⁸ The increase in long-term interest rates has an almost immediate effect on investment decisions. In this scenario, global growth slows by about ½ a percentage point throughout the forecast period. The impact on growth is more severe in high- and middle-income countries, reflecting lower interest rates (and therefore a bigger percentage shock) and in countries/regions with strong trade linkages to the most affected high-income countries.

Table 6. Impact from a 100 basis point increase in risk aversion

	2009	2010	2011	2012
	(Percent change in GDP from baseline)			
World	0.0	-0.4	-0.9	-1.4
High-income	0.0	-0.4	-1.0	-1.5
High-income (ex EU-5)	0.0	-0.4	-0.9	-1.4
Developing countries	0.0	-0.3	-0.8	-1.3
Middle-income	0.0	-0.3	-0.8	-1.3
Low-income	0.0	-0.4	-1.0	-1.6
East Asia and Pacific	0.0	-0.4	-1.0	-1.5
Europe and Central Asia	0.0	-0.2	-0.6	-0.8
Latin America and Caribbean	0.0	-0.4	-1.0	-1.6
Middle East and N. Africa	0.0	-0.3	-0.6	-0.9
South Asia	0.0	-0.4	-0.8	-1.1
Sub-Saharan Africa	0.0	-0.2	-0.5	-0.7
<hr/>				
	(annual percentage growth)			
World	-2.1	2.7	2.4	2.7
High-income	-3.4	1.6	1.3	1.7
High-income (ex EU-5)	-3.3	1.9	1.5	1.8
Developing countries	1.9	5.8	5.2	5.1
Middle-income	1.8	5.8	5.2	5.1
Low-income	4.5	4.7	5.6	5.6
East Asia and Pacific	7.1	8.2	6.9	6.4
Europe and Central Asia	-5.2	3.8	3.8	4.0
Latin America and Caribbean	-2.3	3.9	3.2	3.4
Middle East and N. Africa	3.2	3.7	3.8	4.1
South Asia	7.1	7.1	7.5	7.3
Sub-Saharan Africa	1.6	4.2	4.6	4.9

Source: World Bank.

1. Percentage growth after shock

A less likely scenario might see confidence levels fall so far as to cause a freezing up of both domestic and external credit to heavily indebted countries. In such a scenario, a sharp and sudden reduction in domestic demand in affected countries might be anticipated. Should such a crisis engulf all of the EU-5 countries, it would have significant

impacts on EU-5 exports and on activity in the rest of Europe and indeed the rest of the world.

Table 7 presents the results of a simulation that combines the generalized increase in risk premia of the earlier scenario, with the impact of an acute crisis in confidence that hits the EU-5 in the second half of 2010. The impact of the confidence crisis on domestic demand in EU-5 countries is modeled on the East Asia Crisis, and assumes that, either following a default, or based on market expectations of a default, credit (both international and domestic) to the EU-5 countries dries up and that a brutal fiscal adjustment and credit crunch ensues. GDP in EU-5 countries declines by as much as 15 percent, which has serious knock-on effects to the exports and activity levels in the rest of the EU and the rest of the world. Although the world economy escapes a recession in this scenario, global growth declines by about 2 percent in 2011.

Growth begins to recover in 2012, but overall world GDP is some 4 percentage points lower than it would have been in the baseline no crisis scenario. Because the shock runs through the trade channel, the hardest hit economies are those where export value-added is a large share of GDP and those with tight trade connections to the hardest hit countries. East Asia and the Pacific is particularly hard hit because of the importance of exports to its overall economy; likewise South Asia's still relatively low export-to-GDP ratios insulate it from the worst effects of the shock. Impacts in Sub-Saharan Africa and the Middle-East and North Africa are relatively muted despite the high concentration of EU-5 countries in their exports, because of low export to GDP ratios overall.

Table 7. Impact of a 100 basis point increase in risk aversion combined with the a severe debt crisis in EU-5 countries

	2009	2010	2011	2012
	(Percent change in GDP from baseline)			
World	0.0	-1.0	-3.1	-4.1
High-income	0.0	-1.1	-3.5	-4.6
High-income (ex EU-5)	0.0	-0.9	-2.4	-3.5
Developing countries	0.0	-0.8	-2.0	-2.9
Middle-income	0.0	-0.8	-2.0	-2.9
Low-income	0.0	-0.6	-1.6	-2.2
East Asia and Pacific	0.0	-0.9	-2.3	-3.4
Europe and Central Asia	0.0	-0.6	-1.6	-2.1
Latin America and Caribbean	0.0	-0.9	-2.2	-3.4
Middle East and N. Africa	0.0	-0.7	-1.9	-2.4
South Asia	0.0	-0.8	-1.9	-2.5
Sub-Saharan Africa	0.0	-0.4	-1.1	-1.3
<i>Post shock</i> ¹	(annual percentage growth)			
World	-2.1	2.0	0.7	2.1
High-income	-3.4	0.9	-0.6	1.0
High-income (ex EU-5)	-3.3	1.4	0.5	1.2
Developing countries	1.9	5.3	4.4	4.6
Middle-income	1.8	5.3	4.4	4.6
Low-income	4.5	4.4	5.1	5.7
East Asia and Pacific	7.1	7.7	5.9	5.7
Europe and Central Asia	-5.2	3.4	3.0	3.7
Latin America and Caribbean	-2.3	3.5	2.5	2.7
Middle East and N. Africa	3.2	3.3	2.9	4.0
South Asia	7.1	6.6	6.8	7.0
Sub-Saharan Africa	1.6	4.0	4.2	4.9

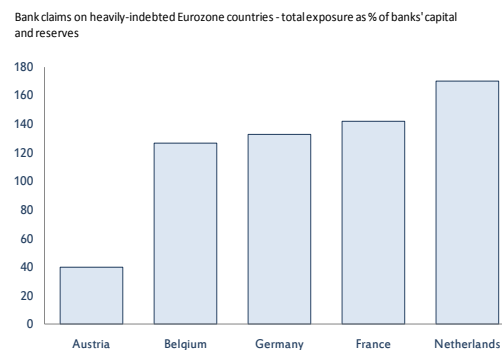
Source: World Bank.

1. Percentage growth after shock

The financial channel has the potential to be even more disruptive to global growth. A default or major restructuring among heavily indebted European sovereigns could have serious knock-on effects among the banks of other European countries. Banks located in Austria, Belgium, France, Germany, and the Netherlands have loan exposures to heavily-indebted European countries totaling €1.4 trillion at end-2009 (Figure 12), with those exposures exceeding the capital of these banks in many countries. A sharp decline in the value of such assets could threaten the solvency of some of these banks, with potentially far-reaching consequences for the overall banking system and the global economy.

Ex ante, there is little that developing

countries can do to insulate themselves from the possibility of a widening of the sovereign debt crisis. Clearly countries are well advised to improve their own fundamentals to ensure that markets continue to distinguish between their risks and those of these high-income countries. Countries that have run-down their reserves to dangerous levels should institute policies now that help to rebalance domestic demand (fiscal austerity in some cases, enhanced exchange rate flexibility in others) so as to engineer a relatively smooth current account adjustment rather than a sudden and disruptive market driven one.

Figure 12. European Banks are also at risk from a default or restructuring

Sources: World Bank; JP Morgan

A faster fiscal consolidation would be better for both high-income and developing countries

Even in the event of a smooth resolution of the fiscal challenges in high-income countries, how they are resolved may have important implications for outcomes in developing countries. In particular, simulations suggest that a policy that sought to unwind the fiscal challenges of high-income countries

relatively quickly would benefit developing countries, more than a policy that sought to unwind them only slowly.

Table 8 presents the results of simulations using the G-cubed dynamic general equilibrium model. The simulations compare GDP outcomes from two fiscal consolidation scenarios. In the baseline scenario, which is based on IMF (2010), countries slowly increase their primary balances between 2010 and 2020 to a level, which if maintained until 2030, would bring their debt-to-GDP ratios down to 60 percent by this time.⁹ Table 8 reports the changes in the level of GDP that would be observed at two points in time if the same fiscal consolidation (increase in primary balance) were undertaken more within four years and maintained until 2030.¹⁰ Two main factors are at work in these simulations. First, reduced government expenditure tends to lower GDP and import demand in the G-20 countries undertaking a consolidation. This effect is offset by the influence of lower interest rates due to decreased demand for global savings.

Among consolidating high-income countries, the first effect dominates for the first few years, so that GDP comes in as much as 1.8 percent lower than in the baseline for the United Kingdom. In Germany, however, where less fiscal consolidation is required, the second effect dominates and GDP is actually higher by 1.1 percent in 2014. For developing countries and high-income countries that do not need to undertake consolidation, the impact of the consolidation is positive even in the short-run because the negative effects from weaker demand for their exports is more than offset by the benefits to be derived from lower real interest rates

because of the fiscal tightening. Real interest rates in developing countries could be as much as 300 basis points lower in the short-run. The simulation assumes that interest rates in developing countries respond to international market conditions. To the extent that developing country interest rates do not react, perhaps because of market controls, this simulation will overestimate the positive effects for growth of lower interest rates.

Table 8. Impact of a faster fiscal consolidation

	2010	2014	2022
	(Per cent of GDP)		
World	0.0	0.6	1.2
<i>High-income</i>	0.0	-0.3	1.3
United States	0.0	-0.9	1.1
Japan	0.0	-1.6	1.3
United Kingdom	0.0	-1.8	2.9
Germany	0.0	1.1	0.5
Euro Area	0.0	0.5	1.6
Canada	0.0	2.0	0.5
Australia	0.0	1.7	0.7
New Zealand	0.0	1.4	1.7
ROECD	0.0	1.1	0.8
<i>Low- and Middle-income</i>	0.0	2.3	1.0
Low- and middle income (ex. China and India)	0.0	2.7	1.2
Low- and middle-income (ex. China, India, Europe and Central Asia)	0.0	3.4	0.9
China	0	2.9	0.9
India	0	2.3	1.2
Other Asia	0	3.4	1.1
Latin America	0	2.9	0.9
Other developing countries	0	4.1	0.6
Europe & Central Asia	0	2.3	1.1
OPEC	0	0.3	2.4

Source: World Bank. Simulations using the G-cubed model.

Overall, although a more rapid consolidation policy would imply (at least for the United States) a bigger short-term cost in terms of reduced GDP, in the long run such a policy would be a win-win. Lower interest rates and the stronger projected growth in developing countries in the quick adjustment scenario cause GDP in high-income countries to be higher in the long run, and even in the short-run in the case of

high-income countries that do not have to undertake a large fiscal adjustment.

Interestingly, in addition to alleviating the fiscal imbalances that currently characterize the global economy, the simulations suggest that this needed consolidation will also go a long way to reducing global imbalances. For example, in the short-run a quick adjustment scenario would see the U.S. trade deficit decline by about 3 percent of GDP and China's trade surplus decline by more than 6 percent of its GDP. In the longer run, the adjustments are more muted 1.6 and 4.5 percent respectively.

The conduct of monetary policy in high-income countries may also pose challenges for developing countries. For the moment, inflationary pressures have been on the wane in the vast majority of developing countries, reflecting both lower food and fuel prices and the extended bout of spare capacity brought about by recession (see the Appendix on inflation for more). As a result, monetary policy has been broadly expansionary. However, the recovery is much more advanced in many developing countries, and central bankers in many have begun to tighten monetary policy, including in Brazil and China. As a result, the spread between their short-term interest rates and those in several high-income countries are growing. This increases the financial incentive to make short-term investments in these countries, and associated capital inflows have the potential to be de-stabilizing for their economies.

The depth and duration of the crisis in Europe and Central Asia continues to be a source of concern

The expected duration and depth of the crisis will complicate matters further, especially for countries in the Europe and Central Asia region. As the recession wears on, firms are increasingly likely to have difficulty meeting their debt obligations. Non-performing loans are rising, and in some countries: Ukraine, Croatia, and Romania, bank provisioning is lagging more than 50 percent of the non-performing loans. Banking-sector fragility is accentuated in several countries that have significant exposures to Greek Banks. Should difficulties in Greece become more serious, these banks may be forced to cut activities or extract capital from their subsidiary operations – which could have serious knock-on effects for countries in the region.

Moreover, many companies in the region borrowed heavily during the boom period. Private companies borrowed \$418 billion dollars over the 2003-2008 period, with as much as \$133 billion expected to come due in 2010. Tighter global financial conditions may result in a reduction in rollover rates (international financial institutions and high-income Central European countries exercised considerable moral suasion on banks to renew loans in 2009), which could cause individual firms in the region to default – potentially putting them into bankruptcy and adding to pressure on regional banks.

Concluding remarks

The strong recovery that currently characterizes monthly data for the global economy is expected to lose some steam in the coming months; but annual growth rates should continue to strengthen—especially among developing countries. These countries are responsible for a growing share of global growth, a trend that is expected to continue in the years and decades to come. The outlook, nevertheless remains fragile and significant challenges stand in the way of a smooth recovery.

Chief among these are the problems in Greece and other highly indebted high-income countries—problems which continue to have the potential to widen. Although developing country finances are much stronger, a widening of the Greek crisis to other much larger high-income economies with serious fiscal difficulties could generate significant disruption to developing country export and GDP growth. If markets lose confidence in the credibility of efforts to put policy on a sustainable path, global growth could be significantly impaired and a double-dip recession could not be excluded.

More generally, significant fiscal consolidation is necessary to ensure the long-term sustainability of public finances in many high-income countries. While the domestic motivations for bringing government accounts back onto a sustainable path should be sufficient, more than the economic well-being of high-income countries is at stake. A prolonged period of rising high-income country indebtedness would raise global borrowing costs for developing countries, reducing investment and growth and ultimately resulting in more

poverty.

The fiscal challenges facing developing countries are less marked, but if aid flows are compromised, as they have been following past high-income recessions, then the consequences for developing-country investment and long-term growth prospects could be serious.

Continued very relaxed monetary policy in high-income countries could also pose challenges for developing countries, especially as they move to tighten their own policy stance. Rising interest rate differentials could induce significant capital inflows that could serve to regenerate some of the asset bubbles that created the conditions of the crisis in the first place.

Notes

1. In particular, while movements in global equity markets were highly correlated in May, they have been much less so than in the fall of 2008. Moreover, current correlations are lower than those observed in early 2010. Co-movements in other asset classes (CDS spreads for example) are also stronger, but they remain well below levels seen during the fall of 2008.
2. The index combines information on the changes since March 30th in sovereign spreads; domestic 3-month commercial interest rates; stock-market indices; and nominal exchange rates into a single index. The raw data are normalized by expressing them as the deviation from the average change, divided by the standard deviation of those deviations, such that each measure contributes equally to the overall index. Because of the normalization procedure, the index is a relative index. If financial conditions in all countries deteriorated, the index would show no change.
3. Several sovereign borrowers (including Argentina, Albania, Angola, Kenya, FYR Macedonia, Poland, and Tanzania) have delayed issuance plans likely due consideration of current market conditions.
4. Over the next 10 years, the United Nations predicts that the working-age population in Western Europe will decrease 0.42 percent per annum – in stark contrast to growth of 0.54 and 1.44 percent per annum in the United States and developing countries respectively.
5. The aggregate financing gap is defined as the sum of the difference between the estimated financing needs and projected private capital flows for all countries whose country-specific gap is negative. Thus, if *ex ante* projected financing exceeds the requirements of some countries, this positive gap is not used to offset the negative gap of countries with unmet needs.

Developing countries' external financing needs, are defined as the current-account deficit (assumed to be a constant at its 2009 level as a percent of GDP) plus scheduled principal payments on private debt (based on information from the World Bank's Debtor Reporting System). Private capital flows include disbursements on private debt, net equity flows (inflows minus outflows), and net unidentified capital outflows, which are projected at the country level.

Previous calculations utilized current account projections. Earlier estimates of the financing gap for 2009 used forecasts for current account deficits in 2009. Had a similar methodology been employed as reported here, the *ex ante* financing gap for 2009 would have been around \$460 billion rather than \$350 billion as estimated using the projections.
6. Ireland increased its primary balance in the 1980s by 20 percent of GDP, while nine countries have engineered improvements in excess of 10 percent of GDP over a time period ranging from 3 to 15 years (IMF, 2009).

7. Although during periods of heightened uncertainty there is a tendency for bond yields in safe-haven currencies to fall as money is repatriated, over the longer-run, once these portfolio adjustments occur, long-term rates even in safe-haven countries tend to rise once again. Indeed, prior to the EU-5 debt concerns dominating market attention, long-rates in the United States were rising. The simulations presented here examine this long-term behavior and abstract from the short-term fluctuations associated with short-term portfolio adjustments.
8. The scenario assumes short-term investment to long-term interest rate elasticities broadly consistent with Hervé et al. (2010). Following Kinoshita (2006) it assumes that countries risk premia rise or fall with the rate of the risk-free interest rate linearly (2 basis points per 1 percent of Government debt-to GDP ratio). Following, a 10 basis point increase in the risk-free interest rate would result in a 10.2 basis point increase in the interest rate paid by a country with a 1 percent debt-to GDP ratio and a 14 basis point increase in a country with a 20 percent of GDP debt ratio. In this scenario, where the long-term yield in the U.S. where Government debt-to-GDP is 71 percent (2008), interest rates rose by 100 basis points; the yield for Brazil, whose debt-to-GDP ratio is 65 percent (2008), would rise by 95 basis points.
9. This is a simplification of the IMF scenario. The degree of adjustment in most countries is as described. In the case of Japan, however, the scenario is adjusted to bring the net government debt-to-GDP ratio to 80 percent by 2030 (equal to about 200 percent in gross terms), while for Greece the 7.6 percent of GDP tightening announced for 2010 is assumed to occur.
10. In the second scenario, debt-to-GDP ratios are lower in 2030 than in the first scenario because the adjustment in primary balances is the same, but occurs 6 years earlier.

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