2012 began on a propitious note …

The year began on a positive note. A marked improvement in market sentiment, combined with monetary policy easing in developing countries, was reflected in a rebound in economic activity in both developing and advanced countries. Industrial production, trade and capital goods sales all returned to positive territory, following the slow growth of the fourth quarter of 2011. Developing countries, once again, led the rebound, helping to pull the Euro Area into marginally positive GDP growth in the first quarter.

However, since the beginning of May, much of this progress has been called into question by a re-igniting of Euro Area jitters, which roiled financial markets around the globe. Credit default swap (CDS) rates in Euro Area economies have increased to near record levels, while those of other high-income countries are also up considerably.

So far, conditions in most developing countries are better than they were in the second half of 2011. Outside of Europe and Central Asia and the Middle East and North Africa, CDS rates remain well below the maximums seen in 4Q 2011. Nonetheless, developing and high-income country stock markets have lost some 7 percent since May 1st, giving up two-thirds of the gains generated over the preceding four months. Most industrial commodity prices are down, with crude oil and copper prices down by 19 and 14 percent respectively, while developing country currencies have lost value against the US dollar, as international capital fled to safe-haven assets, such as German and U.S. government bonds.

Renewed uncertainty adds to pre-existing headwinds…

The resurgence of tensions in the Euro Area is a reminder that the after effects of the 2008/09 crisis have not yet played out fully. Financial market uncertainty and fiscal consolidation associated with the high deficits and debt levels of high-income countries are likely to be recurring sources of volatility for the foreseeable future as it will take years of concerted political and economic effort before debt to GDP levels of the United States, Japan and many Euro Area countries are brought down to sustainable levels.

Although debt levels in developing countries are lower, several countries (notably Jordan, India, and Pakistan) must reduce their structural fiscal balances to reduce debt to 40 percent of GDP by 2020 (or prevent debt-to-GDP ratios from rising further).

Banking-sector deleveraging is cutting into growth and developing country capital flows …

Even before the latest bout of risk aversion, pressure on European banks to deleverage intensified in the second half of 2011. Faced with rising funding costs, increased counter-party risk assessments, deteriorating bank asset quality, and growing concerns over the adequacy of capitalization, European banks started to reduce their loan books in the second half of 2011.

For the moment, data do not permit a full accounting of the extent of spillover effects to developing countries. However, the quantity of syndicated bank loans to developing countries organized and led by European banks (not including interbank and bilateral loans) fell by almost 40 percent during the six months ending March 2012, compared with the same period a year earlier. Almost all developing regions were affected, with the biggest percentage declines among projects in South Asia (down 72 percent), partly reflecting a deterioration of investment conditions in India. European-led lending to Russia and Turkey plunged by 50 and 56 percent, respectively.

Trade finance delivered by European banks (major players in this market) also declined in 4Q 2011, from a pre-crisis high of 2.8 percent of developing country exports to a post-crisis low of 1.4 percent in 1Q 2012. While the pace of deleveraging is expected to slow, lending conditions are likely to remain tight in the years to come, partly because markets will demand higher interest rates for a given level of risk, but also because of tighter regulation.

Capacity utilization may become a binding constraint in major developing countries …

Developing countries have been important drivers of global growth in the post-crisis period, generating about 50 percent of the increase in global import demand and GDP growth. While they are expected to continue to play an important role, many of the larger and faster growing economies are close to or above potential, which suggests that they will not be able to drive global growth as before.

Outside of Europe and Central Asia and the Middle East and North Africa – two regions hard hit by either the financial crisis or domestic turmoil – about half of the developing countries for which data are available are operating at or above potential. In some of these countries, capacity constraints are generating inflationary pressures in either goods or asset markets, or raising current account imbalances. Domestic tensions appear to be particularly acute in countries like Turkey and India where inflation is high and fiscal and current account deficits elevated.

Growth is expected to slow in 2012 and then pick up slowly …

The increase in tensions so far can be expected to subtract about 0.2 percentage points from Euro Area growth in 2012. The direct effect on developing country growth will be smaller (in part because there has been less contagion), but increased market jitters, reduced capital inflows, high-income fiscal and banking-sector consolidation are all expected to keep growth weak in 2012.

- GDP in developing countries is projected to expand 5.3 percent in 2012. Weak high-income demand, high oil prices, weak capital flows, rising capital costs and capacity constraints in several large middle-income countries will conspire to keep growth from exceeding 6 percent in each of 2013 and 2014.
- High-income GDP is expected to expand only 1.4 percent this year, weighed down by market jitters, banking-sector deleveraging and ongoing fiscal consolidation. As these pressures ease, growth is projected to firm to what will be a still modest 1.9 and 2.3 percent pace in each of 2013 and 2014. The Euro zone is projected to contract by 0.3 percent this year, returning to positive territory with a weak 0.7 percent growth in 2013 and 1.4 percent in 2014.
- Overall, global GDP is projected to increase 2.5 percent in 2012, with growth accelerating to 3.0 and 3.3 percent in 2013 and 2014.

Macroeconomic buffers have been depleted, increasing developing country vulnerabilities …

- Although the most likely outturn for the global economy is a gradual easing of current tensions, a sharp deterioration of conditions cannot be ruled out. If this occurs developing countries would probably not bounce back as quickly as they did in 2008/09 because their economies will enter into such a crisis with much weaker macroeconomic fundamentals. For instance, on average, developing country budget deficits are 2.5 percent of GDP higher than in 2007, suggesting they would be less able to respond with fiscal stimulus in the event of a serious crisis.
- Their external vulnerability has increased as well. Developing country current account deficits have deteriorated by an average of 2.8 percent of GDP, with most of the deterioration having been among oil importing and non-oil commodity exporters. Should international financing not

be available in the event of a crisis, a lack of foreign funds might force many countries to cut back on government spending and/or imports.

- In addition, the very rapid expansion of credit in past years in some countries may have increased their vulnerability either to tighter international conditions or domestic shocks. In Brazil, China and Nigeria, for example, loan-to-GDP ratios increased by more than 10 percentage points between 2005 and 2010. Loan performance could deteriorate markedly in these countries in the face of slowing growth, heightened risk aversion and restricted access to finance.

In a crisis no developing country would be spared …

In the immediate run, the new tensions pose the most serious potential risk for developing countries, particularly those with strong reliance on worker remittances, tourism, commodities or those with high levels of short-term debt or medium-term financing requirements.

- Remittances to developing countries could decline by 5 percent or more, representing as much as a 3 or more percent decline in GDP among countries heavily dependent on remittances.
- Tourism, especially from high-income Europe, would be impacted with significant repercussions for countries in North Africa and the island economies of the Caribbean.
- Countries with high levels of short-term debt could be forced to cut sharply into government and public spending if global finance were to freeze up.
- In case of a serious recession, commodity prices could fall precipitously, cutting into fiscal balances (by 1.8 or more percent of GDP) and incomes in oil and metal exporters, but helping to cushion the blow among oil importing economies.
- A disorderly unwinding of sovereign debt obligations could force a much accelerated process of bank deleveraging in Europe with economies in Europe and Central Asia, and to a lesser degree Latin America, among the hardest hit.

Managing growth in a volatile world …

Even in the absence of a full-blown crisis, elevated fiscal deficits and debts in high-income countries and the very loose monetary policies they are pursuing suggests that for the foreseeable future, the external environment for developing economies is likely to remain characterized by volatile capital flows and heightened investor uncertainty.

As a result, sharp swings in investor sentiment and financial conditions will continue to complicate the conduct of macroeconomic policy in developing countries. In these conditions, policy in developing countries needs to be less reactive to short-term changes in external conditions, and more responsive to medium-term domestic considerations. A return to more neutral macroeconomic policies would also help developing countries reduce their vulnerabilities to external shocks, by rebuilding fiscal space, reducing short-term debt exposures and recreating the kinds of buffers that allowed them to react so resiliently to the 2008/09 crisis.

Table 1.1 The global outlook in summary
(percentage change from previous year, except interest rates and oil price)

	2010	2011	2012e	2013f	2014f
Global Conditions					
World Trade Volume (GNFS)	13.0	6.1	5.3	7.0	7.7
Commodity Prices (USD terms)					
Non-oil commodities	22.5	20.7	-8.5	-2.2	-3.1
Oil Price (US$ per barrel) [1]	79.0	104.0	106.6	103.0	102.4
International capital flows to developing countries (% of GDP)					
Developing countries					
Net private and official inflows	5.8	4.6	3.3	3.6	3.8
Net private inflows (equity + debt)	5.4	4.4	3.1	3.4	3.7
East Asia and Pacific	5.9	4.9	3.3	3.4	3.5
Europe and Central Asia	4.9	4.4	2.6	3.7	3.9
Latin America and Caribbean	6.1	4.8	3.9	3.9	4.0
Middle East and N. Africa	2.3	0.0	1.0	1.7	2.2
South Asia	5.2	3.7	2.8	3.0	3.5
Sub-Saharan Africa	3.6	3.4	2.6	3.3	4.3
Real GDP growth [2]					
World	**4.1**	**2.7**	**2.5**	**3.0**	**3.3**
Memo item: World (PPP weights) [3]	5.1	3.7	3.3	3.9	4.2
High income	**3.0**	**1.6**	**1.4**	**1.9**	**2.3**
Euro Area	1.8	1.6	-0.3	0.7	1.4
Japan	4.5	-0.7	2.4	1.5	1.5
United States	3.0	1.7	2.1	2.4	2.8
Developing countries	**7.4**	**6.1**	**5.3**	**5.9**	**6.0**
East Asia and Pacific	9.7	8.3	7.6	8.1	7.9
Europe and Central Asia	5.4	5.6	3.3	4.1	4.4
Latin America and Caribbean	6.1	4.3	3.5	4.1	4.0
Middle East and N. Africa	3.8	1.0	0.6	2.2	3.4
South Asia	8.6	7.1	6.4	6.5	6.7
Sub-Saharan Africa	5.0	4.7	5.0	5.3	5.2

Source: World Bank.
Notes: PPP = purchasing power parity; e = estimate; f = forecast.
1. Simple average of Dubai, Brent and West Texas Intermediate.
2. Aggregate growth rates calculated using constant 2005 dollars GDP weights.
3. Calculated using 2005 PPP weights.