



GLOBAL ECONOMIC PROSPECTS

Coping with policy normalization in high-income countries



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Chapter I

GLOBAL OUTLOOK

Overview and main messages

After several years of extreme weakness, high income economies appear to be finally turning the corner, contributing to an acceleration in global growth from 2.3 percent last year to [3.1] percent this year and to [3.4] and [3.5] percent in each of 2015 and 2016 (table 1).

Most of the acceleration is expected to come from high-income countries, as the drag on growth from fiscal consolidation and policy uncertainty eases and private-sector recoveries gain firmer footing. High-income growth is projected to strengthen from only [1.2] percent in 2013 to [2.2] percent this year and 2.4 percent in each of 2015 and 2016. The strengthening of output among high-income countries marks a significant shift from recent years when developing countries alone pulled the global economy forward.

Activity and sentiment in developing countries has turned up since mid-year bolstered by strengthening high-income demand and a policy induced rebound in China. These positive developments were partly offset by tighter financial conditions and reduced capital flows as long-term interest rates in the U.S. ticked up in response to expectations of the gradual withdrawal of quantitative easing that will. Other major headwinds included declining commodity prices for commodity exporters.

Overall, growth in developing countries is projected to pick up modestly from [4.8] percent in 2013 to [5.3] percent this year and [5.5] and [5.7] percent in each of 2015 and 2016. Developing GDP growth will be about .2 percentage points weaker than it was during the pre-crisis boom period. However, the slower growth is not cause for concern. More than two-thirds of the slowdown reflects a decline in the cyclical component of growth and less than one third is due to slower potential growth.

Growth accelerations are projected to be particularly muted in both East Asia & Pacific and

Latin America & Caribbean regions, as economies in these regions have already recovered from the crisis and are growing at potential. In the East Asia & the Pacific region, GDP growth is projected to remain flat at about [7.1-7.2] percent over the projection horizon, partly reflecting a trend slowing of growth China as it rebalances its economy. In Latin America & the Caribbean, a strong rebound in Mexico following very weak growth in 2012, coupled with more modest firming of growth elsewhere is projected prompt a pick up in growth from [2.6] percent in 2013 to around [3.3] percent in 2014 and around [3.5] percent in 2016.

Trade and financial linkages with high-income Europe and a reduced pace of domestic household, fiscal, and banking sector consolidation are expected to boost GDP growth in developing Europe & Central Asia from [3.1] percent in 2013 to [3.7] percent in 2014, rising further to [4.6] percent in 2016. In the Sub-Saharan Africa region relatively robust domestic demand, notably resource-sector investments, should help support regional growth of about [5.4] percent in 2015 and 2016. In South Asia, very weak growth in India – following several years of rising inflation and current account deficits – has opened up a large negative output gap, which is projected to gradually close as the economy slowly recovers. Better Indian performance will be heavily reflected in a regional growth that is expected to strengthen from [4.7] percent in 2013 to [5.6] percent in 2014 and about [6.6] percent in 2016.

Many of the economies of the Middle East and North Africa region remain in turmoil nearly three years after the Arab Spring uprisings first began. Nascent recoveries have repeatedly faltered due to the flaring up of political and social tensions. These tensions and their economic consequences are assumed to persist in the baseline forecast — holding back a more vigorous rebound. Regional GDP is estimated to have remained flat in 2013 and to expand by [2.7] percent in 2014 before rising to [2.8] percent in 2016. Of course should tensions ease more quickly than anticipated (or deteriorate) outcomes could be substantially better (worse).

Prospects will be sensitive to the pace at which extraordinary monetary support measures in

Table 1. The global outlook in summary

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

	2012	2013e	2014f	2015f	2016f	GEP 13b Forecast (Jun 2013)				Change				
						2012	2013	2014	2015	2012	2013	2014	2015	
<i>Global conditions</i>														
World trade volume (GNFS)	2.4	3.1	4.6	5.1	5.2	2.7	4.0	5.0	5.4	-0.3	-0.9	-0.4	-0.3	
Consumer prices														
G-7 Countries ^{1,2}	1.8	1.3	1.8	1.9	2.0									
United States	2.1	1.5	1.7	2.0	2.2	2.1	2.4	2.5	2.5	0.0	-0.9	-0.8	-0.5	
Commodity prices (USD terms)														
Non-oil commodities	-8.6	-8.3	-0.2	-0.3	0.1	-9.5	-4.7	-1.1	-1.5	0.9	-3.6	0.9	1.2	
Oil price (US\$ per barrel) ³	105.0	105.0	105.7	102.0	100.7	105.0	102.4	101.0	101.0	0.0	2.6	4.7	1.0	
Oil price (percent change)	1.0	0.0	0.7	-3.5	-1.3	1.0	-2.5	-1.3	-0.1	0.0	2.5	2.0	-3.4	
Manufactures unit export value ⁴	-1.3	-1.6	2.3	1.0	1.4	-2.1	2.4	2.2	1.9	0.8	-4.0	0.1	-0.9	
Interest rates														
\$, 6-month (percent)	0.7	0.4	0.4	0.7	1.3	0.5	0.7	1.1	1.4	0.2	-0.3	-0.7	-0.7	
€, 6-month (percent)	0.8	0.3	0.3	0.5	0.8	0.2	0.5	1.2	1.5	0.6	-0.2	-0.9	-1.0	
International capital flows to developing countries (% of GDP)														
Developing countries														
Net private and official inflows	5.1	4.7	4.3	4.3	4.2	5.0	4.7	4.4	4.3	0.1	0.0	-0.1	0.0	
Net private inflows (equity + debt)	5.0	4.6	4.2	4.2	4.1	4.9	4.7	4.4	4.3	0.1	-0.1	-0.2	-0.1	
East Asia and Pacific	4.7	4.4	4.0	3.9	3.7	4.6	4.2	3.9	3.8	0.1	0.2	0.1	0.1	
Europe and Central Asia	7.8	6.6	6.0	6.2	6.3	5.7	6.5	6.1	6.0	2.1	0.1	-0.1	0.2	
Latin America and Caribbean	5.7	5.3	5.0	5.1	4.9	6.4	5.9	5.5	5.3	-0.7	-0.6	-0.5	-0.2	
Middle East and N. Africa	2.1	1.5	1.1	1.6	1.7	1.4	1.1	1.4	1.7	0.7	0.4	-0.3	-0.1	
South Asia	4.1	3.7	3.6	3.7	3.9	4.0	3.6	3.4	3.3	0.1	0.1	0.2	0.4	
Sub-Saharan Africa	4.8	5.3	4.3	4.2	4.1	3.5	3.8	3.9	4.2	1.3	1.5	0.4	0.0	
Real GDP growth ⁵														
World	2.5	2.3	3.1	3.4	3.5	2.3	2.2	3.0	3.3	0.2	0.1	0.1	0.1	
Memo item: World (2010 PPP weights)	2.9	2.9	3.6	3.9	4.0	2.9	3.1	3.8	4.1	0.0	-0.2	-0.2	-0.2	
High income														
OECD countries	1.4	1.1	2.1	2.2	2.3	1.2	1.1	1.9	2.2	0.2	0.0	0.2	0.0	
Euro Area	-0.6	-0.5	1.1	1.5	1.5	-0.5	-0.6	0.9	1.5	-0.1	0.1	0.2	0.0	
Japan	1.9	1.8	1.6	1.2	1.3	2.0	1.4	1.4	1.3	-0.1	0.4	0.2	-0.1	
United States	2.7	1.7	2.6	2.9	3.0	2.2	2.0	2.8	3.0	0.5	-0.3	-0.2	-0.1	
Non-OECD countries	3.5	2.5	3.3	3.7	3.8	2.8	3.1	3.7	3.9	0.7	-0.6	-0.4	-0.2	
Developing countries														
East Asia and Pacific	4.8	4.8	5.3	5.5	5.7	5.0	5.1	5.6	5.7	-0.2	-0.3	-0.3	-0.2	
East Asia and Pacific	7.4	7.2	7.2	7.1	7.1	7.5	7.3	7.5	7.5	-0.1	-0.1	-0.3	-0.4	
China	7.7	7.7	7.7	7.5	7.5	7.8	7.7	8.0	7.9	-0.1	0.0	-0.3	-0.4	
Indonesia	6.2	5.6	5.3	5.5	5.5	6.2	6.2	6.5	6.2	0.0	-0.6	-1.2	-0.7	
Thailand	6.5	3.2	4.5	5.0	5.2	6.5	5.0	5.0	5.5	0.0	-1.8	-0.5	-0.5	
Europe and Central Asia	2.0	3.4	3.5	3.7	3.8	2.7	2.8	3.8	4.2	-0.7	0.6	-0.3	-0.5	
Kazakhstan	5.0	5.8	5.9	6.0	6.0	5.0	5.0	5.3	5.5	0.0	0.8	0.6	0.5	
Turkey	2.2	4.3	3.5	3.9	4.2	2.2	3.6	4.5	4.7	0.0	0.7	-1.0	-0.8	
Romania	0.7	2.5	2.5	2.7	2.7	0.7	1.7	2.2	2.7	0.0	0.8	0.3	0.0	
Latin America and Caribbean	2.6	2.5	2.8	3.1	3.7	3.0	3.3	3.9	3.8	-0.4	-0.8	-1.1	-0.7	
Brazil	0.9	2.2	2.4	2.7	3.7	0.9	2.9	4.0	3.8	0.0	-0.7	-1.6	-1.1	
Mexico	3.9	1.4	3.4	3.8	4.2	3.9	3.3	3.9	3.8	0.0	-1.9	-0.5	0.0	
Argentina	1.9	4.9	2.8	2.5	2.5	1.9	3.1	3.0	3.0	0.0	1.8	-0.2	-0.5	
Middle East and N. Africa	1.5	-0.1	2.8	3.3	3.4	3.5	2.5	3.5	4.2	-2.0	-2.6	-0.7	-0.9	
Egypt ⁶	2.2	1.5	1.7	2.0	2.4	2.2	1.6	3.0	4.8	0.0	-0.1	-1.3	-2.8	
Iran	-2.9	-1.5	1.0	1.8	2.0	-1.9	-1.1	0.7	1.9	-1.0	-0.4	0.3	-0.1	
Algeria	3.3	2.8	3.3	3.5	3.5	2.5	2.8	3.2	3.5	0.8	0.0	0.1	0.0	
South Asia	4.2	4.6	5.7	6.3	6.7	4.8	5.2	6.0	6.4	-0.6	-0.6	-0.3	-0.1	
India ^{6,7}	5.0	4.8	6.2	6.6	7.1	5.0	5.7	6.5	6.7	0.0	-0.9	-0.3	-0.1	
Pakistan ^{6,7}	4.4	3.6	3.4	4.1	4.5	3.7	3.4	3.5	3.7	0.7	0.2	-0.1	0.4	
Bangladesh ⁶	6.2	6.0	5.7	6.1	6.0	6.2	5.8	6.1	6.3	0.0	0.2	-0.4	-0.2	
Sub-Saharan Africa	3.6	4.8	5.4	5.4	5.4	4.4	4.9	5.2	5.4	-0.8	-0.1	0.2	0.0	
South Africa	2.5	1.9	2.7	3.4	3.5	2.5	2.5	3.2	3.3	0.0	-0.6	-0.5	0.1	
Nigeria	6.6	6.7	6.7	6.8	6.8	6.5	6.7	6.7	7.0	0.1	0.0	0.0	-0.2	
Angola	5.2	5.1	8.0	7.3	7.0	8.1	7.2	7.5	7.8	-2.9	-2.1	0.5	-0.5	
Memorandum items														
Developing countries														
excluding transition countries	4.8	5.0	5.4	5.6	5.8	5.0	5.3	5.8	5.9	-0.2	-0.3	-0.4	-0.3	
excluding China and India	2.9	3.2	3.6	3.9	4.2	3.3	3.5	4.2	4.4	-0.4	-0.3	-0.6	-0.5	

Source: World Bank.

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

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

2. In local currency, aggregated using 2010 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 2010 dollars GDP weights.

6. In keeping with national practice, data for Bangladesh, Egypt, India, and Pakistan are reported on a fiscal year basis in table 1.1.

Aggregates that depend on these countries are calculated using data compiled on a calendar year basis.

7. Real GDP at factor cost, consistent with reporting practice in Pakistan and India.

high-income countries are withdrawn

The strengthening of growth in the U.S.A. has already prompted the Federal Reserve to announce plans to begin reducing the extent of support it provides to the economy on January. In the baseline, the withdrawal of quantitative easing (and its effect on the long-end of US interest rates) is assumed to follow a relatively slow orderly trajectory as the US economy improves.

The corresponding increase in global interest rates is expected to weigh on investment and growth in developing countries as capital costs rise and capital flows recede in line with a rebalancing of global asset portfolios. So far, market reactions have been subdued. If, however, the taper is met with a sharp adjustment in portfolios as occurred in the summer of 2013, capital flows could weaken sharply — placing renewed stress on vulnerable developing economies. In a scenario where long-term interest rates rise rapidly by 100 basis points, capital flows could decline by as much as [30] percent for several quarters ([80] percent in the less likely scenario of a sudden 200 basis point increase). Impacts on developing countries under such scenarios are likely to be concentrated among middle-income countries with deeper financial markets and domestic imbalances.

Especially in the scenarios where interest rates adjust rapidly and capital flows weaken, financial conditions in many developing countries could tighten sharply. The ability to withstand these such shocks will depend crucially on domestic vulnerabilities and policy buffers, with some better placed to navigate these headwinds.

Risks will be most pronounced among developing economies where short-term and/or foreign debt represents a large proportion of overall debt, or where credit has been expanding rapidly in recent years. Policy makers in these economies should be taking steps now to restructure debt holdings toward longer-term issues, and requiring banks to stress-test their loan books and begin provisioning now (before they go bad) loans that might be at risk.

Rebalancing, retrenchment and reforms will prove much harder to deliver than stimulus

Developing countries responded to the 2007/08 global financial crisis by deploying fiscal and monetary stimulus. However, with government deficits and current account balances some [3] or more percent of GDP higher in most countries the scope for such reactions has declined greatly.

More to the point, for most developing countries improved growth will have to come from supply-side reforms that increase underlying growth potential.

Given the risks that developing countries are facing, policy makers need to give thought now to how they would respond to a sharp deterioration in external conditions. Appropriate policy responses will vary from country to country, but may include tightening monetary policy to reduce vulnerabilities and attract capital, allowing a controlled depreciation (particularly for economies with flexible exchange regimes and overvalued exchange rates, and the prudent use of capital controls and macro-prudential regulations. These measures may need to be supplemented by policy reforms—for example, of the kind being adopted in Mexico and China. By improving the longer term growth outlook, credible reform agendas can go a long way towards boosting investor and market confidence and potentially set in motion a virtuous cycle of stronger investment, including foreign investment, and output growth over the medium term.

Older risks include fiscal policy uncertainty in the US and rebalancing in China.

If upcoming debt ceiling debates in the US prove as tense as in October, these could hobble the recovery underway through negative confidence and spending impacts and, at worst, could spark an acute global crisis in case of a debt default. In China, policy makers attempts to steer the economy to a more sustainable path are raising concerns about the ability of firms and banks to continue to service loans contracted during the investment boom. The structural shift in China's growth patterns also poses commodity price risks, so that producers in sub-Saharan Africa and Latin America could suffer further negative terms of trade shocks on top of those already experienced from the sharp falls in food and metals prices over the past year.

Recent Developments

High income economies are finally emerging from the crisis

After years of feeble growth or outright recessions, a recovery appears to be taking hold in high income economies (figure 1). Among the three major high-income economies (the United States, the Euro Area and Japan), the recovery is the most advanced in the US, with GDP having been growing for [10] quarters now, and having reached a level [5] percent higher than in the pre-crisis period (although only 1 percent above in per capita terms) (figure 2).

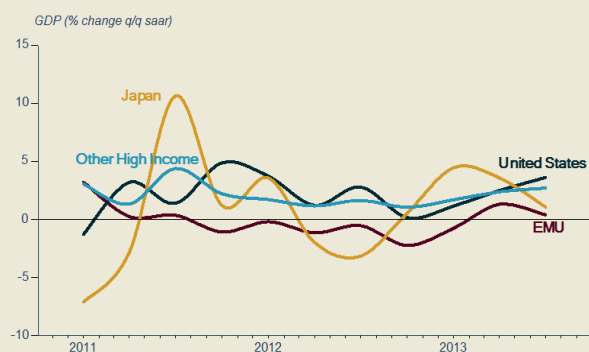
In the US, headwinds from higher long-term interest rates, fiscal uncertainty and the government shutdown have delayed but not derailed the recovery. A rebound in consumer and business sentiment in the fourth quarter reflected in rising household spending, industrial output and employment gains indicate continued firming in growth after a strong acceleration in growth in the third quarter. Meanwhile a recent budget compromise that puts an end to protracted budget negotiations and eases “sequester” cuts that have weighed on activity in recent years should also should boost confidence and help unleash pent up demand by households and businesses over the medium term. Partly as a result, the Federal Reserve has announced that it will begin withdrawing quantitative easing stimulus beginning in January.

In Japan, the economy has responded to strong fiscal and monetary stimulus with robust growth, rising inflation and a depreciation of the currency. Partly as a result, output has now reached [98] percent of its pre-crisis levels. Although growth nearly halved in the third quarter, indications are that activity has rebounded with momentum gaining additional strength in the fourth quarter as consumers frontload spending ahead of the upcoming consumption tax increase in April 2014.

Finally in the Euro Area, growth turned positive in the second quarter. However, headline growth slowed in the third quarter reflecting weaker growth in Germany and a decline in France. In contrast, output in the periphery continued to strengthen. Three of the five high-spread economies have now exited recession (Ireland, Portugal and Spain) helped by strong export growth, while the recession is easing in the other two (Italy and Greece). Nevertheless, Euro Area output remains well below pre-crisis levels and 10 or more percent below pre-crisis levels in some of the hardest hit countries of the area.

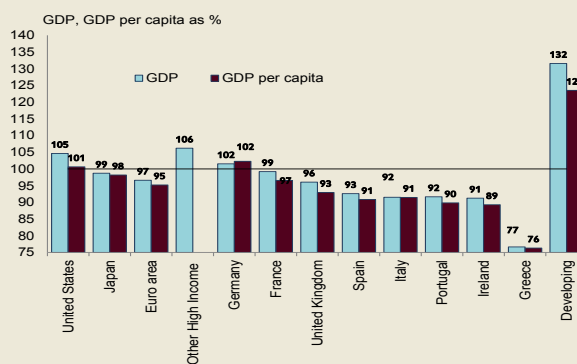
Surveys in all three major high-income economic regions are pointing to further firming in business activity and to an upturn in investment spending over the coming year. Manufacturing Purchasing Managers Indices (PMIs) rebounded to their highest level in 2013 in November the US as drags from the October government shutdown faded, and rose to a 50-month high in Japan. Euro Area PMIs indicated a fifth consecutive month of expansion, signaling the durability of the ongoing

Figure 1. Growth is slowly improving in high income economies



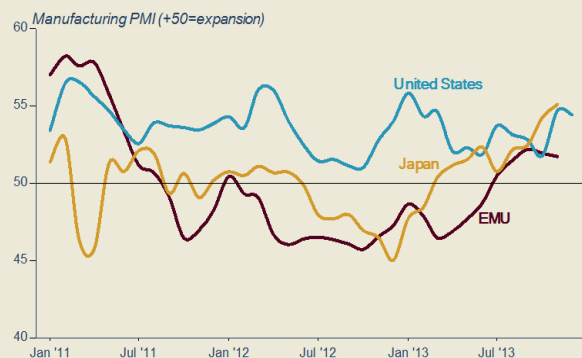
Source: World Bank.

Figure 2. GDP in most high-income economies remains below pre-crisis levels



Source: World Bank.

Figure 3. Manufacturing surveys are pointing to expanding output levels



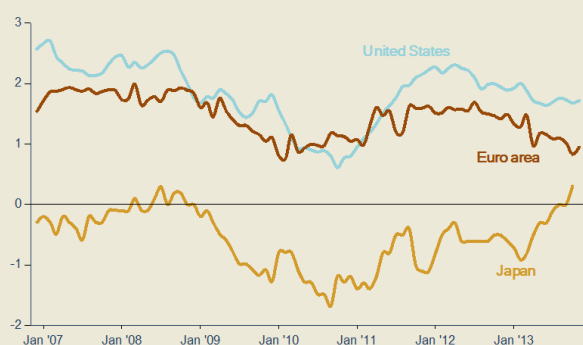
Source: World Bank, Markit.

recovery (figure 3). PMIs for the service sector — which accounts for nearly two-thirds of total output — have also strengthened in the US and Germany, indicating a broadening of the recovery.

While the outlook is brightening, significant challenges remain in all three economies: including the weak levels of activity compared to pre-crisis years, burdensome debt levels, and risks that crisis fatigue and improving economic conditions slow the pace of reforms. In Japan, structural reforms unveiled by the government—arguably the most important of the “three arrows” of “Abenomics”—have disappointed thus far, raising doubts about whether the improvement in economic performance can be sustained over the medium to longer term.

In Europe, a return to growth is not yet a signal of a return to health. Although labor markets are showing signs of stabilizing, long-term and youth unemployment remain endemic spreading concerns about the potentially permanent employability effects of extended joblessness. At the same time, significant spare capacity has opened up — contributing to a sharp slide in core inflation (figure 4) and fears that a pernicious debt-deflation cycle could begin. Banks are holding a rising share of sovereign debt in the troubled economies, and continue to face deleveraging pressures ahead of asset quality reviews due in 2014. Any delays in the development of credible banking union also carry the potential for renewed bout of financial market turmoil or further deleveraging pressures if adequate backstops for the banking sector are not found.

Figure 4. Core inflation is sliding sharply in the Euro Area reflecting significant spare capacity



Source: World Bank, Haver.

In the US, any missteps as the US Federal Reserve gradually exits from extraordinary monetary support measures could undermine the recovery underway, as could politically charged negotiations in February over raising the debt ceiling. Furthermore, although unemployment at 7 percent of the labor force is at its lowest level since 2008, employment rates remain well below pre-crisis levels — partly because of withdrawal from the labor force of retirees, but also reflecting large numbers of part-time workers.

Activity has strengthened in developing countries after a weak start to 2013...

Activity in the developing world strengthened in the second and third quarters of 2013, despite financial market tensions and slightly weaker momentum in high income countries. This followed a period of weakness that set in toward the end of 2012. The firming of growth is broadly-based, with activity rebounding particularly strongly in India and China (figure 5). Overall, developing country industrial production grew at a [13.8] percent annualized pace during the three months ending October ([8.9] percent excluding China). Meanwhile the aggregate PMI for developing countries moved into the above 50-zone in August and has continued to strengthen through November improving in 4 of 5 regions where data are available (figure 6).

Box 1. Recent Regional Economic Developments

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

2013 marked the third consecutive year of easing growth in **East Asia & the Pacific** with the regional growth moderating from 7.4 percent in 2012 to an estimated [7.2 percent in 2013]. This reflected slower growth in Indonesia, Malaysia and Thailand, where weak revenues related to declining commodity prices, combined with policy tightening aimed at addressing domestic vulnerabilities, cut into activity in the first quarter of 2013 when global demand was still subdued. Regional currencies and asset prices came under pressure later in the year, as global portfolios started to shift in anticipation of a tapering in the US. Despite the mid-year financial turbulence regional output growth has strengthened in the second half of the year supported by improved external demand, lower imports and policy stimulus in China. Excluding China, regional industrial production and exports remain weak, especially in Indonesia and Thailand, reflecting on-going domestic adjustment exacerbated by pressures related to tightening of external financing conditions and also due to on-going political tensions in Thailand.

Output in the developing **Europe & Central Asia** region has continued to firm through 2013, growing at a 4.8 percent annualized pace in the three months ending September. The improvement has been led by Central and Eastern European countries whose exports have been lifted by strengthening demand in the Euro Area as well as by continued strength in energy commodity-exporting Central Asian countries. Hungary, Serbia, Turkey, and Ukraine were the most affected in the region by global financial market volatility during the summer, with currencies and equities coming under pressure. Commonwealth of Independent States countries are exposed to the slowdown in Russia although remittances and exports have held up so far. Non-energy commodity exporters have suffered a negative terms of trade shock over the past year reflecting the decline in metal and agricultural commodity prices. Several countries are struggling to lower fiscal deficits (Albania, Macedonia, Serbia, and Ukraine). Current account deficits are also elevated in a number of countries (Bosnia, Kyrgyz Republic, Montenegro, and Turkey).

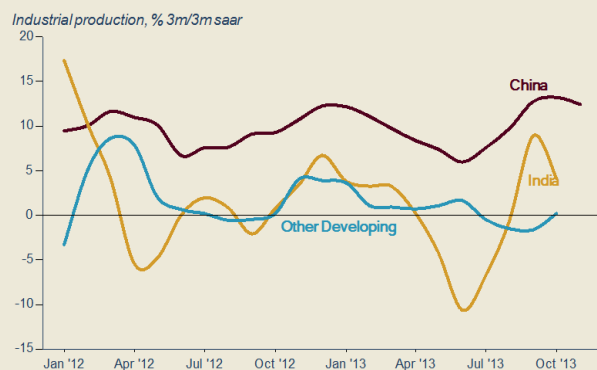
The slowdown in global trade in 2012 followed by tighter financing conditions and less supportive commodity markets in 2013 has left many countries in the **Latin America & Caribbean** region struggling with relatively weak and volatile growth patterns. Regional merchandise exports from January to September grew less than 4 percent compared to over 8 percent over the same period in 2012. Domestic demand growth is also moderating from cyclical highs and there are only modest signs of improvement in Q4, notably in Brazil where industrial activity is currently contracting, in part reflecting monetary tightening along with foreign exchange rate interventions during the summer that successfully stemmed currency pressures. Activity is starting to recover in Mexico, after weakening due to fiscal consolidation and hurricane related damage earlier in the year. Bumper harvests in Argentina have supported growth and export revenues in the face of headwinds from weak growth in Brazil, a continued lack of access to international debt markets and restrictive currency, capital and price controls. Exports are rebounding in Central American economies, partly supported by the expansion of the Panama Canal.

Two years after the Arab Spring, the economies of the **Middle East and North Africa** region remain depressed. Political turmoil in Egypt and Tunisia and an escalation of the civil war in Syria with spillovers to neighboring Lebanon and Jordan have weakened activity in the developing oil importing countries. Meanwhile, security setbacks, strikes, infrastructure problems, and in the case of Iran, international sanctions, have negatively affected developing oil exporting countries. Growth for the region is estimated at just 0.1 percent in 2013—down from a weak growth of 1.4 percent in 2012, with growth in both oil-exporting and oil-importing countries weakened relative to 2012. If Syria is removed from the regional aggregate, the growth slowed to 1 percent, down from 2.6 percent in 2012. In addition, fiscal and external balances have worsened and macroeconomic vulnerabilities have deepened. Meanwhile, the persistent structural problems of high youth unemployment and poor service delivery remain unaddressed two years after the Arab Spring.

South Asia's GDP rose an estimated [4.6] percent in 2013 on a market price-calendar year basis vs. [4.2] percent in 2012. Growth was, however, subdued compared to average growth over the past decade, reflecting a combination of domestic imbalances and weak external environment. Regional exports and industrial activity experienced a cyclical recovery in Q3, reflecting both strengthening external demand and currency depreciation in India (the latter resulting from a sharp withdrawal of capital flows during mid-year on apprehensions of tapering of U.S quantitative easing). Despite the cyclical rebound, industrial activity for the full year was very weak, growing an estimated 1.5 percent (y/y). Lower international commodity prices helped ease inflation in Bangladesh and Sri Lanka, but inflation remains stubbornly high in India. Despite a moderation in Q1, remittances rose an estimated [6.8] percent in 2013—while India was the largest recipient by size, flows were more important for Bangladesh, Nepal, Pakistan, and Sri Lanka as a share of their GDP.

Economic growth picked up in **Sub-Saharan Africa** in 2013, supported by strong domestic demand, notably resource-based investments. Real GDP growth strengthened to an estimated [4.8] percent for the region, up from 3.6 percent in 2012; excluding South Africa, its largest economy, average GDP growth accelerated to [6.1] percent from 4.1 percent. The recovery in during the first half of 2013 remained weak among oil exporters (Angola, Gabon, and Nigeria), partly because of domestic challenges in Nigeria. Industrial output in South Africa contracted at an 8 percent annualized pace in Q3 partly reflecting the impacts of labor strikes. Overall in the region, strong investment spending— notably large public infrastructure programs - have exacerbated current account deficits, which widened further in 2013. However, these were financed to a large extent with official transfers and FDI flows which rose to an estimated US\$44 billion in 2013 from US\$37 billion in 2012, flowing into both mining and non-mining sectors. Lower food prices and prudent monetary policies helped push inflation lower in many countries, which combined with a [6.5] percent increase in remittances has helped to support private consumption. However fiscal balances deteriorated further in 2013, especially among oil exporters in part reflecting weak commodity revenues.

Figure 5. Industrial output growth has rebounded in China and India



Source: World Bank, Thomson Datastream.

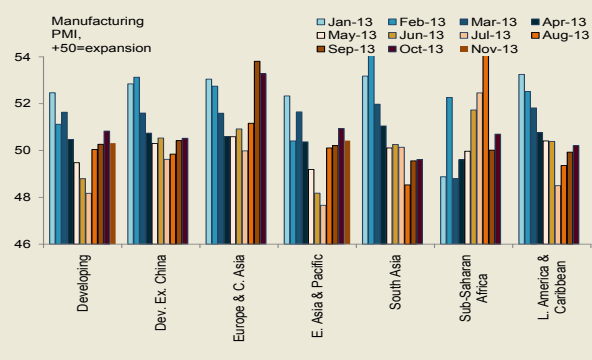
The improvement partly reflects strengthening high-income economies and rising demand in China where growth accelerated to 9.3 percent annualized pace in the third quarter from just 6.9 percent in the first, helped by a “mini-fiscal stimulus” earlier in the year. As a result (and boosted by currency depreciations in some countries during the summer) developing country exports (excluding China) grew at a [12.2] percent pace during the 3 months ending October the fastest in 7 months.

At the regional level, strengthening was most visible in East Asia, notably China but also Thailand and Malaysia where GDP growth accelerated in Q3. In other regions, a sharp recession in Ukraine has tempered a broader improvement in industrial activity in developing Europe and Central Asia region. In Latin America and the Caribbean region, activity is recovering in Mexico following a sharp slowdown earlier in the year, but has weakened in Brazil. Activity in the Middle-East & North Africa is weak reflecting unsettled political conditions among oil importers in the region, and production setbacks among its oil exporters.

Slower growth in recent years mainly reflecting an easing in the cyclical component of growth

Cyclical factors have played a large role in developing countries' GDP growth during both the pre-crisis and post-crisis periods. A decomposition of the sources of developing countries' growth suggests that most of the slowdown between the pre-crisis (2003-07) and post-crisis (2010-13)

Figure 6. PMI's are rising in 4 of 5 regions where data are available



Source: World Bank, Markit.

periods was due to cyclical factors rather than any significant slowing in potential growth.

Overall, developing country growth has slowed by 2.4 percentage points, with cyclical factors accounting for 2.0 percentage points of the total (table 2). Slower potential growth accounted for the remainder (0.4 percentage points), with almost all of the slowing reflecting weaker productivity growth (a slight increase in the contribution from capital accumulation was offset by an equally modest decrease in the contribution from increased labor supply).

These trends are broadly visible across most developing regions. Indeed in the majority of developing countries actual growth remains broadly in line with potential. Although, the slower growth of the past year or so in these countries has served to unwind some of the overheating pressures that had built up earlier (notably in East Asia), negative output gaps in most of these economies are small – despite growth rates below potential.

The exceptions are Europe & Central Asia where potential growth slowed to a larger extent (accounting for half of the 3.4 percentage point growth deceleration and reflecting steep contractions in investment during the crisis) and the Middle East & North Africa, where productivity growth has slowed sharply due to severe political turmoil.

In many middle income economies, spare capacity has remained limited. For Brazil, Turkey and Russia, output gaps remain either positive or only

slightly negative – suggesting that the recent slowdown has been helping to alleviate some of the excess demand pressures that have contributed to a build up of imbalances and vulnerabilities in these countries (box 2). The main exception is India where the sharp slowdown in the first half of 2013 opened up a relatively larger negative output gap,

but this has begun to narrow as growth rebounded in the third quarter.

Tighter international financial conditions pose a headwind for developing countries

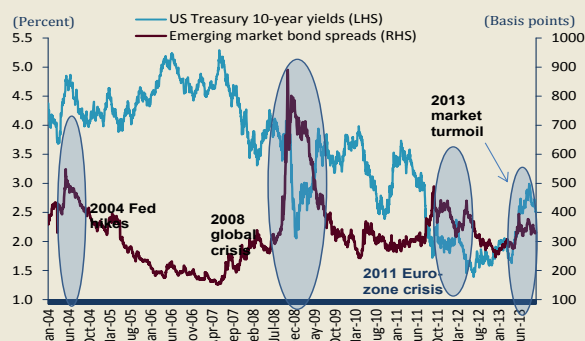
Table 2. Contributions to Potential Growth in Developing Countries (percentage points)

	2003-07	2007-10	2010-13	2013-16
All Developing Countries				
GDP growth	7.7	5.5	5.3	5.5
Cyclical Component growth	1.5	-0.6	-0.5	0.0
POT growth	6.2	6.2	5.8	5.6
--of which TFP growth	2.6	2.5	2.2	2.1
--of which capital growth	2.2	2.5	2.4	2.2
--of which labor growth	1.3	1.2	1.1	1.2
East Asia and the Pacific				
GDP growth	10.2	8.5	7.6	7.2
Cyclical Component growth	1.3	-0.2	-0.6	-0.4
POT growth	8.9	8.7	8.2	7.6
--of which TFP growth	4.7	4.5	4.0	3.8
--of which capital growth	3.0	3.4	3.3	2.8
--of which labor growth	1.0	0.8	0.8	0.8
Europe and Central Asia				
GDP growth	7.3	1.3	3.9	4.1
Cyclical Component growth	2.0	-2.6	0.3	0.3
POT growth	5.3	3.9	3.6	3.8
--of which TFP growth	2.0	1.3	1.3	1.4
--of which capital growth	2.5	1.8	1.7	1.7
--of which labor growth	0.7	0.7	0.6	0.7
Latin America and Caribbean				
GDP growth	5.4	2.9	3.0	3.3
Cyclical Component growth	1.9	-0.8	-0.3	0.2
POT growth	3.5	3.7	3.4	3.0
--of which TFP growth	1.3	1.2	0.9	0.6
--of which capital growth	1.0	1.3	1.4	1.4
--of which labor growth	1.2	1.1	1.0	1.0
Middle East and North Africa				
GDP growth	5.4	4.0	0.8	2.5
Cyclical Component growth	0.9	0.4	-2.0	0.1
POT growth	4.5	3.6	2.8	2.4
--of which TFP growth	1.1	0.4	-0.1	0.0
--of which capital growth	1.5	1.8	1.4	1.0
--of which labor growth	1.9	1.4	1.5	1.5
South Asia				
GDP growth	8.4	6.9	5.2	6.3
Cyclical Component growth	1.3	-0.1	-1.0	0.4
POT growth	7.1	7.0	6.3	5.9
--of which TFP growth	2.9	2.7	2.4	2.3
--of which capital growth	2.7	2.8	2.5	2.2
--of which labor growth	1.5	1.4	1.3	1.3
Sub-Saharan Africa				
GDP growth	7.2	5.3	5.1	6.3
Cyclical Component growth	1.5	-0.8	-0.7	0.3
POT growth	5.7	6.1	5.8	6.0
--of which TFP growth	2.1	1.8	1.6	1.6
--of which capital growth	1.6	2.3	2.3	2.4
--of which labor growth	2.0	2.0	1.8	1.9

Financial conditions in developing countries over the past 6 months, were roiled by a portfolio adjustment that was set into motion by speculation over the timing as to when the US Federal Reserve would begin to withdraw some of the extraordinary measures have been put in place to support growth during the post-crisis period. Despite no actual change in the long-term asset purchases of the United States Federal Reserve (it merely indicated that it might begin reducing the extent of its long-term interventions toward the end of the calendar year), financial markets rapidly priced in a significant increase in long-term yields. The yield on 10-year United States Treasury bills rose by 100 basis points, increasing US mortgage rates by 1.2 percentage points and causing spreads on developing country sovereign bonds to rise by some 80 basis points between early May and end August (figure 7).

The increase in long-term U.S. yields sparked a significant portfolio readjustment. Previously, unprecedentedly low interest rates on United States Treasury bills had induced investors to place their money into riskier higher-yielding assets – including developing country bonds and equities. Partly as a result, over the past 5 years the share of developing country bond markets (net of Brady

Figure 7. U.S treasury yields and emerging market spreads rose rapidly during the summer



Source: World Bank.

Box 2. Slower growth in major middle-income countries reflects a closing of output gaps from above

Growth dynamics in developing countries over the past several years have been heavily influenced by capacity constraints. Among several large middle-income countries, capacity constraints appear to have stymied efforts of policy makers to boost GDP growth through fiscal and monetary policy stimulus -- yielding increased fiscal deficits, larger current account deficits and higher inflation rather than faster growth.

Several of these economies entered the great recession with demand levels well above capacity following several years of unusual fast growth during the boom period 2003-07. While the crisis caused output in these economies to slow (as elsewhere in the world), the slowing occurred from positions of significant excess demand or strongly positive output gaps (the difference between the level of actual demand and supply capacity/potential output expressed as a percent of potential output, (table 1.1). Initially growth in these economies bounced back from the crisis very quickly – in part because of fiscal and monetary stimulus. As a result, by 2010 they had regenerated positive output gaps (Brazil and India) or closed them significantly (Turkey).

Box 2 Table 1.1

	Average Growth				Output Gap				Growth in 2013		
	1995-99	1999-03	2003-2007	2010-2012	2007	2010	2012	2013	Actual	Latest Q	Potential
Brazil	1.4	2.3	4.7	1.8	1.8	2.8	-0.2	-1.3	2.1	6	3.2
India	6.1	5.2	9	5.8	2.6	2.2	0	-2	4.3	3.7	6.5
Russia	-0.4	6.8	7.1	3.8	10.1	-1	-0.1	-1.8	1.8	-1.1	3.5
Turkey	3.4	3	7.3	5.5	4.4	-2.3	0	-0.5	3.5	8	4
South Africa	2.4	3.4	5.2	3	4.4	-1	-1	-1.8	2.1	3	3

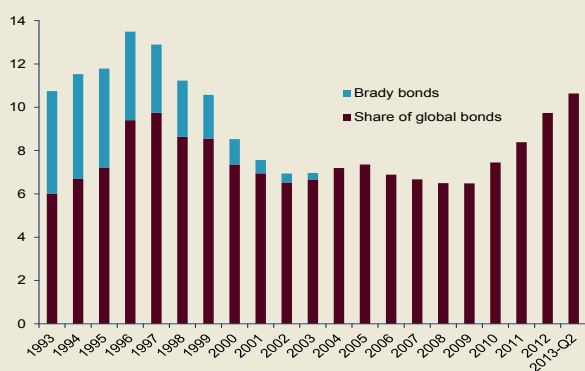
Source: Bloomberg.

However, growth during 2010-12, was held back by supply constraints and slowed significantly (relative to 2003-07) despite further fiscal and monetary stimulus. In the case of Brazil, India and South Africa GDP grew much less quickly than potential output growth. As a result, by 2012 the large positive output gaps of 2010 had been closed. For Russia and Turkey, growth was also much slower than during the boom years, but was still stronger than potential output growth so in these countries output gaps closed from below by 2012. For 2013 as a whole, GDP growth for these countries is below potential, with large negative output gaps having been opened up in four of the five countries under consideration. However, quarterly growth has rebounded and currently exceeds or is equal to potential in Brazil, Turkey, and South Africa.

bonds^{FN1}) in global allocations have increased from a broadly stable 7 percent share in the last decade to more than [10] percent in the first half of 2013, the highest level observed since 1998 (figure 8).

As yields on 10 year US Treasury bills nearly doubled, investors quite naturally decided to increase the share of now higher-yielding US bonds in their overall portfolios. This portfolio adjustment caused a temporary but significant reversal in capital flows from developing countries to the United States. On a cumulative basis, investors withdrew a net total of US \$ 64 billion from developing country mutual funds between June and August. Gross capital flows to developing countries fell by half and the currencies and stock markets of several major developing economies declined by as much as 15 percent.

Figure 8. Developing countries have been active issuers in international bond markets



Source: World Bank.

Markets are increasingly differentiating between countries on the basis of macroeconomic risks

Financial market pressure was much more focused on a few developing countries than is broadly

Figure 9. Currency depreciations were concentrated in a few middle-income economies



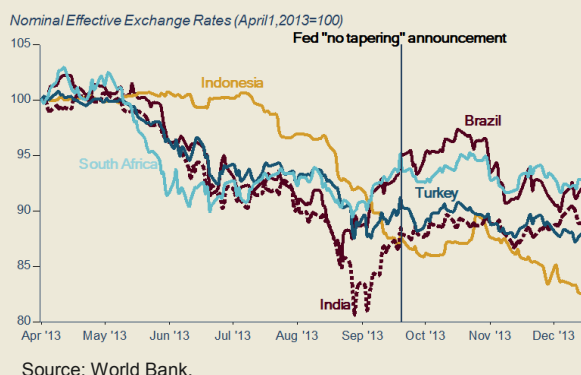
recognized. Rather than depreciating, the currencies of the vast majority (62 percent) of developing countries were stable or appreciated during the May through September period (Figure 9).

The impact of the portfolio adjustment on developing-country financial assets and currencies was most pronounced among middle income economies notably Brazil, Turkey, South Africa, India, Mexico, Malaysia and Indonesia. In part these economies were hit, because they have relatively deep financial markets, and therefore the investors seeking to rebalance their portfolios actually had money in these economies to withdraw. But other economies, like Peru, Mexico, and China have also received large inflows but were much less affected. What distinguishes those economies that were most affected from those that were not is the extent to which they had been characterized by growing external and domestic imbalances (including current account deficits, government deficits, and rising inflation). With markets re-pricing risk, those economies with weaker domestic reform agendas and poorer macroeconomic fundamentals came under more pressure than others (Box 3).

Although financial market tensions have eased, capital flows remain volatile

Financial market conditions began to improve in mid-August, likely reflecting an end to the portfolio

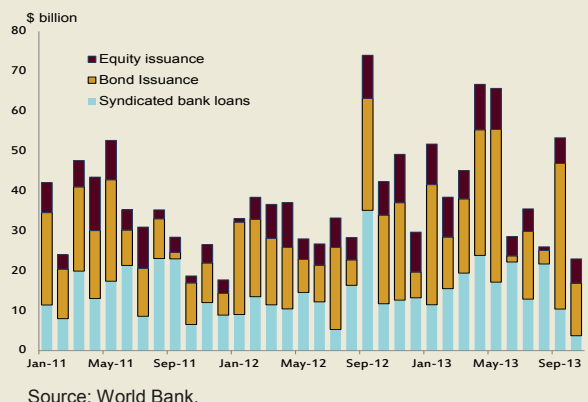
Figure 10. Downward pressure on currencies began to ease in mid-August as portfolio adjustments drew to a close



adjustment in asset markets. Negative pressures eased on currencies in the middle-income economies that had been hit hardest by the capital outflows during the summer accompanied by a recovery in stock market valuations and some narrowing in developing country bond spreads. This recovery in levels was bolstered further by the late September announcement by the Federal Reserve that it would delay the beginning of its tapering operations (figure 10). Initial financial market reactions have also remained muted [thus far] after following the December 18th announcement that the Federal Reserve would curtail its \$85 billion bond purchasing program by about \$10 billion starting in January 2014.

However gross capital flows have remained volatile in recent months (figure 11). A sharp drop in October fully reversed the rebound in September, with the decline led by a steep fall in syndicated

Figure 11 Developing country gross capital flows remain volatile



Box 3. Why some middle-income countries fared better than others during the mid-summer sell-off

International financial market developments during the summer of 2013 are a stark reminder of the vulnerability of developing economies to rapid changes in global financial conditions. Currency and equity market declines that followed after expectations of a tapering of US monetary policy began to build in May were concentrated mostly in middle-income economies with relatively deep capital markets. But even among these there were clear differences, with some experiencing sharper declines than others.

Despite policy action from local central banks working mostly through foreign exchange interventions and domestic monetary tightening, the currencies of Brazil, India, Indonesia and Turkey fell by 10 percent or more between late May and September in trade weighted terms. In contrast, currency declines were significantly smaller in Mexico, Malaysia and South Africa (about 7 percent), and Chile (about 3 percent).

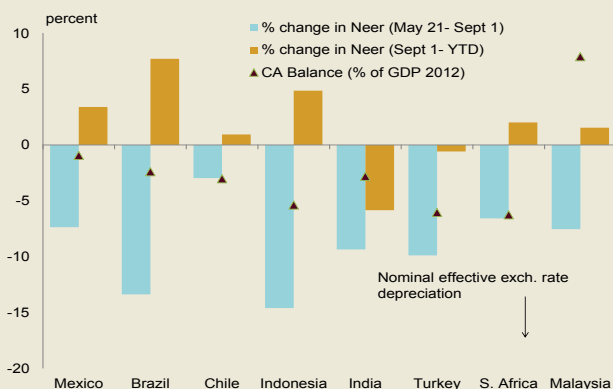
The degree to which countries were hit reflected a combination of three factors: namely degree of market liquidity, domestic vulnerabilities and growth prospects. In part the stress reflected an unwinding of sizable carry trades that had built up in recent years. As investors started to rethink prospects for US interest rates, funding for carry trade flows into large middle-income economies also fell back. However market reassessments of their growth prospects and the size of domestic and external imbalances also likely played a role. For example, despite news that growth contracted in Mexico by 2.9 percent (saar) in Q2 compared to an acceleration to 6 percent in Brazil, currency declines were smaller in Mexico likely reflecting greater market confidence in light of strong progress on an ambitious structural reforms in energy and labor markets and fiscal retrenchment which has helped to contain fiscal deficits.

Chile meanwhile has benefited from decades of prudent macroeconomic management: despite strong domestic demand, capital inflows, and ample liquidity, there are no signs of generalized asset or credit bubbles, inflation remains below target

and growth robust with ample fiscal space to boost the economy in case of adverse external shocks. Malaysia has continued to run large current account surpluses (to the order of 7 percent of GDP) and a newly elected government has unveiled an ambitious structural reform agenda to improve rural infrastructure, education and tackle corruption.

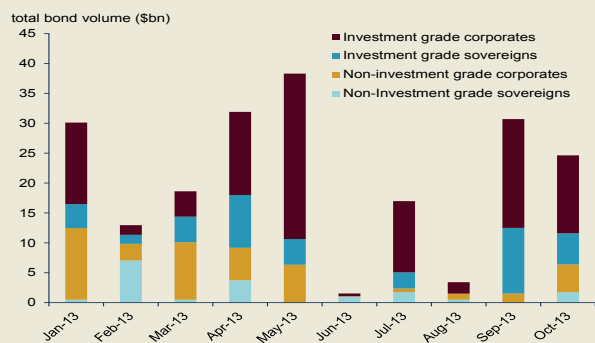
In Brazil in contrast, investor and consumer confidence has weakened on poor macroeconomic management and interventionist government policies at the same time as terms of trade have deteriorated in line with declining agricultural and metal prices since 2012. In India, currency and equity pressures only began to subside on indications of an improving trade balance in August and a strengthening of its central bank's inflation credibility and regulatory changes to encourage the repatriation of capital. Indonesia's currency has however fallen by a further 6 percent since early September, mainly reflecting poor incoming news on current account imbalances and rising domestic inflation.

Box Figure 2.1 Nominal effective exchange rates and current account balances, selected economies



Source: World Bank.

Figure 12 Bond issuance by un-rated sovereign and corporate borrowers in developing countries have dropped sharply since May 2013

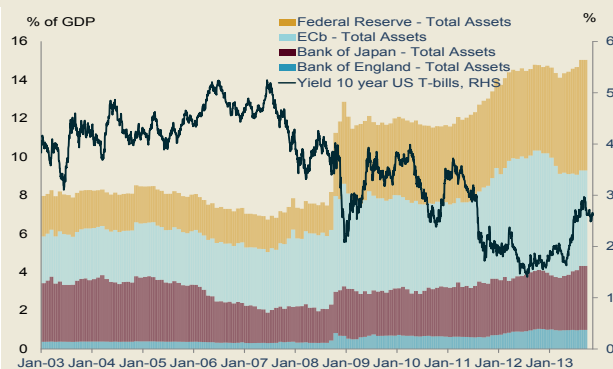


Source: World Bank.

bank lending flows which tend to trail equity and bond flows, and which had remained resilient during the summer turmoil. Much of the decline in bond flows since September reflects a decline in flows to un-rated borrowers. In the first half of the year these borrowers sold about half of all bonds. Since September that share has fallen to only 16 percent (figure 12). Bond issuance by investment grade sovereigns and corporates appear to have recovered the levels of the first half of the year.

The bulk of adjustment to the normalization of monetary policy in high income economies lies ahead

Figure 13. The increase in long term rates has only unwound about a third of the effects of QE



Source: ECB, World Bank.

Although the U.S. authorities have postponed the beginning of the tapering of quantitative easing, they are likely to begin the process sometime during the course of 2014, in line with the expected strengthening of growth in the U.S. economy. As active intervention at the long end of the yield curve eases, some further increase in yields on 10 year U.S. Treasuries can be expected that should reduce capital flows to developing countries (figure 13). When that occurs there is likely to be a further tightening of global financial conditions and additional portfolio adjustment.

Although some financial adjustment has taken place (the average long term cost of bond financing for developing countries is up some 50 basis points since early May), based on pre-crisis yields U.S. yields could have a further 100 basis points to rise (figure 13) and could increase even more depending if the markets demand an additional return given the increase in the U.S. debt to GDP ratio from 64 percent in the pre-crisis period to an estimated 107 percent of GDP in 2014. Developing country yields are likely to rise by more, possibly 200 basis points or higher, on average in the medium-term as spreads over US benchmark yields also increase (Kennedy 2013).

Internationally traded food and metal commodity prices have weakened over the past 18 months

Figure 14. Food and metal commodity prices have fallen sharply since 2011



Source: World Bank.

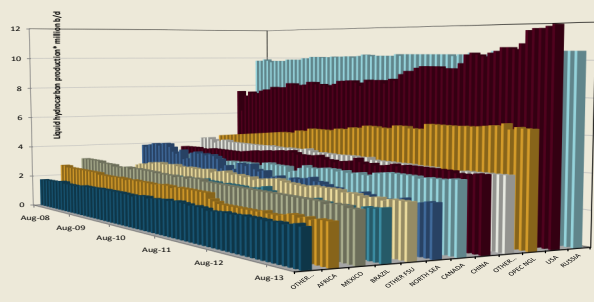
The USD price of internationally traded food and base metal commodities have declined by nearly 25 percent since January 2011 (figure 14), boosting incomes in commodity importers, but hurting exporters. Energy prices are up [13] percent over the same period, although oil prices have eased most recently due to growing supply in the US and the easing of tensions surrounding Iran.

The decline in metals prices has been steady throughout this period, reflecting both moderate demand growth in China and a strong supply response to earlier price increases that have attracted a 5-fold increase in long-term investments in new mines over the past few years.

In contrast to metals prices, much of the decline in food prices has occurred more recently, with a [16] and [20] percent fall in rice and maize prices since June of 2013 due to improved maize harvests and the release of Thai rice stocks. While prices have declined they remain [110] and [53] percent higher than their January 2005 levels. Wheat prices have not eased nearly as much and risks remain to the upside due to relatively low stocks.

Price risks remain generally weighted to the downside in commodity markets. In metal markets, prospects hinge on China, which accounts for 45 percent of global metal consumption. If robust supply trends continue and Chinese demand remains weaker than in recent years, the sharp price falls over the past two years could extend further. In agricultural markets, weather-related supply disruptions could push prices higher (especially for wheat where stocks remain relatively low), but

Figure 15. The US is now the largest non-OPEC producer of liquid hydrocarbons*



Source: KBC, World Bank.* includes crude oil condensate, natural gas liquids (NGLs) and ethanol. OPEC data includes NGLs which are not subject to quota.

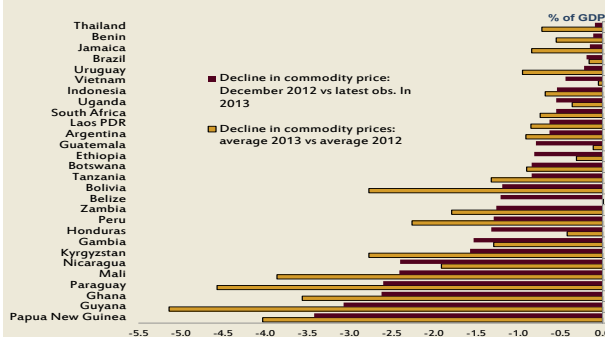
upside risks are limited on account of rising production and adequate stocks, notably for rice.

In energy markets, downside risks include weak oil demand if growth prospects in emerging economies (where most of the demand growth is taking place) deteriorate. However, changing supply patterns also mark a structural shift. Surging US production due to advancements in shale extractive technologies has allowed the US to surpass Russia (figure 15) as the largest non-OPEC producer of liquid hydrocarbons.^{FN2} This is reducing its oil import demand, putting downward pressure on global markets. It has also increased its potential to become a major energy exporter for natural gas – which is also putting downward pressure on global natural gas prices, notably in Europe. Over the long term, oil demand is likely to be dampened further as substitution between crude oil and natural gas intensifies (a slow and expensive process due to a lack of infrastructure to support wider use of natural gas in vehicle transport).

... generating a large negative terms of trade shock for food and metals producers

The sharp fall in global food and metal prices has led to a steady worsening in the terms of trade of commodity producers hurting export and fiscal revenues. In addition to impacting outturns this year, continued price declines in the second half of 2013 should continue to weigh on growth in 2014.

Figure 16. Commodity exporters have suffered large terms of trade shocks as commodity prices have fallen



Source: World Bank.

Comparing average prices in 2013 with average prices in 2012 – suggest that since 2012 commodity producers in Sub-Saharan Africa and Latin America and the Caribbean have suffered on average terms-of-trade losses of over 1 percent of GDP and over 2.5 percent in some cases. Income declines in major middle-income commodity producers are smaller but not insignificant: about 0.4-0.6 percent of GDP in Indonesia, South Africa and Vietnam and nearly 0.2 percent in Brazil (figure 16).

Estimates of the year-to-date fall in commodity prices show much larger impacts for agricultural commodity producers (reflecting the sharper declines in prices in the second half of the year), amounting to 0.7 percent in major producers such as Thailand and Indonesia and 3.5 percent or more of GDP in smaller economies, which should weigh on growth during 2014.

Improvements in global trade should provide an important tailwind to developing countries

Global trade growth has weakened markedly in the post-crisis period. During the period 1990-2007, global trade tended to grow twice as quickly as global GDP, with the share of trade in developing country GDP steadily rising as developing countries increased their share in both final and intermediate goods markets.

However, in the post-crisis period 2010-13 global trade has grown at about the same speed as the global economy – sparking speculation as to whether the period of rapid trade deepening by developing countries may have come to an end, and with it whatever contributions it may have made to growth.

National accounts data suggest that that import elasticities for high income economies have fallen from around 2.6 in the pre-boom period (2003-05) to 2.1 in the post crisis period (2010-13),^{FN3} and in developing countries from 2.28 to 1.25. Detailed trade data suggests that much of the decline in the elasticity of trade relative to GDP (the ratio of the trade growth rate and GDP growth rate) reflects a change in the composition of global demand away from goods and services with heavy import content and toward products that tend to have a higher domestic component in value added (and therefore less gross trade per unit of final demand).

Data from the World Input Output Data Tables suggests that on average the import content of private demand is much higher than the import content of government consumption (and highest for private investment) (table 3). These results hold for both developing and high income economies, although on aggregate import intensities are higher for the latter. The financial crisis has cut sharply into activity and growth in high-income countries, and weak private demand has translated into weakness in import demand.

Mathematically the change in trade elasticities can be decomposed into a part reflecting changes in the composition of final demand, and a part due to changes in the partial elasticities of trade to different types of demand.^{FN4} World Bank computations suggest that some 30 percent of the recent decline in trade elasticities can be attributed to changes in the composition of final demand.

Looked at from the perspective of value-chains, this is equivalent to saying that during the post-crisis period the average amount of gross trade to value added trade has declined due to a shift away from products that involve many intermediate steps towards those that involve fewer steps. An analysis of the OECD's TiVA database is consistent with this hypothesis noting that the share of goods like automobiles, which tend to have long value chains and a low share of final exporter value added to total value added ratio, has declined while that of goods with short product chains and final-exporter high value added ratios has increased.

Based on this result, assuming that the composition of global final demand evolves as in the forecast period a relatively stronger acceleration in high-income country investment and final demand, then trade can be expected to accelerate and the average trade elasticity reach around [2.4]. Nevertheless, this should be lower than in the pre-crisis period, reflecting a slow recovery in private domestic demand – notably consumption- in both Europe and Japan (see below).

Prospects are for a slow acceleration in global economic growth driven by high income economies

Global GDP growth is projected to accelerate gradually from 2.3 percent in 2013 to 3.5 percent

Table 3. *Import Intensities* by Component of Aggregate Demand in High Income and Developing Countries*

	Government	Consumption	Export	Investment
Developing	0.12	0.22	0.24	0.34
High-Income	0.14	0.33	0.33	0.38
Average	0.14	0.31	0.31	0.37

Source: World Bank, World Input-Output Database Project.* These indicate the increase in imports for a unit increase in aggregate demand component

by 2016, mainly reflecting a slow but steady improvement in outturns among high income economies and the developing countries of Europe and Central Asia.

Growth in high income economies is expected to rise to [2.1] percent in 2014 from [1.3] percent in 2013, increasing to about [2.4] percent by 2016. The recovery in Europe and the United States is expected to be supported by still very loose monetary policy; a diminished drag on growth from government and household budget consolidation efforts; and pent-up demand for consumer durables and investment goods. The baseline projection assumes a timely resolution to the debt ceiling debate in the US, steady progress in economic rebalancing in the Euro Area, and some additional fiscal stimulus in Japan that helps offset a drag from higher consumption taxes in 2014.

The pace of recovery in Europe is projected to be slow, reflecting the long and deep private sector balance sheet adjustments. However, the drag from these adjustments is expected to ease over time, as balance sheets improve. In particular the drag from fiscal consolidation is expected to ease from about 0.8 percentage points of GDP in 2013 to 0.4 percentage points in 2014. This gradual healing process is expected to allow growth to improve to around 1.5 percent in each of 2015 and 2016.

In the US, overall growth for 2014 is projected to accelerate sharply to [2.6] percent from a relatively subdued at [1.7] percent in 2013. A main driver of this improvement is a reduction in the drag on growth from fiscal consolidation, which in 2013 amounted to 1.8 percent of GDP and is projected to decline to less than [0.5] percent of GDP in 2014. The pick up in growth will also reflect an acceleration in residential investment, which as a percent of GDP remains nearly [2] percentage points lower than its long-term average (business investment rates are closer to their long-term average).

In Japan, aggressive fiscal and monetary easing have sparked a strong cyclical recovery, but in the absence of structural reforms that boost productivity growth and wages, particularly in the relatively low-productivity domestic service sector, this is unlikely to be sustained. In addition, in contrast to other high income economies, fiscal tightening is expected to weigh on growth in 2014. Accordingly, the economy is projected to grow broadly in line with potential growth, expanding by 1.5 percent in 2014, and slowing to about 1.3 percent in 2016.

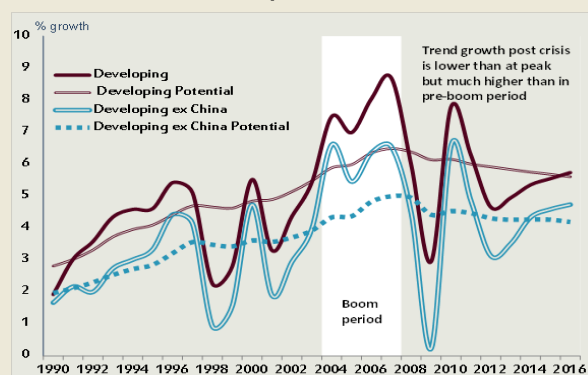
Developing country growth should remain weaker than in pre-crisis years, but in line with potential

Developing country GDP in 2013 is estimated to have grown about [4.9] percent, roughly the same pace as in 2012, reflecting weakness at the start of the year. However, as discussed earlier, growth accelerated in the second half of 2013. This has generated a positive carry over for 2014, with GDP expected to expand by 5.3 percent, broadly in line with potential (figure 17).

Going forward, developing countries face significant headwinds as monetary policy returns to “normal” in high income economies. Higher interest rates — U.S. long term rates are expected to rise by a 100 basis points by 2016 in line with forward market expectations, with short rates expected to start rising in 2015 and to increase rise by 150 basis by end 2016 — can be expected to boost the cost of capital and further add to headwinds. Capital flows to developing countries are meanwhile projected to decline by about [0.6] percent of developing country GDP by 2016 (see Chapter 3 for more), as global asset portfolios are rebalanced towards high income economies. For commodity producers, slower demand for their products from China as it rebalances its economy are also expected to weigh on export and fiscal revenues.

However the tightening of global financial conditions will be accompanied by strengthening of growth in high income economies. Consequently, better import demand from high-income countries (high-income

Figure 17. Developing countries are expected to grow in line with potential



Source: World Bank.

import growth is projected to rise from 2.4 percent in 2013 to 4.2 percent by 2016)^{FN5} is expected to partly offset negative impacts from higher interest rates and weaker capital flows to developing countries.

In addition, a weakening of developing country currencies as capital flows to developing countries ease will be an essential part of the rebalancing in these economies. As figure 19 shows, this process has already begun—although it has yet to fully unwind the significant currency appreciations since 2003 in major middle-income economies that reflected strong capital inflows and elevated commodity prices for commodity exporters. Further depreciations should help improve the competitiveness of the traded sectors and for commodity exporters, help reverse some of the Dutch Disease impacts associated with elevated commodity prices over the past decade.

Accordingly, aggregate developing country growth is expected to accelerate modestly to about [5.7] percent in 2016. Although broadly in line with potential, this would be nearly 2 percentage points lower than average growth of 7.3 percent during the pre-crisis boom years (figure 19).

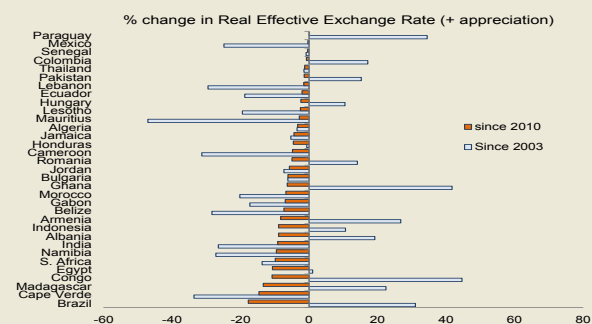
Supply side constraints remain a dominant factor in the outlook for developing East Asia and the Pacific (excluding China) and Latin America and the Caribbean keeping growth broadly in line with potential (figure 18). Growth for manufacturing intensive economies in both regions should benefit from stronger demand in high income economies,

but growth in commodity exporters should suffer (especially in 2014) as a result of the decline in commodity prices over the past year (see earlier discussion of terms of trade effects).

Barring structural reforms that boost supply capacity and productivity, growth in East Asia and the Pacific (excluding China) — which is broadly in line with potential—is unlikely to accelerate much further without hitting supply side constraints and generating overheating pressures. Overall growth is projected to rise mildly from about [5.2] percent in 2013 and 2014 to reach about [5.6] percent in 2016 with output gaps projected to turn positive by 2015. Similarly, growth in the Latin America and the Caribbean region is expected to remain broadly stable at or just below [3.5] percent annually in the projection period, up from [2.6] percent in 2013. China’s GDP is expected to grow about [7.5] percent growth over the projection horizon (in line with potential) as the economy shifts to slower but more sustainable consumption-led growth.

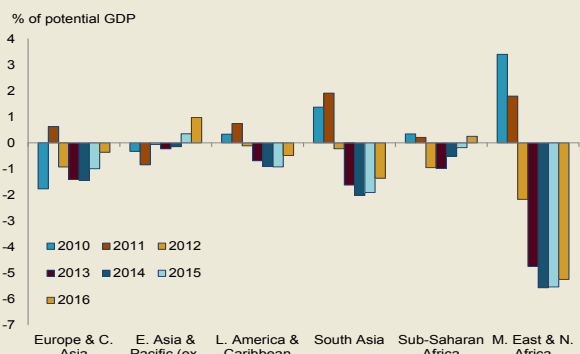
In developing Sub-Saharan Africa, continued robust investment in resource sectors is projected to lift growth from about 4.8 percent in 2013 to 5.3 percent in 2013 and about 5.4 percent in 2015 and 2016 despite the negative income effects of lower commodity prices. Regional growth is projected to With its close trade and financial ties to the Euro Area, growth in developing Europe is expected to benefit from the recovery in high-income Europe, which will transition from being a serious negative factor for growth in the region to a small positive one. However, growth in developing Central Asia will be held back by weakness in Russia (now classified as a high-income country), a

Figure 18. Strong real currency appreciations over the past decade in developing countries have begun to unwind



Source: World Bank.

Figure 19 Output is expected to remain supply constrained in East Asia and Latin America



Source: World Bank.

Box 3. Regional Economic Outlook

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

Growth in the **East Asia & the Pacific region** is likely to remain supply constrained over the forecast period in the absence of structural reforms that boost supply potential and productivity. Tighter global financial conditions and lower capital flows are also expected to weigh on investment in the region. Growth in China is projected to slow to 7.5 in 2015 from 7.7 percent in 2013 and 2014 reflecting policy efforts to rebalance its economy. In the rest of the region, growth is projected to stay flat at around 5.3 percent in 2014 and to settle around 5.5 percent in 2016 as external demand solidifies and adjustment is completed. Regional risks relate to the potential for a disorderly unwinding in Chinese investment as it rebalances and weaker contribution from net-exports than assumed under the baseline. A rapid increase in global interest rates could also expose vulnerabilities, notably current account financing pressures (Indonesia, Mongolia), low foreign exchange reserves (Cambodia, Indonesia, Lao PDR, Mongolia, Vietnam and the Pacific Islands) or high levels of non-government debt in China, Malaysia and Thailand. Commodity exporters (Indonesia, Malaysia, PNG, Mongolia, Vietnam) could suffer if commodity prices fall more sharply than projected. A potential escalation of political tensions is an added risk to the regional outlook.

The overall outlook for the **Europe & Central Asia** region remains positive. Growth is expected to accelerate to 3.1 percent in 2013 from 1.9 percent in 2012 and to gradually lift to 4.6 percent in 2016. However, the outlook remains divergent across countries within the region. Those with close trade and financial links Europe are expected to benefit further from the latter's recovery. Prospects are considerably weak for some countries, notably Belarus and Ukraine where rising fiscal and current account deficits look increasingly unsustainable. The region continues to face considerable risks, including prolonged weakness in the Euro Area and Russia (although by the same token, stronger than expected growth would be an upside); risks of a disorderly adjustment to tighter global financial conditions once tapering of US monetary policy begins particularly in countries with weak banking sectors, high current account deficits financed by portfolio inflows, and high levels of private external debt; and further sharp declines in commodity prices.

With global economic conditions expected to improve in 2014 and beyond, the economic outlook in the **Latin America and the Caribbean** in the medium term is positive, with regional growth picking up from 2.5 percent in 2013, to 3.2 percent in 2014 and 3.2 percent in 2015. Strong export growth along with a steady consumption growth is expected to nudge Brazil's growth higher from 2.4 percent in 2014 to 3.7 percent in 2016. Argentina and Paraguay will be moderating from their bumper harvest booms in 2013 to grow at average rate of 2.6 percent and 4.0 percent, respectively, for the remainder of the forecasting period. Hinging on the pickup in the United States, Mexico is expected to see a growth rate of 3.4 percent in 2014, accelerating to 4.2 percent in 2016. The outlook for the Central American economies is generally positive with growth accelerating in Belize, El Salvador, Honduras and Nicaragua. Downside risks for the region include a disorderly jump in global interest rates due monetary tightening, which would hike financing costs and threaten investment, and a prolonged and deeper slump in commodity prices which could further substantially cut export revenues.

Growth in the **Middle East and North Africa** region is expected to remain weak during the forecast period. The outlook for the region is shrouded in uncertainty and subject to a variety of risks, mostly domestic in nature, and linked to political instability and policy uncertainty. Under the baseline scenario for the forecast period, marked improvement in the political uncertainty that has plagued the region is not expected. Consequently, aggregate growth for the region is expected to slowly pick up to about [3.3] percent in 2016, but remain well below its potential growth. In developing oil importing countries, consumption will be underpinned by large public outlays on wages and subsidies, while public investment will likely be constrained in the forecast period by large fiscal deficits, while growth in developing oil exporters will strengthen as the oil prices remain relatively high and infrastructure problems and security setbacks are resolved and mitigated.

GDP growth in **South Asia** is projected to improve to [5.7] percent in 2014, rising gradually to [6.7] percent in 2016, led mainly by a recovering high income import demand and regional investment. The pickup in investment, however, depends critically on macroeconomic stability, sustained policy reforms, and progress in reducing supply-side constraints (particularly in energy and infrastructure) -- and is therefore subject to significant downside risks. India's growth is projected to rise to just over [6] percent in FY2014-15, and to [6.6] and [7.1] percent by the 2015-16 and 2016-17 fiscal years. Pakistan's growth is expected to moderate to about [3.5] percent in FY2013-14, reflecting necessary fiscal tightening, and then rise to about [4.5] percent in the medium term. A projected decline in international commodity prices will help reduce inflation and current account pressures, and -- together with normal harvests and sustained remittance flows -- support consumption demand in the region. The main regional risks to the outlook are fiscal and policy reforms going off-track; uncertainties related to national elections in Afghanistan, Bangladesh and India; and a possible disorderly adjustment of portfolio capital flows to tapering of U.S quantitative easing

Robust domestic demand, relatively resilient FDI flows and slower pace of inflation that boosts real income are expected to continue to support growth in **Sub-Saharan Africa** in the medium term, despite tighter global financial conditions to which countries in the region are relatively insensitive. A modest fiscal consolidation is expected to start in 2014 and current account deficits are expected to narrow in 2016 as export capacity rises and import growth slows. Significant external risks relate to sharper than projected declines in commodity prices, and spillovers from U.S. monetary tapering to South Africa where rising domestic and external imbalances render it vulnerable to rapid capital flow movements. For frontier countries that have been raising funds in international bond markets, currency depreciations could raise repayment costs. Domestic risks relate to weather shocks to local harvests and food prices, security risks in Northern Nigeria, and pirate attacks along the gulf of Guinea, which could raise shipment costs and disrupt regional trade

major trading partner and major source of remittances. In addition, debt overhang from the 2008/09 crisis will impede a strong pickup in growth, which for Europe and Central Asia as a whole is projected to accelerate from 3.1 percent in 2013 to about 4.6 percent by 2016.

Growth in South Asia is estimated to have been a very weak [4.6] percent in 2013, mainly reflecting weakness in India following several years of rising inflation and current account deficits, and high government deficits. Growth appears to be recovering toward the end of this year, and regional GDP on a calendar basis is projected to slowly accelerate to [about [6.6] percent in 2016, mainly reflecting stronger growth in India, and a gradual implementation of structural reforms throughout the region.

Prospects for developing countries in the Middle East remain extremely poor, reflecting continued social and political tensions that have sapped macroeconomic conditions and have exacerbated the severe structural challenges inherited from the period prior to the Arab Spring. Growth in the baseline is predicated on is expected to pick up to [3.1] percent by 2016, up from [1.6] percent in 2013, worse than average growth in the pre-Arab Spring period. However the baseline is predicated on an improvement in political conditions necessary to lift confidence and activity and create the room for necessary reforms, but this is increasingly looking optimistic. In the absence of a political consensus, the balance of risks remains weighed to the downside.

The outlook is subject to significant uncertainties

While the baseline forecast remains the most likely outcome, the outlook is subject to significant uncertainties. While the main tail-risks that have preoccupied the world economy over the past 5 years have subsided, the underlying challenges that underpinned them – though less acute — remain.

- *In the Euro Area* much has been achieved

and banks have gone a long way to restructuring themselves, but there is still a long road ahead before all of the problems that the global financial crisis laid bare are fully resolved. In order for the large output gaps that have opened up to close, a strong acceleration in growth will be necessary, and the drivers of such growth remain unclear. Moreover with the banking sector still weak and details on a fully-fledged banking union still being worked out, the currency bloc remains susceptible to shocks, including a tightening of policy in the US.

- Meanwhile significant amounts of spare capacity have opened up. On the one hand ,pervasive youth and long-term unemployment are raising concerns about a permanent deterioration in job skills and employability of the jobless. At the same time, continued sharp credit contractions raise the specter of deflation, which could exacerbate debt overhang problems and result in a much more muted recovery than considered in the baseline.
- *In the United States* the general government deficit has also come down significantly – mainly due to heavy spending cuts imposed by the sequester and rising tax revenues as the economy recovers. Nevertheless, little progress has been made to agree to a medium-term plan for bringing the debt-to-GDP ratio under control and the risk of additional brinkmanship and an excessive and disruptive tightening of policy remains.
- *In China* concerns persist over the scale of investments being made, their medium-term profitability and the viability of the loans taken out to finance them. Chinese policy makers face formidable challenges in reorienting the economy away from an export/investment led model, with reforms required across a range of sectors if private consumption is to underpin future growth. Meanwhile past high levels of investment have generated significant vulnerabilities, which could generate significant banking and fiscal risks. An abrupt unwinding of investment in China as it deleverages could sharply reduce GDP by 3 percent or more (see World Bank, Global Economic Prospects 2013a for more)

with significant knock on effects in the region and other economies with close trading linkages (including commodity producers).

While disappointments along any of these fronts could slow growth there are also potential upside risks. A forceful reinforcement of the structural component of Japanese policy, a multi-year agreement on fiscal policy in the United States and additional progress toward a banking union and recapitalization of European banks would all likely boost confidence and clear the way for a more forceful recovery in high-income countries.

A stronger than expected recovery in high income economies could provide considerable support to external demand in developing countries, helping offset downward adjustments in domestic demand triggered by rising global interest rates. Finally, lower food prices should also reduce inflation pressures and contain food import costs, although they are a negative for food exporters.

In the near term, the transition to higher global interest rates is likely to be bumpy

Over the medium term, the gradual return of long-term interest rates in both high-income and developing countries to more normal levels should help reduce the excesses and vulnerabilities associated with a persistently low interest rate environment from building up further. The higher cost of capital implied by a gradual normalization

and its negative impacts on investment and growth are incorporated into the baseline.^{FN6}

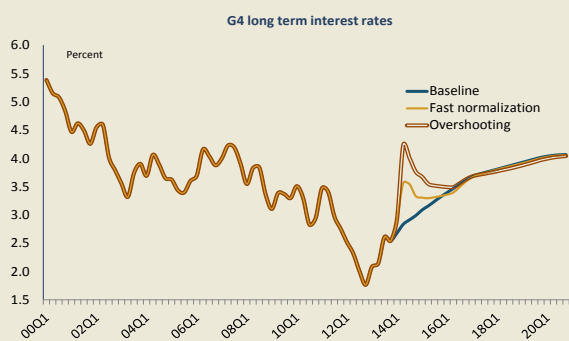
Gross capital flows to developing countries are also expected to recede in the baseline as asset portfolios are rebalanced (see the extensive discussion in Chapter 3), with flows expected to taper off by 0.6 percent of developing country GDP to about [4.0] percent of GDP by 2016 (about a 10 percent relative to current levels).

However, should market reactions to the withdrawal of extraordinary monetary measures in high-income countries be less orderly than assumed in the baseline, then a much more disruptive path toward the new equilibrium can be envisaged where long term interest rates in “G-4” economies rise rapidly by 200 basis points (figure 20).

Simulations based on econometric work discussed in more detail in Chapter 3 suggest that a more precipitous adjustment of interest rates and investor portfolios could inflict significant damage on developing economies, raising domestic and external costs of debt servicing. Those most at risk would include those that are more integrated into the global financial system, those that have large external imbalances. In addition countries with large amounts of external debt and those that have experienced large credit expansions in recent years could also be at risk.

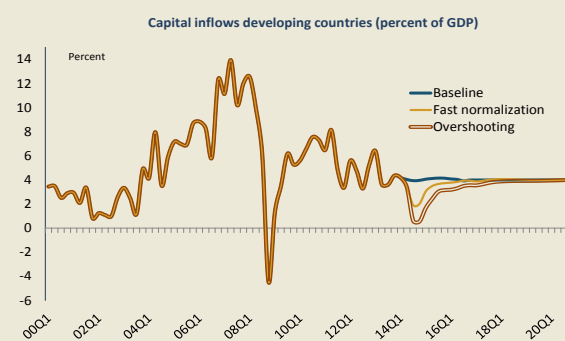
In a disorderly adjustment scenario, gross flows to developing countries could decline by as much as 70 percent for several months, falling to about 0.6 percent of developing country GDP (figure 21). In

Figure 20 Long term interest rates in G4 countries under different normalization scenarios



Source: World Bank.

Figure 21. Gross capital inflows to developing countries under different scenarios



Source: World Bank.

the event, nearly a quarter of developing countries could experience sudden stops in their access to global capital, substantially increasing the probability of economic and financial instability. World Bank simulations suggest that in such a scenario, GDP in middle income countries could fall by a cumulative 1.2 percent relative to the baseline by 2016, and roughly 0.4 percent in low income economies, reflecting the different degrees of global financial and trade integration of these economies (Box 4).

For some countries, the effects of a rapid adjustment in global interest rates and pull back in capital flows could trigger balance of payments or domestic financial crisis. As research in Chapter 3 shows, more than a third of past crises (over the last 20 years) were either preceded by a sharp surges or accompanied by a sharp stops. Global and domestic factors seem equally important triggers, with the probability of crisis rising significantly after periods of low global interest rates, low risk aversion, high commodity prices and rapid domestic credit growth.

...and comes at a time when policy space has been significantly eroded and macroeconomic imbalances have deteriorated

While the resilience that developing countries displayed in the face of the great recession is comforting, and symptomatic of their much improved fundamentals and macroeconomic management, they are much more vulnerable now than they were then. Currently, fiscal deficits are over 4 percentage points of GDP higher 2007 in nearly half of developing countries (figure 22), with the deterioration having been particularly marked in the Middle East, but also among commodity producers in Sub-Saharan Africa and East Asia, and in South Asia and the smaller economies in Latin America.

Monetary policy is also loose in most developing countries, leaving little room for additional stimulus were it to be required (figure 23). Since

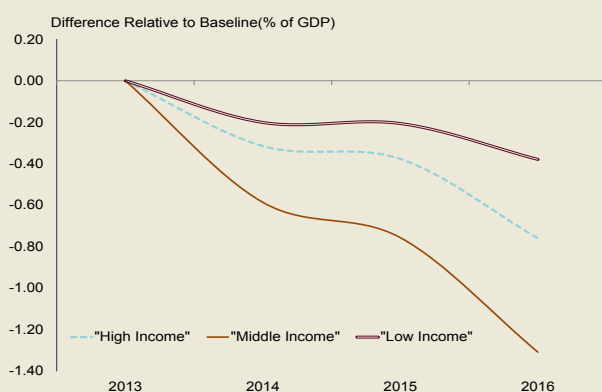
Box 4. Potential impacts from a disorderly unwinding of capital flows and rapid increase in global interest rates associated with an unwinding of quantitative easing policies in high income economies

World Bank simulations of the potential impacts of a disorderly adjustment to the unwinding of quantitative easing policies in high income economies – which triggers a rapid increase of 200 basis points in long term interest rates in the US– suggest that gross flows to developing countries could decline by as much as 70 percent for several months, falling to about 0.6 percent of GDP before recovering gradually after (figure 22).

Results derived from VAR simulations integrated into the World Bank's multi-country econometric model show that in such a scenario, growth in medium income countries would be most affected, with rapid increases in global interest rates and temporary capital pullbacks subtracting a cumulative 1.3 percentage points from GDP levels over the forecast period (see Figure 23) compared to the baseline. The impact of a rapid tightening of global financing conditions on high income countries would be around half the effect estimated for medium income countries, as rising long-term interest rates would itself reflect signs of a sustained recovery in high income countries while a reversal of capital flows would support their resilience.

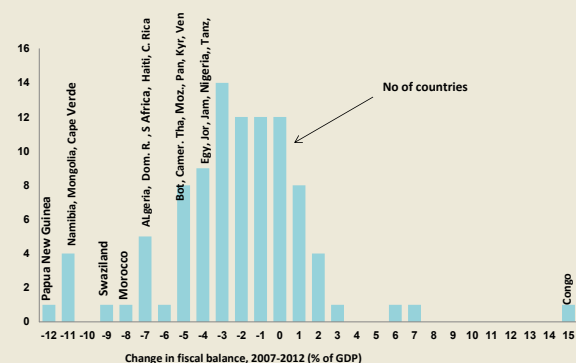
Low income countries that are less dependent on international capital flows or less integrated in global financial markets, are mainly affected through trade channels (as weaker import demand from medium and high income countries sap export growth and activity). Simulations indicate that a rapid tightening of global financial conditions in medium and high income countries would lower real GDP levels in low income countries by 0.4 percent compared to the baseline forecast. This should be considered as a lower bound impact, as the multi-country model does not cover financial market spillovers that could impact financing costs for many low income economies that had begun to enter international debt markets in recent years.

Box Figure 4.1 Impact of a rapid 200 basis points increase in global interest rates on real GDP in developing countries



Source: World Bank.

Figure 22. Fiscal balances have deteriorated in most developing countries



Source: World Bank.

November 2011, the number of rate cuts have outnumbered rate increases by a ratio of 4^{FN7}. Loose policy has translated into rising or persistently high inflation in many countries. Developing country inflation has continued to accelerate over the past year despite sharp declines in food commodity prices in recent months suggesting that wage pressures and limited spare capacity (along with currency depreciations and other factors) are sustaining higher prices (figure 24).

With demand stimulus keeping import demand relatively strong despite a sharp easing in exports, the aggregate developing countries current account balance has swung from a surplus of nearly 3 percent of developing country GDP in pre-crisis years to a small but growing deficit since 2011 (figure 26 and figure 27).

Figure 24. Developing country inflation has continued to rise despite a sharp declines in international food prices

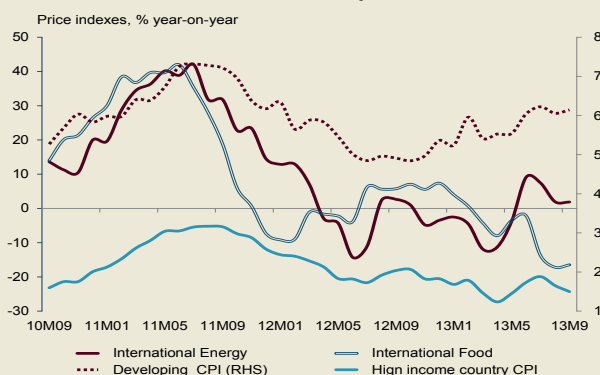
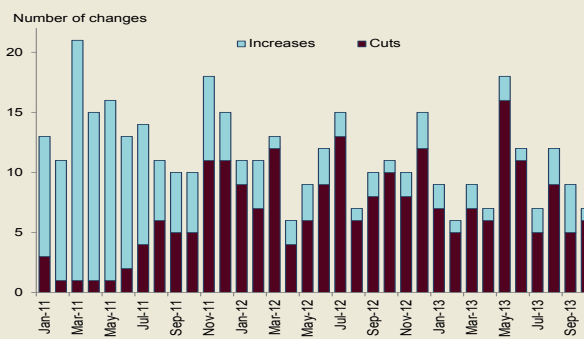


Figure 23. Central banks have yet to unwind cuts implemented in recent years so that monetary policy remains loose



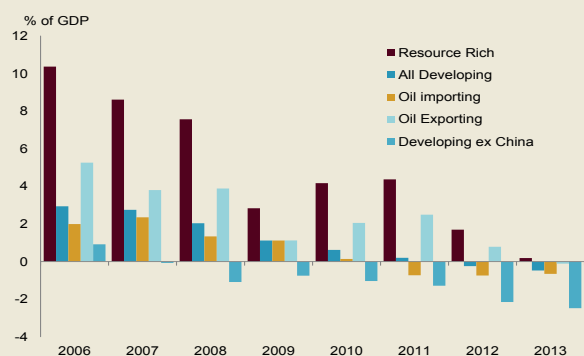
Source: World Bank.

As a result, developing countries will be more vulnerable to a deterioration in external financing conditions like that expected. For commodity exporters, whose current account surpluses have mostly been wiped out (compared to surpluses approaching 10 percent of GDP in 2006), financing pressures could be further exacerbated if there are sharp falls in commodity prices during this period., more than projected in the baseline.

Financial sector risks have increased across developing countries, but are most pronounced in East Asia

The stock of credit as a share of GDP in several developing countries has increased very rapidly over the past 5 years (figure 27), reflecting policy stimulus at home and spillovers from loose global

Figure 25. Current account balances have deteriorated for most developing countries...



Source: World Bank.

financial conditions. This indicates the potential for debt servicing difficulties among untested/first-time borrowers and a possibly significant increase in the exposure of existing borrowers, with risks to financial stability if economic cycles worsen. Among major middle income economies, the stock of credit has increased by 20 percent or more of GDP since 2007 in Brazil, Turkey, Malaysia, Vietnam, Thailand, Indonesia and China. In China, credit stock has increased by over 60 percentage points since 2007 to 210 percent of GDP in Q4 2013 (if credit that has originated from the under-regulated shadow banking sector is included).

Public sector indebtedness is also high, in excess of 60 percent of GDP in many developing economies (figure 28). Moreover, given implicit guarantees to banking sectors in many developing economies and the use of state owned banks to stimulate domestic credit growth (Brazil, China, India), public debt levels could rise rapidly in case of rising loan

Business-as-usual is no longer a policy option for developing countries

With developing countries entering a potentially disruptive period of global financial tightening, maintaining a business-as-usual policy stance is no longer an option. Policy complacency risks a further accumulation of domestic vulnerabilities likely requiring larger adjustments down the road, and at greater economic cost given the closer scrutiny of domestic risks by financial markets.

However, the already daunting political challenge represented by implementing necessary measures – both short term to boost macroeconomic stability during the transition to higher global interest rates and longer term reforms to raise growth potential – may be made even more difficult given upcoming elections in several of those countries that were most tested during the summer, including South Africa, Thailand, Turkey, Indonesia, Brazil and India.

Furthermore indications of policy complacency also appeared once financial market pressure subsided after the summer sell-off. Although there have been positive developments, credit continues to expand too quickly in several of the countries hardest hit by markets during the summer, which

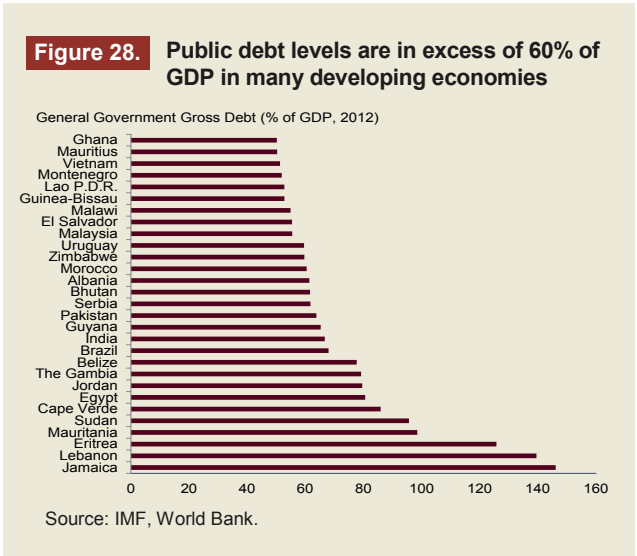
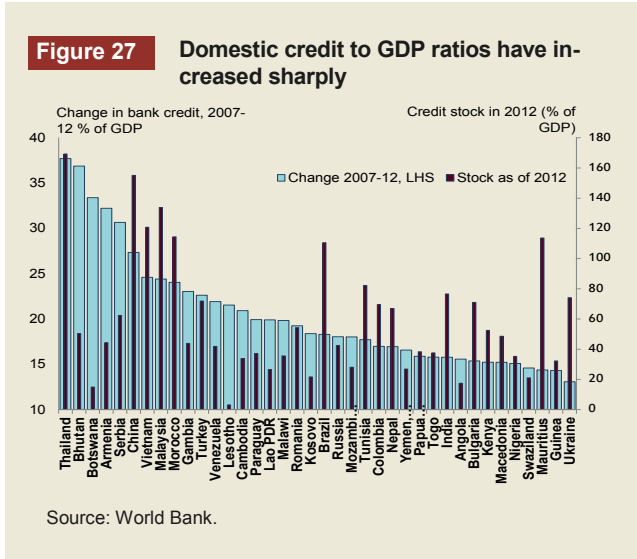
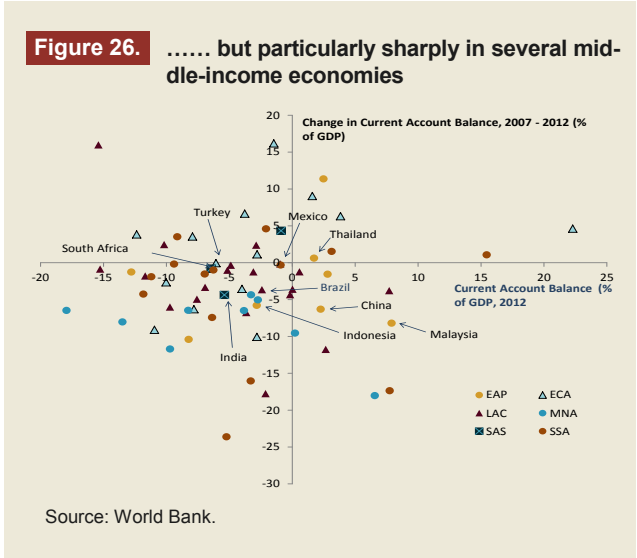
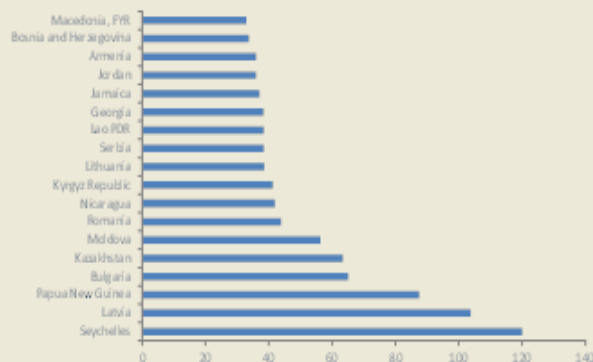


Figure 29. While private external debt is also considerably high in some countries



Source: World Bank.

may be adding to vulnerabilities. For example in Brazil, despite rate hikes, lending by state-owned banks and quasi-sovereign institutions continues to remain strong and may be adding to vulnerabilities.

Similarly, although inflation expectations remain entrenched, the Indian central bank is only gradually tightening policy – raising its main policy rate by a cumulative 50 basis points to 7.75 percent since September, so that real rates remain firmly in the red at [2.3] percent currently. Meanwhile, the ratio of restructured advances to gross advances plus the non-performing asset ratio reached 9.4 percent of loans in March 2013. This prompted the Reserve Bank of India to warn recently of the stress on banks' asset books, in particular from lending to iron, steel and infrastructure sectors which have the highest levels of stressed assets. The authorities' recent decision to allow increased foreign participation and private-sector competition in the sector is a good initial step in the right direction.

In Turkey, although credit is growing at close to a 30 percent annual rate the authorities have not yet raised interest rates. Mexico has eased policy, cutting rates (by 25 basis points) recently but this is easier to justify in light of reforms that have already been initiated that address some of the structural issues in that economy.

1) Developing countries need to stand ready to respond to financial market pressures

With tapering at hand, policy makers need to stand

ready to respond to financial market pressures including through tighter monetary policy, exchange rate adjustment supported by central banks' reserve management policies, macro-prudential policies and capital controls (see Chapter 3 for more discussion). These measures helped limit spillovers to domestic activity during the summer sell-off, and remain relevant in the current environment for reducing external financing dependencies; bringing down domestic imbalances, and ensuring the viability of existing loans to a hike in interest rates.

However, even during May-September episode policy actions were complicated by domestic vulnerabilities and imbalances. Notably the usefulness of exchange rate as a “first line of defense” or “shock absorber” was constrained by risks that rising import costs would add to cost-push inflation (India, Indonesia and Brazil) or budgetary pressures in countries with large (imported) fuel subsidies (India and Indonesia). In addition, some policy measures, notably trade restrictions deployed by India, may prove counterproductive over the long term while having a relatively limited impact in the short term.

2)... and to supplement these efforts by rebuilding policy buffers and implementing structural reforms

The resilience of developing countries to the 2008/09 global financial crisis was underpinned partly by strong macroeconomic fundamentals and partly by strong growth potential. However, as discussed earlier, buffers have eroded considerably since then as growth eased and stimulus was deployed. The experience of high-income countries, where fiscal sustainability unraveled and monetary buffers were quickly exhausted (even among countries that started from a position of relative strength) serves as an object lesson of the importance of possessing sufficient policy room to absorb the impact of financial and economic stress.

Meanwhile, for most developing countries a further acceleration of growth (or even sustaining current growth levels which are broadly in line with potential) cannot be assured without constant efforts to expand capacity and increase productivity. In middle-income economies

structural reforms are needed if they are to escape the so-called “middle income trap” and boost per capita incomes further. As productivity gains associated with shifting workers out of low-productivity agriculture towards manufacturing diminish, growth will increasingly have to be driven by rising productivity and innovation within manufacturing and services instead.

Policy actions that address the rebuilding of policy buffers and boost supply capacity and productivity growth are intertwined, with some measures yielding pay-offs both in the near term and over a longer horizon. In fiscal policy, relatively easy short-term “wins” include subsidy cuts. Although precise numbers are hard to obtain, the cost of food and fuel subsidies can be disproportionate in developing countries compared to other priority public spending areas. For instance, agricultural subsidies are estimated at close to over 2 percent of GDP in Indonesia, China and Turkey (OECD, 2013). Fuel subsidies alone in several economies in the Middle East and North Africa region amount to more than 6 percent of GDP (IMF, 2012).

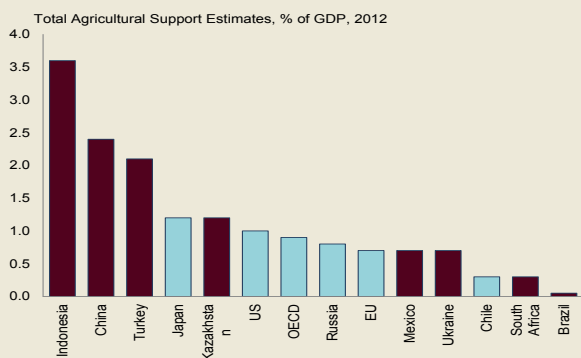
Scaling back such subsidies would also potentially yield benefits over the medium term to the current account through the rationalization of (imported goods) prices, and longer term benefits to fiscal sustainability and potential growth if they create room to raise spending on priority areas such as infrastructure, health and education that relieves supply side constraints. Explicitly combining a reduction in subsidies with targeted social assistance of the very poor can make such reforms more acceptable, minimize the negative poverty

effects and improve the functioning of automatic fiscal stabilizers.

Policy steps that would stimulate the supply side include addressing energy bottlenecks that are particularly prominent across the South Asia region, and infrastructure bottlenecks that are significant for all developing regions but are a particularly binding constraint in Sub-Saharan Africa and the Middle East and North Africa. However, solutions for boosting infrastructure are complex and not a macro but a micro problem for most developing countries, with policy makers needing to pay close attention to improving the quality of investment and infrastructure spending. Arguably levels of investment are already quite high in countries such as China and India and are at historically high levels in most of Sub-Saharan Africa (figure 31) where public investment has in recent years (rightly) been geared toward the provision of basic infrastructure, particularly power generation, and roads and port facilities (World Bank, 2013b).

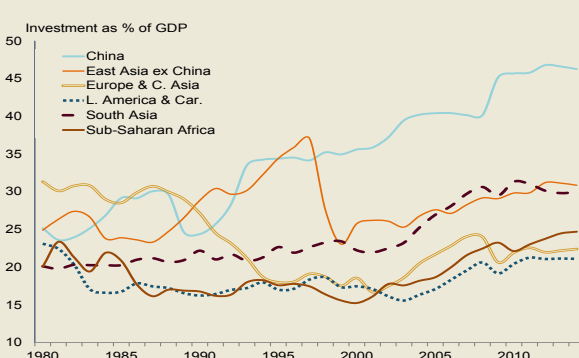
Other policies that could help boost longer term productivity growth include reducing regulatory impediments to business and trade which are particularly severe in Sub-Saharan Africa and to a lesser extent in the Middle East and North Africa and South Asia regions (World Bank, 2013c). Although local conditions and therefore recommendations differ, such policies are likely to generate the largest dividends, and are more likely also to attract long-term stable FDI flows.

Figure 30. ...Agricultural subsidies are quite high as a share of GDP in some developing countries



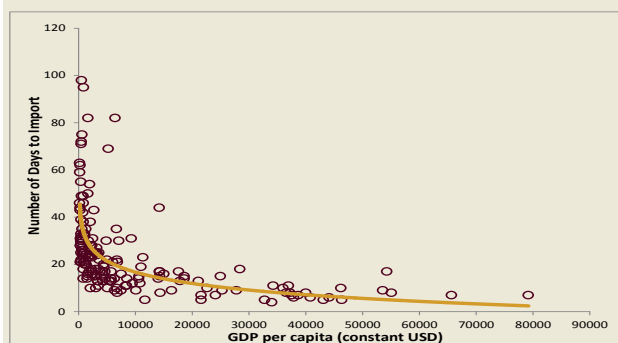
Source: World Bank, OECD (2013).

Figure 31. Investment levels are at historical highs in China, India and Sub-Saharan Africa



Source: World Bank.

Figure 32. Developing countries have more cumbersome custom clearances than high income economies



Source: World Bank.

Trade facilitation reforms represent particularly low-hanging fruit that could yield substantial benefits for developing countries. It takes about thrice as much time and twice as much documents and cost to import goods in developing countries compared to high-income OECD countries (World Bank, 2013c). Reducing these costs could yield gains of nearly \$120 billion in additional global GDP per annum, most of which should accrue to developing countries (Hufbauer et al, 2013). In this context, the recently negotiated Agreement on Trade Facilitation (as part of the Doha Development Agenda) is an important step in facilitating greater merchandise trade, although facilitation of trade in services and agricultural goods continues to be a thorny issue.

In many developing economies, financial sectors tend to be bank-centric and heavily dominated by the state, and local debt markets relatively underdeveloped. This is also true in middle-income economies despite significant capital market deepening efforts in recent years. For instance, in Malaysia, government controlled or influenced investment entities hold nearly a third of market capitalization in listed companies, while in Indonesia, the largest three state-owned commercial banks account for a third of the banking sector asset and deposit base (IMF, 2010). Meanwhile, both the ownership and the client base of the banking sector in China are dominated by the state, which provides implicit guarantees in the

absence of an explicit deposit insurance system and resolution frameworks.

In India, regulations mandating that a portion of bank lending be directed towards priority sectors such as agriculture have limited the availability of credit for industry forcing it to seek debt funding from overseas, and increasing the vulnerability of domestic firms to changes in risk sentiment and funding conditions overseas. In Brazil state owned banks accounted for 50 percent of all outstanding credit in mid-2013, up from 33 percent in 2008—the first time they passed the halfway mark since a wave of bank privatizations in 1999.

Accordingly, further progress on financial reforms is needed to fully mobilize domestic savings and push them towards their most productive use. The heavy involvement of the state needs to be rolled back in order to increase exposure to market discipline and to improve governance, the efficiency of capital allocation and risk management.

Among major middle income economies, China and Mexico stand out as having the most ambitious and advanced reform agendas. However progress on the credible implementation of reform measures is critical not only for reinvigorating growth over the medium to longer term, but in the short term can also help to limit the vulnerability of domestic economies to tighter, or more volatile, global financing conditions. In this context, by boosting investor confidence, they can also help to support a sustainable virtuous cycle of strong investment, including foreign investment, and output growth over the medium term.

Notes

1. Brady bonds were dollar-denominated bonds, issued mostly by Latin American countries beginning in 1980 as a debt-reduction and restructuring agreement in order to convert bank loans into a variety of "menu" of new bonds after many of those countries defaulted on their debt in the 1980s.
2. Crude oil, condensate, biofuels and liquid natural gas .
3. The analysis excludes the years 2008 and 2009, when trade and GDP first declined sharply and then bounced back and focuses instead on the relatively calm pre- and post-crisis years .
4. Mathematically, the growth of global imports can be expressed as the weighted average of the growth rate of imports due to increased consumer consumption, government consumption, investment and exports (in many countries exports tend to have a high import content). Taking the total derivative gives and dividing by imports in the previous period gives the following expression for the growth rate of imports, and dividing by GDP growth on both sides gives an expression for the trade elasticity of GDP. Using econometric estimates of the partial elasticity of imports to different components of demand and the change in the various components of final demand (C, G, I, X) we can calculate the contribution to the change in imports from changes in demand, leaving the contribution to be explained by changes in the elasticities as a residual .
5. Despite the firming, global trade growth rates are not expected to regain pre-crisis levels in large part because global growth – though strengthening – will be almost [2] percentage points slower than during the pre-crisis boom period .
6. Impacts have been estimated to be as high as 0.6 percentage points per annum in the medium term (World Bank, 2010) , although this does not take into account potential productivity gains from capital being used more efficiently .
7. Since November 2011, there have been some 200 policy rate cuts by central banks in developing countries, compared to less than 60 rate increases .

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Chapter II

REGIONAL OUTLOOKS

EAST ASIA and the PACIFIC REGION



GLOBAL
ECONOMIC
PROSPECTS

January
2014

Chapter 2

Despite a weak start and mid-year turbulence, output growth in the region strengthened in the second half of 2013 supported by better net exports and a modest stimulus in China. Regional output is projected to stay flat in 2014 and pick up in 2015 & 2016 when benefits from stronger global trade outweigh the impact of tighter financing conditions. The region is vulnerable to risks of disorderly unwinding in Chinese investment and abrupt tightening in global financing conditions.

Recent Developments

2013 marked another year of weakening growth in the East Asia and the Pacific region.

Growth moderated to 7.2 percent in 2013 from 7.4 percent in 2012. Growth in China unchanged from the 7.7 percent recorded in 2012. A one percentage point slowdown in growth in the rest of the region reflects a moderation of economic activity in Indonesia, Malaysia and Thailand, and sharp slowdown in Papua New Guinea due to a completion of construction of the Liquid Gas facility. Despite the damage caused by the natural disasters, output in the Philippines is estimated to expand at a 6.9 percent rate in 2013 reflecting an ongoing construction boom.

Weakening of regional growth reflects unwinding of imbalances accumulated during the years of above potential growth. As output in the region was capacity constrained at the onset

of the 2008-09 crisis, domestic policy induced quick rebound from the economic slowdown in 2009, left output in the region close to or above capacity. Continued fiscal and monetary stimulus in the post-crisis period combined with the strong foreign inflows exacerbated imbalances leading to a rapid expansion of credit, deteriorating current account positions, and growing asset price pressures, in several countries between 2007-2012 (Figure 2.1). Domestic credit expanded by more than 20 percentage points of GDP in Malaysia, Thailand, China, Vietnam, Cambodia and Lao during this period. In several countries, including Mongolia, Papua New Guinea, Lao and Vietnam, a large part of the debt was foreign financed (World Bank, GEP 2012b, 2013a, 2013b, East Asia & Pacific economic updates 2013, 2014).

Beginning toward the end of 2012, authorities in the region tightened policies to unwind imbalances, contributing to sharp decline in economic activity in the first quarter of 2013. Policy tightening along with still weak external demand contributed to the sharp decline in real

economic activity in the first part of 2013, when regional quarterly GDP growth fell from an 8.3 percent annualized rate in Q4 2012 to 5.3 percent in Q1 2013 (8.2 percent to 2.7 percent for the region excluding China). The decline was most pronounced in Indonesia, Malaysia and Thailand, where investment growth slowed sharply. Significant fiscal policy tightening measures taken include a reduction of domestic stimulus in China and a 33 percent increase in fuel prices in Indonesia. Monetary policy on hold and then tightening was a major contributing factor in Indonesia, but also played role in broadly unchanged in Malaysia, China (since July of 2012), and in the Philippines (since October of 2012) -- although China has sought to actively guide credit flow within the economy. Only Thailand, where the decline in economic activity was most marked, continued to ease policy throughout 2013, including a rate cut implemented in November.

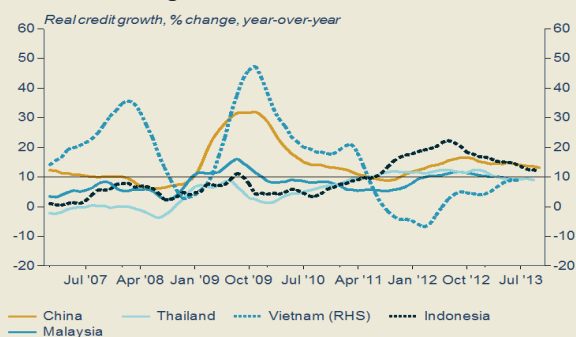
Declining commodity prices have cut into fiscal revenues among commodity exporting countries complicating the process of adjustment. World metal and mineral prices have declined nearly 30 percent, agricultural food prices eased by over 24 percent, and raw materials have weakened by almost [40] percent from their post-crisis high in February 2011 hurting the regional food, metal and raw material exporters. Deteriorating terms of trade are estimated to have reduced incomes by as much as 3.4 percent of GDP in Papua New Guinea, 2.5 percent of GDP in Mongolia, and 0.5-0.6 percent of GDP in Lao, Indonesia and Vietnam (about 0.5-0.6 percent of GDP).

The impact of domestic adjustment was also exacerbated by tightening of international

financial conditions in the second quarter of 2013. Speculation about the timing of tapering in the US, provoked a global portfolio adjustment toward US assets, whose yields had nearly doubled, and cut sharply into the regional financial flows and asset prices. Net capital flows to the region declined by 20 percent between May and September 2013. Hardest hit were those economies where prolonged expansionary policies had increased domestic vulnerabilities (current account deficits, high debt). Sovereign spreads increased by 200 basis points in Indonesia and 130 basis points in Vietnam, compared with a developing country average of around 100 basis points. Despite interest rate hikes, Indonesia's currency declined by about [9 percent] in nominal trade weighted terms reflecting a deteriorating current account and rising inflation, and Thailand's currency dropped by about 7 percent (Figure 2.2). Stock markets fell by between 20 (Thailand and the Philippines) and 35 percent (Indonesia) versus a 12 percent decline on average for developing countries.

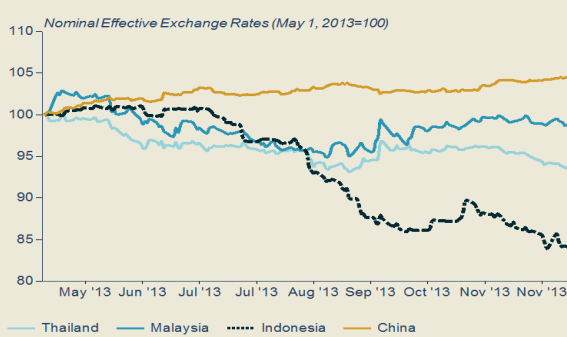
Despite the mid-year financial turbulence, growth in the region has been strengthening since Q1 supported by improved external demand, lower imports and policy stimulus in some countries. The weaker than expected growth in China in Q1 (5.9 percent saar) prompted authorities to deploy a relatively modest stimulus package. This, in combination with recovering import demand from high income countries, pulled Chinese quarterly GDP growth up to a 9.3 percent annualized rate in the third quarter. Outside of China quarterly GDP growth also accelerated to [5.2] percent annualized rate in Q3, mainly benefitting from better net exports due to lower imports (Figure 2.3). Quarterly GDP growth in Thailand

Figure 2.1 Loose policies domestically and globally helped sustain a period of rapid credit growth



Source:

Figure 2.2 Downward pressure on currencies began to ease in mid-August, except of Indonesia and to some extent Thailand



Source:

Figure 2.3 Imports are contracting at an accelerated rate

Source:

accelerated to 5.2 percent annualized rate in Q3 following two previous quarters of disappointing outcomes. In Indonesia, growth remains robust, but quarterly GDP growth has eased to 4.9 percent in Q3 relative to its recent trend. In Malaysia, output has coped relatively well recovering from contraction in the first quarter to a strong 6.8 percent annualized rate expansion in Q3. In the Philippines, the impact of typhoon Haiyan, has caused large humanitarian impact, and has cut deeply into activity in the central islands, but its impact on the country's overall economic growth is likely to be limited and growth is estimated to be 6.9 (about a 0.9 percent decline in growth in Q4 2013

leading to a 0.2 percentage point fall in annual growth rate in 2013).

Since August 2013, capital inflows to the region have rebounded leading to decline in bond yields, which nevertheless remain elevated, partial recovery of asset prices, and easing pressures on local currencies.

Pressures on current accounts have considerably eased from May-September tightening episode, but remained present, particularly in Indonesia reflecting ongoing adjustment to external balance pressures. Despite earlier losses, regional reserve positions have remained stable in excess of 5 months of import coverage in most countries, with the notable exception of [Vietnam, Lao, Cambodia and some Pacific Islands]. Increased revenue from tourism and remittances, fueled by recovering economic activity in high-income countries, played some role in easing pressures on regional current accounts. Remittances to the region grew an estimated 7.4 percent in 2013 (to US\$115.3 billion). In the Philippines remittances, continued to expand by an estimated 5.8 percent in 2013, and will likely accelerate in the wake of typhoon. Buoyant revenue from tourism have benefitted Thailand, and smaller economies of the region including the Pacific Islands.

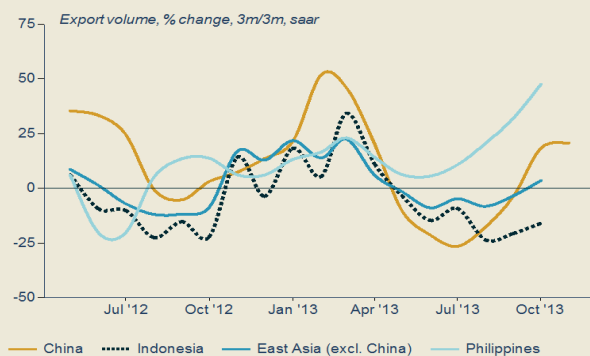
Sentiment has turned up and both industrial production and exports started to firm but performance remains uneven across the region.

Table 2.1 Net capital flows to East Asia and the Pacific (\$billions)

	2008	2009	2010	2011	2012	2013e	2014f	2015f	2016f
Capital Inflows	208.2	259	529.6	546.4	485.8	495.7	505.9	536.1	560.6
Private inflows, net	208.6	255.1	525.6	546.8	482.5	495.3	506.0	537.4	562.5
Equity Inflows, net	203.6	184.7	331.5	346.6	351.6	335.3	350.8	369.1	386.5
Net FDI inflows	211.2	154.5	291.1	339.9	313.7	320.0	326.0	337.0	348.0
Net portfolio equity inflows	-7.6	30.2	40.3	6.7	37.9	15.3	24.8	32.1	38.5
Private creditors, Net	5.0	70.4	194.1	200.2	130.9	160.0	155.2	168.3	176.0
Bonds	2.7	9.5	28.1	30.6	45.7	56.0	41.3	38.1	39.5
Banks	17.8	-4.2	16.0	28.9	31.9	41.0	38.2	41.3	43.3
Other private	-2.3	0.1	1.1	-4.5	-3.3	0.2	0.4	0.6	1.0
Short-term debt flows	-13.3	65.0	148.9	145.1	56.7	62.8	75.3	88.3	92.2
Official inflows, net	-0.4	3.9	4.0	-0.4	3.3	0.4	-0.1	-1.3	-1.9
World Bank	1.2	2.2	2.7	0.9	1.0	0.2	..	..	..
IMF	0.0	0.1	0.0	0.0	-0.1	-0.3	..	..	..
Other official	-1.5	1.6	1.3	-1.3	2.3	0.5	..	..	..

Source: The World Bank

Note: e = estimate, f = forecast

Figure 2.4 Regional exports excluding China and the Philippines continue to be weak


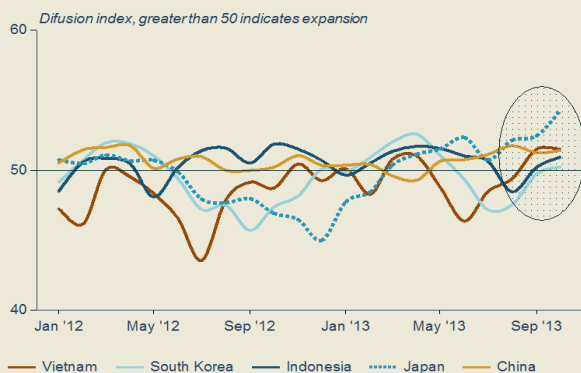
Source:

Sentiment has turned up, helped by strengthening high-income demand and the growth rebound in China. Business surveys in the region, which dropped below the 50 growth/no growth line in May, have improved most recently and the divergence within the region has also narrowed (Figure 2.5). Export performance in Indonesia (double digit rate contraction since August) and Thailand (2.9 percent annualized rate growth in October following six month period of contraction) remains weak, but continue to firm up in China, Malaysia, Philippines and Vietnam (Figure 2.4). Industrial production firmed up in China (about 12 percent quarterly growth since September), Malaysia, Philippines and Indonesia but continues to contract in Thailand and showed some signs of weakening in Malaysia most recently.

Outlook

Economic prospects for the region will reflect several counterbalancing factors, including the impact of normalization of long-term interest rates, which is projected to weigh on prospects for several middle-income countries in the region (Indonesia, Malaysia, and Thailand).

Higher borrowing costs are expected to weigh on investment, while reduced capital inflows (projected to decline from estimated 4.7 to 3.7 percent of regional GDP between 2013 and 2016). This will impact countries' ability to access external financing (see Chapter 3 for more), especially when

Figure 2.5 Business sentiment is improving


Source:

portfolio flows represent large share of total capital flows (53 percent in the region excluding China compared with about 10 percent developing country average). Bond issuance in the region will be disproportionately affected and is estimated to decline by about 30 percent over the forecast period from present record high level (about \$ 56 billion in 2013) (table 2.1).

At the same time, the recovery in import demand from high-income countries should contribute to acceleration in global trade and regional exports. Global gross domestic product growth is expected to gradually firm from [2.3] percent to [3.5] percent in 2016. Global trade flows are also projected to recover from current low levels [3.1] percent to 5.2 percent by 2016. Increased trade will particularly benefit exporters of manufacturing products and services (China, Malaysia, Thailand, the Philippines, Pacific Islands), and economies with relatively low unit labor costs and competitive exchange rates (Lao, Vietnam, Cambodia, Myanmar). Declining commodity prices are however projected to weigh on output for commodity exporters (Indonesia, Malaysia, Mongolia and Papua New Guinea).

Overall growth in the region is expected to stay broadly flat at around 7.2 percent throughout the projection period. This is about 2 percentage points slower than during the pre-crisis boom years but broadly in line with potential. Full year growth for China is expected to remain at around [7.7] percent in 2014, but the quarterly pace should slow somewhat toward the second half of the year and growth is projected to stabilize at around 7.5

percent in 2015 and 2016. Growth in the rest of the region should also be broadly stable in 2014, but is projected to pick up in 2015 [5.7] reflecting modest acceleration in Indonesia and Thailand, reconstruction efforts in the Philippines and start of production of Papua New Guinea Liquefied Gas before settling at [5.5] percent in 2016 (table 2.2).

Aligning growth with potential rate in several major middle-income economies in 2014 will help alleviate domestic vulnerabilities generated during the years of expansionary policies. In Indonesia, the current slowdown is projected to run its course during 2014 allowing overheating pressures to ease and economy to adjust to lower commodity price environment and permitting a modest acceleration in 2015. Outturns for Malaysia, Thailand and Vietnam will depend on the ability of the authorities to effectively implement policy tightening to contain further increase in domestic debt, contain potential price pressures and boost international competitiveness to take full advantage of recovering global trade flows. In Thailand, the weak growth of the past year is projected to give way to acceleration on the back of recovering external demand. Political conditions however could see outturns disappoint if investors take a wait and see attitude.

Outturns for the Philippines, Cambodia, Lao and Myanmar, will depend on the effective balance of competing needs. The strong credit and construction boom presents elements of an asset-price bubble in Cambodia, Lao, the Philippines and Myanmar, that could unwind in a disorderly fashion if not managed prudentially. The sustained increase in remittances and FDI flows also continue to put upward pressure on the currencies of the region especially in the Philippines, which is likely to hurt competitiveness. In the Philippines, there is increasing need to undertake structural reforms and rebalance economies from its excessive dependence on consumption, while at the same time prioritizing investment, to rebuild the typhoon stricken portions of the economy. This may require a careful management of fiscal levers to direct spending towards the affected areas and away from the overheating sectors elsewhere.

Growth outlook is favorable for Mongolia, Papua New Guinea and Timor-Leste, but all three countries are facing the formidable

challenge related to effective management of resource boom in the environment of declining commodity prices. Mongolia's economy is expected to continue to register double-digit growth rates in 2014 and 2015 with growth rate easing to 7.7 percent in 2016 with completion of new production facilities. The start of liquid gas exports will significantly raise the level of GDP in Papua New Guinea in 2015, but output growth is estimated to decline to 5 percent rate in 2016. Timor-Leste's growth outlook, while favorable, has moderated in line with lower planned growth in public spending.

Risks

The outlook is subject to significant domestic and external risks. An abrupt tightening of international financing conditions could reduce capital flows, exerting financing pressures in the region. The baseline assumes a gradual adjustment of global financial conditions, but a more disorderly reaction of financial markets to a normalization of conditions in the United States and elsewhere cannot be excluded (see discussions in Chapters 1& 3). In such a scenario, capital flows could decline briskly by as much as 60 percent within for a period of several months placing extreme pressure on countries with large current account deficits (Cambodia, Lao, PDR, Indonesia, Malaysia and Mongolia), overvalued real effective exchange rate overvaluation (Mongolia), large short-term debt exposures (China, Malaysia, Thailand Indonesia) and/or limited reserves (Cambodia, Lao, Fiji, PNG, Mongolia and Vietnam).

Countries where years of expansionary policies have contributed to domestic vulnerabilities are particularly at risk. In such scenarios those countries that have had a significant credit expansion in 2007-2012 (China, Malaysia, Mongolia, Thailand, Vietnam) would experience a spike in debt servicing costs, a sharp rise in non-performing loans and pressure on the balance sheets of banks, which would quickly transmit to lending and investment activity – and in extreme cases could undermine financial stability leading to a banking crisis (see Chapter 3). Although public sector indebtedness is relatively low in most economies in the region, given implicit guarantees

Table 2.2 East Asia and the Pacific forecast summary

(annual percent change unless indicated otherwise)

	00-09 ^a	2010	2011	2012	Est. Forecast			
					2013	2014	2015	2016
GDP at market prices ^b	8.0	9.6	8.3	7.4	7.2	7.2	7.1	7.1
	<i>(Sub-region totals-- countries with full NIA + BOP data) ^c</i>							
GDP at market prices ^c	8.0	9.6	8.3	7.4	7.2	7.2	7.1	7.1
GDP per capita (units in US\$)	7.3	8.9	7.6	6.7	6.5	6.6	6.5	6.5
PPP GDP	8.1	9.6	8.3	7.4	7.2	7.2	7.1	7.1
Private consumption	6.0	7.4	7.9	7.3	7.3	7.7	7.7	7.8
Public consumption	7.4	9.6	8.9	8.4	8.5	8.5	8.0	7.7
Fixed investment	10.7	11.4	8.9	10.3	7.0	6.7	6.5	6.1
Exports, GNFS ^d	10.0	23.3	8.6	3.0	5.3	7.2	8.0	8.2
Imports, GNFS ^d	9.6	19.4	6.2	4.7	5.5	7.2	8.1	8.2
Net exports, contribution to growth	0.4	1.7	1.1	-0.4	0.2	0.3	0.3	0.3
Current account bal/GDP (%)	4.6	3.8	1.9	1.9	1.9	1.9	1.9	1.9
GDP deflator (median, LCU)	5.4	6.2	5.1	2.1	2.9	5.1	3.9	4.0
Fiscal balance/GDP (%)	-1.8	-1.6	-1.7	-1.8	-1.9	-1.9	-1.9	-1.9
Memo items: GDP								
East Asia excluding China	4.4	6.9	4.7	6.2	5.2	5.3	5.7	5.5
China	9.4	10.4	9.3	7.7	7.7	7.7	7.5	7.5
Indonesia	4.6	6.2	6.5	6.2	5.6	5.3	5.5	5.5
Thailand	3.5	7.8	0.1	6.5	3.2	4.5	5.0	5.2

Source: World Bank.

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

b. GDP at market prices and expenditure components are measured in constant 2010 U.S. dollars.

c. Sub-region aggregate excludes Fiji, Myanmar and Timor-Leste, for which data limitations prevent the forecasting of GDP components or Balance of Payments details.

d. Exports and imports of goods and non-factor services (GNFS).

to banking sectors in countries and reliance on state owned banks to stimulate domestic credit growth (China, Vietnam), public debt levels could rise rapidly in case loan defaults if economic cycles turn.

Although major tail-risks have subsided, they have not been eliminated and include rebalancing in China, protracted recovery in the EU and fiscal policy uncertainty in the US.

In China policy makers face formidable challenges in reorienting the economy away from an investment led model, with reforms required across a range of sectors if private consumption is to underpin future growth. Past high levels of investment have generated significant vulnerabilities, which represent risks to banking sector. An abrupt unwinding of investment in China, as it deleverages, could sharply reduce GDP, with

significant knock on effects in the region and other economies with close trading linkages (including commodity producers). Recognition of such risks may have underpinned recent decisions to focus reform on land ownership and use, restructuring of state-owned enterprises and the financial sector. The implementation of this agenda is likely to lead to more balanced growth in the medium-term but the risks in case of a falloff remain formidable. In Euro Area much has been achieved, but protracted recession remains a downside risk due to the remaining formidable challenges. Setbacks in sustainable resolution of debt and fiscal issues in the US could spark an acute global crisis in case of a debt default. In addition, although currently contained, an escalation of country level (e.g. in Thailand) as well as bilateral and/or geo-political tensions may undermine regional growth prospects.

Table 2.3 East Asia and Pacific Country forecasts

	00-09 ^a	2010	2011	2012	Est. Forecast			
					2013	2014	2015	2016
Cambodia								
GDP at market prices (% annual growth) ^b	7.4	6.0	7.1	7.3	7.0	7.0	7.0	7.0
Current account bal/GDP (%)	-4.5	-6.9	-7.9	-10.1	-9.6	-12.0	-11.8	-10.0
China								
GDP at market prices (% annual growth) ^b	9.4	10.4	9.3	7.7	7.7	7.7	7.5	7.5
Current account bal/GDP (%)	5.0	4.0	1.8	2.3	2.4	2.4	2.3	2.3
Fiji								
GDP at market prices (% annual growth) ^b	1.3	0.1	1.9	2.3	2.4	2.1	2.2	2.3
Current account bal/GDP (%)	-7.7	-4.4	-5.5	-1.4	-17.4	-5.5	-6.3	-7.8
Indonesia								
GDP at market prices (% annual growth) ^b	4.6	6.2	6.5	6.2	5.6	5.3	5.5	5.5
Current account bal/GDP (%)	2.5	0.7	0.2	-2.8	-3.5	-2.6	-2.3	-2.1
Lao PDR								
GDP at market prices (% annual growth) ^b	5.5	8.5	8.0	8.2	8.0	7.7	8.1	8.1
Current account bal/GDP (%)	-2.6	-10.0	-10.3	-15.3	-20.8	-20.0	-18.9	-17.0
Malaysia								
GDP at market prices (% annual growth) ^b	3.9	7.2	5.1	5.6	4.5	4.8	4.9	4.9
Current account bal/GDP (%)	12.6	11.1	11.0	6.1	4.3	4.3	4.1	4.0
Mongolia								
GDP at market prices (% annual growth) ^b	5.8	6.4	17.5	12.4	12.5	10.3	10.0	7.7
Current account bal/GDP (%)	-6.3	-14.3	-31.5	-32.7	-25.6	-16.8	-10.7	-9.2
Myanmar								
GDP at market prices (% annual growth) ^b	9.7	5.3	5.9	6.5	6.8	6.9	6.9	6.9
Current account bal/GDP (%)	-0.7	-1.3	-2.6	-4.1	-4.2	-4.8	-5.1	-5.1
Papua New Guinea^c								
GDP at market prices (% annual growth) ^b	3.0	7.7	10.7	8.1	4.0	8.5	20.0	5.0
Current account bal/GDP (%)	2.4	-21.4	-23.5	-51.0	-27.0	-2.0	12.3	9.3
Philippines								
GDP at market prices (% annual growth) ^b	4.0	7.6	3.6	6.8	6.9	6.5	7.1	6.5
Current account bal/GDP (%)	1.5	4.5	3.2	2.9	2.0	0.6	0.7	1.0
Solomon Islands								
GDP at market prices (% annual growth) ^b	2.8	7.0	10.7	4.8	4.0	3.5	3.7	4.0
Current account bal/GDP (%)	-20.5	-30.8	-6.7	-0.1	-2.0	-6.5	-5.3	-7.6
Thailand								
GDP at market prices (% annual growth) ^b	3.5	7.8	0.1	6.5	3.2	4.5	5.0	5.2
Current account bal/GDP (%)	3.3	4.1	2.8	1.7	1.1	1.1	1.3	1.4
Timor-Leste^b								
GDP at market prices (% annual growth) ^b	3.3	9.5	12.0	8.3	8.1	8.0	7.7	8.6
Current account bal/GDP (%)	17.1	39.8	40.4	43.5	34.3	32.1	27.0	27.7
Vietnam								
GDP at market prices (% annual growth) ^b	7.1	6.8	6.2	5.2	5.3	5.4	5.4	5.5
Current account bal/GDP (%)	-10.8	-3.8	0.2	5.9	5.1	3.0	0.6	0.5

Source: World Bank.

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

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

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

b. GDP measured in constant 2010 U.S. dollars.

c. The start of production at Papua-New-Guinea-Liquefied Natural Gas (PNG-LNG) is expected to boost PNG's GDP growth to 20 percent and shift the current account to a 9 percent surplus in 2015. PNG's GDP deflators are expected to be updated in 2014 and the new GDP series is expected to be significantly different from the existing one.

d. Non-oil GDP. Timor-Leste's total GDP, including the oil economy, is roughly four times the non-oil economy, and highly volatile, subject to global oil prices and local production levels.

EUROPE and CENTRAL ASIA REGION

GLOBAL
ECONOMIC
PROSPECTS

January
2014

Chapter 2



Regional growth strengthened in 2013, due to higher demand from Europe and strong growth in energy commodity-exporters. Non-energy commodity exporters suffered declines in metal and agricultural prices. Strong growth in high-income Europe will benefit most countries with strong trade ties. Prospects are weaker for those struggling with high fiscal and external deficits. A sharper slowdown in Russia and tighter global finance are key downside risks.

Recent Developments

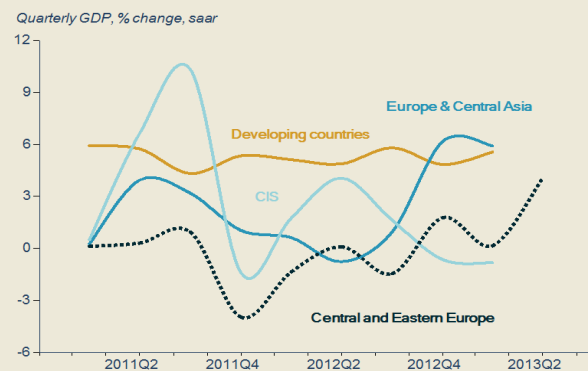
Economic activity strengthened in the Europe and Central Asia^{FN1} region in 2013 supported by strengthening external demand.

After sub-par growth in 2012 (2.0 percent) economic activity in the region is estimated to have accelerated to 3.4 percent in 2013, albeit, with divergent performances across countries (figure 2.6). The pick-up was strongest in the Central and Eastern European sub-region where output increased by 1.6 percent in 2013 (up from -0.1 percent in 2012), supported by strengthening demand in the Euro Area. In Turkey, the largest economy in the region, buoyant domestic demand underpinned acceleration in growth to 4.3 percent in 2013 from 2.2 percent in 2012. Growth in the remainder of the region was broadly stable at an estimated 3.4 percent in 2013 (3.4 percent in 2012),

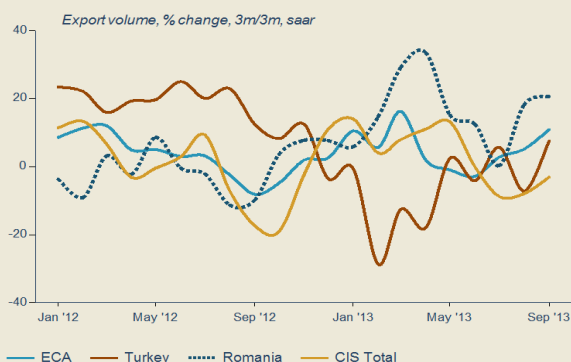
notwithstanding an estimated -1.1 percent contraction in Ukraine.

A moderate pick-up in external demand boosted regional economic activity. The return to growth in the Euro Area in the second quarter of 2013 supported real side activity in the region, particularly in the Central and Eastern European countries due to strong trade linkages.^{FN2} On a year

Figure 2.6 Growth is picking up in East Central Asia region



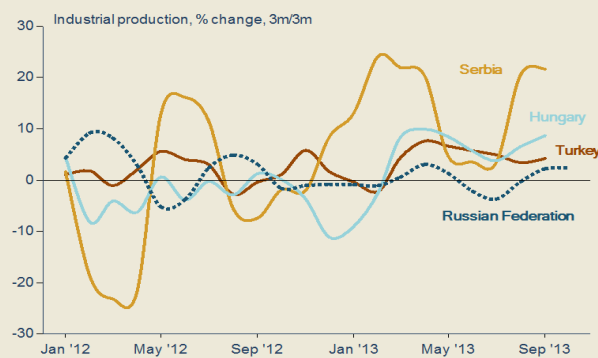
Source: Datastream and the World Bank

Figure 2.7 Exports are recovering led by the CEE countries


Source: The World Bank

-to-date basis, exports in the sub-region grew by 8.8 percent during the first nine months of 2013 compared with the same period in 2012 reflecting particularly strong growth in the third quarter (14.4 percent annualized) (figure 2.7). In contrast Turkish exports were some 0.6 percent lower than a year before during the first 9 months of 2013, reflecting weak global growth during the first half of the year and tighter sanctions on Iran (which cut sharply into gold exports). As elsewhere stronger global growth in Q3 and the 10.9 percent depreciation of the Lira since May has contributed to an annualized 7.6 percent increase in Q3 exports, with new foreign orders up (fastest pace in 22 months according to November business sentiment indicators). Recent monthly data for the Commonwealth of Independent States is not available, but given strong trade links with Russia and falling Russian import demand (-24.1 and -4.5 percent in Q2 and Q3) non-commodity exports of these countries are likely to have been weak during this period. In contrast, oil production and exports in Kazakhstan and Azerbaijan have shown continued strength, supporting their above regional -average GDP growth rates.

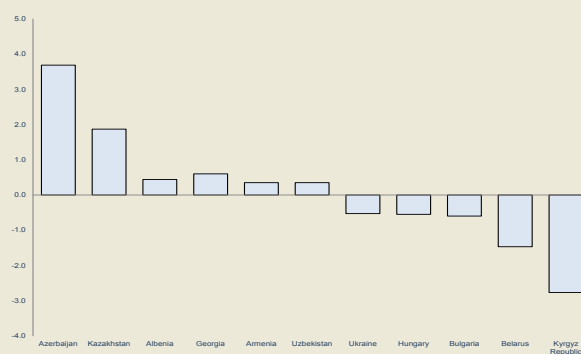
Regional industrial production strengthened, but performance differed across economies. For the region as an aggregate, industrial production accelerated to 2.3 percent growth during the first nine months of 2013 compared with a 0.9 percent in 2012. In the Central and Eastern European sub-region industrial production accelerated to an annualized pace of 5.7 percent in Q3 2013 on stronger exports. (figure 2.8). In Turkey industrial activity has grown at a 3.1 percent year-to-date

Figure 2.8 Performance of industrial production varies across countries


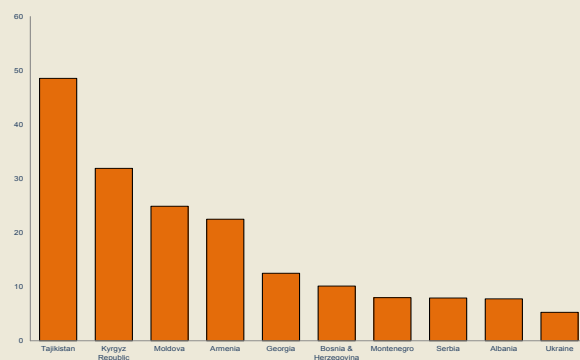
Source: Datastream and the World Bank

reflecting strong domestic demand bolstered by accommodative monetary policies, particularly in the first half of the year.

Performance among the Commonwealth of Independent States has been mixed. Among energy-exporting countries (Azerbaijan, Kazakhstan, and Uzbekistan), activity has remained strong reflecting relative strength in energy-related commodity prices, expansion of production in extractive sectors, and robust growth in domestic demand supported by government spending and so far stable remittance inflows (see below). In contrast, political disturbances have dampened economic activity and domestic demand in Ukraine, where industrial production contracted at a 2.9 percent annualized pace in the three months ending October, a fifteenth consecutive month of contraction. Among metal and mineral exporting countries in the sub-region, a 30 percent decline in

Figure 2.9 Estimated impact of commodity price changes on trade balance (% GDP, 2013)


Source: The World Bank

Figure 2.10 Remittances (% GDP, 2013)

Source: The World Bank

metals and mineral prices since 2011 has cut into incomes and activity. Agricultural food prices are down 24 percent and raw materials have declined by almost 37 percent (energy prices are up 8 percent). Kyrgyz Republic, Belarus and Ukraine experienced the most negative terms of trade impacts—as lower export prices and higher energy import prices are estimated to have reduced incomes by some 2.7 percent, 1.5 percent, and 0.6 percent of GDP, respectively (figure 2.9).

The negative impact of deteriorating terms of trade was partially mitigated by strong remittance inflows. On account of strengthening activity in the Euro Area as well as resilient flows from Russia (despite its growth deceleration in the second half of 2013) remittances to the region rebounded by an estimated 11 percent in 2013, helping to support household consumption. The rebound was strongest in Tajikistan, with an estimated 23 percent increase in 2013. Remittances are particularly important to the economies of Tajikistan where they represent 48 percent of GDP, Kyrgyz Republic (31 percent of GDP) and Moldova (24.1 percent of GDP) (figure 2.10).

Capital inflows to the region began strong, but declined with speculation about the timing of an end to US quantitative easing. Overall, net capital inflows to the region are estimated to have slightly decreased by \$1.9 billion or –1.6 percent year on year in 2013, mainly reflecting strong flows during the first 5 months of the year being offset by mid-year weakness and ensuing volatility since then. The higher interest rates on US government debt that accompanied speculation as to the timing

Figure 2.11 Non Performing Loans remain elevated in the region

Source: The World Bank

of an end of quantitative easing sparked an adjustment in global portfolios away from developing countries. As a result, average monthly capital flows to developing Europe and Central Asia fell by 60 percent between June and October as compared with the first 5 months of the year. Within the region, Turkey felt the most immediate impacts. The country's large current account deficits funded by relatively large share of short-term loans and volatile portfolio flows were seen as being particularly vulnerable to outflows and a rise in global interest rates. Hungary, Serbia and Ukraine were also hard-hit by the sudden reversal in capital flows, but other countries, including Georgia and Kazakhstan, where the stock of private external debt is particularly high, also came under considerable pressure, resulting in increases in long term interest rates. The weakness in capital inflows caused currencies to depreciate (by 3.7 percent on average for the region in nominal effective terms, stock markets to depreciate by 10.5 percent in June and by 4.3 percent between June and September), while efforts to resist depreciation in some countries was reflected in a significant decline in reserves (e.g., Hungary, Romania, Turkey) when expressed as a percent of monthly imports. Since August, capital inflows to the region have rebounded and local currencies appreciated, equity prices have recovered earlier losses and bond yields declined, but remain elevated compared to pre-May levels. This episode which led to the tightening of financing conditions is a stark reminder of the vulnerabilities of economies in the region (see risk section).

Table 2.4 Europe and Central Asia forecast summary

(annual percent change unless indicated otherwise)

	00-09 ^a	2010	2011	2012	Est. Forecast			
					2013	2014	2015	2016
GDP at market prices ^b	3.9	6.0	6.3	2.0	3.4	3.5	3.7	3.8
	<i>(Sub-region totals-- countries with full NIA + BOP data)^c</i>							
GDP at market prices ^c	3.9	6.1	6.3	2.0	3.4	3.5	3.6	3.8
GDP per capita (units in US\$)	3.5	5.3	5.5	1.2	2.7	2.8	3.0	3.1
PPP GDP	3.9	5.8	6.1	1.9	3.2	3.4	3.5	3.6
Private consumption	4.3	4.5	7.0	2.2	3.7	3.9	3.9	4.0
Public consumption	3.7	-0.7	2.9	4.1	2.5	2.3	2.8	2.8
Fixed investment	5.0	12.7	9.5	-0.7	4.3	5.1	5.2	4.8
Exports, GNFS ^d	5.1	8.5	8.6	4.6	2.6	4.2	4.8	5.2
Imports, GNFS ^d	5.4	12.5	11.1	1.3	4.9	4.9	5.8	5.7
Net exports, contribution to growth	-0.2	-1.7	-1.3	1.2	-1.1	-0.5	-0.6	-0.4
Current account bal/GDP (%)	-3.7	-3.3	-4.3	-3.5	-4.0	-4.0	-4.0	-3.9
GDP deflator (median, LCU)	9.3	8.5	8.7	3.4	4.3	4.2	4.6	4.3
Fiscal balance/GDP (%)	-4.4	-2.2	0.7	-1.1	-1.0	-1.0	-0.7	-0.7
Memo items: GDP								
ECA including high income countries	3.9	4.7	4.9	2.3	2.1	2.8	3.1	3.3
Transition countries ^e	4.8	3.4	4.2	1.7	2.6	3.5	3.4	3.5
Central and Eastern Europe ^f	3.1	0.3	2.0	-0.1	1.5	2.1	2.2	2.6
Commonwealth of Independent States ^g	6.5	6.1	6.0	3.4	3.4	4.6	4.3	4.2
Turkey	3.0	9.2	8.8	2.2	4.3	3.5	3.9	4.2
Romania	3.8	-0.9	2.3	0.7	2.5	2.5	2.7	2.7

Source: World Bank.

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

b. GDP at market prices and expenditure components are measured in constant 2010 U.S. dollars.

c. Sub-region aggregate excludes Bosnia and Herzegovina, Kosovo, Montenegro, Serbia, Tajikistan and Turkmenistan. Data limitations prevent the forecasting of GDP components or Balance of Payments details for these countries.

d. Exports and imports of goods and non-factor services (GNFS).

e. Transition countries: CEE and CIS (f + g below).

f. Central and Eastern Europe: Albania, Bosnia and Herzegovina, Bulgaria, Georgia, Kosovo, Lithuania, Macedonia, FYR, Montenegro, Romania, Serbia.

g. Commonwealth of Independent States: Armenia, Azerbaijan, Belarus, Kazakhstan, Kyrgyz Republic, Moldova, Tajikistan, Turkmenistan, Ukraine, Uzbekistan.

Across the region, the banking sector remains weak, saddled with overhang of non-performing loans (NPLs). Fourteen of the twenty developing countries with the highest share of non-performing loans are in Europe and Central Asia (led by Kazakhstan, Serbia, Albania, Bulgaria, and Romania) (figure 2.11). In Central and Eastern European countries, high NPLs partly reflect the deep recession and the tepid economic recovery. Slow growth has delayed the recovery in asset prices, discouraging banks from actively writing-off loans and disposals. High NPLs in turn have weakened credit creation by the banks hampering potentially productive investments. In the Commonwealth of Independent States sub region, the profitability of banks has generally recovered since the crisis, but the conditions underlying the vulnerabilities in the banking sector remain,

including widespread use of state-directed credit and subsidized lending to priority sectors including the state-owned enterprises in commodity sectors.

Outlook

After expanding by an estimated 3.4 percent in 2013, GDP growth for the region is projected to steadily rise from 3.5 percent in 2014 to 3.8 percent by 2016. This pick-up in activity, though generally broadly-based, will be most marked in the Central and Eastern European economies, where there is currently the most spare capacity.

Table 2.5 Net capital flows to Europe and Central Asia (\$ billions)

	2008	2009	2010	2011	2012	2013e	2014f	2015f	2016f
Capital Inflows	324.9	101.3	85.3	137.3	121.2	119.3	116.6	133.1	149.9
Private inflows, net	300.3	52.3	57.3	130.4	128.1	114.2	111.6	124.1	137.9
Equity Inflows, net	165.5	54.8	27.6	75.1	72.4	55.4	54.1	59.3	65.1
Net FDI inflows	166.0	51.1	23.8	75.8	64.4	55.0	51.0	55.0	60.0
Net portfolio equity inflows	-0.4	3.7	3.7	-0.7	8.0	0.4	3.1	4.3	5.1
Private creditors, Net	134.8	-2.5	29.7	55.3	55.7	58.8	57.5	64.8	72.8
Bonds	-3.2	-6.8	7.1	8.2	38.7	29.7	22.7	20.6	19.7
Banks	133.2	14.4	-19.0	33.1	8.1	15.3	14.7	18.6	22.5
Other private	-0.9	-0.2	0.1	-0.1	-0.1	0.7	0.6	1.1	0.2
Short-term debt flows	5.7	-9.9	41.6	14.1	9.0	13.1	19.5	24.5	30.4
Official inflows, net	24.6	49.0	28.0	6.9	-6.9	5.1	5.0	9.0	12.0
World Bank	1.2	3.4	3.9	2.9	2.0	3.1	..	..	..
IMF	12.8	25.5	9.0	-1.0	-13.0	-4.0	..	..	..
Other official	10.6	20.2	15.1	5.1	4.0	6.0	..	..	..

Source: The World Bank

Note: e = estimate, f = forecast

GDP growth in the Central and Eastern European sub region is expected to reach 2.9 percent by 2016, up from an estimated 1.5 percent in 2013, supported by strengthening economic activity in the European Union. Despite stronger growth, domestic demand, is expected to remain sluggish due to ongoing banking-sector restructuring and tighter international financial conditions, which will weigh on investment and consumer durable demand. Ongoing or planned fiscal consolidation in some countries (e.g. Albania, Macedonia and Serbia), will also serve to partly offset the growth impetus from stronger exports. While conditions are projected to improve, growth will not be strong enough to make a substantial dent in regional unemployment and spare capacity over the forecast horizon.

Growth in the Commonwealth of Independent States is projected to pick-up from an estimated 3.3 percent in 2013 to 4.2 percent in 2016. Among resource rich Commonwealth of Independent States, this will be supported by the expected coming on stream of new export capacity following years of investment in the energy sectors. The strengthening of the global economy should be supportive of increased energy demand, although technological developments will continue to weigh on medium to long-term prices. Oil prices are projected to remain stable in nominal terms through 2014 (\$105.7) before declining marginally in 2015 and 2016. Among non-energy

Commonwealth of Independent States, a strengthening outlook will be supported by a pick-up in remittances and exports as the global economy strengthens. Sub-region remittances are projected to increase by 10.3 percent in 2014 benefitting from an economic recovery in the EU countries and strengthening growth in Russia (from x percent in 2013 to y percent in 2014–16), the destination for a large number of migrants from Central Asian economies. On the downside, weaker metal and agricultural prices are likely to weigh on export revenues and government spending.

Growth in Turkey, the region's largest economy, is expected to stabilize around its potential growth rate of about 3.9 percent over the 2014–16 period—well below its pre-crisis rate of 6.8 percent (2002–2007 average). As a significant beneficiary of international capital flows in recent years, Turkey will be impacted by the tighter global financial markets. Gross capital flows to the region are expected to decline by 0.3 percent of regional GDP to about 6.3 percent of GDP by 2016 as global asset portfolios are rebalanced (see the extensive discussion in Chapter 3). While tighter financial conditions should temper growth in Turkey, these effects are expected to be partially offset by relatively strong private consumption and investment and higher government consumption in the run up to elections in 2014.

Risks

While the baseline forecast remains the most likely outcome, the outlook is subject to downside risks. Although the main tail-risks of the past 5 years have subsided, the underlying challenges that underpinned them—though less acute—remain. In the Euro Area much has been achieved and banks have gone a long way to restructuring themselves, but the recovery will take time and considerable effort. Protracted recession in the Euro area is therefore a downside risk to the outlook especially for countries with stronger trade and financial links with the area (in particular, Central and Eastern European economies). Further, slower than projected growth in China, perhaps provoked by a quicker than anticipated decline in investment, could slow global growth by as much as 0.3 percent but with more marked effects on regional industrial commodity producers (e.g. Belarus and Ukraine). A sharper than expected slowdown in Russia would be a key downside risk for many Commonwealth of Independent States, especially those that are heavily dependent on Russia for import demand, remittance flows, and foreign investment (e.g., Tajikistan, Moldova, the Kyrgyz Republic, Armenia, and Uzbekistan).

Further tightening in global finance conditions is a downside risk to the outlook especially for countries with high refinancing needs. Over the medium term, the gradual return of long-term interest rates in both high income and developing countries to more sustainable levels should help reduce the excesses and vulnerabilities that can accumulate in a persistently low interest rate environment. However, in the near term, the transition to higher global interest rates could be volatile. Should market reactions to the withdrawal of extraordinary monetary measures in high-income countries be less orderly than assumed in the baseline, simulations based on econometric work discussed in more detail in Chapter 3, suggest that capital flows to developing countries could decline by 80 percent or more for several months—potentially sparking local crises in countries with large external imbalances and those that have experienced large credit expansions in recent years (e.g., Albania, Bosnia, Kyrgyz Republic, Montenegro, Serbia, and Turkey).

High levels of external private sector debt levels are a challenge in the region. Particularly high debt levels in some countries in the region (e.g., Bulgaria, Kazakhstan, Moldova, and Latvia) increase their susceptibility to changes in external financing conditions and currency mismatch. Added to this, banks in many countries remain weak due to high levels of non-performing loans left over from the previous crisis. Ukraine is the most vulnerable on account of a de-facto peg against the US dollar which has come under pressure over the past year due to a severe recession. Risks in Turkey reflect rising leverage in the corporate sector with large amounts of foreign exchange liabilities (intermediated through the banking sector), relatively low reserve coverage of short term external debt (compared to other major middle-income economies), and a reliance on short term capital flows to cover its current account deficits.

On the upside, stronger growth than envisaged in the baseline could provide additional boost to the regional economies. A stronger recovery in high income economies could provide considerable support to external demand, notably in Central and East European developing countries, helping offset downward adjustments in domestic demand triggered by rising global interest rates. Declining global food prices should also reduce inflation pressures and food import costs, although they are a negative development for food exporters.

Table 2.6 East Central Asia Country forecasts

	00-09 ^a	2010	2011	2012	Est. Forecast			
					2013	2014	2015	2016
Albania								
GDP at market prices (% annual growth) ^b	4.9	3.8	3.1	1.6	1.3	2.1	3.0	3.0
Current account bal/GDP (%)	-8.6	-11.5	-13.0	-10.8	-8.2	-7.1	-6.3	-6.7
Armenia								
GDP at market prices (% annual growth) ^b	7.7	2.2	4.7	7.2	3.2	5.0	5.0	5.0
Current account bal/GDP (%)	-7.4	-14.8	-11.0	-11.2	-10.6	-10.0	-9.2	-8.0
Azerbaijan								
GDP at market prices (% annual growth) ^b	14.1	5.0	0.1	2.2	4.9	5.3	4.5	3.9
Current account bal/GDP (%)	2.9	29.3	25.4	21.2	17.7	15.9	14.3	12.5
Belarus								
GDP at market prices (% annual growth) ^b	6.6	7.7	5.5	1.5	1.0	1.5	2.0	1.5
Current account bal/GDP (%)	-4.6	-15.0	-9.0	-2.8	-8.9	-8.1	-9.2	-8.4
Bosnia and Herzegovina								
GDP at market prices (% annual growth) ^b	4.0	0.7	1.3	-1.1	0.8	2.0	3.5	3.5
Current account bal/GDP (%)	-13.3	-5.6	-8.8	-9.6	-7.5	-6.6	-6.3	-6.1
Bulgaria								
GDP at market prices (% annual growth) ^b	4.0	0.4	1.8	0.8	0.6	1.7	1.8	2.0
Current account bal/GDP (%)	-11.3	-1.5	0.3	-1.3	2.1	-0.5	-0.9	-1.0
Georgia								
GDP at market prices (% annual growth) ^b	5.6	6.3	7.0	6.0	2.5	6.3	6.3	6.5
Current account bal/GDP (%)	-12.6	-10.2	-12.7	-11.7	-7.5	-7.1	-7.0	-6.3
Hungary								
GDP at market prices (% annual growth) ^b	1.8	1.3	1.6	-1.7	0.7	1.7	1.5	2.7
Current account bal/GDP (%)	-6.8	1.1	0.9	1.6	2.3	2.2	2.1	3.2
Kazakhstan								
GDP at market prices (% annual growth) ^b	7.5	7.3	7.5	5.0	5.8	5.9	6.0	6.0
Current account bal/GDP (%)	-2.0	0.9	5.4	0.3	-0.3	-1.3	-1.7	-1.8
Kosovo								
GDP at market prices (% annual growth) ^b	5.8	3.9	5.0	2.7	3.0	4.0	4.2	4.2
Current account bal/GDP (%)	-7.3	-12.0	-13.8	-7.6	-10.7	-8.7	-8.3	-8.6
Kyrgyz Republic								
GDP at market prices (% annual growth) ^b	4.2	-0.5	6.0	-0.9	7.8	6.5	5.4	5.3
Current account bal/GDP (%)	-6.0	-6.4	-6.0	-15.3	-10.4	-11.7	-11.0	-10.9
Moldova								
GDP at market prices (% annual growth) ^b	4.4	7.1	6.4	-0.8	4.2	3.8	4.0	4.0
Current account bal/GDP (%)	-8.4	-9.6	-12.4	-7.9	-8.4	-8.7	-9.6	-8.0
Macedonia, FYR								
GDP at market prices (% annual growth) ^b	2.3	2.9	2.9	-0.4	2.5	3.0	3.5	3.7
Current account bal/GDP (%)	-6.1	-2.1	-2.5	-3.1	-3.2	-4.5	-5.7	-6.1
Montenegro								
GDP at market prices (2005 US\$) ^b	-	2.5	3.2	-2.5	1.8	2.5	2.7	2.9
Current account bal/GDP (%)	-11.4	-22.9	-17.7	-18.7	-15.0	-15.0	-15.0	-15.0
Romania								
GDP at market prices (% annual growth) ^b	3.8	-0.9	2.3	0.7	2.5	2.5	2.7	2.7
Current account bal/GDP (%)	-7.5	-4.6	-4.8	-3.8	-1.5	-1.8	-2.5	-2.7
Serbia								
GDP at market prices (% annual growth) ^b	3.6	1.0	1.6	-1.7	2.0	1.0	2.2	2.5
Current account bal/GDP (%)	-9.7	-6.7	-9.2	-10.5	-6.0	-6.0	6.3	6.5

	00-09 ^a	2010	2011	2012	Est. Forecast			
					2013	2014	2015	2016
Tajikistan								
GDP at market prices (% annual growth) ^b	7.7	6.5	7.4	7.5	7.0	6.0	6.0	6.0
Current account bal/GDP (%)	-4.8	-1.2	-4.7	-1.9	-2.2	-2.4	-2.5	-2.5
Turkey								
GDP at market prices (% annual growth) ^b	3.0	9.2	8.8	2.2	4.3	3.5	3.9	4.2
Current account bal/GDP (%)	-3.2	-6.2	-9.7	-6.1	-7.3	-7.1	-6.8	-6.5
Turkmenistan								
GDP at market prices (% annual growth) ^b	12.6	9.2	14.7	11.1	10.1	10.7	10.5	10.1
Current account bal/GDP (%)	7.4	-10.6	2.0	0.0	-3.4	-1.7	-1.5	-1.5
Ukraine								
GDP at market prices (% annual growth) ^b	3.9	4.2	5.2	0.2	-1.1	2.0	1.0	0.7
Current account bal/GDP (%)	2.2	-2.2	-5.5	-8.4	-8.1	-5.7	-5.6	-5.5
Uzbekistan								
GDP at market prices (% annual growth) ^b	6.1	8.5	8.3	8.2	7.4	7.0	6.7	6.7
Current account bal/GDP (%)	5.2	0.8	0.5	-2.8	-2.7	-2.5	-1.9	-1.3

Source: World Bank.

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

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

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

b. GDP measured in constant 2010 U.S. dollars.

Notes

1. For the purposes of this report, the Europe and Central Asia region concerns only the low- and middle-income countries of the geographic region. As such it excludes from the aggregate Russia .
2. CEE refers to Albania, Bosnia and Herzegovina, Bulgaria, Hungary, Kosovo, Macedonia, Montenegro, Romania, Serbia, and Turkey

LATIN AMERICA and the CARIBBEAN REGION

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Chapter 2

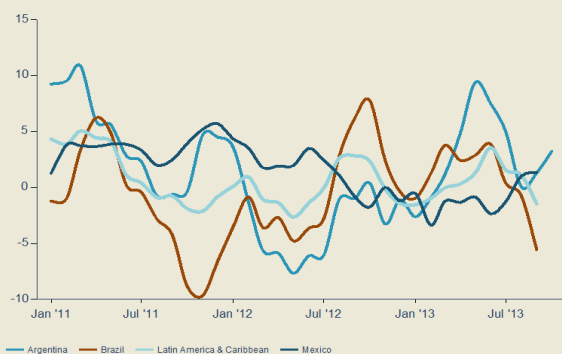


The slowdown in global trade, less supportive commodity markets, and domestic challenges weakened the region's growth in 2013. However, with global economic conditions expected to improve, the regional economic outlook is positive, with growth picking up to an average of 3.2 percent over the medium term from 2.5 percent in 2013. Downside risks include a disorderly rise in global interest rates and a prolonged and deeper slump in commodity prices.

Recent Developments

Amid a sluggish global recovery and lower commodity prices, economic activity in the Latin American and the Caribbean region fell marginally in 2013. Weakening consumption and export growth led regional growth to edge downwards to [2.5] percent in 2013, from 2.6 percent in 2012. With GDP growing below its potential rate (estimated at 3.3 percent), the negative output gap that opened in 2012 further widened in 2013. Underlying the regional trend, growth in developing Central and North America, and the Caribbean slowed considerably, from 4.0 to [1.7] percent, and from 2.9 to [2.2] percent, respectively. Growth in South America was more diverse with countries such as Argentina and Paraguay surging ahead, Venezuela slowing down considerably, and Bolivia and Colombia growing at around the same speed as in 2012.

Despite a strong H1 2013, overall exports growth for 2013 was relatively subdued. Consistent with developments in the strength of global import demand during 2013, the region's merchandise exports saw solid growth in the first half of 2013, but fizzled out towards the end of Q3. Global import demand expanded at an average annualized rate of 6.1 percent in the first half of 2013 but contracted by -0.7 percent in Q3, partly reflecting uncertainty sparked by speculation about the future of United States monetary policy. Similarly, the region's merchandise exports grew at an average annualized rate of more than 9 percent through June before receding to 0.4 percent in Q3. Overall, merchandise exports growth slowed dramatically in 2013. Indeed, for the ten months to October, exports advanced by only [4.3] percent, compared with the 8.1 percent expansion observed over the same period in 2012. Bolivia, Colombia, Costa Rica, Jamaica, and Mexico all saw marked decelerations in export growth, while export volumes contracted in 2013 in Honduras, Nicaragua and Peru. In contrast, thanks to a bumper harvest, Argentina's export volumes were

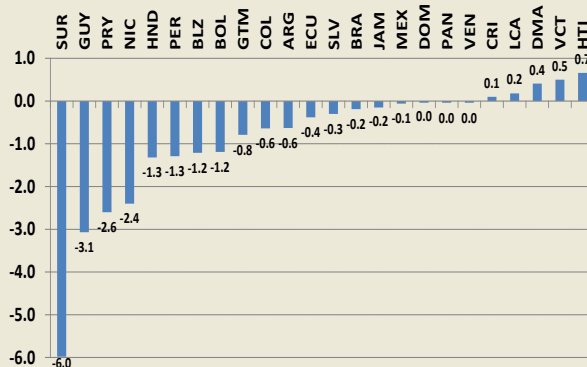
Figure 2.12 Industrial production decelerates in Latin American Countries


Source: Datastream, Haver Analytics.

up by [23] percent through the first ten months of 2013.

A short-lived upturn in industrial production gave way to broad-based weakness in H2 2013. Regional industrial production accelerated in H1 2013 and peaked at an annualized pace of 3.6 percent in June from -1.6 percent in January (figure 2.12). However, industrial activity has since then decelerated with output contracting at a 1.4 percent annualized pace in Q3. This pattern was most pronounced in Brazil where industrial activity rose in H1 2013 riding on strong investment and exports. However, monetary tightening since April, partly as a reaction to the reversal of capital flows and exchange rate depreciation following speculation about U.S. tapering, and associated uncertainty took a toll on industrial production and GDP after June. Similarly, boosted by expansionary policies and a good harvest and consequently agricultural exports, Argentina's industrial production peaked in June, before retreating in H2 2013. Largely due to the delayed effects of weak export demand, developments among Central American economies took on a different path with industrial activity contracting until July, and early signs of a recovery being observed in August and September where industrial production grew at an annualized 1.2 percent.

A deterioration in the terms-of-trade widened current account balances in the region's economies. In 2013, the USD prices of agriculture, metals and precious metals commodities fell 7.8, 8.0 and 19.2 percent, respectively. Given the commodity intensity of the region's exports, the

Figure 2.13 Effect of Lower commodity prices on the terms of trade (% of GDP)


Source: World Bank.

decline in prices severely dented the region's value of exports, and consequently led to a fall in export revenue, and in many cases, government revenue as well. Our calculations suggests that the income effect of the negative terms-of-trade shock led to a deterioration of the region's trade balances by some 0.3 percent of GDP. Suriname, where commodities constitute 97.5 percent of exports in 2010, experienced a terms of trade hit of almost 6 percent of GDP, leading to a substantial increase in its current account deficit (figure 2.13). In contrast, in Haiti, where primary commodities make up only 3 percent of exports, the terms of trade changes were favorable as reflected in an improving trade balance and an easing of its current account deficit in 2013. Similarly, other Central American and Caribbean countries with low commodity export shares, such as Costa Rica, St. Lucia, Dominica, and St. Vincent and the Grenadines observed varying degrees of improvement to their current account balances. For the region as a whole, lower commodity prices, together with the slowdown in export volumes, led the current account deficit as a share of GDP to increase from 1.7 in 2012 to [2.5] percent in 2013.

Gross capital flows to the region increased overall for 2013, despite a H2 slump in equity issues. Gross capital flows to the region, consisting of the new equity issues, new bond issues and syndicated bank lending, totaled \$147 billion during the first ten months of 2013, an increase of 16.4 percent compared with the \$127 billion over the same period in 2012 (table 2.7). Boosted by strong flows to Brazil and Mexico, equity flows jumped 80 percent, reaching \$26

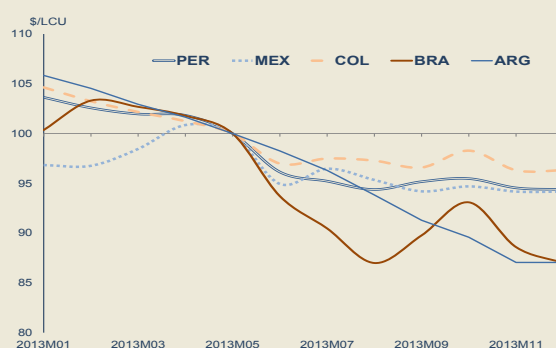
Table 2.7 Gross capital flows to Latin America and the Caribbean region

Billions of US\$	Total Gross Capital Flows	Equity Issue	Bond Issue	Bank Lending
Total Jan - Oct 2012	126.4	14.4	83.5	28.5
Total Jan - Oct 2013	147.1	26.0	86.6	34.5
% change	16.4	80.9	3.7	21.3
Average Jan - May 2012	11.6	1.2	8.6	1.9
Average Jul - Oct 2012	15.1	1.9	8.9	4.4
% change	29.7	61.1	3.5	128.5
Average Jan - May 2013	15.1	3.4	9.4	2.4
Average Jul - Oct 2013	16.5	1.8	9.9	4.9
% change	9.3	-48.2	5.7	106.9

Source: World Bank.

billion compared with \$14 billion in 2012. After posting robust flows in the first five months of 2013, capital flows to the region fell sharply in June on the prospect of QE tapering. Flows then rebounded in July, and with the unexpected non-tapering announcement by the U.S. FED in September, capital flows to the region surged to \$22 billion as region's borrowers sold a record high of \$20.6 billion worth of bonds in the month with Mexico accounting for \$12 billion. While total flows to the region did strengthen substantially overall in 2013, average monthly equity issues for July to October amounted to only \$1.8 billion, nearly half the average amount of monthly issues from January to May of \$3.4 billion. However, Central American and Caribbean economies, on account of being less financial integrated, observed less turbulences from a reduction in capital inflows.

Regional currencies depreciated after May on tapering announcement. With the sell-off in emerging market assets following mid-year expectations on QE tapering, regional currencies depreciated, in particular those that benefitted the most from earlier capital inflows and had relatively larger domestic imbalances. Between May and August, the Brazilian real, Colombian peso, Peruvian Nuevo sol and Mexican Peso depreciated by some 13.0, 2.7, 5.6 and 4.7 percent respectively (figure 2.14). However, as expectations of the tapering waned in September, regional currencies regained some of its depreciated value, although they still remain below their May 2013 levels. For the Brazilian real, the Central Bank did intervene in the currency market over the summer months that led to its appreciation in September. Bucking this

Figure 2.14 Regional currencies depreciate on prospect of QE tapering (US\$/LCU exchange rate index, May 2013 = 100)

Source: World Bank.

trend, the Argentine peso has however continued to depreciate, even past September, in part reflecting loose monetary policy and weak investor sentiment. The broad depreciation in regional currencies has however been supportive of a nascent pick-up in regional exports starting in [October].

Outlook

The economic outlook for the Latin America and Caribbean region is projected to strengthen over the medium term, growing around potential – but below the boom years before the crisis. Regional GDP growth is forecast to strengthen from [2.5] percent in 2013 to [2.8] percent in 2014, and subsequently to [3.1] and [3.7] percent in 2015 and 2016 (table 2.8).

Strengthening global demand should be supportive of the region's growth over the forecast horizon. The baseline assumes that global economic activity will pick-up over the projection horizon, supported in particular by a moderate acceleration of growth in high-income countries (see chapter one). Indeed, from a weak 2.3 percent in 2013, global GDP is projected to gradually strengthen – reaching 3.5 percent in 2016. As a result, global trade growth will pick-up from 3.1 percent in 2013 to 5.2 percent in 2016. The recovery in global trade, albeit it being subdued

Table 2.8 Latin America and the Caribbean forecast summary

(annual percent change unless indicated otherwise)	Est. Forecast							
	00-09 ^a	2010	2011	2012	2013	2014	2015	2016
GDP at market prices ^b	2.7	6.0	4.1	2.6	2.5	2.8	3.1	3.7
	<i>(Sub-region totals-- countries with full NIA + BOP data)^c</i>							
GDP at market prices ^c	2.7	6.0	4.1	2.6	2.5	2.9	3.2	3.7
GDP per capita	1.5	4.8	2.9	1.4	1.3	1.7	2.1	2.7
PPP GDP	2.6	6.1	4.5	2.9	2.7	3.1	3.3	3.8
Private consumption	3.1	5.6	4.9	3.8	2.6	2.8	2.9	3.2
Public consumption	2.7	4.3	2.8	3.7	2.2	2.3	2.6	2.7
Fixed investment	3.6	13.1	8.3	1.7	2.7	2.6	3.4	4.1
Exports, GNFS ^d	2.8	11.3	6.1	2.5	2.2	4.0	4.8	5.4
Imports, GNFS ^d	3.6	21.6	10.1	3.8	3.7	3.1	3.6	3.7
Net exports, contribution to growth	-0.1	-1.9	-0.9	-0.4	-0.4	0.1	0.1	0.3
Current account bal/GDP (%)	-0.4	-1.4	-1.4	-1.7	-2.5	-2.5	-2.3	-2.0
GDP deflator (median, LCU)	6.5	5.1	6.9	5.8	4.6	4.8	4.8	5.0
Fiscal balance/GDP (%)	-2.6	-3.1	-2.6	-3.9	-3.1	-3.1	-2.5	-2.4
Memo items: GDP								
LAC excluding Argentina	2.6	5.8	3.7	2.7	2.2	2.9	3.2	3.8
Developing Central & North America ^e	1.5	5.1	4.0	4.0	1.7	3.5	3.8	4.2
Caribbean ^f	3.2	4.4	3.9	2.9	2.2	3.4	3.9	4.1
Brazil	2.9	7.5	2.7	0.9	2.2	2.4	2.7	3.7
Mexico	1.2	5.3	3.9	3.9	1.4	3.4	3.8	4.2
Argentina	2.9	9.2	8.9	1.9	4.9	2.8	2.5	2.5

Source: World Bank.

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

b. GDP at market prices and expenditure components are measured in constant 2010 U.S. dollars.

c. Sub-region aggregate excludes Cuba and Grenada, for which data limitations prevent the forecasting of GDP components or Balance of Payments details.

d. Exports and imports of goods and non-factor services (GNFS).

e. Developing Central & North America: Costa Rica, Guatemala, Honduras, Mexico, Nicaragua, Panama, El Salvador.

f. Caribbean: Belize, Dominica, Dominican Republic, Haiti, Jamaica, St. Lucia, St. Vincent and the Grenadines, and Suriname.

compared to pre-crisis levels, will be supportive of exports from the Latin American and Caribbean region. We project that the region's export volumes will be expanding by over 5 percent in 2016, up from the below 3 percent growth observed in both 2012 and 2013.

Continued decline in commodity prices will moderate export revenues. With few exceptions, commodity prices are projected to continue their downward trend in the medium term, yielding negative terms-of-trade developments for the majority of the region's commodity exporters along with decreases in export and government revenue, and ceteris paribus worsening of the trade and current account balances. Countries such as Belize with a commodity export share of more than 80 percent of total exports, Colombia with a

commodity export share of more than 70 percent of exports, and Ecuador a major exporter of bananas and crude oil, will see a deterioration of export revenues and trade balances, and quite possibly their current account balances as well. Depreciated exchanges rates will mitigate to some extent the effects of the lower commodity prices on the trade and current account balance with the net effect being determined on a country specific basis.

Global financing conditions are expected to tighten further thus moderating capital flows to the region. In the baseline, the tapering of quantitative easing in the United States is assumed to commence in H1 2014, as a result long-term interest rates on U.S. Treasuries will rise further leading investors to demand higher yields on

Table 2.9 Net capital flows to Latin America and the Caribbean (\$billions)

	2008	2009	2010	2011	2012	2013e	2014f	2015f	2016f
Capital Inflows	163.1	160.4	303.4	267.7	312.1	296.2	285.3	303.8	313.8
Private inflows, net	156.7	143.2	280.8	262.8	300.3	289.9	277.8	294.5	308.4
Equity Inflows, net	109.9	112.5	150.1	147.5	170.5	172.7	162.3	177.7	189.2
Net FDI inflows	121.5	71.2	110.9	145.0	150.3	158.0	144.0	152.0	160.0
Net portfolio equity inflows	-11.6	41.2	39.3	2.6	20.2	14.7	18.3	25.7	29.2
Private creditors, Net	46.8	30.7	130.7	115.3	129.8	117.2	115.5	116.8	119.2
Bonds	9.1	43.3	65.6	75.6	79.8	76.3	71.2	62.5	60.1
Banks	35.6	-4.2	18.3	46.1	28.0	23.4	20.1	35.4	36.2
Other private	-0.5	-0.5	0.9	-0.4	9.6	2.1	1.5	0.8	2.4
Short-term debt flows	2.6	-7.9	45.9	-5.9	12.3	15.4	22.7	18.1	20.5
Official inflows, net	6.4	17.2	22.6	4.9	11.8	6.3	7.5	9.3	5.4
World Bank	2.5	6.2	8.3	-2.9	3.6	2.2	..	..	..
IMF	0.0	0.4	1.3	0.2	-0.1	0.4	..	..	..
Other official	3.9	10.6	13.0	7.5	8.4	3.7	..	..	..

Source: The World Bank

Note: e = estimate, f = forecast

developing country debts. Increased capital costs will slow debt flows to developing countries, including to the Latin American and Caribbean region, which has been one of the largest beneficiaries of the increased capital flows to developing countries observed in recent years (table 2.9). Overall, total net capital flows to the region will decline by about 3.7 percent in 2014, on top of the 5.0 percent decline saw in 2013. The weaker growth in capital flows will thus temper the contribution of domestic demand to overall GDP growth, an effect that should be partially offset by stronger exports.

Performance across individual countries will vary. Riding on strong exports growth, together with public investments for the upcoming World Cup in 2014 and summer Olympics in 2016, Brazil, the largest economy in the region, is expected to see a modest but sustained growth over the forecasting horizon from [2.4] percent in 2014 accelerating to [3.7] in 2016 (Latin America and the Caribbean forecast table). Driven by broad public transportation investment program that includes the expansion of the canal, Panama will continue to be an outlier, with high growth rates exceeding [7] percent for 2014, and moderating to around [6] percent for 2015 and 2016. Mexico is also expected to post a relatively robust performance, predominantly benefiting from a maturing recovery in the United States, and will see GDP growth

steadily accelerate from [1.4] percent in 2013 to [4.2] percent in 2016. Similar to Mexico, other Central & North American countries with tight trade links to the strengthening U.S. are also expected to see growth rising to [3.5] percent in 2014, and to [4.2] percent in 2016. The Caribbean economies are also expected to strengthen from [3.4] percent in 2014 to [4.1] percent in 2016, on stronger tourism income. In contrast, the Venezuelan economy is projected to undergo a drawn-out adjustment and weak growth in the medium term, as goods shortages and supply bottlenecks persist and inflation is high.

Risks

Potential for a disorderly adjustment to long-term higher interest rates. Prospects will be sensitive to the pace at which accommodative monetary policy in high-income countries are withdrawn. In the baseline, the withdrawal of quantitative easing, and its effect on long-term interest rates in United States, is assumed to follow a relatively gradual trajectory in line with improving economic conditions in the United States. If however markets react sharply to signs of a taper then capital flows to developing countries could

decrease by as much as 60 percent or more, destabilizing current account balances, and leading to disorderly depreciations of exchange rates, and quite possibly increasing imported inflation. These would compel local governments to tighten monetary policies and further reduce growth prospects. The Latin America region will not be immune to such developments, particularly so as it is one of the developing regions that has benefitted the most from higher capital flows arising from loose monetary policies in high-income countries. As earlier observed, reflecting the mid-2013 perturbations in global financial markets, equity issuances slumped by nearly 50 percent, and regional currencies depreciated by up to 13 percent over the same time period. Econometric analysis (see chapter 3) suggests that because investors tend to discriminate among countries those with poorer macroeconomic fundamentals (e.g. high current account and fiscal deficits) are likely to see larger adjustments on the prospects of a disorderly tapering process.

Weaker than expected growth in the global economy. The baseline forecast assumes the continued improvement of advanced economies namely, the United States and the Eurozone.

However, this recovery still remains hesitant, and is subject to a number of downside risks. For instance, outturns in Central and North American and Caribbean developing economies are likely to be particularly sensitive to the U.S. economy and in particular the evolution of fiscal policy discussions in that country. Similarly in the Eurozone, although growth has encouragingly turned positive in recent quarters, the recovery is in early stages and much needs to be done before the region regains sustained levels of strong growth.

Sharper-than-expected decline in commodity prices. Although the baseline assumes a moderate decline in commodity prices, this is not guaranteed. Indeed, given China's importance in global commodity markets (particularly in metal markets) a sharper-than-expected slowdown in China is likely to impact commodity exporters in the region, thereby eroding export and government revenues and potentially aggravating current account imbalances

Table 2.10 Latin America and the Caribbean country forecasts

	00-09 ^a	2010	2011	2012	Est. Forecast			
					2013	2014	2015	2016
Argentina								
GDP at market prices (% annual growth) ^b	2.9	9.2	8.9	1.9	4.9	2.8	2.5	2.5
Current account bal/GDP (%)	2.7	0.4	-0.6	0.0	-0.8	-0.9	-0.8	-0.2
Belize								
GDP at market prices (% annual growth) ^b	5.0	2.7	1.9	5.3	2.0	2.5	3.3	3.8
Current account bal/GDP (%)	-12.7	-2.9	-1.1	-2.2	-1.1	-1.3	-1.2	-0.3
Bolivia								
GDP at market prices (% annual growth) ^b	3.4	4.1	5.2	5.2	5.3	4.7	4.0	3.6
Current account bal/GDP (%)	3.9	4.6	2.3	7.7	7.1	5.9	4.5	3.0
Brazil								
GDP at market prices (% annual growth) ^b	2.9	7.5	2.7	0.9	2.2	2.4	2.7	3.7
Current account bal/GDP (%)	-0.7	-2.2	-2.1	-2.4	-3.6	-3.7	-3.5	-3.2
Colombia								
GDP at market prices (% annual growth) ^b	3.7	4.0	6.6	4.2	3.8	4.2	3.8	3.8
Current account bal/GDP (%)	-1.4	-3.1	-2.9	-3.3	-3.5	-3.6	-3.3	-3.0
Costa Rica								
GDP at market prices (% annual growth) ^b	3.8	5.0	4.4	5.1	3.3	4.3	4.2	4.1
Current account bal/GDP (%)	-5.0	-3.5	-5.4	-5.6	-5.1	-4.8	-4.6	-4.2
Dominica								
GDP at market prices (% annual growth) ^b	2.4	1.2	1.0	0.4	1.1	1.7	1.8	2.0
Current account bal/GDP (%)	-18.4	-17.5	-13.8	-10.2	-9.8	-9.6	-9.2	-8.1
Dominican Republic								
GDP at market prices (% annual growth) ^b	4.5	7.8	4.5	3.9	2.5	3.9	4.6	4.9
Current account bal/GDP (%)	-2.6	-8.4	-8.2	-6.8	-4.8	-4.0	-3.2	-2.7
Ecuador								
GDP at market prices (% annual growth) ^b	4.2	3.5	7.8	5.1	4.0	4.1	4.2	4.3
Current account bal/GDP (%)	1.0	-2.3	-0.3	-0.3	-0.9	-0.8	-0.6	-0.5
El Salvador								
GDP at market prices (% annual growth) ^b	2.0	1.4	2.0	1.6	1.9	2.3	2.6	2.9
Current account bal/GDP (%)	-3.8	-2.7	-4.7	-5.1	-4.3	-3.5	-2.6	-1.1
Guatemala								
GDP at market prices (% annual growth) ^b	3.4	2.9	4.1	3.0	3.3	3.4	3.3	3.2
Current account bal/GDP (%)	-4.8	-1.6	-3.6	-2.9	-3.0	-2.8	-2.8	-2.9
Guyana								
GDP at market prices (% annual growth) ^b	2.1	3.6	5.2	3.9	4.5	4.1	4.0	4.0
Current account bal/GDP (%)	-10.0	-7.0	-10.2	-13.7	-17.1	-16.9	-16.3	-18.9
Honduras								
GDP at market prices (% annual growth) ^b	3.8	3.7	3.7	3.3	2.9	3.4	3.8	3.9
Current account bal/GDP (%)	-6.7	-5.4	-9.0	-9.7	-11.2	-8.2	-6.9	-6.0
Haiti								
GDP at market prices (% annual growth) ^b	0.6	-5.4	5.6	2.8	3.4	4.2	3.9	3.9
Current account bal/GDP (%)	-6.8	-29.4	-24.3	-17.3	-15.6	-15.0	-14.5	-27.0

	00-09 ^a	2010	2011	2012	Est. Forecast			
					2013	2014	2015	2016
Jamaica								
GDP at market prices (% annual growth) ^b	1.0	-1.5	1.7	-0.5	0.2	0.8	1.0	1.3
Current account bal/GDP (%)	-10.1	-7.1	-14.6	-12.7	-10.8	-6.9	-3.3	0.4
Mexico								
GDP at market prices (% annual growth) ^b	1.2	5.3	3.9	3.9	1.4	3.4	3.8	4.2
Current account bal/GDP (%)	-1.6	-0.2	-0.9	-0.9	-1.5	-1.5	-1.4	-1.4
Nicaragua								
GDP at market prices (% annual growth) ^b	2.8	3.6	5.4	5.2	3.8	4.2	4.4	4.3
Current account bal/GDP (%)	-17.3	-10.0	-13.2	-12.8	-13.6	-13.2	-12.2	-11.2
Panama								
GDP at market prices (% annual growth) ^b	5.6	7.6	10.6	10.5	7.6	7.3	6.1	6.2
Current account bal/GDP (%)	-4.8	-10.8	-12.8	-9.1	-8.5	-8.4	-8.0	-7.4
Peru								
GDP at market prices (% annual growth) ^b	4.8	8.8	6.9	6.3	4.9	5.5	5.9	5.8
Current account bal/GDP (%)	-0.7	-2.5	-1.9	-3.6	-4.9	-4.4	-3.8	-3.2
Paraguay								
GDP at market prices (% annual growth) ^b	2.0	13.1	4.3	-1.2	12.7	3.7	4.2	4.0
Current account bal/GDP (%)	2.0	-0.4	1.4	0.6	4.5	2.3	0.8	0.8
St. Lucia								
GDP at market prices (% annual growth) ^b	2.1	3.2	0.6	-0.2	1.2	1.7	2.0	3.8
Current account bal/GDP (%)	-19.6	-18.9	-21.7	-15.4	-13.2	-11.2	-9.4	-17.2
St. Vincent and the Grenadines								
GDP at market prices (% annual growth) ^b	2.8	1.0	1.5	3.1	1.9	2.5	3.0	-3.5
Current account bal/GDP (%)	-18.8	-29.0	-26.4	-26.5	-25.4	-24.7	-23.8	-14.4
Suriname								
GDP at market prices (% annual growth) ^b	4.4	4.1	4.7	4.5	3.9	4.1	3.5	3.5
Current account bal/GDP (%)	9.8	6.4	5.8	4.2	0.5	3.7	4.4	4.5
Venezuela, RB								
GDP at market prices (% annual growth) ^b	3.3	-1.5	4.2	5.5	0.7	0.5	1.7	2.3
Current account bal/GDP (%)	9.7	2.6	7.5	2.5	1.7	2.1	2.2	2.2

Source: World Bank.

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

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

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

b. GDP measured in constant 2010 U.S. dollars.

MIDDLE EAST and NORTH AFRICA REGION

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2014

Chapter 2



Political turmoil has weakened activity in the developing oil importing countries while security setbacks have negatively affected developing oil exporting countries, with deterioration of fiscal and external accounts across the board. Growth for the region is expected to remain weak and to remain below its potential in the forecast period, picking up to [3.3] percent by 2016. The outlook is subject to significant downside risks which are mostly internal to the region, while external risks are more balanced.

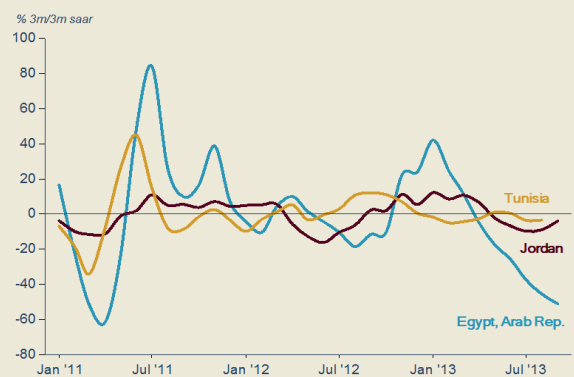
Recent Developments

Three years after the Arab Spring, the economies of the Middle East and North Africa region remain depressed. In the decade prior to the uprisings in 2011, the region averaged solid growth of about [4] percent with macroeconomic stability underpinned by fiscal and external accounts that were broadly in balance. However, that growth was accompanied by persistent structural problems—high youth unemployment, poor service delivery and unequal access (of firms and households) to economic opportunities—which contributed to the discontent that led to the uprisings of the Arab Spring. Three years since, political turbulence, and in some cases violence, continues while the political transition remains far from complete and its outcome uncertain. Not surprisingly, economic growth has slowed, fiscal and external balances have worsened and macroeconomic vulnerabilities

have deepened. Meanwhile, the persistent structural problems remain unaddressed.

Activity has weakened on account of political instability in oil importing countries.^{FN1}

Political turmoil in Egypt, stalemate in Tunisia and an escalation of the civil war in Syria with spillovers to neighboring Lebanon and Jordan have weakened activity in the developing oil importing countries. Rising social and political tensions in the run up to and after the overthrow of the Morsi government weighed heavily on confidence in Egypt, causing investment and industrial output to plummet in the second and third quarters. Egypt's GDP contracted by [3.1] percent (saar) in 2013Q2, and growth for the fiscal year (ending in the same quarter) amounted to a meager [1.5] percent, down from an already modest [2.2] percent in 2012. Since 2011, Egypt has experienced four separate episodes of a sharp deceleration or contraction in activity as political and social tensions erupted, punctuated by ultimately short-lived rebounds in activity. Two separate political assassinations in Tunisia contributed to the delay of the political transition

Figure 2.15 Developing oil importers—industrial production


Source: Datastream, World Bank.

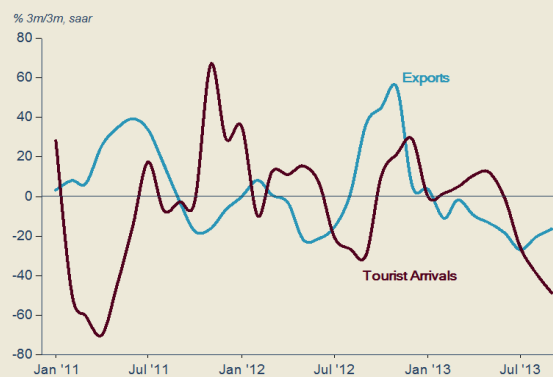
towards the new constitution with GDP expanding by just [2.1] percent (saar) in 2013Q3, versus growth of [4.5] percent in 2012.

Industrial production in the oil importing countries contracted by [43] percent (saar) in three months to September, led mainly by sharp declines of over [50] percent in Egypt (figure 2.15). However, Purchasing Managers Index (PMI) surveys exceeded the 50 threshold in November 2013 for the first time in 13 months, signaling an improvement in manufacturing output. Momentum in industrial production growth has strengthened recent months in Jordan and Tunisia as well.

Similar to industrial production, data for the third quarter indicate that exports contracted by [16] percent (saar) in the three months to September, led by contractions in Egypt, Morocco and Lebanon. Overall, exports—which have been contracting since the start of 2013—have bottomed out in July and have recovered since led by gains in Tunisia and Jordan.

Tourism arrivals to the oil importing countries rebounded strongly in the first quarter of 2013, but plunged dramatically due to security uncertainties in the wake of the overthrow of Morsi government in Egypt and due to the Syrian civil war, affecting Lebanon and Jordan (figure 2.16). Tourist arrivals dropped by 48 percent (saar) in three months to September in the oil importing countries of the region.

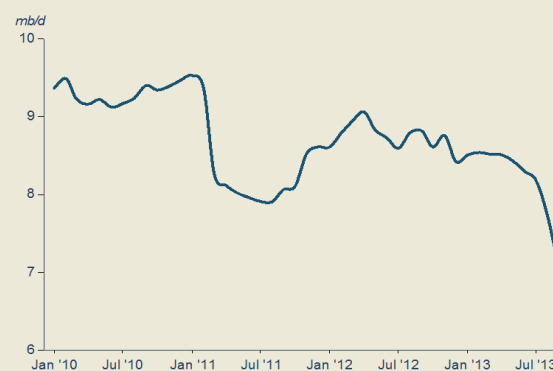
Oil production is declining in developing oil exporting countries.^{FN2} Oil production in

Figure 2.16 Developing oil importers—Exports and tourist arrivals


Source: Datastream, UN World Tourism Office, World Bank.

developing oil exporting countries—accounting for nearly a third of the region’s oil output—has fallen over the past year by nearly 7 percent (year to date) in 2013, reflecting security setbacks, strikes, infrastructure problems (Algeria, Iraq and Libya), and in the case of Iran, international sanctions. By the end of September 2013, the aggregate production of developing oil importers averaged just 7 mb/d, down from 8.5 mb/d at the beginning of 2013 and 9.5 mb/d at the end of 2010 (figure 2.17). Meanwhile, the developed oil exporters (Gulf Cooperation Countries or GCC) continue to make up the loss in oil production, and, in some cases, providing financial support to the region’s transition economies.

Security setbacks affected oil production in several countries. For example, Libyan production plunged to a post-war low of 0.3 mb/d in September 2013 as labor disputes, political turmoil,

Figure 2.17 Developing oil exporters— Production of crude oil


Source: Bloomberg, Energy Intelligence Group.

and infighting among local militias crippled the country's output. Output was on the decline in August, falling to 0.6 mb/d, less than the average output of 1.4 mb/d in 2012 and 1.6 mb/d in 2010. Similarly, in Iraq—who surpassed Iran as the second largest oil producer in OPEC at the end of 2012—production peaked at 3.2 mb/d and fell to 2.8 mb/d in September reflecting militant attacks on the Kirkuk to Ceyhan pipeline in the north (with volumes cut in half from March 2013) as well as planned maintenance disruptions in the south. Crude oil production in Syria collapsed some 57 percent in 2013—after falling 50 percent in 2012—and is virtually non-existent as the on-going civil war brought it to a standstill.

International sanctions affected Iran's crude oil production in 2012, but it has been stable in 2013. The International Energy Agency (IEA) estimates that Iran's oil production was about 2.5 mb/d in September, of which some 1.2 mb/d were exported. Prior to sanctions introduced in 2011, Iran used to produce about 3.5 mb/d and export about 2.5 mb/d of crude oil. The interim deal on Iran's nuclear program reached in November 2013 is expected to have a very limited impact and not to lift Iran's exports much above current levels.

External imbalances have worsened across the developing countries of the Middle East and North Africa region. Current account deficits have widened in the oil importing countries—hurt particularly by the steep decline in tourism receipts—while current account surpluses have shrunk for the oil exporting countries as oil exports have declined. Oil importers have experienced difficulty financing current account deficits as foreign investment flows declined and access to traditional capital markets became more limited in the midst of political turmoil.

In Egypt, balance-of-payments pressures eased in 2013 thanks to exceptionally high bilateral borrowing from the Gulf counties, increased exchange rate flexibility, and weak economic activity. The current account deficit also narrowed in response to high inflows of remittances and a smaller non-oil trade deficit. In Tunisia, the current account deficit is expected to persist despite lower imports because of stagnating tourism receipts and remittances, and weak exports. Interventions to sustain the currency in the face of a worsening current account and lower-than-expected official

financing have led to a reduction in reserves, which had fallen to 3.5 months of imports as of end-September 2013. After a challenging 2012, Jordan's external balance improved in 2013 due to a decline in energy imports in response to the subsidy reforms and an increase in official transfers. As external financing in the form of grants and loans from international financial institutions filled the financing gap in 2013, the pressure on the currency and foreign exchange reserves subsided.

With only a few exceptions, fiscal imbalances have worsened across the Middle East and North Africa region, especially in oil importing countries. Deterioration reflects weaker revenues due to slow growth, rising public sector spending on wages and subsidies for food and fuel in the wake of the Arab Spring and in some cases, increased debt servicing charges. With limited external financing, deficits have been financed mostly from the domestic banking sectors and, more recently, with loans and grants from the GCC countries.

Subsidies have historically played an important role in the economies of the region. Governments provided price subsidies on energy products and food to provide a social safety net in the oil importing countries and to share the oil revenues in the oil exporting countries. According to IMF estimates, pretax energy subsidies in 2011 amounted to over 8 percent of regional GDP and nearly 50 percent of all subsidies in the world. Attempts to reduce general energy subsidies are underway in Egypt, Morocco, Jordan and Tunisia. However, rising political uncertainty and lower economic growth pose challenges for implementation of these reforms.

Fiscal policies have remained expansionary. For example, in Egypt, the new government has announced a stimulus package equivalent to 1.6 percent of GDP on the back of the financing provided by the GCC countries. One of the key provisions of the new stimulus package is a 64 percent public sector wage increase beginning in January 2014. Rising fiscal deficits have led to growing public sector debt and concerns about debt sustainability. As a share of GDP, government debt rose in most developing countries in the region. In Egypt, spending pressures exacerbated by rising borrowing costs have pushed interest expenditures to about 8.4 percent of GDP or 25

Table 2.11 Net capital flows to Middle East and North Africa (\$ billions)

	2008	2009	2010	2011	2012	2013e	2014f	2015f	2016f
Capital Inflows	23.9	30.9	31.4	10.2	32.7	28.9	21.3	28.8	32.1
Private inflows, net	25.6	28.4	30.1	9.0	27.9	19.8	15.2	23.7	27.7
Equity Inflows, net	30.0	27.5	24.2	13.0	18.0	14.8	12.9	19.5	21.8
Net FDI inflows	29.6	26.3	22.3	13.7	19.3	15.5	13.1	18.4	20.3
Net portfolio equity inflows	0.4	1.2	2.0	-0.6	-1.3	-0.7	-0.2	1.1	1.5
Private creditors, Net	-4.4	0.9	5.9	-4.0	9.9	5.0	2.3	4.2	5.9
Bonds	-0.8	0.1	3.2	-0.6	5.8	1.2	0.2	2.3	3.4
Banks	-0.4	-1.2	-1.0	-0.1	0.4	-0.4	-0.1	0.7	1.1
Other private	-1.3	-1.0	-0.8	-0.7	-0.3	-0.1	-0.1	-0.2	0.3
Short-term debt flows	-1.9	3.0	4.5	-2.6	4.0	4.3	2.3	1.4	1.1
Official inflows, net	-1.7	2.5	1.3	1.2	4.8	9.1	6.1	5.1	4.4
World Bank	-0.3	0.9	0.8	0.9	0.8	0.8	..	..	..
IMF	-0.1	-0.1	0.0	-0.1	0.5	0.0	..	..	..
Other official	-1.4	1.6	0.5	0.3	3.5	8.3	..	..	..

Source: The World Bank

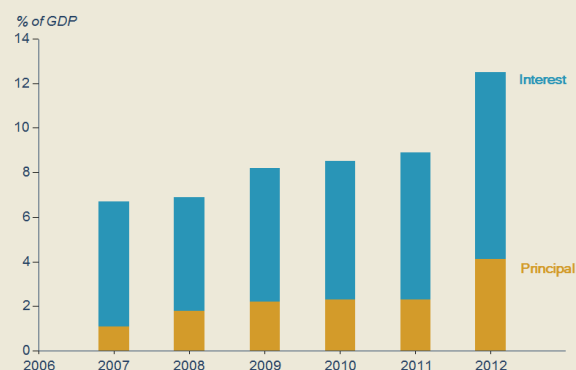
Note: e = estimate, f = forecast

percent of total expenditures in fiscal year 2012 (figure 2.18). To finance its revenue shortfall Egypt has relied heavily on domestic borrowing, increasing the exposure of the banking sector to sovereign risk, crowding out private sector borrowing and pushing domestic interest rates higher. The quality of government spending deteriorated in some cases too: in Morocco, for the first time the government spent more on subsidies than on public investment in 2012.

Capital flows to the developing countries of the region fell in 2013 to an estimated \$28.9 billion after recovering to \$32.7 billion in 2012. The deterioration reflected a decrease in net FDI flows (down 14.5 percent) to Egypt and Tunisia on

account of political turmoil. Overall net FDI levels remain well below pre-Arab Spring inflows and are not projected to recover to those levels in the forecast period (table 2.11). A strong official inflows in form of aid from the Gulf countries have helped the region buffer the drop off in private flows. In addition, sovereigns that have successfully accessed international markets have done so with external assistance. Jordan issued a U.S. government-backed \$1.25 billion Eurobond while Tunisia successfully issued a \$230 million with a Japanese guarantee.

Remittance inflows to the region are moderating as well and have grown by 3.6 percent in 2013 to about US\$49 billion. The growth in remittances is easing from the 12 percent average annual growth recorded in 2010 to 2013 and is expected to be in the 5-6 percent range annually between 2014 and 2016. With about US\$20 billion in remittances anticipated in 2013, Egypt is the sixth largest beneficiary in the developing world, and receives about 40 percent of remittances sent to the region (remittances are more than three times larger than receipts from the Suez Canal, and are equivalent to about 165 percent of Egypt's official reserves). Egypt accounted for much of the expansion in earlier years, as well as the slowing expected in 2013. Remittances to Lebanon and Morocco, two other large recipients in the region, have recovered in 2013, after flat or negative growth in 2012.

Figure 2.18 Debt service in Egypt

Source: Egyptian Ministry of Finance.

Outlook

Growth in the Middle East and North Africa region is expected to remain weak during the forecast period. Given the persistent bouts of political instability and policy uncertainty, economic growth has contracted by [0.1] percent in 2013—down from already weak growth of [1.5] percent in 2012. If Syria is removed from the regional aggregate, the growth slowed to [0.8] percent, down from [2.7] percent in 2012. The outlook for the region is shrouded in uncertainty and subject to a variety of risks, mostly domestic in nature and linked to political instability and policy uncertainty. Under the baseline scenario for the forecast period, marked improvement in the

political uncertainty that has plagued the region is not expected.

Among developing oil exporters, growth has been the most volatile and is estimated to have contracted in 2013 by [1.5] percent reflecting production setbacks in Libya and Iraq, sanctions in Iran and civil war in Syria. Going forward growth is expected to firm to [3.4] percent by the end of the forecast period as the oil prices remain relatively high and infrastructure problems and security setback are resolved and mitigated. This should underpin domestic demand and lead to a gradual improvement in fiscal and current account deficits. Importantly, the baseline outlook for Iran assumes a partial easing of the sanctions in line with steps taken to date.

Aggregate growth in oil importers is expected to remain weak and below potential at [2.5]

Table 2.12 Middle East and North Africa forecast summary

	(annual percent change unless indicated otherwise)							
	00-09 ^a	2010	2011	2012	Est. Forecast			
					2013	2014	2015	2016
GDP at market prices, geographic region ^{b,c}	4.0	4.2	2.3	3.4	1.8	3.6	4.0	4.0
GDP at market prices, developing countries ^c	4.1	4.4	-0.7	1.5	-0.1	2.8	3.3	3.4
	<i>(Sub-region totals— countries with full NIA + BOP data)^d</i>							
GDP at market prices, developing countries ^c	4.3	4.6	1.6	-1.1	0.0	1.8	2.7	2.8
GDP per capita (units in US\$)	2.8	3.0	0.0	-2.6	-1.5	0.3	1.3	1.4
PPP GDP ^e	4.3	4.6	1.5	-1.1	0.0	1.8	2.7	2.8
Private consumption	4.0	2.0	1.2	2.3	1.4	3.1	3.7	2.9
Public consumption	3.5	3.3	2.7	1.8	3.5	3.4	3.2	3.1
Fixed investment	6.9	5.1	3.4	-0.2	-1.0	0.6	1.2	2.3
Exports, GNFS ^f	4.3	6.9	-0.8	-2.5	1.4	2.9	4.8	4.7
Imports, GNFS ^f	7.5	4.0	1.2	4.1	3.3	4.4	5.2	4.0
Net exports, contribution to growth	-0.6	0.8	-0.6	-2.0	-0.6	-0.6	-0.4	0.0
Current account bal/GDP (%)	5.2	1.7	2.0	-1.6	-3.4	-3.7	-3.7	-3.7
GDP deflator (median, LCU)	6.0	8.4	7.0	8.7	4.4	4.1	4.2	6.0
Fiscal balance/GDP (%)	-0.5	-1.7	-1.7	-7.6	-7.2	-6.4	-5.9	-5.8
Memo items: GDP								
Developing countries, ex. Syria	4.0	4.5	-0.5	2.7	0.8	3.2	3.4	3.4
Selected GCC Countries ^g	3.8	3.8	6.4	5.7	4.1	4.6	4.7	4.7
Developing Oil Exporters	3.8	4.8	-2.4	1.4	-1.5	3.0	3.4	3.4
Developing Oil Importers	4.5	3.7	2.3	1.5	2.5	2.6	3.2	3.3
Egypt	4.4	3.5	2.0	0.5	1.8	2.3	2.7	2.5
Fiscal Year Basis	4.3	5.1	1.8	2.2	1.5	1.7	2.0	2.4
Iran	4.6	5.9	2.2	-2.9	-1.5	1.0	1.8	2.0
Algeria	3.4	3.6	2.6	3.3	2.8	3.3	3.5	3.5

Source: World Bank.

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

b. Geographic region includes the following high-income countries: Bahrain, Kuwait, Oman, Saudi Arabia, United Arab Emirates and Qatar.

c. GDP at market prices and expenditure components are measured in constant 2010 U.S. dollars.

d. Sub-region aggregate excludes Iraq and Libya, for which data limitations prevent the forecasting of GDP components or Balance of Payments details.

e. GDP measured at PPP exchange rates.

f. Exports and imports of goods and non-factor services (GNFS).

g. Selected GCC Countries: Bahrain, Kuwait, Oman, Saudi Arabia and United Arab Emirates.

percent in 2013, but performance will not improve dramatically in the forecast period unless there is a credible restoration of political stability and return of confidence. Aggregate growth for the region is expected to slowly pick up to about [3.3] percent in 2016, closer to—but still well below—the region’s potential growth. Consumption will be underpinned by large public outlays on wages and subsidies, while public investment will likely be constrained in the forecast period by large fiscal deficits.

The global economic environment will remain challenging for the recovery in the region. On the one hand, the real-side recovery in the high-income countries anticipated during the forecast period should lead to stronger exports. On the other hand, a normalization of the extraordinary monetary stimulus introduced in the wake of the global financial crisis in 2008 will raise interest rates and slow investment. While the region does not rely heavily on the portfolio capital flows, it is expected to continue to underperform in attracting FDI. Of course, these effects would be more than counterbalanced if the domestic political and security situation were to improve.

Risks

The region’s outlook is subject to significant downside risks which are mostly internal to the region. A further escalation of violence in Syria and spillovers on the rest of the region, namely Lebanon, Jordan and Iraq can adversely affect the region. Over 2.1 million Syrian refugees are hosted in the region and refugees in Lebanon and Jordan amount to 19 and 8 percent of populations there.

Economic, social and fiscal pressures are high for these countries and could be exacerbated further should the civil war in Syria intensify.

Countries in political transition have benefited from large official transfers from the Gulf economies. While these are expected to continue, they nonetheless pose refinancing risk for the recipients. In addition, public debt levels have increased significantly in the last three years and could be approaching unsustainable levels as debt service takes a ever larger share of the expenditures, especially in the domestic debt markets.

Setbacks in political transitions and further escalation of violence in Egypt, Tunisia, Libya and Iraq would further undermine confidence and delay the structural reforms or reduce oil output. On the upside, restoration of political stability and policy certainty that would lead to sustained addressing of structural reforms could substantially boost confidence and return growth to the long-run potential.

External risks are more balanced. European growth could disappoint the already modest recovery projected, but it could also do better. Exports from the countries in North Africa, tourism, remittances, capital flows and external balances would all be sensitive to differences in the outturn in Europe. In addition, risks from tightening of global financial conditions could lead to a rise in risk premiums for developing countries and lead to lower FDI. Furthermore, a sharper than expected decline in commodity prices than those currently projected will lead to a significant deterioration in external and fiscal accounts of the oil exporting countries although benefiting more vulnerable importers in the region.

Notes

1. Oil importing countries are: Egypt, Jordan, Lebanon, Morocco and Tunisia. Djibouti and West Bank and Gaza are not included due to data limitations.
2. Developing oil exporters are: Algeria, Iran, Iraq, Libya, Syria and Yemen.

Table 2.13 Middle East and North Africa Country forecasts

	00-09 ^a	2010	2011	2012	Est. Forecast			
					2013	2014	2015	2016
Algeria								
GDP at market prices (% annual growth) ^b	3.4	3.6	2.6	3.3	2.8	3.3	3.5	3.5
Current account bal/GDP (%)	22.3	7.3	8.9	5.9	2.7	1.2	0.1	0.0
Egypt, Arab Rep.								
GDP at market prices (% annual growth) ^b	4.4	3.5	2.0	0.5	1.8	2.3	2.7	2.5
Fiscal Year Basis	4.3	5.1	1.8	2.2	1.5	1.7	2.0	2.4
Current account bal/GDP (%)	1.1	-2.0	-2.3	-2.7	-3.5	-3.1	-2.8	-2.7
Iran, Islamic Rep.								
GDP at market prices (% annual growth) ^b	4.6	5.9	2.2	-2.9	-1.5	1.0	1.8	2.0
Current account bal/GDP (%)	6.3	7.0	9.2	2.8	-0.9	-1.6	-1.9	-2.2
Iraq								
GDP at market prices (% annual growth) ^b	-1.0	0.8	8.5	8.4	4.2	6.5	6.6	8.3
Current account bal/GDP (%)	0.0	3.0	12.5	7.0	1.0	1.2	1.5	1.9
Jordan								
GDP at market prices (% annual growth) ^b	6.1	2.3	2.6	2.8	3.0	3.1	3.3	3.8
Current account bal/GDP (%)	-4.4	-7.1	-12.0	-17.7	-14.9	-14.0	-13.0	-11.6
Lebanon								
GDP at market prices (% annual growth) ^b	4.4	7.0	3.0	1.4	0.7	2.0	2.7	4.2
Current account bal/GDP (%)	-16.8	-20.4	-12.1	-13.5	-14.1	-13.3	-12.3	-11.3
Libya								
GDP at market prices (% annual growth) ^b	3.8	3.5	-53.9	104.5	-6.0	23.0	12.2	9.0
Current account bal/GDP (%)	0.0	19.5	9.1	29.1	3.2	5.4	4.4	5.5
Morocco								
GDP at market prices (% annual growth) ^b	4.6	3.6	5.0	2.7	4.5	3.6	4.4	4.7
Current account bal/GDP (%)	0.2	-4.6	-8.4	-9.7	-7.8	-7.3	-6.6	-5.7
Syrian Arab Republic								
GDP at market prices (% annual growth) ^{b,c}	4.6	3.2	-3.4	-21.8	-22.5	-8.6	1.7	1.7
Current account bal/GDP (%)	2.7	-0.6	-19.7	-19.0	-20.5	-15.5	-11.7	-9.1
Tunisia								
GDP at market prices (% annual growth) ^b	4.2	3.0	-2.0	3.6	2.6	2.5	3.3	3.6
Current account bal/GDP (%)	-2.7	-4.7	-7.3	-8.3	-8.9	-7.8	-7.5	-7.3
Yemen, Rep.								
GDP at market prices (% annual growth) ^b	3.5	7.7	-12.6	2.4	3.0	3.4	3.9	3.9
Current account bal/GDP (%)	1.1	-5.4	-5.4	-3.1	-5.1	-5.2	-4.6	-4.4

Source: World Bank.

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

Djibouti, West Bank and Gaza are not forecast owing to data limitations.

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

b. GDP measured in constant 2010 U.S. dollars.

c. The estimates for GDP decline in Syria in 2012 and 2013 are subject to significant uncertainty.

SOUTH ASIA REGION



GLOBAL
ECONOMIC
PROSPECTS

January
2014

Chapter 2

South Asia's GDP growth rose to an estimated [4.6] percent in 2013 from [4.2] percent in 2012, but was well below its average in the last decade, reflecting both rising domestic imbalances and a challenging external environment. Regional GDP growth is projected to improve to [5.7] percent in 2014, and then rise further to [6.3] and [6.7] percent in 2015 and 2016. The projected pickup will depend critically on ensuring macroeconomic stability, sustaining reforms, and reducing supply-side constraints.

Recent Developments

Regional GDP growth is estimated to have picked up modestly in 2013, but was weak when compared to past performance. South Asia's GDP growth rose to an estimated [4.6] percent in 2013 in calendar year-market price terms from [4.2] percent growth recorded in 2012. GDP growth, however, remained well below its pre-crisis pace. For instance, in India, the largest regional economy, GDP growth measured on a factor cost basis is estimated to have moderated to [4.8] percent in the 2013-14 fiscal year (similar to the [5] percent rate in the previous fiscal year)—but well below the close to [8] percent average growth achieved during the past decade. GDP growth in Pakistan, South Asia's second largest economy, has also been relatively weak, averaging [3.5] percent in factor cost terms since 2010, below the nearly [5] percent average growth during the previous decade. The relatively weak GDP growth rates in these two

countries, which together account for close to [90] percent of regional GDP, reflect a combination of domestic imbalances (large fiscal deficits, high inflation), weakening investment rates, and a more challenging external environment (see Rajan 2013a and 2013b for a discussion on India). Among the smaller countries, Bangladesh's growth slowed to [6.0] percent in FY2012-13 from [6.2] percent in FY2011-12, while growth in Afghanistan weakened sharply to an estimated [3.1] percent in 2013 from an exceptionally high [14.4] percent in 2012. By contrast, growth in Sri Lanka picked up to an estimated [7.0] percent in 2013 from [6.4] percent, with strengthening manufacturing and services activity, and a rebound in agriculture in Q3.

A cyclical improvement in activity in the second half of 2013 was led by a rapid expansion of exports. Activity in South Asia registered a cyclical recovery during the second half of 2013, following a mid-year slump. Regional export volumes expanded by a robust annualized [53] percent in the three months to October (3m/3m saar), reflecting a gradual recovery in global

demand and currency depreciation in India (see figures 2.19 and 2.22). Export volumes in South Asia excluding India also rose robustly in Q3. Despite the strong momentum in the second half, regional export growth slowed in 2013. Nevertheless, the regional current account deficit fell by [1] percentage point of GDP—mainly due to weaker import growth from weak domestic demand, stable crude oil prices relative to 2012, and restrictions on import of gold in India. Even with a cyclical rebound in Q3, full-year industrial output growth for South Asia was very weak at an estimated [1.5] percent (y/y), although industrial activity picked up at a decidedly faster pace in Pakistan.

Investment growth in South Asia is estimated to have improved in 2013, but was still weak.

Regional investment growth is estimated to have improved from a decade-low [1.1] percent recorded in the 2012 calendar year to a still relatively lackluster [3.5] percent in 2013. India's investment growth slowed sharply in FY2012-13, but improved in the second half of 2013. In Pakistan, investment as a share of GDP has been falling (albeit at a slowing pace) in recent years. Generally weak regional investment reflects subdued, albeit improving, business sentiment in India (figure 2.20), as well as structural bottlenecks (including in electricity provision), policy uncertainties, and high inflation. In Bangladesh, disruptions and violence in the run-up to national elections slowed private sector investment growth, although compensated to some extent by public investment.

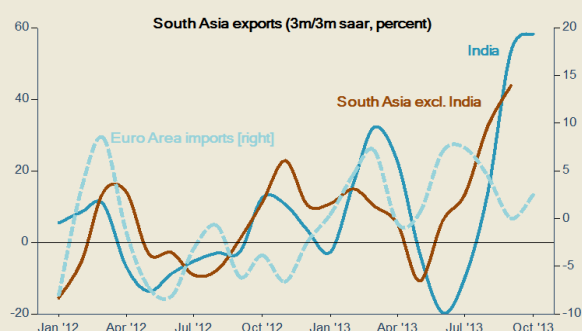
Weaker international commodity prices and normal harvests supported a stabilization of

consumption growth. Lower international commodity prices has helped inflation momentum to weaken in South Asia, with Bangladesh and Sri Lanka experiencing significant declines during the course of 2013. But in India, despite a negative output gap, consumer price inflation remained elevated at close to [10] percent (y/y), reflecting persistent food price inflation, currency depreciation, fuel price adjustments, and supply-side constraints. In Pakistan, both monetization of large fiscal deficits and structural constraints have contributed to inflationary pressures. Lower international commodity prices in 2013, together with normal agricultural harvests, helped to marginally raise relatively weak regional consumption growth.

The pace of increase in migrant remittances moderated in 2013.

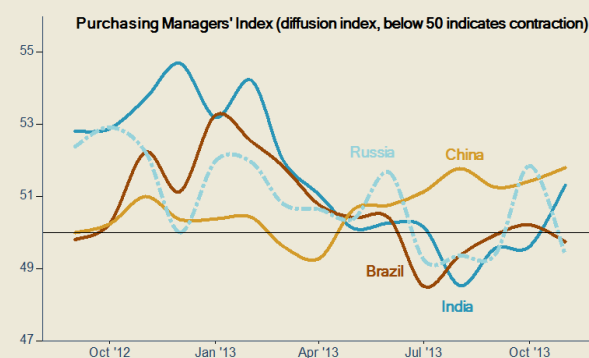
Growth in remittances to South Asia is estimated to have moderated to [6.8] percent in 2013 from [9.7] percent the previous year, according to World Bank estimates (World Bank 2013a). Flows to India dipped in the first quarter, but with the depreciation of the rupee, they rebounded to reach an estimated \$71 billion in 2013. Remittance flows to Nepal and Sri Lanka (where they are [25] and [10] percent of GDP) are estimated to have experienced double-digit growth in the 2013 calendar year. After rising [12.4] percent in FY2012-13, remittance inflows to Bangladesh fell [9.2] percent (y/y) in the first five months of the current fiscal year, reflecting both weak labor exports and political unrest. Flows to Pakistan, however, rose [7.1] percent (y/y) in the same period, compared to the [5.6] percent increase in FY2012-13.

Figure 2.19 Regional exports surged with strengthening recovery in external demand and INR depreciation



Source: Datastream, Haver Analytics, World Bank

Figure 2.20 Business sentiment improves in India in second half



Source: Markit, Haver Analytics, World Bank

Fiscal deficits remain high reflecting subsidy expenditures and weak revenue mobilization.

Fiscal positions have improved marginally across the South Asia region, but deficits remain elevated (figure 2.21), with the regional deficit close to [7] percent of GDP. India's central government fiscal deficit at [4.9] percent of GDP in FY2012-13 was below target. But since April, the government's deficit target for FY2013-14 came under pressure, reaching [84] percent of the target by October as compared to [43] percent in the previous fiscal year. Pakistan's fiscal deficit was [8] percent of GDP in the 2012-13 fiscal year, although planned fiscal consolidation (including tax administration reforms) is expected to reduce this gradually. Sri Lanka's deficit has fallen in recent years, but is estimated to be nearly 6 percent of GDP in 2013.

Weak GDP growth has adversely affected tax revenues, already among the lowest (as a share of GDP) compared to developing countries at similar levels of economic development (see World Bank 2013b). Subsidies on fuel and other items (including food and fertilizers) were [2.6] percent of GDP in India and [3.1] percent in Bangladesh, while energy subsidies are close to [2] percent in Pakistan, according to the IMF estimates and national sources. South Asian countries have made some progress in fuel subsidy reforms. For instance, India has increased regulated diesel prices at monthly intervals. More decisive action, including eventually deregulating fuel prices while protecting the poor through targeted assistance, may be needed to lower subsidy burdens. Lowering subsidies will help to reduce fiscal deficits or, alternatively, to raise productivity-enhancing expenditures in a fiscally neutral manner.

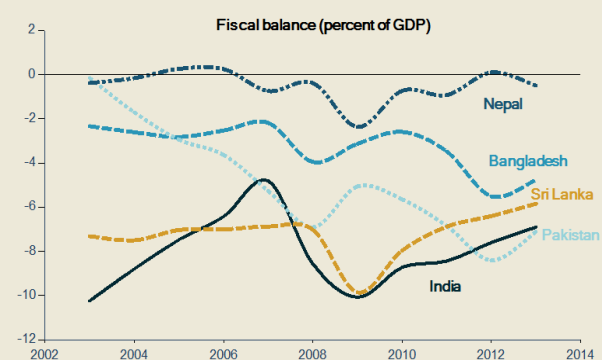
Capital flows to the South Asia region experienced a sharp correction during mid-year.

India, with large current account and fiscal deficits and slowing growth, was hit particularly hard by a withdrawal of portfolio capital and steep currency depreciation during mid-year (figure 2.22) on concerns of tapering of US quantitative easing (QE). The rupee subsequently appreciated (in part due to policy interventions to support foreign exchange markets), and capital flows and equity markets rebounded as QE tapering was delayed to December. Nevertheless, net private capital flows to South Asia weakened to an estimated \$85 billion in 2013 from \$92 billion in 2012 (table 2.14).

Reserve buffers in the region have been depleted in recent years, but external debt ratios are relatively modest.

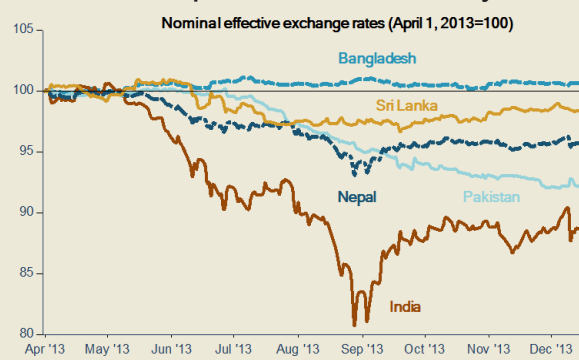
International reserves as a share of imports have been drawn down in several South Asian countries in recent years, due to slower pace of increase in exports, capital inflows, and remittances. International reserves have fallen below 2 months of imports in Pakistan. Nepal and Maldives both have trade deficits exceeding a quarter of GDP. The former's is mostly offset by remittances, but in the Maldives, it has resulted in a current account deficit of [28] percent of GDP and weakening reserves. External debt as a share of GDP is modest in most South Asian countries. But in Sri Lanka, they are close to 80 percent of GDP. Sri Lanka's large current account deficit, high foreign debt, and openness to capital flows suggest that it remains especially vulnerable to tightening of international financial conditions – alongside India whose current account deficit narrowed in Q3 2013, but was still elevated for the full year.

Figure 2.21 Fiscal positions are improving but remain under stress



Source: Datastream, Haver Analytics, World Bank

Figure 2.22 Sharp currency depreciation in India, Nepal and Pakistan since mid-year



Source: Datastream, Haver Analytics, World Bank

Table 2.14 South Asia capital flows (\$ billions)

	2008	2009	2010	2011	2012	2013e	2014f	2015f	2016f
Capital Inflows	64.7	90	106.9	84.7	96.1	90.6	92.8	101.4	113.5
Private inflows, net	55.8	79.0	96.1	78.1	92.1	84.7	87.7	96.7	109.7
Equity inflows, net	35.1	63.6	61.1	36.1	50.8	50.3	54.4	59.5	70.0
Net FDI inflows	50.9	39.5	31.2	40.4	27.4	32.0	35.3	38.1	43.6
Net portfolio equity inflows	-15.8	24.1	29.9	-4.3	23.4	18.3	19.1	21.4	26.4
Private creditors, Net	20.7	15.4	35.0	42.0	41.3	34.4	33.3	37.2	39.7
Bonds	1.7	1.9	10.1	0.7	5.1	6.2	5.3	4.7	4.1
Banks	11.2	10.9	13.2	18.6	23.0	15.2	12.5	15.7	16.2
Other private	-0.1	-0.1	0.0	0.0	-0.2	-0.1	0.1	0.1	0.2
Short-term debt flows	7.9	2.6	11.7	22.7	13.4	13.1	15.4	16.7	19.2
Official inflows, net	8.9	11.0	10.8	6.6	4.0	5.9	5.1	4.7	3.8
World Bank	1.4	2.4	3.3	2.0	0.9	0.5	..	..	..
IMF	3.2	3.6	2.0	0.0	-1.5	0.5	..	..	..
Other official	4.3	4.9	5.6	4.6	4.6	4.9	..	..	..

Source: The World Bank

Note: e = estimate, f = forecast

Outlook

South Asia's regional GDP growth is projected to improve to [5.7] percent in 2014 in market price-calendar year terms, and rise further to [6.3] and [6.7] percent in 2015 and 2016 (table 2.15). A gradual improvement in regional growth over the forecast period will be led mainly by a projected recovery in global demand and domestic investment, although the latter remains subject to significant downside risks. Regional export growth is expected to gradually rise over the forecast horizon together with a projected strengthening of demand in the Euro Area and U.S (the two largest destinations of South Asian exports) and robust growth in developing-country markets. Developing countries have become increasingly important trade partners for South Asian countries, accounting for over a third of regional exports.

Regional investment activity is expected to firm in 2014, with a further increase projected for 2015 and 2016. Despite slowing of US quantitative easing, investment rates in India are projected to experience a cyclical recovery. After declining for several years, the investment-to-GDP ratio in Pakistan is also expected to improve over the medium term. The projected increase in investment rates, however, will depend critically on ensuring

macroeconomic stability (including reducing fiscal deficits and inflation), making sustained progress on policy reforms, and reducing structural and regulatory constraints to production (particularly in the provision of energy and infrastructure). For instance, moving towards market-based pricing and dealing with losses and debts of state-owned companies in the electricity and petroleum sectors will not only be important for reducing subsidies and fiscal deficits, but also for creating incentives for provision of reliable energy supplies for the private sector.

Relatively stable or declining international commodity prices during the forecast period will contribute to reducing inflationary and current account pressures, and – together with normal harvests and sustained remittance flows – support consumption in the region. Normal agricultural production and a gradual decline in inflation expectations (provided structural reforms to release production bottlenecks are accelerated) will contribute to stronger consumption growth. In the near term, however, planned fiscal consolidation in Pakistan (and to a lesser extent in India) are likely to result in subdued government spending growth.

Private capital flows to the South Asia region are projected to rise marginally by [3] percent to [\$88] billion in 2014 - led mainly by a [10] percent increase in FDI flows (partly reflecting easing of regulations on foreign investment in India).

Table 2.15 South Asia forecast summary

(annual percent change unless indicated otherwise)	Est. Forecast							
	00-09 ^a	2010	2011	2012	2013	2014	2015	2016
GDP at market prices ^{b,e}	5.9	9.9	7.2	4.2	4.6	5.7	6.3	6.7
GDP per capita (units in US\$)	4.4	8.4	5.8	2.7	3.2	4.3	4.9	5.3
PPP GDP ^c	5.9	10.0	7.3	4.1	4.6	5.7	6.3	6.7
Private consumption	5.3	7.7	7.0	3.8	4.1	5.3	6.0	6.4
Public consumption	5.5	7.1	7.4	4.5	4.0	5.2	5.9	6.3
Fixed investment	8.9	16.7	6.2	1.1	3.5	6.2	7.7	7.9
Exports, GNFS ^d	11.5	14.9	16.1	8.2	6.5	7.7	7.8	8.1
Imports, GNFS ^d	9.4	16.2	16.9	9.9	3.4	6.2	7.7	7.9
Net exports, contribution to growth	-0.2	-1.2	-1.3	-1.1	0.5	-0.1	-0.5	-0.5
Current account bal/GDP (%)	-0.6	-2.6	-3.1	-4.1	-3.0	-2.7	-2.6	-2.5
GDP deflator (median, LCU)	6.5	9.6	8.5	7.6	7.5	6.5	6.3	6.0
Fiscal balance/GDP (%)	-7.3	-8.0	-7.9	-7.5	-6.7	-6.8	-6.4	-6.0
Memo items: GDP at market prices^e								
South Asia excluding India	4.5	4.9	5.2	4.9	4.8	5.1	5.2	5.3
India at factor cost	7.6	9.3	6.2	5.0	4.8	6.2	6.6	7.1
Pakistan at factor cost	4.9	2.6	3.7	4.4	3.6	3.4	4.1	4.5
Bangladesh	5.2	6.1	6.7	6.2	6.0	5.7	6.1	6.0

Source: World Bank.

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

b. GDP at market prices and expenditure components are measured in constant 2010 U.S. dollars.

c. GDP measured at PPP exchange rates.

d. Exports and imports of goods and non-factor services (GNFS).

e. National income and product account data refer to fiscal years (FY) for the South Asian countries, while aggregates are presented in calendar year (CY) terms. The fiscal year runs from July 1 through June 30 in Bangladesh, Bhutan, and Pakistan, from July 16 through July 15 in Nepal, and April 1 through March 31 in India. Due to reporting practices, Bangladesh, Bhutan, Nepal, and Pakistan report FY2010/11 data in CY2011, while India reports FY2010/11 in CY2010.

Portfolio equity flows are projected to rise marginally in 2014, while private debt flows contract. Despite tapering of U.S. quantitative easing and eventual normalization of interest rates in high income countries, private capital flows to South Asia are projected to rise to [\$98] billion and [\$110] billion respectively in 2015 and 2016—together with improvement in regional GDP growth and firming global activity. Remittance inflows are also projected to pick up, and reach [\$145] billion by 2016 (World Bank 2013a).

Country GDP growth forecasts (table 3) broadly reflect the above regional trends, but are also influenced by country-specific factors. Growth rates in India are projected to rise to just over [6] percent in FY2014-15 (from an estimated [4.8] percent in the current fiscal year), and then gradually increase to [6.6] and [7.1] percent by the

2015-16 and 2016-17 fiscal years. Growth will be led by recovery in global demand and increase in domestic investment, subject to downside risks outlined below. Growth in Pakistan is expected to moderate to [3.4] percent in FY2013-14, reflecting necessary fiscal tightening, but rise to [4.5] percent in the medium term. Political uncertainty and disruptions in the run-up to elections in Bangladesh will contribute to growth slowing to an estimated [5.7] percent in the 2013-14 fiscal year. Coupled with earlier safety problems in garment factories, election-related disruptions could slow a recovery in Bangladesh's GDP and exports.

Growth in Nepal is projected to pick up after delayed budget approval and weak agricultural performance in the 2012-13 fiscal year resulted in a deceleration in growth. Sri Lanka's growth is projected to accelerate to [7.4] percent in 2014,

mainly as a result of infrastructure spending, and consumption and services activity buoyed by remittance inflows. However, over the medium term, Sri Lanka's growth is projected to slow towards a more sustainable rate of around [6.5] percent. The gradual withdrawal of international forces will affect Afghanistan, as previously donor-financed expenditure will need to be financed from budget expenditure. Afghanistan's GDP growth is projected at [3.5] percent for 2014 (a slight improvement upon an estimated [3.1] percent in 2013), before rising gradually to around [5] percent as the security situation stabilizes and mining projects come online. As the presence of international forces in Afghanistan winds down, reductions in Coalition Support Funds for Pakistan are likely to be offset by continued disbursements under the IMF's extended fund facility and robust inflows of remittances.

Risks

Risks to the outlook for the South Asia region are tilted to the downside, on balance. Some potential upside risks include better than anticipated global growth, and lower crude oil prices than projected. Domestic risks are particularly relevant for a sustained revival of investment and for medium-term growth prospects.

Domestic risks. The main domestic risk includes current and planned reforms in South Asian countries going off-track and the inability to maintain fiscal discipline. A stalling or reversal of policy reforms could see investment and growth significantly lower than that projected in the baseline. Limited fiscal space in South Asian countries compared to the immediate pre-2008 crisis period has already made it difficult to respond forcefully to intensification of crises. An inability to maintain fiscal discipline and to reduce subsidies could adversely affect sovereign creditworthiness. Political uncertainties related to national elections in Bangladesh in early 2014 and in India in mid-2014 could hamper a sustained revival of business confidence and investment. In Afghanistan, the combination of political transition and withdrawal of international forces in 2014 could pose risks to the country's fiscal sustainability and growth. Entrenchment of inflation

expectations in India (RBI 2013a) could reduce space for monetary easing, and adversely affect investment. Lack of progress in reducing supply-side constraints (particularly in electricity, infrastructure and agricultural sectors) could also pose significant downside risk to the outlook.

Disorderly adjustment of capital flows. The tapering of U.S. quantitative easing is expected to proceed gradually, but a disorderly adjustment of capital flows could result in currency depreciation pressures, and put further stress on the private sector. Weak GDP growth has already taken a toll on corporate and bank balance sheets in India, as gross non-performing and restructured loans rose to [9.4] percent of loans in the 2012-13 fiscal year, with India's central bank warning of stress on asset quality in the iron, steel, and infrastructure sectors (RBI 2013b). Further strains from a sharp withdrawal of foreign capital could increase risk of corporate debt distress, while one-off costs of bank recapitalization can put pressure on fiscal positions.

Fragile global growth. Prolonged weakness in the Euro Area, U.S. fiscal policy brinkmanship, and geopolitical risks in the Middle East are additional sources of external risk. A relatively subdued recovery in the Euro Area, reflecting unresolved financial fragilities and structural problems, would act as a drag on global trade and affect South Asian exports. The risks from brinkmanship on U.S. fiscal policy have diminished, but a recurrence could affect global activity through negative confidence effects. Tensions in the Middle-East have subsided recently, but a resurgence and associated supply shocks could result in a spike in international crude oil prices, and threaten the gains made in stabilizing current account positions in South Asia.

South Asian policymakers must continue the urgent task of rebuilding domestic and external policy buffers and reducing imbalances to deal with potential intensification of external pressures, as well as accelerate productivity-enhancing reforms and improve their business environment to raise growth rates on a sustained basis. Given already large fiscal and current account deficits, high inflation, and weak reserve positions (or a combination of these) in some South Asian countries, policymakers need to maintain an appropriately tight macroeconomic stance so as not to exacerbate external vulnerabilities and domestic inflationary pressures.

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Table 2.16 South Asia country forecasts

	00-09 ^a	2010	2011	2012	Est. Forecast			
					2013	2014	2015	2016
Calendar year basis^b								
Afghanistan								
GDP at market prices (% annual growth) ^c	11.9	8.4	6.1	14.4	3.1	3.5	4.3	5.1
Current account bal/GDP (%)	-0.3	2.8	3.1	3.9	2.5	1.8	0.5	-0.3
Bangladesh								
GDP at market prices (% annual growth) ^c	5.2	6.4	6.5	6.1	5.8	5.9	6.1	6.0
Current account bal/GDP (%)	0.6	2.0	0.2	1.5	1.7	1.6	1.3	1.0
Bhutan								
GDP at market prices (% annual growth) ^c	7.7	9.6	9.5	8.3	7.9	8.4	8.6	8.6
Current account bal/GDP (%)	-0.1	-19.1	-25.5	-20.7	-20.9	-19.2	-18.4	-18.4
India								
GDP at factor cost (% annual growth) ^c	7.4	9.1	7.0	5.3	4.9	5.8	6.5	7.0
Current account bal/GDP (%)	-0.5	-3.2	-3.4	-5.0	-3.5	-3.2	-3.1	-2.9
Maldives								
GDP at market prices (% annual growth) ^c	6.3	7.1	7.0	3.4	4.3	4.2	4.1	4.1
Current account bal/GDP (%)	-1.1	-9.2	-21.4	-27.1	-28.0	-26.0	-25.0	-25.0
Nepal								
GDP at market prices (% annual growth) ^c	3.4	4.4	4.3	4.1	3.7	4.1	4.8	5.2
Current account bal/GDP (%)	-0.9	-2.6	0.2	1.4	1.5	1.0	0.6	0.1
Pakistan								
GDP at factor cost (% annual growth) ^c	4.9	3.1	4.0	4.0	3.5	3.8	4.3	4.5
Current account bal/GDP (%)	-1.4	-0.7	-1.1	-0.9	-1.7	-1.6	-1.4	-1.2
Sri Lanka								
GDP at market prices (% annual growth) ^c	4.4	8.0	8.2	6.4	7.0	7.4	6.5	6.3
Current account bal/GDP (%)	-3.7	-2.3	-7.9	-6.4	-5.1	-4.4	-3.8	-3.2
Fiscal year basis^b								
Bangladesh								
GDP at market prices (% annual growth) ^c	5.2	6.1	6.7	6.2	6.0	5.7	6.1	6.0
Bhutan								
GDP at market prices (% annual growth) ^c	7.7	9.3	10.0	9.0	7.6	8.1	8.6	8.6
India								
GDP at factor cost (% annual growth) ^c	7.6	9.3	6.2	5.0	4.8	6.2	6.6	7.1
Nepal								
GDP at market prices (% annual growth) ^c	3.4	4.8	3.9	4.6	3.6	3.8	4.4	5.2
Pakistan								
GDP at factor cost (% annual growth) ^c	4.9	2.6	3.7	4.4	3.6	3.4	4.1	4.5

Source: World Bank.

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

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

b. National income and product account data refer to fiscal years (FY) for the South Asian countries with the exception of Sri Lanka, which reports in calendar year (CY). The fiscal year runs from July 1 through June 30 in Bangladesh, Bhutan, and Pakistan, from July 16 through July 15 in Nepal, and April 1 through March 31 in India. Due to reporting practices, Bangladesh, Bhutan, Nepal, and Pakistan report FY2010/11 data in CY2011, while India reports FY2010/11 in CY2010. GDP figures presented in calendar years (CY) terms for Bangladesh, Bhutan, Nepal, India and Pakistan are calculated taking the average growth over the two fiscal year periods to provide an approximation of CY activity.

c. GDP measured in constant 2010 U.S. dollars.

SUB-SAHARAN AFRICA REGION



GLOBAL
ECONOMIC
PROSPECTS

January
2014

Chapter 2

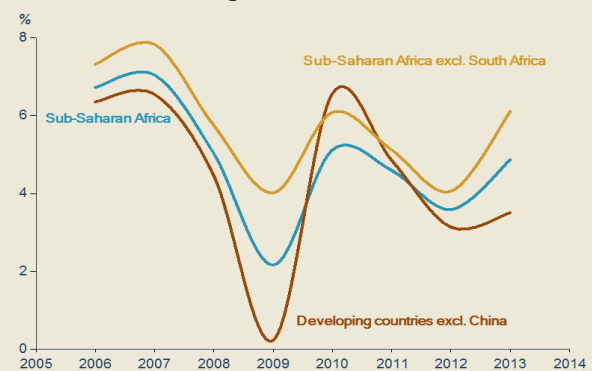
Sub-Saharan Africa's real GDP growth picked up to [4.8] percent in 2013 supported by robust domestic demand, notably investment growth. Strengthening external demand is expected to support growth over the forecast horizon, with regional GDP growth projected to rise to [5.4] percent in 2014-16. However, a protracted decline in commodity prices, tighter global financing conditions, and domestic risks including rising fiscal pressures, and adverse weather conditions could weaken growth prospects.

Recent Developments

Economic activity remained robust in much of Sub-Saharan Africa, with GDP growth in the region picking up in 2013. After an increase of 3.6 percent in 2012, GDP growth in the region strengthened to 4.8 percent in 2013, supported by robust domestic demand – notably investment growth. In South Africa, the region's largest economy, structural bottlenecks and tense labor relations combined with weak external demand contributed to keep growth slow at [1.9] percent. Excluding South Africa, the average growth for the rest of the region was 6.1 percent (figure 2.23). About a third of countries in the region grew by 6 percent or more in 2013 (figure 2.24), boosting real per capita incomes. However, in many of these countries, poverty remains widespread and unemployment is high.

Strong investment demand continues to support growth in the region. Gross fixed capital formation continued to increase rapidly in the region, expanding an estimated [7.8] percent in 2013, reaching [23.2] percent of GDP. Net foreign direct investment inflows to the region grew [16] percent to \$43 billion in 2013 (table 2.16). Much of the investment has flowed to the natural resource

Figure 2.23 Real GDP growth in Sub-Saharan Africa strengthened in 2013



Source: World Bank.

Table 2.17 Net capital flows to Sub-Saharan Africa (\$billions)

	2008	2009	2010	2011	2012	2013e	2014f	2015f	2016f
Capital Inflows	46.5	56.5	59.5	62.9	73.6	86.1	66.9	73.2	79.8
Private inflows, net	41.5	46.3	46.0	50.1	62.6	74.5	66.9	73.2	79.8
Equity Inflows, net	38.7	48.2	40.4	39.0	46.4	52.6	51.7	57.6	62.0
Net FDI inflows	44.3	37.7	32.2	40.0	37.0	43.0	41.0	44.2	47.8
Net portfolio equity inflows	-5.6	10.5	8.2	-1.0	9.4	9.6	10.7	13.4	14.2
Private creditors, Net	2.8	-1.9	5.6	11.1	16.2	21.9	15.2	15.6	17.8
Bonds	-1.6	2.0	1.4	6.0	3.6	7.3	4.1	4.7	5.2
Banks	2.6	0.8	0.7	3.4	4.0	6.4	5.1	6.1	6.8
Other private	-0.1	0.8	0.5	0.1	0.6	1.0	0.8	0.7	1.3
Short-term debt flows	1.9	-5.5	3.0	1.6	8.0	7.2	5.2	4.1	4.5
Official inflows, net	5.0	10.2	13.5	12.8	11.0	11.6	..	..	..
World Bank	1.9	3.1	4.0	3.2	3.9	3.5	..	..	..
IMF	0.7	2.2	1.2	1.4	0.9	0.6	..	..	..
Other official	2.5	4.9	8.3	8.2	6.2	7.5	..	..	..

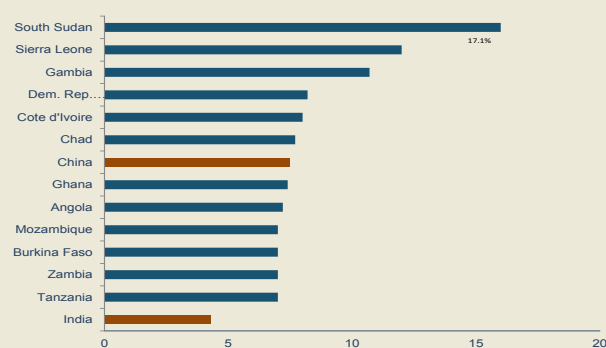
Source: The World Bank

Note: e = estimate, f = forecast

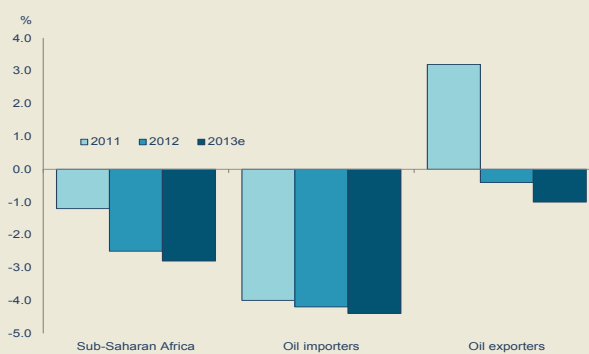
sector, supporting exploration and production in oil, gas, and mining. However, FDI flows to the non-resource sector also increased. This is particularly the case of the service sector where rising consumer incomes are buoying activity in telecommunications, finance, retail, and transportation. Consumer-oriented FDI projects in manufacturing and services have expanded rapidly in recent years. As a result, their share in the total value of FDI greenfield projects in the region has risen from about [7] percent in 2008 to about [23] percent in 2012.

Fiscal deficits widened in 2013 and debt-to-GDP ratios continued to rise across the region.

After more than doubling in 2012, fiscal deficits in the region are estimated to have deteriorated a further [0.5] percentage points in 2013, with the largest deterioration occurring among oil exporters and low-income countries (figure 2.25). In Cameroon and Chad, fiscal deficits as a share of GDP are estimated to have doubled in 2013; and in Malawi, the overall fiscal deficit is expected to widen to about [19] percent of GDP in 2013 after rising to 16.6 percent of GDP in 2012. Among middle-income countries, Ghana's fiscal deficit jumped to 11 percent of GDP in 2012 and remained high in 2013; and in South Africa, the fiscal deficit has not declined as expected, remaining unchanged at [4.2] percent of GDP in

Figure 2.24 Sub-Saharan Africa was the second fastest growing region in 2013

Source: World Bank.

Figure 2.25 The overall fiscal deficit (% of GDP) deteriorated in oil-exporting countries

Source: IMF Data.

2013. Ambitious public investment programs and increases in public wages coupled with weak revenues contributed to the deterioration of fiscal balances in many of these countries. The increase of fiscal deficits despite the acceleration of economic activity suggests rising structural imbalances, which falling commodity prices and reduced access to concessional resources could exacerbate.

Partly as a result, the debt to GDP ratio for the region as a whole has risen from 29 percent in 2008 to an estimated [34] percent in 2013. These averages, however, reflect significant differences across countries. Debt-to-GDP ratios range from as low as [8] percent of GDP in Equatorial Guinea, to as high as [126] percent of GDP in Eritrea. Some middle-income countries saw a sharp rise in their debt ratios, the latter exceeding [50] percent of GDP in Ghana and [90] percent of GDP in Cape Verde in 2013. The rising debt ratios and widening fiscal deficits suggest rising fiscal vulnerabilities that may hamper potential growth. For most countries in the region fiscal consolidation is needed not only to help create fiscal space for development spending but also to start rebuilding fiscal buffers to minimize exposure to external headwinds.

Supported by decelerating inflation and rising remittances household consumption demand has been expanding robustly. Inflation eased in the region, declining to 7.1 per cent in September 2013 from 9.8 percent the previous year (figure 2.26). However, currency depreciations, wage increases and infrastructure bottlenecks have kept inflation in double digits in many countries, including

Malawi, Burundi and Guinea. Central banks in many countries in the region have maintained an accommodative monetary policy stance in an effort to stimulate domestic demand. Central Banks in Kenya and South Africa have kept monetary policy unchanged; and, in the CFA franc zone, the two regional central banks cut their benchmark discount rates. Remittance inflows to the region remained robust and are estimated at \$33 billion in 2013, up from \$31 billion in 2012. These inflows, combined with lower food prices, supported household incomes and demand. High frequency consumption data is not available for much of the region. However, the annualized 6 percent growth in total imports for the first half of 2013, despite a 1.7 percent decline in capital equipment imports, suggests that private consumption, which accounts for over 60 percent of regional GDP, remained robust in 2013.

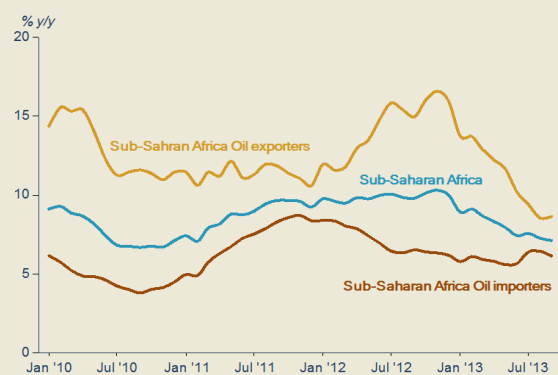
The region's export performance was adversely impacted by the decline in commodity prices.

The World Bank's commodity price indices show that in the first 9 months of 2013 the USD prices of agricultural goods and metals and minerals declined by [12.8] and [1.6] percent respectively while the price of oil remained stable, compared with the same period a year ago. The fall in commodity prices dampened export receipts in the region, even though on a volume basis exports went up in many countries. Year-to-date, export receipts fell an estimated [2.4] percent in the region. Meanwhile, supported by the coming on stream of new mines and wells, export volumes for oil, minerals and metals rose in several countries.

Tourism, an increasingly important driver of growth in several Sub-Saharan African countries, continues to grow at a robust pace.

Data from the UN World Tourism Organization (UNWTO) shows that tourist arrivals to the region grew by 4 percent in the first half of 2013, a faster pace compared with the same period a year ago. Among the Sub-Saharan African destinations for which quarterly data is available, the strongest performers were Cape Verde (+18%), Seychelles (+13%), South Africa (4%), Swaziland (+2%), and Mauritius (+1%). International tourist arrivals in the region are expected to remain robust in the second half of 2013. UNWTO estimates tourist arrivals to the region will expand by up to [6] percent in 2013.

Figure 2.26 Inflation eased in Sub-Saharan Africa in 2013



Source: World Bank.

Table 2.18 Sub-Saharan Africa forecast summary

(annual percent change unless indicated otherwise)

	Est. Forecast							
	00-09 ^a	2010	2011	2012	2013	2014	2015	2016
GDP at market prices ^b	4.4	5.1	4.6	3.6	4.8	5.4	5.4	5.4
	<i>(Sub-region totals-- countries with full NIA + BOP data)^c</i>							
GDP at market prices ^c	4.4	5.1	4.6	3.6	4.8	5.4	5.4	5.4
GDP per capita (units in US\$)	2.1	2.6	2.0	1.0	2.2	2.8	2.9	2.9
PPP GDP ^c	4.6	5.2	4.7	2.1	5.6	6.0	5.7	5.5
Private consumption	5.1	8.9	4.9	4.3	5.6	5.3	5.1	5.1
Public consumption	5.4	5.8	7.9	5.5	5.4	5.7	3.8	5.0
Fixed investment	8.9	0.1	8.8	6.9	7.8	6.5	7.4	6.2
Exports, GNFS ^d	4.2	5.5	6.2	0.2	5.4	6.2	6.2	5.8
Imports, GNFS ^d	4.5	8.7	10.1	4.6	7.6	6.5	5.7	5.1
Net exports, contribution to growth	-0.4	-1.0	-1.3	-1.6	-0.9	-0.3	0.0	0.1
Current account bal/GDP (%)	0.0	-1.3	0.2	-1.5	-3.0	-3.3	-3.3	-3.1
GDP deflator (median, LCU)	6.5	7.3	7.8	6.0	5.8	5.7	5.5	5.6
Fiscal balance/GDP (%)	-0.4	-3.5	-1.2	-2.6	-2.9	-2.6	-2.5	-2.5
Memo items: GDP								
SSA excluding South Africa	5.1	6.1	5.1	4.1	6.1	6.5	6.3	6.2
Oil exporters ^e	5.6	6.0	4.3	2.9	6.3	6.8	6.4	6.2
CFA countries ^f	3.6	4.0	2.6	5.5	4.6	5.3	5.0	5.3
South Africa	3.2	3.1	3.5	2.5	1.9	2.7	3.4	3.5
Nigeria	5.6	8.0	7.4	6.6	6.7	6.7	6.8	6.8
Angola	10.7	3.4	3.9	5.2	5.1	8.0	7.3	7.0

Source: World Bank.

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

b. GDP at market prices and expenditure components are measured in constant 2010 U.S. dollars.

c. Sub-region aggregate excludes Liberia, Chad, Somalia and São Tomé and Príncipe. Data limitations prevent the forecasting of GDP components or Balance of Payments details for these countries.

d. Exports and imports of goods and non-factor services (GNFS).

e. Oil Exporters: Angola, Cote d'Ivoire, Cameroon, Congo, Rep., Gabon, Nigeria, Sudan, Chad, Congo, Dem. Rep.

f. CFA Countries: Benin, Burkina Faso, Central African Republic, Cote d'Ivoire, Cameroon, Congo, Rep., Gabon, Equatorial Guinea, Mali, Niger, Senegal, Chad, Togo.

Outlook

Medium-term growth prospects for Sub-Saharan Africa are strong. Regional GDP growth is projected to strengthen to 5.4 percent during 2014-16 from 4.8 percent in 2013 (table 2.17). Excluding South Africa, the rest of the region is projected to grow at 6.3 percent on average in 2014-16.

Domestic demand, associated with investment in infrastructure and household consumption, will remain the main driver of growth for most countries in the region. The expected improvement in growth relative to 2013 also

reflects anticipated higher growth notably in high-income countries. In this environment, foreign direct investment flows are projected to remain an important driver of growth for many countries in the region. Although commodity prices have eased, they remain high and investment opportunities in the region are profitable. As a result, FDI flows, which are less sensitive to global interest rates hikes than short-term portfolio flows, are projected to rise to US\$[44.2] billion in 2015 and reach US\$[47.8] billion in 2016.

Private consumption in the region is expected to remain strong in 2014-16. Reduced imported inflation, helped by a benign global inflationary environment, stable exchange rates, and adequate local harvests are expected to help contain inflationary pressures, which should allow for further interest rate cuts. Combined with steadily

rising remittances, these effects should stimulate demand and permit a continued rapid expansion of domestic demand.

Government spending is projected to continue rising at a moderate pace, as governments expand spending on pro-poor projects in health, education and social services in an effort to reach the millennium development goals by 2015. After rising by a robust 5.4 percent in 2013, public consumption is projected to increase by [4.8] percent on average in 2014-16. Reflecting this slowdown, fiscal deficits are expected to decline; however, fiscal space will remain depleted for most countries in the region.

Growth in the region is expected to be driven by resource as well as non-resource rich countries. Oil exporters, led by Angola, are projected to grow at 6.4 percent on average during 2014-16. Growth is also projected to remain robust in many mineral-exporting countries including Burkina Faso, Ghana, and Mozambique, driven by FDI flows in the natural resource sector and increased production from projects coming on stream. In several non-resource rich countries, notably Ethiopia and Rwanda, real GDP growth is projected to exceed the regional average supported by robust growth in agriculture, services, and investments in infrastructure. Elsewhere, growth is forecast to remain moderate. While real GDP growth in many countries in the region is expected to remain stronger than in many other developing countries, poor physical infrastructure limits the region's growth potential. Unreliable electricity supply and poor road conditions will continue to impose high costs on business, reduce efficiency, and impede intra-regional trade.

Net exports are projected to make a marginal contribution to GDP growth in the region over the forecast horizon. Following a sharp contraction in 2012, exports rebounded with an estimated [5.4] percent annual increase in 2013; but massive imports of capital and construction goods saw net exports subtract an estimated 1.0 percentage point off GDP growth. Export capacity is expected to strengthen during 2014-16, providing a boost to economic growth. The contributions of net exports will be somewhat constrained, however, by lower commodity prices, which will be exacerbated by low output in some countries, notably the oil-exporting Central African

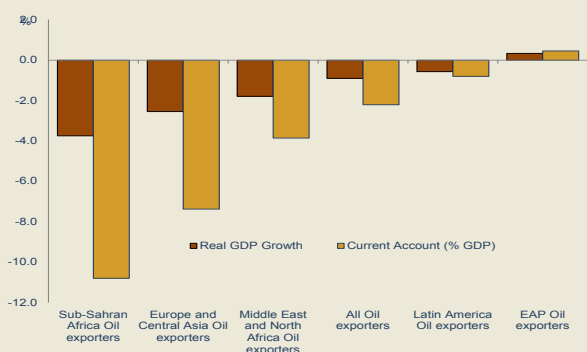
countries where production is stagnating. In metal-exporting countries, increased output will mitigate the weakness of metal prices. On the import side, the demand for capital goods is projected to remain strong, but as investments mature and construction projects approach completion in many countries, imports are expected to grow at a slower pace. Reflecting these trends and the weakening of commodity prices, the current account deficit in the region is projected to increase from an estimated [3.0] percent of GDP in 2013 to an average of [3.3] percent of GDP in 2014 and 2015, before narrowing to [3.1] percent of GDP in 2016. For most countries in the region net exports will be less of a drag on GDP growth during 2014-16

Risks

The main risks that threaten the region's economic outlook include a protracted decline in commodity prices brought on by increased output and weaker demand, second-round effects from the tightening of monetary conditions as the Federal Reserve begins to taper its asset purchases; and domestic risks from political unrest, security problems and weather shocks.

Long-term structural decline in commodity prices: Simulation results of a one-standard deviation decline in the price of oil from the baseline in 2014 show that growth in the region will decline by about 1.3 percentage points and current account balances will deteriorate by 4.5 percentage points compared to baseline projections. Oil exporters, especially the less diversified ones such as Angola and Gabon, would be hit the hardest, with a GDP decline relative to the baseline of 3.8 percentage points and the current account deficit worsening by 10.8 percentage points (figure 2.27), which underscores the need for structural reforms to foster economic diversification. In contrast, the region's oil importers would benefit from the decline in oil prices, with GDP rising by some 0.61 percentage points and current account balances improving by 0.77 percentage points (figure 2.28).

Figure 2.27 A one-standard deviation shock to oil prices will affect Sub-Saharan Africa the most

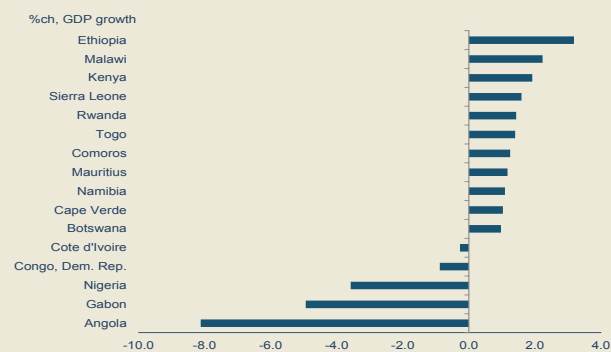


Source: World Bank.

Tighter monetary conditions: The tapering of asset purchases by the Federal Reserve is expected to lead to a rise in base interest rates and spreads. A 100-basis point increase in high-income country base rates is likely to be associated with a 110 to 157 basis point increase in developing-country yields (World Bank), implying an increase in the cost of raising capital, which could lead to lower investment and growth. South Africa, which has strong links with global financial markets, is particularly vulnerable to sudden stops of capital inflows given its reliance on portfolio inflows to finance its current account deficit; but frontier countries such as Kenya and Nigeria, which have seen significant portfolio inflows in local securities markets, will also be affected by the reversal of capital flows; and countries that are planning to tap the international bond markets are likely to face higher coupon rates.

Domestic risks associated with social and political unrest as well as emerging security problems remain a major threat to the economic prospects of a number of countries in the region. For example, political instability in the Central African Republic, which has added to the impoverishment of its population, could deteriorate further with spillovers to neighboring countries. Piracy attacks in the Gulf of Guinea, which increased sharply in 2012 both in their number and intensity, could escalate and impose greater security spending on government budgets, push up shipments costs higher and disrupt trade in the sub-region. Ongoing conflicts in Northern Nigeria are also emerging as an important security

Figure 2.28 Less diversified oil exporters would be hit hardest



Source: World Bank.

problem that might adversely affect economic activity in the sub-region.

Risks from food price spikes at the global level appear contained for now. Yet, while short-term forecasts of weather conditions are broadly favorable, most countries in the region remain highly vulnerable to changing weather conditions given the importance of rain-fed subsistence agriculture for their economies and the livelihoods of their populations. Inadequate rainfalls could affect growth prospects in many of these countries. The resulting lower local harvests might raise the risk of food insecurity and push food prices higher, dampening household consumption which has been an important driver of growth in the region in recent years.

Table 2.19 Sub-Saharan Africa Country forecasts

	00-09 ^a	2010	2011	2012	Est. Forecast			
					2013	2014	2015	2016
Angola								
GDP at market prices (% annual growth) ^b	10.7	3.4	3.9	5.2	5.1	8.0	7.3	7.0
Current account bal/GDP (%)	4.9	9.1	12.6	10.4	10.6	9.2	9.5	10.1
Benin								
GDP at market prices (% annual growth) ^b	3.6	2.6	3.5	5.4	4.2	4.1	4.2	4.0
Current account bal/GDP (%)	-8.3	-9.4	-13.2	-11.6	-9.8	-9.8	-9.2	-8.9
Botswana								
GDP at market prices (% annual growth) ^b	3.5	8.1	6.1	4.3	4.6	5.0	5.2	5.2
Current account bal/GDP (%)	7.4	-7.4	-1.4	-4.5	-0.2	-1.2	-1.9	-2.4
Burkina Faso								
GDP at market prices (% annual growth) ^b	5.2	7.9	4.2	10.0	7.0	7.0	7.0	7.0
Current account bal/GDP (%)	-13.2	-5.8	-4.8	-6.8	-4.9	-4.3	-3.4	-1.2
Burundi								
GDP at market prices (% annual growth) ^b	2.9	3.8	4.2	4.0	4.3	4.5	4.1	3.5
Current account bal/GDP (%)	-17.5	-15.9	-16.3	-17.2	-17.9	-16.3	-16.0	-15.6
Cape Verde								
GDP at market prices (% annual growth) ^b	5.6	1.5	4.0	2.5	2.6	2.9	3.3	3.6
Current account bal/GDP (%)	-11.3	-14.5	-17.4	-12.4	-9.9	-8.1	-8.8	-8.9
Cameroon								
GDP at market prices (% annual growth) ^b	3.0	3.3	4.1	4.7	4.8	5.0	5.1	5.1
Current account bal/GDP (%)	-2.4	-3.8	-5.8	-6.4	-5.7	-5.9	-6.1	-6.4
Central African Republic								
GDP at market prices (% annual growth) ^b	0.7	3.3	3.1	4.1	-18.0	-1.8	1.1	2.5
Current account bal/GDP (%)	-8.6	-13.3	2.5	2.5	-1.1	-0.1	1.7	1.6
Comoros								
GDP at market prices (% annual growth) ^b	1.8	2.1	2.2	3.0	3.3	3.5	3.5	3.2
Current account bal/GDP (%)	-11.9	-27.4	-32.1	-16.9	-14.1	-13.5	-13.1	-11.9
Congo, Dem. Rep.								
GDP at market prices (% annual growth) ^b	4.2	7.2	6.9	7.2	7.5	7.5	7.4	6.7
Current account bal/GDP (%)	0.6	-16.6	-8.2	-12.3	-8.2	-5.3	-4.8	-4.6
Congo, Rep.								
GDP at market prices (% annual growth) ^b	3.8	8.8	3.4	3.8	5.6	5.4	5.5	5.5
Current account bal/GDP (%)	-2.0	-28.0	31.2	1.8	1.8	0.4	0.4	-0.3
Cote d'Ivoire								
GDP at market prices (% annual growth) ^b	0.8	2.4	-4.7	9.5	8.7	8.2	8.1	7.6
Current account bal/GDP (%)	1.9	2.1	1.4	-2.2	-3.5	-4.5	-4.3	-4.7
Equatorial Guinea								
GDP at market prices (% annual growth) ^b	15.0	-1.7	4.9	2.5	-1.5	-0.5	-1.6	2.1
Current account bal/GDP (%)	10.9	-24.7	-16.4	-14.9	-13.9	-12.9	-9.5	-7.4
Eritrea								
GDP at market prices (% annual growth) ^b	0.7	2.2	8.7	7.0	6.0	3.5	3.0	3.0
Current account bal/GDP (%)	-20.9	-5.5	3.2	22.5	23.5	27.6	28.8	29.3
Ethiopia								
GDP at market prices (% annual growth) ^b	7.5	8.6	7.9	7.7	7.0	7.1	7.0	7.1
Current account bal/GDP (%)	-5.0	-1.2	-2.0	-6.2	-6.4	-6.4	-6.5	-6.5

	00-09 ^a	2010	2011	2012	Est. Forecast			
					2013	2014	2015	2016
Gabon								
GDP at market prices (% annual growth) ^b	1.3	6.7	7.0	6.1	4.2	4.2	3.9	3.9
Current account bal/GDP (%)	14.8	5.8	11.4	14.4	9.6	9.1	7.3	6.9
Gambia, The								
GDP at market prices (% annual growth) ^b	3.2	6.5	-4.3	5.3	6.5	7.5	6.4	5.5
Current account bal/GDP (%)	-3.6	2.2	5.3	-7.3	-12.7	-13.1	-13.5	-10.3
Ghana								
GDP at market prices (% annual growth) ^b	5.0	8.0	15.0	7.9	7.4	7.4	7.3	6.7
Current account bal/GDP (%)	-6.5	-9.6	-8.9	-12.5	-11.7	-11.7	-10.2	-9.9
Guinea								
GDP at market prices (% annual growth) ^b	2.4	1.9	4.3	3.9	4.0	4.7	5.0	6.0
Current account bal/GDP (%)	-7.2	-7.0	-23.8	-35.4	-25.5	-46.3	-43.5	-38.7
Guinea-Bissau								
GDP at market prices (% annual growth) ^b	2.3	1.7	5.7	-1.5	3.0	2.7	2.7	2.9
Current account bal/GDP (%)	-9.0	-11.9	-6.1	-7.0	-5.8	-5.0	-4.5	-3.4
Kenya								
GDP at market prices (% annual growth) ^b	3.6	5.8	4.4	4.6	5.0	5.1	5.2	5.3
Current account bal/GDP (%)	-2.5	-7.7	-10.3	-9.8	-9.5	-8.6	-7.5	-7.5
Lesotho								
GDP at market prices (% annual growth) ^b	3.3	7.9	3.7	4.0	4.6	5.1	4.5	4.4
Current account bal/GDP (%)	2.9	-19.9	-20.5	-21.4	-14.5	-13.1	-12.0	-11.5
Madagascar								
GDP at market prices (% annual growth) ^b	3.0	0.5	1.9	3.1	4.1	4.8	5.4	5.4
Current account bal/GDP (%)	-12.4	-10.2	-10.4	-11.8	-13.6	-18.1	-20.3	-16.3
Malawi								
GDP at market prices (% annual growth) ^b	3.8	6.5	4.3	1.9	4.4	4.8	5.5	5.5
Current account bal/GDP (%)	-10.7	-16.8	-13.6	-15.0	-18.4	-15.9	-14.7	-15.6
Mali								
GDP at market prices (% annual growth) ^b	4.2	5.8	2.7	-1.2	4.0	5.2	4.5	4.6
Current account bal/GDP (%)	-8.3	-14.1	-7.0	-4.4	-9.6	-10.1	-10.0	-9.7
Mauritania								
GDP at market prices (% annual growth) ^b	4.5	5.1	4.0	7.6	5.7	4.6	4.0	3.3
Current account bal/GDP (%)	-10.8	-6.0	-1.9	-25.3	-25.5	-21.5	-17.0	-16.9
Mauritius								
GDP at market prices (% annual growth) ^b	3.4	7.7	3.8	3.2	3.7	4.1	4.3	4.2
Current account bal/GDP (%)	-2.7	-10.3	-13.4	-11.2	-9.6	-8.4	-7.7	-10.5
Mozambique								
GDP at market prices (% annual growth) ^b	7.1	7.1	7.3	7.4	7.0	8.5	8.5	8.5
Current account bal/GDP (%)	-14.0	-16.4	-23.8	-35.4	-40.3	-40.9	-39.2	-37.9
Namibia								
GDP at market prices (% annual growth) ^b	3.9	6.0	4.9	5.0	4.2	4.3	4.4	4.4
Current account bal/GDP (%)	3.5	-2.1	-4.7	-3.4	-2.0	-2.3	-3.8	-3.8
Niger								
GDP at market prices (% annual growth) ^b	3.6	-8.0	2.3	11.2	5.6	6.2	6.0	5.8
Current account bal/GDP (%)	-9.7	-21.3	-24.6	-19.6	-17.9	-17.7	-17.6	-16.8
Nigeria								
GDP at market prices (% annual growth) ^b	5.6	8.0	7.4	6.6	6.7	6.7	6.8	6.8
Current account bal/GDP (%)	14.4	6.3	12.2	13.7	7.2	5.2	3.5	1.7
Rwanda								
GDP at market prices (% annual growth) ^b	7.2	7.2	8.2	8.0	7.0	7.5	7.2	7.0
Current account bal/GDP (%)	-6.0	-7.5	-7.4	-11.2	-8.4	-8.2	-8.5	-8.8
Senegal								
GDP at market prices (% annual growth) ^b	3.6	4.1	2.6	3.7	4.0	4.5	4.6	4.6

	00-09 ^a	2010	2011	2012	Est. Forecast			
					2013	2014	2015	2016
Current account bal/GDP (%)	-8.0	-4.7	-7.4	-9.2	-8.3	-7.2	-6.7	-5.9
Seychelles								
GDP at market prices (% annual growth) ^b	1.5	7.1	5.0	2.9	3.5	3.9	3.5	3.0
Current account bal/GDP (%)	-13.9	-19.5	-21.3	-23.8	-24.8	-21.7	-17.1	-22.2
Sierra Leone								
GDP at market prices (% annual growth) ^b	6.0	5.4	6.0	15.2	17.0	14.1	12.1	12.1
Current account bal/GDP (%)	-11.1	-25.0	-40.6	-37.1	-19.3	-10.6	-7.8	-7.4
South Africa								
GDP at market prices (% annual growth) ^b	3.2	3.1	3.5	2.5	1.9	2.7	3.4	3.5
Current account bal/GDP (%)	-3.0	-2.8	-3.4	-6.3	-6.9	-6.5	-6.4	-6.3
South Sudan								
GDP at market prices (% annual growth) ^b	4.4	3.9	4.7	-42.0	33.9	23.9	8.7	4.0
Current account bal/GDP (%)	10.7	30.1	17.2	-25.4	-14.3	8.8	12.9	15.4
Sudan								
GDP at market prices (% annual growth) ^b	5.6	3.5	-3.3	-10.1	2.9	2.9	3.0	3.2
Current account bal/GDP (%)	-5.9	-0.6	-0.4	-0.5	-5.3	-4.5	-4.0	-2.1
Tanzania								
GDP at market prices (% annual growth) ^b	6.2	7.0	6.4	6.9	7.3	7.4	7.6	7.8
Current account bal/GDP (%)	-9.3	-12.0	-19.3	-14.8	-17.2	-16.6	-16.0	-15.5
Togo								
GDP at market prices (% annual growth) ^b	1.7	4.0	4.8	5.6	5.0	4.5	4.5	4.4
Current account bal/GDP (%)	-9.2	-6.3	-4.1	-6.3	-9.2	-8.4	-8.7	-7.9
Uganda								
GDP at market prices (% annual growth) ^b	6.9	6.2	5.0	4.6	6.2	6.6	7.0	7.1
Current account bal/GDP (%)	-4.0	-7.9	-9.3	-5.5	-5.1	-4.6	-3.5	-3.2
Zambia								
GDP at market prices (% annual growth) ^b	4.8	7.6	6.8	7.3	6.0	6.5	6.0	5.8
Current account bal/GDP (%)	-10.8	6.0	2.9	2.7	2.8	2.4	2.2	2.2
Zimbabwe								
GDP at market prices (% annual growth) ^b	-5.9	9.6	9.4	4.4	2.2	3.3	3.4	3.5
Current account bal/GDP (%)	-12.2	-10.3	-23.0	-19.7	-21.9	-17.6	-14.7	-18.6

Source : World Bank.

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

Liberia, Somalia, Sao Tome and Principe are not forecast owing to data limitations.

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

b. GDP measured in constant 2010 U.S. dollars.

Chapter III

CAPITAL FLOWS AND CRISIS RISKS IN DEVELOPING COUNTRIES

Introduction

The past two decades have seen dramatic changes in international capital flows to developing countries, characterized by a substantial increase both in absolute terms and as a share of developing country GDP — but also by surges and stops in response to changes in global financial and economic conditions.

Thus during the boom years 2003–07 capital flows surged peaking at more than 12 percent of developing country GDP in 2007Q3, before crashing to negative territory in 2008 with the global financial crisis. They partly recovered in the post-crisis period — averaging [6] percent between 2010 and 2013.^{FN1}

Capital flows eased in the second half of 2013 due to market expectations that the strengthening of growth in high-income countries would prompt an end to the extraordinary macroeconomic policies that brought global interest rates to historically low levels, pushing capital toward faster growing and higher-yielding developing countries.

As the recovery in high-income countries continues (see Chapter 1), the global conditions of recent years will also evolve. Fiscal policies are being tightened, growth differentials between high-income and developing countries are narrowing, and monetary policy interventions for countering the recession will be gradually withdrawn. This normalization of external conditions will have important ramifications for developing countries, including for capital inflows.

This chapter examines in greater detail the recent pattern of capital flows to developing countries with a view to better understanding the possible impacts that a normalization of activity and policy in high-income countries may have. It is organized into three sections.

The first section describes the evolution of capital flows in recent years and presents econometric evidence outlining the relative importance of changing global and country-specific conditions in that evolution. It finds that about 60 percent of

the increase in overall capital flows to developing countries between 2009 and 2013 could be accounted for by global factors with the remainder explained by country-specific developments.

Assuming a smooth recovery consistent with the baseline projection of Chapter 1, the model is then used to evaluate the likely impact on capital flows in developing countries of a normalization of high-income country growth and policy conditions. With the aid of a second multivariate vector autoregression model focusing on the short-term adjustment dynamics between capital flows and their main external drivers, two disorderly adjustment scenarios are also presented.

A second shorter section concentrates on crisis risks and domestic vulnerabilities in the event of a disorderly adjustment, focusing on an evaluation of banking crisis probabilities at the individual country level. It proposes a classification of country risks in relation to domestic credit, external debt, exchange rate and current account imbalances.

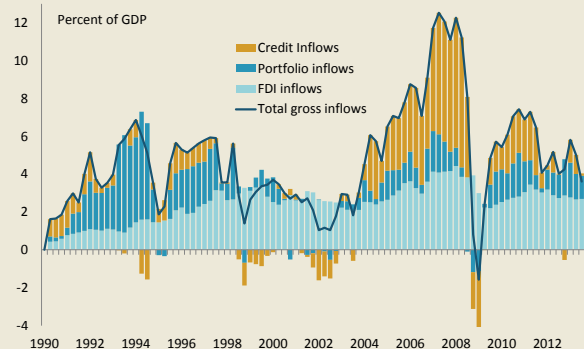
A final section discusses policy options in the face of capital retrenchment risks, including capital flow management instruments, macro, prudential and structural reforms.

Capital flows: past and expected trends

Since the 1990s, when they represented an average of 4 percent of developing-country GDP, gross capital inflows^{FN2} to developing countries increased markedly, averaging 9 percent of GDP between 2005Q1 through 2008Q3. The financial crisis saw them drop precipitously before recovering again, to 6 percent of GDP between 2010Q1 and 2013Q2 (see figure 1).

For the most part, strong capital inflows to developing countries during the pre-crisis period contributed to higher investment rates and facilitated capital deepening and technological transfer, all of which had positive effects on growth potential and level of development (World

Figure 1. Gross capital inflows to developing countries



Source: World Bank, based on IMF Balance of payments statistics.

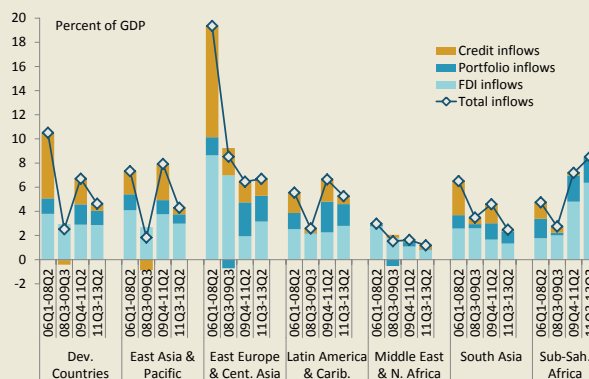
Bank, 2010a). In most cases, the rise in capital inflows during the pre-crisis years did not cause excessively large current account imbalances or domestic vulnerabilities in developing countries.

Developments in central Europe were a notable exception. Massive cross-border lending flows (bank flows alone represented 6 percent of regional GDP in the 2003-07 period, see figure 2), fueled credit and asset price bubbles in the pre-crisis period, contributing to a boom in private consumption, mounting current account deficits and indebtedness problems similar to those observed in high-income countries during the same period. As a result, unlike other regions developing Europe has gone through an extended period of restructuring and deleveraging similar to that of high-income countries.

While the remarkable increase in gross financial flows to developing countries implied investment and growth opportunities in “normal” times, it also amplified the transmission of global financial shocks, as starkly illustrated during the 2008-09 financial crisis, when gross flows to developing countries fell abruptly to about [-1] percent (negative inflows are possible because they are counted net of repayment of past liabilities and thus can be negative).

Most developing regions exited from the crisis relatively quickly, in part because of counter-cyclical stimulus they deployed. Their rapid growth, improving relative fundamentals (reflected in the credit ratings see figure 3), and a gradual thawing of global financial conditions, contributed to a rapid

Figure 2. Gross capital inflows to developing countries by region and type



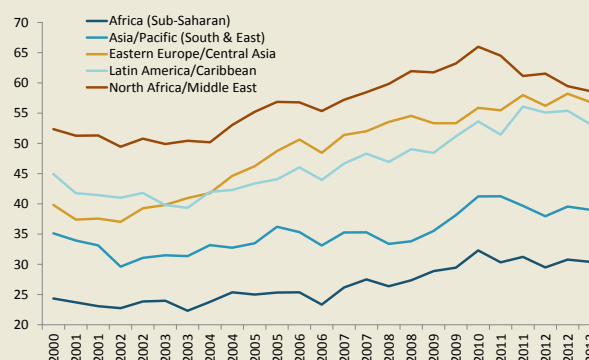
Source: World Bank, based on IMF Balance of payments statistics.

recovery in financial flows to developing countries. As demonstrated throughout this Chapter, exceptionally loose monetary policy in high income countries also contributed significantly to the vigorous resurgence of financial inflows to developing countries in the post crisis period (peaking at 8 ½ percent of their combined GDP by mid-2011), increasing the probability of a reversal of inflows once conditions normalize.

This post-crisis upsurge was initially driven by a recovery in cross-border lending and later by a persistent rebalancing of portfolio investments, both largely influenced by global interest rates and risk aversion. As a result, the weight of developing country bonds in global fixed income portfolios reached before the summer 2013 levels last seen in the late-1990s (see Chapter 1).

Portfolio investments (bond and equity flows) have

Figure 3. Institutional investor rating for developing countries (relative to US and EU)



Source: Institutional Investor, World Bank.

been robust in most regions since 2009 (see figure 2). In contrast, bank lending has moderated – particularly in emerging Europe – due to continued deleveraging and balance sheet adjustments by banks in high income countries.

Foreign direct investment (FDI) has been most stable overall, although at the regional level the picture is more mixed. In Sub-Saharan Africa, FDI inflows have increased steadily in the post-crisis period, reaching 6 ½ percent of the region’s GDP most recently. This contrasts with South Asia and the Middle-East & North Africa where FDI flows have been declining (to 1.3 and 0.8 percent of regional GDP) respectively during the period 2011-13.

Over the last two years, capital inflows have moderated and stabilized at around 4.5 percent of developing-country GDP. The slowdown was also associated with stagnant international reserves, rising capital outflows and a deterioration of current account balances in a number of countries and regions.

As discussed in Chapter 1, since May 2013, expectations of a gradual unwinding of quantitative easing by the US Federal Reserve led to a significant portfolio adjustment on the part of global investors away from emerging developing countries. Issuances of developing-country bond, equity and syndicated bank loans dropped initially by around 30 percent — imposing significant adjustment pressures on the currencies, asset prices and foreign exchange reserves of several middle-income countries.

Modeling capital flows to developing countries

The remainder of this section presents the results of an econometric evaluation of the main determinants of capital inflows to developing countries, including both the role of domestic and global conditions on capital flows to developing countries. In addition it explores the likely impact on capital flows to developing countries to the recovery in growth and normalization of policies in high-income countries — examining both a scenario where financial markets react in an orderly fashion as well as two scenarios where the adjustment is less orderly.

Analysis of the sensitivity of developing country

capital flows to a recovery in high-income growth, and the tightening of macroeconomic policy likely to accompany it, followed a two pronged strategy.

In a first step, a panel regression was used to assess the relative importance of global and domestic factors in determining the equilibrium level of capital inflows. While useful to understand the long-term reaction (after all adjustment has occurred) to a change in global (or domestic) conditions, the panel regression cannot map out the short-term interaction and interplay between global factors (interest rates, uncertainty, high-income country GDP) and capital flows. To capture the short-term dynamics of capital flows in relation to changes in interest rates, market volatility and GDP growth, a multivariate vector autoregression model was estimated in a second step.

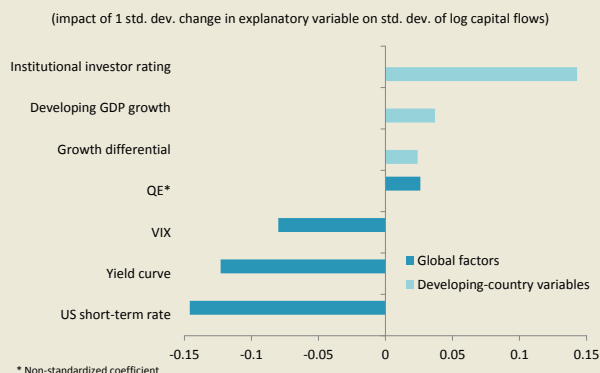
Accounting for global “push” and domestic “pull” factors

The economic literature suggests that capital flows to individual developing countries are determined by both global external conditions (“push” factors) and domestic factors (“pull” factors).^{FN2}

The model outlined in Box 1 was designed to control for the impacts on capital flows of changes in observable global conditions, including real (growth and growth expectations) and financial (interest rates and interest rate differentials) incentives, access to liquidity (global money supply), and global risk aversion. It also accounts for domestic pull factors (credit ratings, local interest rates, GDP levels) that can influence the volumes of gross capital flows to developing economies.

Importantly, the model does not attempt to tease out the full influence that extraordinary monetary policy measures undertaken in high-income countries had on capital flows. To do this would require determine the extent to which quantitative easing itself influenced the various drivers of capital flows (interest rates, liquidity, risk, and growth) — an question that is under active discussion in the literature, but over which there is little consensus as yet.^{FN3} Instead, the model simply uses a series of dummy variable to test whether extraordinary monetary measures may had an effect on capital flows that went over and above those

Figure 4. Impact of global and country-specific variables on capital flows



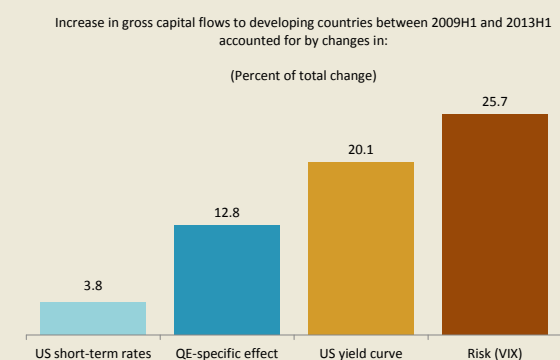
Source: World Bank.

coming through the modeled channels. The results obtained from the model are broadly consistent with the existing literature on observable factors associated with gross financial inflows (Alfaro, Kalemli-Ozcan & Volosovych 2008; Bruno and Shin 2013; Gelos, Sahay and Sandleris 2011; Forbes and Warnock 2012; Fratzscher, 2011). Capital flows to individual developing countries correlate with country ratings, and a number of global financial conditions—in particular the short-term interest rate, the yield curve, and the VIX index—also play an important role. The evidence for the effect of several other country-specific and global factors—such as growth differentials relative to the US, and aggregate developing-world growth—is somewhat weaker, and a number of factors, such as real interest rate differentials, turns out to be statistically indistinguishable from zero.

The various effects are summarized in Figure 4 which shows the response of gross inflows to one standard deviation change in each of the explanatory variables. The response of risk taking/uncertainty appears to be relatively small over the full sample (figure 4). However, because of its very large changes during the crisis and post-crisis periods, its variation between the first half of 2009 and the first half of 2013^{FN4} is estimated to have had the largest impact on capital flows during this period (figure 5).

Both domestic and global factors appear to be important determinants of capital flows to developing countries, with global factors (US interest rates, risk and the additional unmodeled influence of quantitative easing) together

Figure 5. Estimated contribution to increase in capital flows in the post-crisis period



Source: World Bank.

accounting for about 60 percent of the increase in capital flows between 2009 and 2013, with the remaining 40 percent explained by domestic factors such as countries' institutional investor rating, and developing country growth and growth differentials.

About thirteen percent of the total variation in capital flows during this period is picked up by the quantitative easing dummy, suggesting that capital flows were larger in the post-crisis period than would have been expected given the levels of other variables. These effects appear concentrated on earlier rounds of quantitative easing. When the quantitative easing indicator is split into separate episodes corresponding to QE1, 2 and 3, the impact on inflows diminishes between successive episodes. Indeed, when broken out, the QE3 variable is statistically insignificant — implying that by that time all of the impact of quantitative easing on capital flows has been accounted for by its affect (if any) on the traditional drivers of capital flows.

Implications for capital flows as global conditions normalize

The preceding analysis confirms previous research suggesting that global economic conditions play a major role in determining capital flows to developing countries.

As conditions in high-income countries improve (as output gaps are closed and growth realigns with underlying potential output) monetary policy can

Box 1. Modeling the influence of high-income policy (including quantitative easing) and domestic factors on capital flows to developing countries

The results reported in the main text of Chapter 3 are based on a panel econometric analysis designed to illuminate how global and domestic economic conditions influence the volume of capital flows to individual developing countries. The study uses an unbalanced panel of available quarterly gross financial inflows data for 60 developing countries for the 2000Q1-2013Q2 period, thus spanning 8 years of non-crisis year capital flows, and 5 years of post-crisis flows. These gross financial inflows comprise bond and equity portfolio flows, foreign direct investment, and cross-border bank lending, and were derived from the IMF Balance of Payments statistics and the Bank for International Settlements' Locational Banking Statistics, supplemented by national sources drawn from the Datastream and Haver Analytics databases.

The model allows for the influence on individual-country capital inflows of global economic variables ("push factors") that have been identified in the capital flows literature as affecting the propensity to invest as well as country-specific "pull factors" that capture time-varying characteristics of individual countries that may affect the allocation of funds across countries. The observable pull and push factors include measures used to capture:

- Global financial conditions, such as the US Federal Funds rate, the US money supply (M2), and the yield curve (the difference between the US long-term interest rate and short-term policy rates). The role of global uncertainty and risk aversion was proxied for by the VIX index.
- Real-side global conditions, such as high-income and developing world GDP growth, and the global composite purchasing managers index (PMI), which proxies for growth expectations.
- Domestic pull factors, including country GDP levels and institutional investor ratings, a country-specific (lagged) GDP growth differential (relative to the United States), and the interest rate differential between the developing country vis-à-vis the United States.^{FN5}

The extraordinary measures taken by central banks, in the United States, Europe and Japan are likely to have influenced several of the global variables: short-term interest rates would have been affected by conventional monetary policy; the structure of the yield curve would have been affected due to the Federal Reserve's purchase of mortgage-backed securities and long-term debt on secondary markets; and market uncertainty along with U.S. and global growth may have benefited from stimulatory monetary and fiscal policies. To the extent that such measures may have influenced these drivers, their influence on capital flows will have been captured in the regression.

To account for the possibility that extraordinary monetary measures have operated through other unobservable channels (or through conventional channels over and above these observable measures), a series of dummy variables covering the different episodes of quantitative easing were also included. Several alternative specifications were experimented with, including: a single QE dummy variable for all episodes of quantitative easing; separate indicator variables for each of the three episodes; and a continuous measure of QE interventions based on QE-related assets on central bank balance sheets. A non-zero coefficient on these dummies can be interpreted as indicating that there were additional influences on capital flows to developing economies due to quantitative easing that are not directly attributable to observable measures.

The baseline estimation employs econometric techniques that address the influence of time-invariant unobserved country effects, a time trend, and the possibility of bias due to the inclusion of a lagged dependent variable. In addition to the baseline, several additional variations were explored. To ascertain whether quantitative easing may have altered the magnitude of the influence of the conventional transmission channels (say by making flows more sensitive to interest rate developments), a specification that allowed for interactions between the indicator and the observable global variables was considered. However, this specification was not retained as there was little evidence in favor such interaction effects. Furthermore, specifications that included market expectations of future interest rate changes were considered, but not retained because these expectations variables were not statistically significant. Alternative specifications with additional controls, alternative measures of the main controls, and different estimation techniques were also considered, with little change to the baseline results.^{FN6}

More details including benchmark regression results and the regression results for the constituent components of gross flows are provided in Annex 1 (see also Lim, Mohapatra and Stocker forthcoming). Additional results on interactions, expectations and robustness tests are described in an additional annex available online at www.worldbank.org/gep.

be expected to normalize, and the extraordinary monetary policy measures that have been undertaken will be withdrawn. In this context, capital flows to developing countries should adjust to a new equilibrium.

Simulations based on the panel regression results

are shown in Table 1. These simulations are conditioned on the following underlying assumptions:

- Developing and high-income country GDP growth gradually strengthens in line with the projections presented in Chapter 1.

Table 1. Baseline results: a modest decline in capital flows as global conditions normalize

	History		Baseline		
	2012	2013	2014	2015	2016
Developing GDP growth	5.0	5.4	5.5	5.8	5.9
G4 GDP growth	1.4	1.1	2.2	2.4	2.4
Yield curve	1.7	2.1	2.5	2.6	2.3
G4 10 Y Bond Yields	2.2	2.4	2.9	3.2	3.5
G4 3 m interest rates	0.4	0.2	0.3	0.6	1.2
VIX Index	18	15	16.9	18.2	18.9
Deviation in gross capitals from a "no change" scenario					
% of flows			-3.7	-7.4	-10.0
% of developing country GDP			-0.22	-0.42	-0.56

Note: Tan background implies an exogenously given variable

blue background shows VIX simulations derived from the VAR model

gold background denotes results from the panel regression

Source: World Bank.

- QE Tapering by the US Federal Reserve starts in 2014Q1 and has a very gradual effect. It adds 50bp to US long term interest rates by the end of 2015 and a cumulative 100bp by the end of 2016. Policy rates in the US start to increase in 2015Q2, from 0,25% to 2% by the end 2016.
- The ECB, Bank of Japan and Bank of England, start to unwind their own quantitative / qualitative policies in the course of 2015/16, adding 50bp to their long term yields by the end of the forecast horizon, and tighten policy rate later than the US Fed.

Based on the above baseline assumptions, the VAR model described in Box 2, which maps out the inter-temporal relationships between GDP growth in high income and developing regions, global interest rates and uncertainty / risk taking, suggests that the VIX index will gradually rise back toward its long-term average of close to 20 by 2016, some 25 percent above current low levels.

Feeding these global “push factors” into the earlier panel regression results points to a baseline decline of capital flows (relative to a “no change” scenario) of about 10 percent by 2016 (see Table 1), or a 0.6 percent of developing country GDP decline in capital flows by 2016.

These results confirm that a gradual normalization of global conditions would be accompanied by a

modest decline in capital inflows — although at more than 4 percent of GDP broadly in line with their average level between 1990-2003.

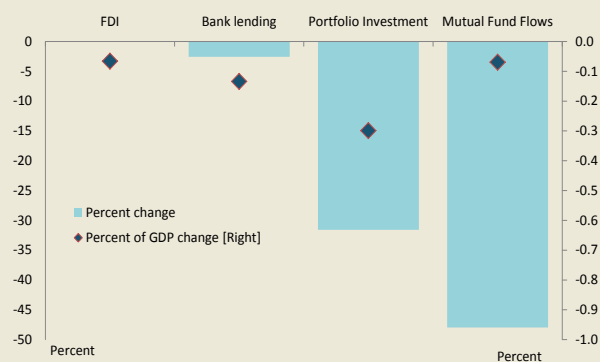
Looking a bit deeper

The above results refer to the sum of all capital flows (portfolio flows, international bank lending, and foreign direct investment). When flows are decomposed into their constituent components, portfolio flows are both the most volatile and the most sensitive to the external drivers associated with global financial conditions.

Estimates of the capital flow model performed on each of these flows individually suggest that equilibrium portfolio flows are sensitive to changes in short-term interest rates, the yield curve, and global risk aversion, as well as to the QE indicator. Equilibrium foreign direct investment, in contrast, tends to be relatively insensitive to the effects of global push factors, although such flows are much more responsive to country specific credit ratings, a result consistent with the literature (Alfaro, Kalemli-Ozcan & Volosovych 2008, Dailami, Kurlat and Lim 2012).

Cross-border bank lending falls into an intermediate category. In particular, the coefficient on the QE dummies was the largest for bank lending—suggesting that more so than for the other flows QE operated through channels other than those modeled to boost bank lending. On the other hand, bank lending was also much less sensitive to the observable fundamental factors. This suggests that the response of overall gross flows to global risk conditions and QE-specific effects are driven to a large extent by the behavior of portfolio capital flows (see figure 6). When flows into developing-country bond and equity mutual funds (a subset of portfolio flows) are considered, the sensitivity of these flows to changes in both the short-term interest rate and yield curve is much higher than for overall portfolio flows, and for other types of capital flows.

To the extent that this historical pattern between different flows persists over future tapering scenarios, portfolio flows are estimated to decline in the first year by 33 percent, while bank lending falls to a much smaller extent, and FDI flows hardly move at all (under the gradual tightening scenario). Partly as a result, the impact on regional capital flows may turn out to be very different.

Figure 6. Estimated decline in capital flows relative to no policy change baseline by type

Source: World Bank.

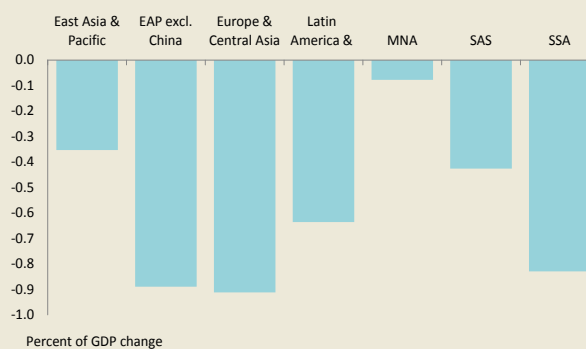
For regions such as East Asia & Pacific (excluding China) and Europe and Central Asia—where portfolio flows represent 53 and 45 percent of total flows respectively—enduring declines in inflows may be significantly larger than the declines in regions like Latin America, the Middle-East and North Africa, or South Asia where portfolio flows are a much smaller proportion of total flows (see figure 7).

Sub-Saharan Africa is the third largest in terms of impact. While in other regions the large overall impact is due to the disproportionate share of portfolio flows in overall flows, in Sub-Saharan Africa these flows are relatively small (outside of South Africa FDI is the dominant type of gross inflows—72 percent of the total). However, both capital flows and portfolio are a particularly large share of Sub-Saharan Africa's GDP (See earlier figure 2) and as a result the impact of reduced portfolio flows is a relatively large share of Sub-Saharan GDP.

Tracking the dynamic behavior of capital flows and overshooting risks

The above results assume that monetary authorities in high income countries are able to engineer a gradual increase in long-term interest rates as quantitative easing is withdrawn in line with improved growth conditions.

However, the experience of the summer of 2013—when the yield on 10-year US Treasury bills jumped by some 100 basis points in a just a few months—

Figure 7. Estimated decline in regional capital flows relative to no policy change baseline

Source: World Bank.

suggests that such a smooth market reaction to an eventual tapering of quantitative easing is not assured. The next set of results considers the impacts on both global push variables and capital flows under two alternative scenarios:

- “Fast normalization”: long-term interest rates snap up by 100 basis points in the first half of 2014, before gradually converging back to baseline levels over the subsequent two years;
- “Overshooting”: market reactions are assumed to be more abrupt, resulting in a sharp (200 bp) increase in long term interest rates in first half of 2014, followed a more protracted adjustment back to the baseline;

To assess dynamic adjustments and risks of disorderly impacts on capital flows, the VAR model described in Box 2 was used to explore the inter-temporal behavior of both global drivers and actual capital flows^{FN9}.

Figure 8 illustrates the adjustment path for three of the co-determined variables (gross capital flows to developing economies; long-term interest rates and market volatility, the VIX) in the VAR system under the three scenarios. In the baseline, the capital flow projections resulting from the VAR simulations are very similar to those drawn from the panel regression, with the share of capital inflows to GDP in developing countries declining by 0.5 percent over the projection horizon.

In the two more extreme scenarios, deviations from the baseline are pronounced. In the “fast

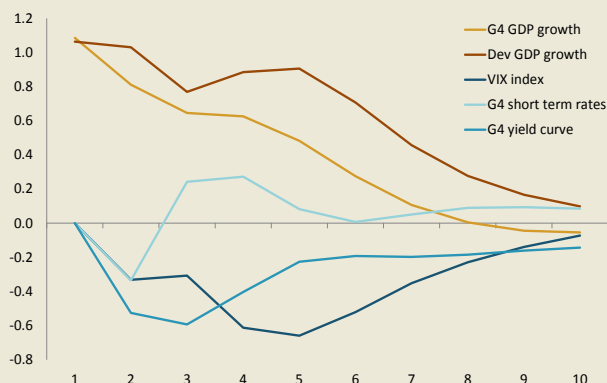
Box 2. Modeling the inter-temporal adjustment path

Inter-temporal interactions between global “push” factors, capital inflows and GDP growth in developing countries are modeled using a six-dimensional Vector Auto-Regressive model (VAR), estimated over the period 2000Q1 to 2013Q2 (see Appendix 2 for a detailed description). The VAR jointly models aggregate gross capital flows to developing countries as a share of their combined GDP; real GDP growth in both developing and “G4” countries (US, euro area, Japan and UK); “G4” short term interest rates; the G4 yield curve (10 year government bond yields minus 3 month interest rates), and the VIX index of implied stock market volatility, a popular measure of the pricing of financial market risks.

The impulse response of aggregate capital inflows in developing countries to one standard deviation shock in the other four variables is presented on Figure B2.1. At first sight, changes in growth patterns between developing and G4 countries seem to be dominant drivers, with the effect of shocks persisting for about 1 ½ year. Rising risk aversion (increase in the VIX) and a steepening of the G4 yield curve are both associated with lower capital inflows (as a share of GDP), with peak effects after about 4 quarters. The direct impact of changes in short-term interest rates in the G4 region is small.

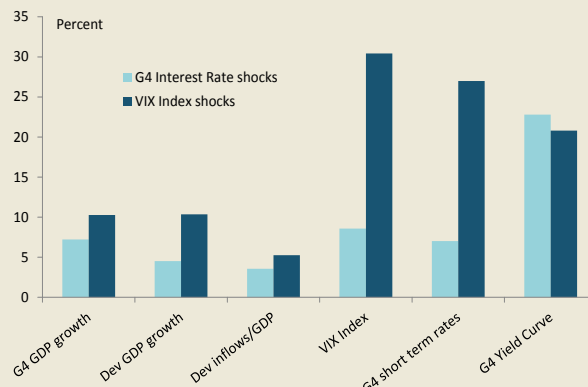
Further investigation shows more complex interactions between global factors and highlights the central role of uncertainty and changes in risk assessments in the transmission of monetary shocks. In particular, an increase in VIX leads within 4 quarters to lower short term interest rates, a steepening of the yield curve and weaker growth in the G4 and developing countries. The impact of market distress on global growth and the slope of the yield curve serve to amplify the initial effect of increased uncertainty on capital inflows.

Box Figure 2.1 Response of developing-country Capital inflows (% of GDP) to one S.D. shock in:



Source: World Bank.

Box Figure 2.2 Share of variance explained by VIX and G4 interest rate shocks (after 2 years)



Source: World Bank.

For the sample period 2000Q1 to 2013Q2, the model suggests that changes in risk aversion explain around 10 percent of the variance of GDP growth in both G4 and developing regions, 20 percent of changes in the yield curve and 25 percent of changes in short term rates.

In addition, the VIX index is itself the variable in the model most sensitive to changes in monetary conditions, with lower interest rates reflected within two to three quarters in lower risk aversion. About 8 percent of the variance of VIX is explained in the model by such change in monetary conditions. These results are consistent with recent studies, which tend to assign an even bigger role of interest rate shocks in determining the price of risk. For instance, Bruno and Shin (2013) find that US Federal Fund Rates explain almost 30 percent of the variance of the VIX at horizons longer than 10 quarters while Bekaert et al (2012) find that monetary policy shocks account for 20 percent. Rey (2013) presents estimates comparable to ours (between 5 and 10 percent).

normalization” scenario, the resulting increase in market volatility and rising risk aversion leads to a sharper but partially temporary correction in flows. In this context, foreign capital inflows drop by an average 30 percent in 2014 with a peak impact of 50 percent towards the end of the year. As discussed in Box 3, the magnitude of these simulated effects is broadly consistent with the

adjustments observed during May-September 2013, a period that lies mainly outside of the estimation period of the model.

In the “overshooting” scenario, where long term interest rates spike by 200 bp in 2014, flows would then drop by 45 percent in 2014 as whole, and up to 80 percent at the peak impact.

Figure 8. Normalization scenarios, overshooting risks and capital flow projections



Source: World Bank.

Such a correction in capital flows, albeit temporary, would have important bearing on the probability of isolated or more diffused crisis under different

macroeconomic scenarios. This is being addressed in the last section of this Chapter.

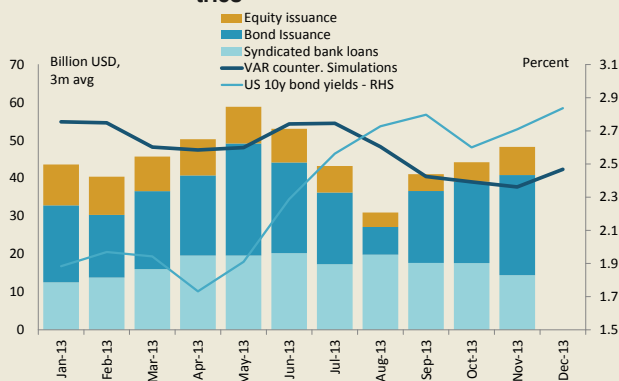
Box 3. A live experiment: tapering expectations and capital flows during the summer of 2013

The simulations derived from the Vector Auto-Regressive (VAR) model can be compared with actual developments after the Fed tapering announcement in May 2013. Following the Congressional testimony of the Federal Reserve Bank's chairman on May 22 2013, laying down the conditions for a gradual unwinding its asset purchase program, the US long term interest rates increased suddenly by 100bp and the VIX index initially rose from 15 to 20. Emerging market bond spreads increased significantly, issuances of developing-country bond, equity and syndicated bank loans dropped by around 30 percent during the summer (see Box Figure 3.1).

Although the aggregation of bond, equity and syndicated bank flows is conceptually different from the Balance of Payment data gross flow data used in our modeling strategy, the observed deceleration of flows during the Summer of 2013 is largely consistent with the elasticities estimated in the VAR model. Counterfactual simulations show that a more gradual decline predicted by the VAR model but of broadly similar magnitude (see Box Figure 3.1). As presented in the "fast adjustment" scenario above, a 100bp shock to the yield curve generally translates within 2 quarters into a drop in inflows by around 50 percent, with the VIX index predicted to increase by 6 points .

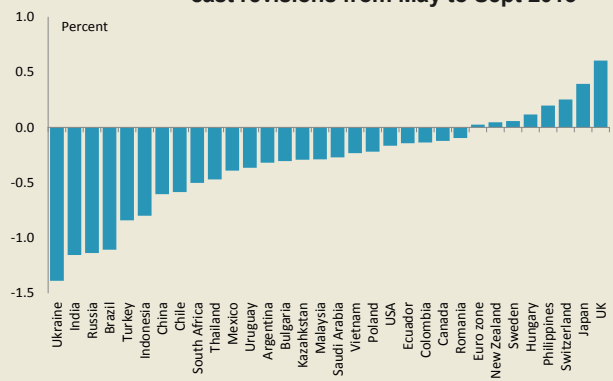
The observed impact of financial market tensions during the summer was also reflected in a deteriorated outlook for many developing economies, particular among those considered most vulnerable (see Figure B3.2).

Box Figure 3.1 Gross capital inflows to developing countries



Source: World Bank.

Box Figure 3.2 2014 real GDP growth consensus forecast revisions from May to Sept 2013



Source: Consensus Economics, World Bank

Disequilibrium risks

The preceding analysis suggests that in the long run, the withdrawal of quantitative easing and a return to a tighter stance of monetary policy in high-income countries will have a relatively small impact on gross capital flows reducing them from 4.6 percent of developing country GDP in 2013Q3 to 4.0 by the end of 2016. However, the path to this new normal level of flows will matter.

If market reactions to tapering decisions are precipitous, developing countries could see flows decline by as much as 80 percent for several months. This would raise the likelihood of abrupt stops at the individual country level, with as many as 25 percent across the developing world experiencing such episode (see Box 4).

While this adjustment period might be short-lived, it is likely to inflict serious stresses on the financial and economic conditions in certain countries – potentially heightening crisis risks.

A brief history of crises in developing countries.

According to data compiled by the IMF (laeven and valencia, 2012), between 1970 and 2009 there were some [147] financial crises globally (figure 9). Of these [123] occurred in what are now classified as developing countries, and 95 developing countries had at least one crisis. These crises have tended to occur in clusters, with currency crises and

banking crises much more common occurrences than sovereign debt crises. The clustering suggests that crises are either being caused by common factors or that there are important contagion effects.

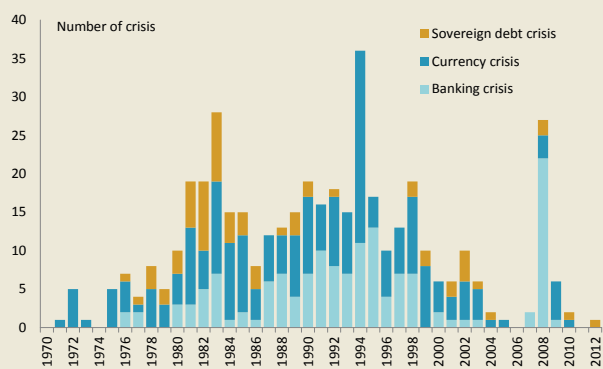
Crisis in developing countries tend to occur following a capital surge episodes, but at the same time as sudden stops in capital flows (see figure 10). While the sudden stop relationship is clear, the causality is less so^{FN9 FN10}. Does the stop in capital flows precipitate the crisis, or do the flows stop once a crisis has begun? What is clear is that banking crises tend to be more common following a capital surge. Thirty-four percent of banking crises occurred within two years after a surge in capital inflows to the country, versus only 20 percent for currency crisis and 17 percent for sovereign debt crisis^{FN11}. Moreover, the evidence suggests that having had a banking crisis in the preceding two years increases the likelihood of a sovereign debt or currency crises, while these other kinds of crises do not increase the likelihood of later banking crises to the same extent^{FN12}.

A more formal look at banking crises

An econometric analysis of the factors associated with an increased probability of crises in developing countries tends to confirm the linkages between the incidence of these crises, global factors and individual country characteristics and vulnerabilities (see Box 5).

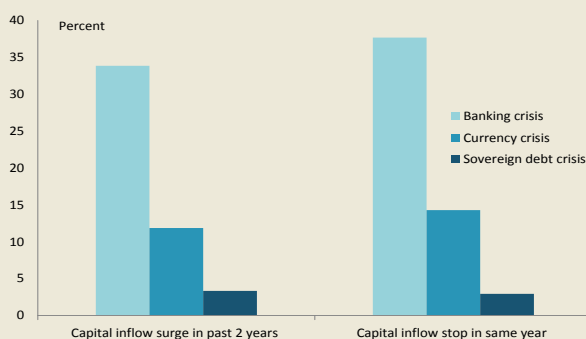
There is a very large empirical literature on banking crises^{FN13}. While early work typically focused on domestic causes of banking crisis, especially in a

Figure 9. Frequency of sovereign, currency and banking crisis



Source: laeven and Valencia (2012), World Bank.

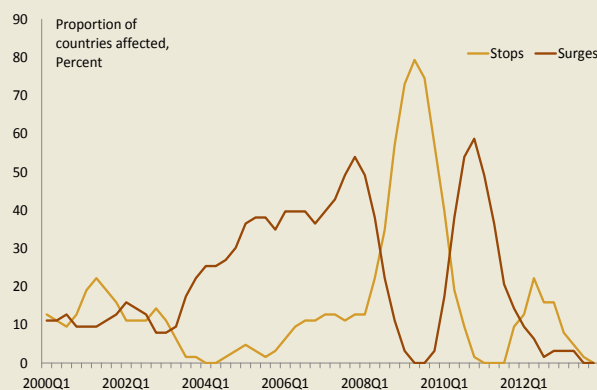
Figure 10. Capital inflows surges, stops and frequency of financial crises in developing countries



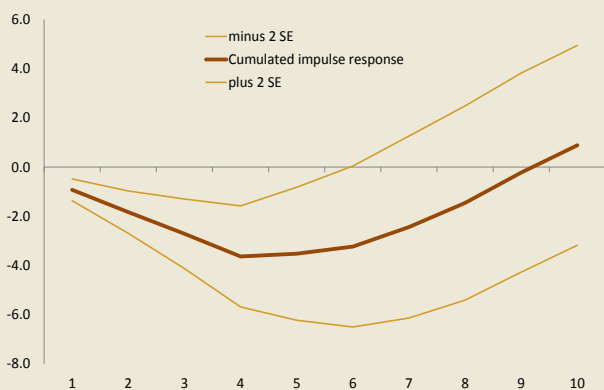
Source: laeven and Valencia (2012), World Bank.

Box 4. Capital surges, stops and aggregate capital flows

As discussed, in the main text, capital flow surges tend to precede financial crises, and crises tend to occur at the same time as sudden stops. The surge in capital flows in the pre-crisis period was typical (see Box Figure 4.1), and some 80 percent of developing countries suffered a sudden stop in flows in its aftermath (of which xx percent had a crisis). The post-crisis rebound, which also classifies as a surge, was also followed by an increased incidence in stops, with 15 percent enduring such episode during 2012-13. The methodology used here to identify surge and stop episodes at the individual country level is based on Forbes and Warnock (2012), with the threshold being defined changes in flows being larger than one standard deviation around a 5 year rolling mean.

Box Figure 4.1 Gross capital inflow episodes in developing countries

Source: World Bank.

Box Figure 4.2 Frequency of stop episodes: impulse response to changes in aggregate flows

Source: World Bank.

The link between aggregate capital flows to developing countries and the proportion of these countries going through either surge or stop episodes can be approximated empirically using a simple Vector-Autoregressive Model approach. Over the period 2000Q1 to 2013Q2, the relationship can be summarized with the following accumulated impulse response (based on a 4 lags VAR selected through the HQ and AIC criteria).

Overall, a one standard deviation decline in the ratio of aggregate capital flows to GDP in developing countries in the course of a quarter (about a 2.7 percent of GDP decline), tends to increase the proportion of countries experiencing sudden stops to 22 percent after 4 quarters. In the “overshooting” scenario presented in the previous section, capital flows are predicted to decline by 3 percent of GDP, implying that more than a quarter of developing countries could experience sudden stops in such scenario .

context of developing countries, more recent work has focused on the effects of outside forces, such as global monetary and financial developments and contagion, on the likelihood of a crisis in a given country^{FN14}.

Relative importance of global, contagion, and domestic factors

The regression results (see Annex Table xx) generally confirm the influence of both global and domestic factors in determining the onset of banking crisis. The modeling strongly suggests that the risk of a banking-crisis rises following an extended period of low interest rates and loose

global monetary conditions that have suppressed global risk aversion and increased liquidity. Risk is further heightened if global agricultural prices are high – which may be a reflection of the strong correlation between capital flows and high commodity prices (Reinart and Rogoff, 2009). Somewhat counter-intuitively, the model suggests that high energy prices in previous years reduce the likelihood of a crisis in any given year perhaps because high oil prices cause oil importing countries to retrench and reduce vulnerabilities.

Among the contagion variables examined, only the trade linkages variable (the share of trade with other countries in crisis) was consistently statistically significant. As expected domestic factors play a critical role in determining whether

Box 5. The banking-crisis regression model

To assess the role of all three concepts (global, contagion, and domestic factors) on the likelihood of a crisis in a given developing country, an unbalanced pooled probit model is estimated (see Appendix 3 for a detailed description) the probability that a country will suffer a banking crisis is modeled as a function of global factors, contagion factors, and domestic factors.

The modeling work focusses on banking crises in developing countries using crisis data developed by Laeven and Valencia (2012) as the determinants of banking causes in developing countries may be distinct from those of high income countries (Eichengreen et al., 1996, 1998, 2000). To avoid sample selection problems, explanatory data for the 67 developing countries that did not have banking crisis are added to the 95 developing countries in the Laeven and Valencia data set, all of which had banking crisis during the sample period. Observations for the three years following a crisis are dropped from the panel, so that the explanatory power of domestic factors that may have triggered a crisis are not diminished by inclusion of their post-crisis period when the binary crisis variable would be zero. All explanatory variables are entered with a one period lag, in order to minimize endogeneity problems.^{FN16}

Global factors

Seven measures of capture global effects were tested for the model, covering global risk appetite, global interest rates, global growth, global liquidity, global bank leverage, and global commodity prices.^{FN17} Global risk appetite was proxied by the Chicago Board of Trade Volatility Index (VXO), a measure commonly used to capture risk appetite in the global financial markets.^{FN18} [Need to check FN18 and revise.] Global growth is measured by the first principal component of real GDP growth in the US, Japan, UK, and Germany. Global liquidity is proxied by M2 as a share of GDP in the United States. Global interest rates are measured by the first principal components of rates on long-term government bonds in the G4.^{FN19} [Need to check the FN19 and revise.] Global commodity prices are measured by agricultural commodity index and energy commodity index.^{FN20}

Contagion factors

Following Forbes and Warnock (2011) and IMF (2013), but giving precedence to variables that allowed for a wider country coverage, four variables were included to capture contagion effects: trade openness, trade linkage, financial linkage, and regional contagion. Trade openness is measured by a country's trade with the rest of the world scaled by its GDP. Trade linkage is defined by a bilateral trade volume between two countries (scaled by each country's total trade with the rest of the world) and multiplied by an indicator variable defined as equal to 1 if the trading partner is experiencing a banking crisis, and to 0 otherwise. Financial linkage is defined by the total bank claims between a country and BIS reporting banks scaled by GDP to capture the country's degree of integration with the global financial markets and hence exposure to financial contagion. Regional contagion is defined as the number of countries in the same region experiencing a banking crisis.^{FN21}

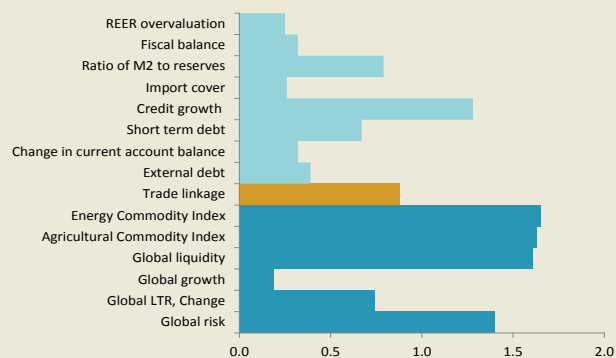
Domestic factors

Ten separate variables were considered to capture country-specific factors: current account and fiscal balance, total external debt and a share of short term debt, domestic credit growth, inflation, per capita GDP growth, ratio of M2 to reserves,^{FN22} and a measure of real exchange rate overvaluation.^{FN23} The definition of each variable is shown in Table x in the appendix .

an individual country enters into crisis. High-levels of foreign and short-term debt, an earlier period of rapid domestic credit growth (measured as the change in credit to GDP rates over the previous 5 years), low levels of international reserves, and an overvaluation of the real exchange all increase the of risk of banking crises.

Figure 12 reports the estimated sensitivity of banking crises to the different variables identified in the econometric work. It shows the absolute value of the relative importance of each identified factor in contributing to an increase or decrease in the likelihood of a crisis. Empirically, between 2000 and 2010 the global variables have played the

Figure 11. Estimated in-sample contribution to changes in banking-crisis risk



Source: World Bank.

Box 6. Monetary policy, domestic credit growth and country-specific vulnerabilities

The “imported” easing of monetary conditions through large capital inflows in recent years has contributed to rapid credit expansion, widening current account deficits and increasing banking sector vulnerabilities in some cases.

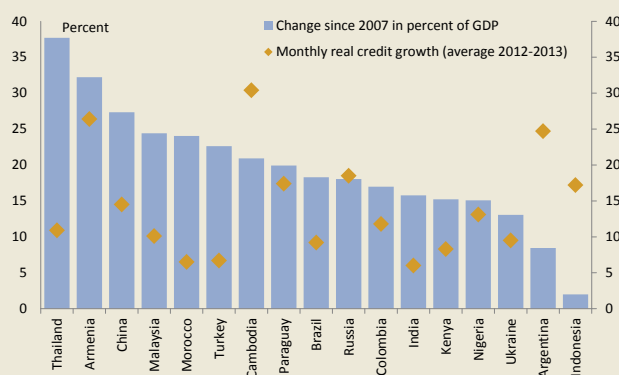
The surge of capital flows in the post crisis period has contributed to lenient domestic credit conditions, directly through cross-border intermediation channels and indirectly through exchange rate and monetary policy spillovers. Regarding the latter, a simple Taylor predicting the monetary policy stance of central banks in developing countries on the basis of domestic conditions (deviation of consumer price inflation from the policy target and the level of slack in the economy) suggests that policy rates were kept lower than normally suggested during periods of large capital inflows (Figure xx and He & McCauley (2013).

In this context, domestic credit has grown very rapidly in several developing countries in recent years, increasing the vulnerability of some economies to a rapid tightening of financing conditions. Outstanding credit exceeds 100 percent of GDP in 15 developing economies, and rose as a share of GDP by 15 or more percentage points in about 40 developing economies between 2007 and 2012. The sharpest upsurge was recorded in Thailand, Armenia, China, Malaysia, Morocco and Turkey. Robust real credit growth continued during 2012 and 2013 in Cambodia, Argentina, Armenia, Indonesia and Paraguay. Monetary, fiscal and regulatory tightening in several countries, including China, Brazil, India, and Indonesia, has helped contain a further build-up of credit risks but banks’ exposure to rising interest rates as become an increase source of concern since the start of QE tapering expectations

Box Figure 5.1 Policy rates and “Taylor rule” rates in emerging and developing countries



Box Figure 5.2 Domestic credit growth in selected developing countries



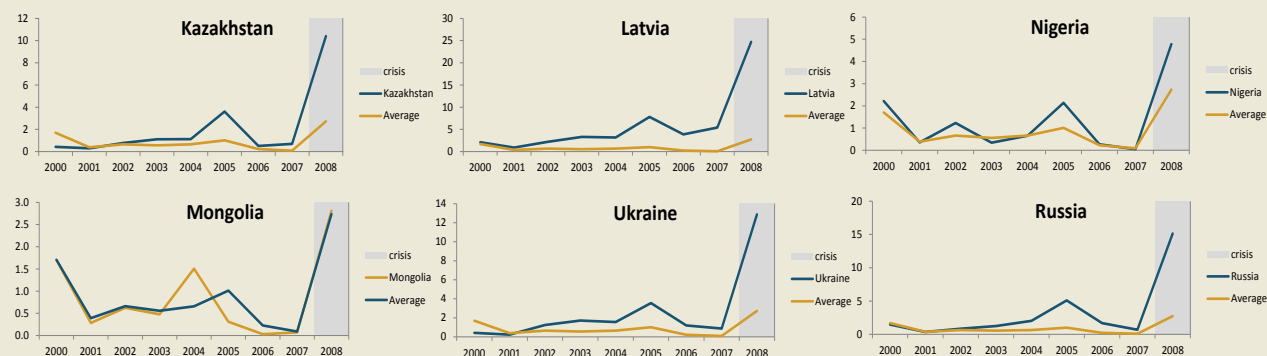
largest role – explaining about 58 percent of the changes in country level banking-crisis risk. Domestic factors – particularly an increase in credit to GDP ratios over the previous 5 years, short-term debt and overall money supply are also important contributors to risk. Changes in these variables explain 35 percent of all the variation in risk over the sample period.

That said, it should be recognized that domestic variables are not entirely independent of external variables. In particular, as discussed in Box 6 loose financial market conditions at the global level can feed through to rapid credit growth, exchange rate changes and fluctuations in reserves at the domestic level. The main difference being that while developing economies do not have the policy levers with which to affect global financial conditions, they can influence the extent and manner in which

these bleed through into the domestic economy (see following discussion on policy).

Model prediction

Probability models like that used here to estimate the sensitivity of banking crises to external, domestic and contagion factors tend to have low predictive power because the events they model are low-probability events. One measure of the adequacy of such models is the proportion of threshold events it correctly predicts (and the proportion of non-events that it correctly predicts). By these measures, the model outlined in column 5 of Annex Table A3.3 does a reasonable job in predicting banking crises in developing countries—a conclusion supported by the AUROC statistic of more than 80 percent in the preferred model specification.

Figure 12. Model predictions for 2008/9 banking crisis

Note: The figures show the predicted risks for the countries that experienced systemic banking crisis (blue) vis-à-vis the average predicted risk for the non-crisis sample (red) based on the econometric model reported in Chart 2.

Another measure is to compare the prediction of the model with actual events (within-sample prediction). Figure 13 plots the estimated probability of a crisis for six of the eight countries that had banking crises in 2008–09 compared to the average predicted risk for all countries during the same period. In all cases, the model suggests an above average risk of crisis for those countries that did have a crisis. Moreover, for all countries the predicted risk of crisis increased rapidly prior to and including the year of crisis. However, in the cases of Mongolia and Nigeria, the predicted likelihood of banking crisis was only marginally higher than the average for all countries.

Assessing current risks

Given current conditions, empirical analysis of banking crisis risks suggests that several countries might be subject to heightened vulnerabilities.

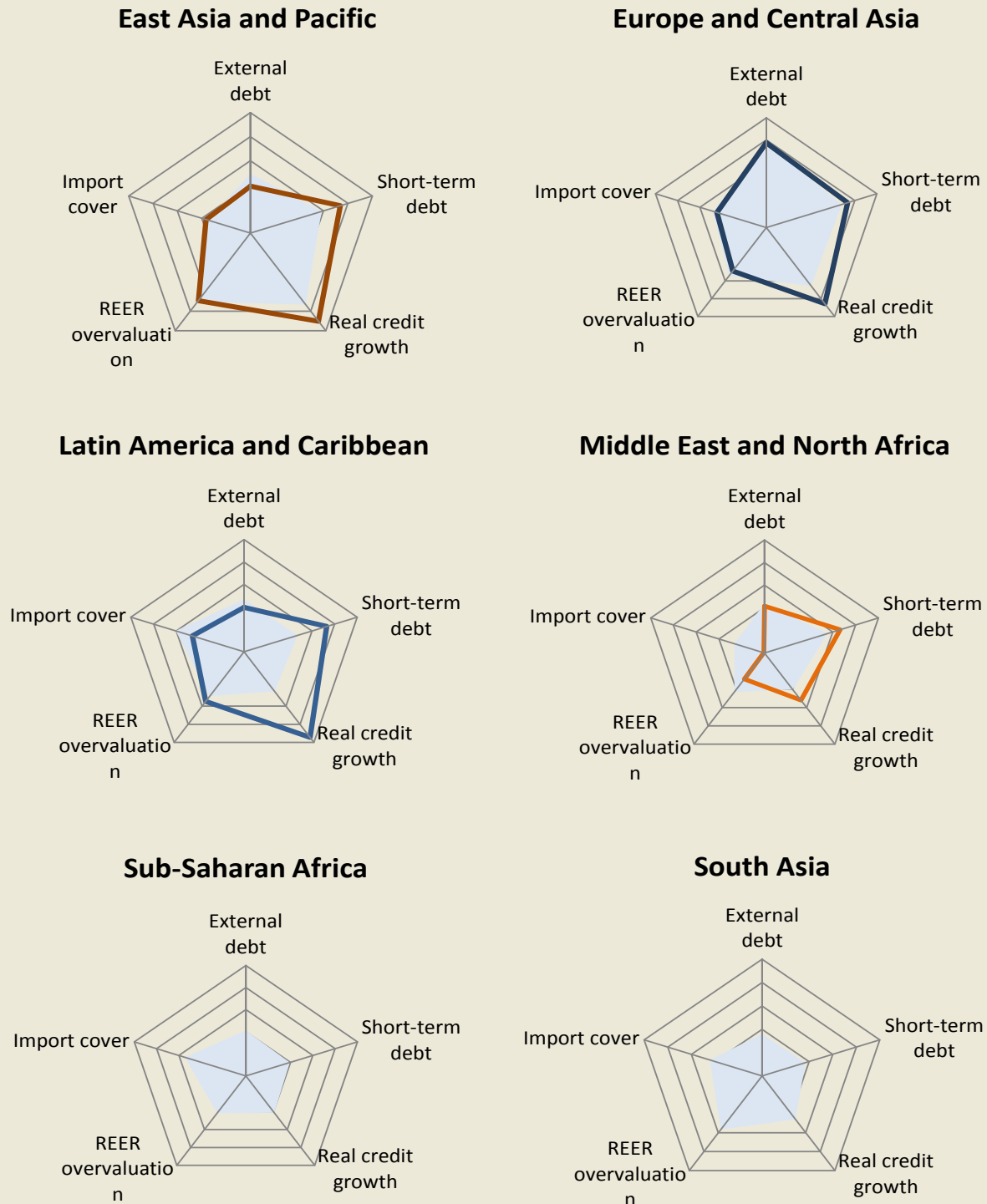
Figure 13 presents key domestic risk factors in those countries. Countries are arranged by region and in alphabetical order. The shaded areas in the table indicate dimensions where current levels are above the 75th percentile of countries for which data are available. Although conditions on the ground will vary and these kinds of gross indicators need to be interpreted with a great deal of caution, the results are instructive and point to areas of vulnerability that individual countries may need to address if they are to reduce risks of a crisis as external conditions tighten.

While results vary widely across countries within regions, some commonalities can be seen at the

regional level.

- In the East Asia & Pacific region rapid credit expansions over the past 5 years, coupled with a rising ratio of short-term debt in total debt are common areas of concern.
- In Europe & Central Asia a high external debt to GDP ratio, which exposes countries to exchange rate and roll-over risk, is an issue in several Central and Eastern European economies, with a heightened share of short term debt in that total being a further concern in several others. High-short term debt ratios makes a given level of debt much more sensitive to short-term swings in investor sentiment or capital flows as might occur in the fast tightening and overshooting scenarios discussed in the previous section. Rapid credit growth is a further issue of common concern in the region with credit to GDP ratios have risen sharply over the past 5 years in a number of economies – increasing the sensitivity of loan quality (and bank solvency) to the kind of sharp rise in interest rates discussed above.
- In Latin America & the Caribbean risks fewer countries appear to be at immediate risk, with rapid credit growth combining with significant short-term debt ratios and exchange rate overvaluation as the main sources of risk.
- In the Middle-East & North Africa, where political turmoil has cut deeply into economic growth in recent years (see Chapters 1 and 2),

Figure 13. Domestic sources of risk by region



Source: World Bank.

Note: Radar charts summarize areas of elevated risk in each region. Each segment corresponds to domestic risk factors from the regression analysis. The center is the least risky area, and the further away from the center, the greater the risk. The thick line in each region represents the average value of each indicator among the countries whose predicted crisis risk is particularly elevated (one standard deviation above the average predicted risk of the entire sample). The grey area represents the average values of each indicator for the region as a whole. There are no countries whose predicted risk is more than one standard deviation above the average predicted risk in Sub-Saharan Africa and South Asia. Indicator values are standardized using percentile ranks.

banking-sector risks stem mainly from rapidly deteriorating current accounts, which increase reliance on external capital flows, and rapid increase in credit to GDP ratios.

- Based on existing data risks in South Asia appear low, but there are concerns that non-performing loans in India are being under-reported and there too there has been a significant deterioration in current account balance.
- In Sub-Saharan Africa, only a few countries appear to have elevated risk, with rapidly deteriorating current account positions in a common thread, along with high exposure to short-term external debt in a few.

Policy response to weaker capital flows

The preceding analysis suggests that in a benign scenario combining a gradual recovery in advanced economies and an orderly normalization of global financial conditions consistent with the baseline forecast of Chapter 1, the risk of a sharp decline in global capital flows is modest.

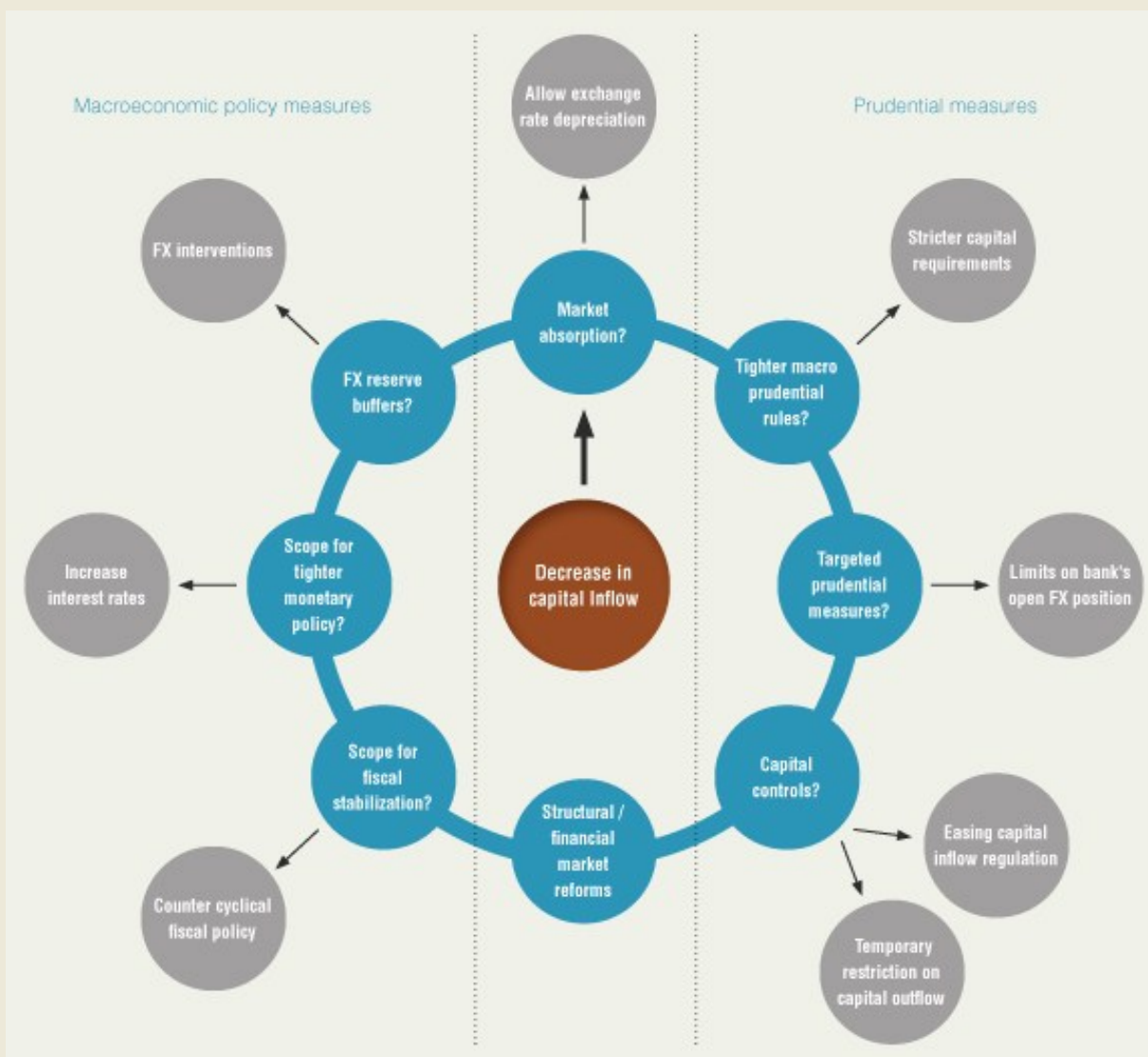
However, events around the summer of 2013 illustrate the difficulties in managing market expectations as major central banks plan their exit from unprecedented market interventions. As discussed above, an abrupt adjustment in global interest rates and increased financial market volatility could have significant impacts for capital flows, growth prospects and financial stability in developing countries, with effects likely being concentrated among those more financially integrated and with the largest vulnerabilities.

If a disorderly adjustment occurs, authorities have a range of policies at their disposal to deal with financial market pressures, bearing in mind that the appropriate mix will vary depending on the individual country situation and policy regime. Steps that were taken developing countries during the recent May-September period included:

- Use of international reserves to support domestic currencies and smooth the adjustment process;
- Implementation or exploitation of temporary swap arrangements with other central banks to increase access to liquidity and foreign currencies;
- Use of monetary policy to raise benchmark interest rates and increase the attractiveness of assets denominated in national currencies
- Imposition of prudential measures such as limiting the foreign exchange positions that investors can take, or adjusting capital requirements of banks
- Putting in place of temporary capital controls on outward financial flows, while removing impediments to capital inflows for foreign direct investments and institutional investors
- Trade measures designed to conserve foreign currency, such as temporary import restrictions in the form of quantitative limits for commodity importers, tariffs, taxes and export support measures;
- Budgetary consolidation policies, cutting subsidies and raising taxation;
- Reforms aimed at bolstering the investment climate, in particular for foreign investors.

Some of these measures worked by helping to smooth adjustment, or by restoring market confidence and thereby reduce short-term pressures. Others such as trade restriction, may have helped reduce pressures in the short run, but could have important distortionary effects and does not address underlying sources of vulnerability.

Figure 14 attempts to summarize the range of policy options available to countries for dealing with a sudden deceleration in capital inflows. Which policy response is right for which country will depend on country specific factors, including the exchange rate regime, the degree of capital openness, the structure of external and banking sector liabilities, and the existing state of fiscal and other macroeconomic imbalances.

Figure 14. Policy options to cope with a sudden deceleration in capital inflows

Source: World Bank

In general, countries with fully floating exchange rates should be able to rely more on market absorption mechanisms (like exchange rate depreciation) and counter-cyclical macro-stabilization - when sufficient buffers are available. Countries with less flexible exchange-rate regimes, large external liabilities and foreign denominated credit may have to focus more on prudential policies and temporary capital controls. Although limited capital account openness may shelter an economy from capital flight, these economies could still be vulnerable through the exposure of financial sector balance sheets, requiring particular

attention to specific contagion channels. Finally, the size of the country will matter, with small open economies having less room for autonomous macro and prudential policies.

From an operational perspective, the design of the most appropriate response will essentially be country specific, should involve multi-stakeholders and be transparent. No single solution will fit all. The rest of this section explores issues associated with individual policy options in greater detail.

Allowing currency depreciation

Relying on exchange rate depreciation in order to absorb adverse external shocks is appropriate if the depreciation does not itself exacerbate existing vulnerabilities (say from currency mismatch in the loan books of firms, banks or the sovereign) and is warranted by the fundamentals of the economy. Particularly in cases where currencies are already overvalued, currency depreciations could stimulate external competitiveness, reduce current account pressures and eventually lead to stronger domestic activity.

Such orderly adjustment would only operate in the presence of a flexible exchange rate regime and a credible macro-economic policy framework. The shift of many developing countries towards inflation-targeting central bank objectives, fully floating currencies and the “de-dollarization” of their economies have arguably moved a number of countries in this camp over the years.

Pursuing more active exchange rate and monetary policies

However, for countries with overvalued currencies and large current account deficits, a sudden decline in capital inflows could generate a disruptively rapid depreciation.

In such cases, temporary interventions in currency markets (leaning against the wind) by spending international reserves or invoking currency swap or other arrangements to reduce liquidity risks and slow the pace of adjustment towards a new equilibrium may be warranted. Swap facilities have gained particular prominence recently, with a growing number of bilateral agreements between central banks to improve liquidity conditions and limit strains on foreign exchange markets in times of financial stress.

However, exchange rate interventions tend to be effective only in the short-term, and a country’s ability to engage in them will depend on the size of reserves that it has accumulated in the past. Central banks may also be able to defend their currencies by tighten monetary policy and increasing the rate of return on domestic assets.

Such a policy is likely to be most effective in countries facing domestic inflationary pressures and excessive credit growth, but could be counterproductive in countries facing severe economic headwinds – if the induced slower growth exacerbates net outflows.

Using capital controls as part of a crisis mitigation strategy

Maintaining an independent monetary policy and stable exchange rate in the face of fully liberalized capital accounts can be very complicated because large capital movements will either be met by large exchange rate developments or undesirable cycles in domestic credit and money supply.

The “impossible trinity” of achieving monetary policy autonomy, stable exchange rates and full capital account openness is often cited as a reason for imposing some form of controls on capital flows and relying more on counter-cyclical prudential and fiscal policies. Capital controls may be particularly attractive for countries with less flexible currency regimes and large foreign currency denominated debt, where a sudden drop in gross capital inflows would more rapidly translate into financial stability risks.

As repeatedly emphasized by the IMF and the World Bank, capital flow management instruments are part of the relevant short term stabilization instruments to be used in a crisis situation. However, they should be used with caution given potential adverse effects on the level and cost of future financing and their mixed record in regulating large capital flow movements in the past (their effects seem to be most visible in changing the structure of foreign assets and liabilities rather than affecting overall fluctuations).

Countries have used both price-based controls such as taxes, as well as quantity restrictions. Evidence on which of these categories have been most efficient and least distortionary, and under what circumstances, is not yet conclusive.

Although discussions on capital controls as part of crisis mitigation strategies generally focus on managing capital outflows, the importance of counter-cyclical controls on inflows, where controls are tightened during an inflow cycle and

loosened during an outflow cycle, should be emphasized.

Capital controls also seem most effective when they are implemented as part of a broad policy package that includes sound macroeconomic policies as well as robust financial regulation. They should be temporary, being lifted once crisis conditions abate, and may need to be adjusted on an ongoing basis in order to remain effective.

Implementing targeted prudential measures

Tighter prudential rules on lending, stricter capital requirement and new regulatory initiative to rein excesses in the shadow banking sector are still a priority in some countries in order to limit the further accumulation of credit risks and prevent a damaging credit crunch.

In those countries facing more immediate external financing pressures, the focus should be on containment strategies. Targeted prudential measures aimed in particular at reducing foreign exchange exposure in the financial sector and foreign currency lending could be effective in certain circumstances, but affect by definition only those flows intermediated through the domestic financial sector and could have negative consequences for access to finance, in particular for small and medium size companies.

As bond and equity flows, in particular from foreign institutional investors, will arguably be most affected by rising global interest rates and the unwinding of quantitative easing policies, measures aimed at lifting barriers to such investments should be considered, along with targeted policies intended to open up new opportunities for foreign direct investments.

Restoring confidence through domestic reforms

Eventually, reforming domestic economies by improving the efficiency of labor markets, fiscal management, the breadth and depth of institutions, governance and infrastructure will be the most effective way to restore confidence and spur stability (see figure 15). As emphasized by the

Figure 15. Main policy pillars to restore confidence



Source: World Bank

dynamic recovery in most developing regions in the immediate aftermath of the global financial crisis in 2008-09, their resilience was significantly underpinned by a combination of a strong growth potential and an accumulation of substantial policy buffers.

Tighter liquidity standards, counter-cyclical fiscal and prudential rules are essential to build-up sufficient policy buffers and “lean against the wind” of disruptive cycles in capital flows. This requires a credible rule-based approach to macroeconomic and macro-prudential policies.

Developing countries should further enhance policies supporting private savings and domestic financial markets to intermediate it, hence reducing exposures to volatile external capital flows. These include long term measures focusing on education, pension and health care reforms and the development of better regulated domestic bond and equity markets. In this process, authorities should closely monitor the composition of both domestic and foreign liabilities, adjusting regulation to the ever changing nature of financial stability risks.

Reforms aimed at promoting growth and financial stability should not lose sight of the need for protecting the most vulnerable and developing social protection mechanism to better cope with global shocks.

Reinforcing global coordination

Finally, the framework for global policy coordination should be further strengthened in the context of the G20, better recognizing large cross-border spillovers from high income country policies, and the mutual benefits of greater financial and economic stability in the developing world.

Over the past five years, G20 members have made significant progress but a certain reform fatigue is apparent. Important gaps in building a more resilient global financial system, improving international oversight and limiting the propagation of systemic risks still need to be filled.

Regarding the G20 developments agenda, tangible progress in areas such as economic growth, financial regulation, trade, financial inclusion, infrastructure and climate change financing could make a significant contribution to promoting development and reducing poverty.

Erecting trade barriers to solve financial and economic headwinds would be counterproductive, and should be resisted in both high income and developing countries. The momentum created by the World Trade Organization agreement last December on trade facilitation, food security, development and access of least developed countries, could lead to new opportunities for growth and development and should be followed up with further multilateral efforts to open up trade in goods and services and strengthen disciplines for investment.

Appendix 1.**Technical note: Panel data model of global and domestic factors that can influence capital flows to developing countries***Data Sources*

The analysis of capital flows relies on an unbalanced panel of available quarterly gross capital flows data for up to 60 developing countries for the 2000Q1–2013Q2 period, thus spanning 8 years of non-crisis year capital flows, and 5 years of post-crisis flows (see country list in Annex table A.1). Aggregate gross financial inflows (GFIit) are defined as the sum of changes in foreign holdings of three categories of assets (portfolio, FDI, and loans) in the developing economy, net of their own disinvestment in each of these three flows. Gross portfolio and FDI inflows were drawn primarily on balance of payments data from the International Monetary Fund's International Financial Statistics (IFS). These were supplemented by data from national sources drawn from Haver Analytics and Datastream (where gaps exist), and with bank lending data from the Bank of International Settlements' Locational Banking Statistics (LBS).^{FN32} We also draw on EPFR Global's Global Fund Flows and Allocations Data—which compiles secondary market transactions of bond and equity purchases in emerging market mutual funds—to obtain a complementary fund inflow measure. The main explanatory and control variables were obtained from IFS, World Development Indicators (WDI), and central banks, supplemented with Datastream and Haver where gaps exist (see specific sources in Annex table A.2). Both capital flows and explanatory variables in the model are measured in real terms, in constant 2010 exchange rates and prices.

Table A1.1 Country list for panel data model of capital flows

Albania	Honduras	Nicaragua
Argentina	India	Nigeria
Armenia	Indonesia	Pakistan
Azerbaijan	Jordan	Panama
Bangladesh	Kazakhstan	Paraguay
Belarus	Kyrgyz Republic	Peru
Belize	Lao PDR	Philippines
Brazil	Latvia	Romania
Bulgaria	Lebanon	Russian Federation
Cape Verde	Lesotho	Seychelles
Chile	Lithuania	South Africa
China	Macedonia, FYR	Sri Lanka
Colombia	Malaysia	Suriname
Costa Rica	Mauritius	Thailand
Dominican Republic	Mexico	Turkey
Ecuador	Moldova	Uganda
Egypt, Arab Rep.	Mongolia	Ukraine
El Salvador	Morocco	Uruguay
Georgia	Mozambique	Venezuela, RB
Guatemala	Namibia	Vietnam

Note: The baseline sample is the largest available sample for the parsimonious and extended benchmark specifications

Model

The main dependent variable of interest, gross financial inflows (GFIit), and its component parts (portfolio investment flows, foreign direct investment, and cross-border bank lending) are each modeled as a function of variables meant to proxy for various factors associated with the movement of cross-border flows.^{FN29}

Table A1.2 Variable list for panel data model of capital flows

Variable	Source
Gross financial inflow	IMF International Financial Statistics, Datastream, Haver, Bank for International Settlements
Portfolio investment	IMF International Financial Statistics, Datastream, Haver
Foreign direct investment	IMF International Financial Statistics, Datastream, Haver
Bank lending	Bank for International Settlements' Locational Banking Statistics
Mutual fund flows (equity and bonds)	EPFR Global
US 3-month T-bill rate	US Federal Reserve; Datastream
US 10-year government bond yield	US Federal Reserve; Datastream
US money supply (M2)	US Federal Reserve; Federal Reserve Bank of St. Louis
VIX	Chicago Board Options Exchange, Datastream
GDP & GDP growth	Datastream, Haver, World Development Indicators
Global Purchasing Managers' Index (PMI)	JP Morgan; Markit
Central bank balance sheet expansion	US Federal Reserve; European Central Bank, Bank of Japan, Bank of England; Federal Reserve Bank of St. Louis.
Developing-country interest rates	IMF International Financial Statistics, Datastream
Country rating	Institutional Investor Ratings
Global savings	World Development Indicators
Trade/GDP	Haver, Datastream, IMF IFS, World Development Indicators
External debt/GDP	World Development Indicators, Datastream, BIS
Private sector credit/GDP	IMF International Financial Statistics

Note: All variables are at quarterly frequency, unless indicated otherwise

$$GFI_{it} = GFI_{it-1} + \pi GRC_t + \lambda GFC_t + \chi QE_t + \beta' X_{it} + CRISIS_t + POSTCRISIS_t + \alpha_i + \tau_t + \varepsilon_{it}$$

Measures used to capture relevant global financial conditions (GFCt) include the US Federal Funds rate; the US money supply (M2); the yield curve (the difference between the US long-term interest rate and short-term policy rates); and the VIX index. Increased short-term treasury yields raise the opportunity cost of alternative investments—including that of developing world assets—such that, ceteris paribus, capital inflows can be expected to fall, suggesting a negative coefficient a priori. The US M2 serves as a quantity-based measure of available liquidity: an increase in M2 indicates an increase in available financing, which reduces the liquidity premium (raises yields on liquid assets) and substitutes away from financial investments in developing countries, thus also suggesting a negative coefficient. FN30 The yield curve captures the effect that quantitative easing (QE) can have on long-term yields, and hence of temporal rebalancing toward higher-risk asset classes, of which developing-country investments are one (Powell 2013); this relationship between a flatter yield curve and greater investment in riskier asset thus implies an a priori negative coefficient. The role of global uncertainty and risk aversion was proxied for by the VIX index (Rey 2013): greater uncertainty is likely to be associated with weaker flows (again, a negative coefficient).

The measures used to capture global real side conditions (GRCt) include high-income country GDP growth (proxied by weighted-average growth rates of the G4 economies – U.S, Euro Area, U.K and Japan) and the global composite purchasing managers index (PMI) which proxies for growth expectations. Overall developing country growth was included to account for a combined pull factor for developing countries. Stronger real-side activity is likely to translate into greater investment opportunities overall and increased flows to developing countries; in general one would expect these coefficients to be positive. FN31 Taken together, these global factors can be regarded as “push” factors.

The extraordinary measures taken by central banks, in the United States, Europe and Japan are likely to have influenced several of the global financial and real-side variables: by affecting short-term interest rates through conventional monetary policy; by affecting the term-structure of interest rates due to the Federal Reserve's

purchase of mortgage-backed securities and long-term debt on secondary markets (Christensen, & Rudebusch 2012; Gagnon et al. 2011; Krishnamurthy and Vissing-Jorgensen 2011); by reducing uncertainty over the future stance of central bank policy by serving as a credible commitment to low future rates (Bauer & Rudebusch 2013); and by the influence of these factors on US and global growth (Chen, Curdia and Ferrero 2012). To the extent that these policies have influenced these drivers, their influence on capital flows will have been captured in the regression.

To account for the possibility that extraordinary monetary measures have operated through other channels—or if QE may have any additional, unobservable effect over and above these standard, observable variables—a series of dummy variables covering the different episodes of quantitative easing (QE_t) were also included. A non-zero coefficient on these dummies can be interpreted as indicating that over and above the (unidentified) influence of quantitative easing on the fundamental drivers included in equation (1), quantitative easing had an additional impact on capital flows to developing countries that are not captured by observable variables.

We consider three alternative measures for the additional effects of QE programs: a single QE variable that corresponds to all episodes of U.S. quantitative easing; separate indicator variables for each of the three distinct episodes; and a continuous measure of QE interventions based on expansions in the size of the central bank's balance sheet. For the indicator variables, our coding scheme for the start/end quarters defines a quarter as belonging to the implementation window if the total number of implementation days exceeded half the days in any given quarter (e.g. QE1 operations, which began on December 16, 2008, is coded as starting 2009Q1, while QE2, which came into effect on November 3, 2010, is coded as beginning 2010Q4). The baseline specification includes QE operations by the U.S. Federal Reserve, while robustness tests took into account QE operations in other major advanced-economy central banks.

The vector X_{it} captures the influence of domestic “pull” factors and includes the log of country GDP volumes, country institutional investor ratings, country-specific lagged GDP growth differential (relative to the United States), the interest rate differential between the developing country vis-à-vis the United States, and aggregate developing-country GDP growth. The interest rate differential relative to the US captures spatial rebalancing that arbitrages cross-country differences in yields. The lagged growth differential captures the relative attractiveness of investing in a particular developing country. Lagged ratios of private credit as a share of GDP (financial depth), trade/GDP (trade openness), external debt/GDP, and real exchange rate appreciation were included in alternative specifications, but were not retained in the benchmark as they were not statistically significant across most specifications and are instead presented in robustness specifications.

Country fixed effects α_i and a time trend τ were included in all specifications. An indicator for crisis and post-crisis were included to account for the large decline in capital flows during 2008-09, and the possibility of a “new normal” in financial flows thereafter. Given that the equation is a dynamic panel model with fixed effects and subject to bias, the coefficients were estimated using bias-corrected Least Squares Dummy Variables estimator (Bruno 2005) under the strictest condition for bias approximation (up to $O(1/NT^2)$), with bootstrapped standard errors.

Results for benchmark specification

The results for the benchmark regression for gross financial inflows (GFI_{it}) are presented in Annex table A.3. Columns B1–B3 present a parsimonious specification, while columns B4–B6 present an extended specification with a larger number of independent variables. The results suggest that global financial conditions (short interest rate, the yield curve, and the VIX index) play an important role in determining the level of capital flows, are signed according to a priori expectations, and are consistent with the findings of Chuhan, Claessens, and Mamingi (1996), Fernandez Arias (1996), Reinhart and Reinhart (2008), Forbes and Warnock (2012), Bruno and Shin (2013), among others. Among global real side indicators, whereas some factors may have had a modest impact on flows (developing country growth rates is marginally significant (at 10 percent) in some specifications, but global PMI and high-income country growth did not prove to be significantly associated with country-level capital flows).

Table A1.3 Benchmark regressions for gross financial inflows (GFI)

	B1	B2	B3	B4	B5	B6
Lagged inflows	0.473 (0.02)***	0.477 (0.02)***	0.481 (0.02)***	0.466 (0.02)***	0.473 (0.02)***	0.473 (0.02)***
All QE episodes	0.031 (0.01)***			0.026 (0.01)***		
QE1 episode		0.041 (0.01)***			0.049 (0.01)***	
QE2 episode		0.031 (0.01)***			0.035 (0.01)***	
QE3 episode		0.025 (0.01)***			0.006 (0.00)	
QE-related expansion			0.003 (0.00)***			0.002 (0.00)***
<i>Global financial-side conditions</i>						
3M T-bill rate	-0.010 (0.00)***	-0.012 (0.00)***	0.001 (0.00)	-0.016 (0.01)*	-0.017 (0.01)**	-0.006 -0.01
Yield curve	-0.014 (0.00)***	-0.017 (0.01)***	-0.001 (0.00)	-0.018 (0.01)**	-0.025 (0.01)***	-0.007 -0.01
VIX				-0.002 (0.00)***	-0.002 (0.00)***	-0.002 (0.00)***
Money supply (M2)				-0.105 (0.22)	0.144 (0.26)	-0.097 (0.22)
<i>Global real-side conditions</i>						
Global PMI				-0.001 (0.00)	-0.001 (0.00)	-0.002 (0.00)
Developing GDP growth	0.003 (0.00)**	0.002 (0.00)	0.002 (0.00)	0.004 (0.00)**	0.000 (0.00)	0.004 (0.00)**
High-income GDP growth	0.001 (0.00)	0.001 (0.00)	0.001 (0.00)	0.000 (0.00)	0.001 (0.00)	0.000 (0.00)
<i>Country-specific controls</i>						
Interest rate differential	0.000 (0.00)	0.000 (0.00)	0.000 (0.00)	0.000 (0.00)	0.000 (0.00)	0.000 (0.00)
Growth differential				0.001 (0.00)*	0.001 (0.00)*	0.001 (0.00)
GDP	0.132 (0.03)***	0.130 (0.03)***	0.130 (0.03)***	0.129 (0.03)***	0.125 (0.03)***	0.128 (0.03)***
Country insitutional rating	0.002 (0.00)***	0.001 (0.00)***	0.001 (0.00)***	0.002 (0.00)***	0.002 (0.00)***	0.002 (0.00)***
<i>Other controls</i>						
Crisis period	-0.046 (0.01)***	-0.052 (0.01)***	-0.050 (0.01)***	-0.022 -0.01	-0.026 (0.01)*	-0.026 (0.01)*
Post-crisis period	-0.016 (0.00)	-0.025 (0.01)*	-0.052 (0.02)***	0.002 (0.01)	-0.010 (0.01)	-0.027 (0.02)
Adj. R2	0.360	0.360	0.358	0.368	0.371	0.367
R2 (within)	0.364	0.365	0.362	0.374	0.377	0.372
R2 (between)	0.525	0.527	0.528	0.526	0.529	0.528
N (countries)	1,938 (60)	1,938 (60)	1,938 (60)	1,925 (60)	1,925 (60)	1,925 (60)

Note: All level variables are in logarithmic form, but rates, indices, and indicator variables are untransformed. Bootstrapped standard errors (with 100 replications) are reported in parentheses. A time trend, country fixed effects, and constant term were included in the regressions, but not reported. * indicates significance at 10 percent level, ** indicates significance at 5 percent level, and *** indicates significance at 1 percent level.

The indicator for quantitative easing episodes has positive and statistically significant relationship, which suggests that over and above the other modeled channels, quantitative easing induced additional capital inflows. Consistent with the literature on the impact of quantitative easing on the US economy (Curdia & Ferrero 2013; Krishnamurthy & Vissing-Jorgensen 2013), these effects are diminishing with each new QE intervention: when the QE indicator is split into separate indicators for each of QE1, QE2 and QE3, the magnitude and significance diminishes between successive episodes (and for QE3 the coefficient is statistically insignificant).

Consistent with the existing literature (Alfaro, Kalemli-Ozcan & Volosovych 2008; Fratzscher, 2011; Gelos, Sahay and Sandleris 2011), the results suggest that capital flows to individual countries are strongly influenced by a number of country-specific pull factors: changes in investor country ratings, which represent the perceived quality of policies and institutions, as are changes in country-specific growth differentials relative to the US (at the 10 percent level), which is consistent with growth performance being a proxy for the relative attractiveness of a country for international investors. Real interest rate differentials are not statistically significant, although this is consistent with the existing literature (e.g. Bruno and Shin 2013).

Interactions of QE episode dummy with global financial and real-side conditions and additional robustness tests

In order to ascertain whether quantitative easing may have altered the influence of the conventional transmission channels of capital flows (say by making flows more sensitive to interest rate developments), a specification that allowed for interactions between the QE indicator and the observable global financial and real-side variables was also explored. These are presented in a detailed version of this annex available online at www.worldbank.org/gep. The main message one receives from this set of results is that there is little evidence that supports the argument that the sensitivity of transmission channels for unconventional monetary policy changed as a result of QE. Several alternative specifications were also examined, including a host of additional controls and alternative measures. These additional controls include the global level of saving (to account for the quantity of investable funds), the (lagged) ratio of trade to output, the (lagged) ratio of private credit to output, the (lagged) ratio of debt to GDP, the inflation differential, and the (lagged) real exchange rate. Note that including these additional variables does not alter the qualitative message from our baseline results nor do the coefficients for these controls generally enter with significant coefficients.

A measure of the third QE episode that includes an additional indicator for the period where there were anticipations of a tapering of QE in 2013Q2 were associated with a significant reduction in inflows: the coefficient on the variable is almost twice as large as average effects over all prior QE episodes. Substituting the baseline interest rate differential with the interest rate spread computed from a richer array of fixed income instruments does not change the main qualitative conclusions.

An alternative set of measures allows for the fact that unconventional monetary policies were more or less simultaneously pursued by the Bank of England (via the Asset Purchase Facility), the Bank of Japan (via its Asset Purchase Program), and the European Central Bank (through its Securities Market Program and Outright Monetary Transactions).^{FN34} This expanded QE indicator has a similar sign and significance as the benchmark specification. Given that the VIX, interest rates and GDP growth tend to be codetermined (Albuquerque, Loayza & Servén 2005; Kose, Otrok & Whiteman 2003) a common factor (the principal component of the three variables) was derived to proxy for global conditions.^{FN36} Using this single factor did not affect other coefficients significantly, although it did reduce the overall power of the regression.

Decompositions

To obtain greater insight into whether specific channels may be more operative than others, depending on the financial flow, we break down our dependent variable—aggregate gross inflows—into portfolio, loans, and FDI. Estimates of the capital flow model performed on each of these flows individually suggests presented in columns (D1)-(D3) of Annex table A.6 suggest that portfolio flows are the most sensitive to the external drivers associated with monetary conditions in high-income countries. The sensitivity of portfolio flows to

changes in the yield curve is almost double that of overall gross capital flows, as is the response to the QE indicator. Foreign direct investment tends to be relatively insensitive to the effects of global push factors, and is much more responsive to country specific characteristics, consistent with the literature (Alfaro, Kalemli-Ozcan & Volosovych 2008, Benassy-Quere, Coupet & Mayer 2007; Dailami, Kurlat and Lim 2012).^{FN38} Cross-border bank lending appears to fall into an intermediate category. In particular, the coefficient on the QE dummies are much larger for bank lending, suggesting that more so than for the other flows, QE operated through channels other than those modeled to boost bank lending. On the other hand, bank lending was much less sensitive to liquidity or portfolio rebalancing factors.

Columns D4-D6 present measures of flows into emerging market mutual funds, a subset of portfolio inflows. The statistically significant coefficients in columns D4 are broadly comparable to overall portfolio inflows (D1). It is notable that while bond flows appear to react to more transmission channels than equity flows—debt is associated with changes in the VIX as well as the global PMI,^{FN39} while equity is not—the magnitude (and standard errors) of the coefficients on equity are generally larger than those for debt. Alternatively, although bond flows are liable to react to a wider range of possible QE transmission channels, equities react more strongly to the few channels to which they do react to

Table A1.4 Decomposition of gross financial inflows

	D1	D2	D3	D4	D5	D6
	<i>Portfolio</i>	<i>Loans</i>	<i>FDI</i>	<i>Gross fund</i>	<i>Bonds</i>	<i>Equity</i>
Lagged inflows	0.261	0.307	0.597	-0.088	0.294	-0.011
	(0.02)***	(0.02)***	(0.02)***	(0.04)**	(0.03)***	-0.03
All QE episodes	0.018	0.021	-0.003	0.061	0.015	0.044
	(0.01)***	(0.01)***	-0.01	(0.02)***	-0.02	(0.03)*
<i>Global financial-side conditions</i>						
3M T-bill rate	-0.015	-0.004	0.004	-0.080	-0.089	-0.053
	(0.01)**	(0.01)	(0.01)	(0.02)***	(0.02)***	(0.03)**
Yield curve	-0.020	-0.002	0.005	-0.090	-0.065	-0.064
	(0.01)***	(0.01)	(0.01)	(0.03)***	(0.02)***	(0.03)**
VIX	-0.002	0.000	0.000	-0.002	-0.006	0.000
	(0.00)***	(0.00)	(0.00)	(0.00)	(0.00)***	(0.00)
Money supply (M2)	0.015	-0.071	0.056	-1.110	-2.120	-0.589
	(0.19)	(0.16)	(0.26)	(0.65)*	(0.45)***	(0.66)
<i>Global real-side conditions</i>						
Global PMI	-0.001	-0.001	-0.001	0.008	0.003	0.004
	(0.00)	(0.00)	(0.00)	(0.01)	(0.00)	(0.01)
Developing GDP growth	0.004	0.000	-0.001	0.014	0.023	0.007
	(0.00)***	(0.00)	(0.00)	(0.01)***	(0.00)***	(0.01)
High-income GDP growth	-0.001	0.002	0.004	-0.011	-0.017	-0.007
	(0.00)	(0.00)	(0.00)	(0.01)	(0.01)***	(0.01)
<i>Country-specific controls</i>						
Interest rate differential	0.000	0.000	0.000	-0.001	-0.002	0.000
	(0.00)	(0.00)	(0.00)	(0.00)	(0.00)*	(0.00)
Growth differential	0.001	0.001	0.000	0.001	0.000	-0.001
	(0.00)*	(0.00)	(0.00)	(0.00)	(0.00)	(0.00)
GDP	0.009	0.110	0.070	-0.060	0.020	0.039
	(0.03)	(0.02)***	(0.04)*	(0.09)	(0.07)	(0.08)
Country insitutional rating	0.001	0.001	0.002	0.002	0.001	0.000
	(0.00)***	(0.00)***	(0.00)**	(0.00)	(0.00)	(0.00)
<i>Other controls</i>						
Crisis period	-0.002	-0.043	-0.005	0.024	-0.043	0.032
	(0.01)	(0.01)***	(0.02)	(0.04)	(0.03)	(0.05)
Post-crisis period	0.024	-0.025	-0.010	0.038	-0.061	0.050
	(0.01)*	(0.01)**	(0.02)	(0.05)	(0.04)	(0.05)
Adj. R2	0.157	0.032	0.399	0.054	0.193	0.005
R2 (within)	0.164	0.037	0.403	0.07	0.203	0.018
R2 (between)	0.572	0.209	0.854	0.45	0.562	0.042
N (countries)	1,925 (60)	3,460 (85)	2,419 (63)	974 (31)	1,220 (39)	1,185 (37)

Source:

Appendix 2.**Data description and technical note for the Vector Autoregressive analysis of capital inflows to developing countries***Model specification*

Inter-temporal interactions between global “push” factors, capital inflows and GDP growth in developing countries are modeled using a six-dimensional Vector Auto-Regressive (VAR) system, estimated over the period 2000Q1 to 2013Q2. The vector of endogenous variables consist of:

- aggregate gross capital flows to developing countries as a share of their combined GDP - source: IFS / Balance of Payment data;
- Quarterly real GDP growth in both developing and “G4” countries (US, euro area, Japan and UK) - source Haver/ Datastream / National Statistical Offices;
- “G4” short term interest rates (3 month money market rates) – source: Datastream
- G4 yield curve (10 year government bond yields minus 3 month interest rates) - source: Datastream
- The VIX index measuring the implied volatility of S&P 500 options - source: Datastream / Chicago Board Options Exchange Market

Table A2.1 Descriptive statistics

	G4 GDP Growth	DEV GDP Growth	DEV Capital Inflows / GDP	VIX Index	G4 3m Interest rate	G4 yield curve
Mean	1.3	6.1	3.5	21	2.0	1.5
Median	1.7	6.6	3.6	20	1.8	1.8
Std. Dev.	1.9	2.1	3.0	9	1.3	1.0

Regarding the lag selection procedures for the VAR, the Hannan and Quinn information criterion (HIC) and Schwartz bayesian information criterion (BIC) suggested one lag (Hannan-Quinn 1979, Schwarz 1978), but the Final Prediction Error and Likelihood Ratio test Statistics recommended two, while the Akaike information criterion (AIC) recommended four. A two period lag structure was decided upon, with all eigenvalues being significant less than one. A formal Johansen Test rejects the presence of co-integration, so the system was estimated the model was estimated as an unrestricted VAR.

Table A2.2 VAR lag order selection criteria*Sample 2000 Q1—2013 Q2*

Lag	LogL	LR	FPE	AIC	SC	HQ
0	-519	NA	325	23	23	23
1	-282	400*	0.05*	14	15*	14*
2	-248	50	0	14	17	15
3	-208	46	0	14	19	16
4	-157	47	0	13*	19	16

To compute impulse responses and variance decompositions, a structural identification was derived by imposing a Cholesky decomposition on the covariance matrix. The Cholesky restrictions were imposed by ordering the variables so that the first variable cannot respond to contemporaneous shocks (in the same quarter) of any other variables, the second one responds to contemporaneous shocks affecting only the first variable, and so on. The following order was suggested by expected time lags in the reaction of “real” variables to financial shocks: “G4” GDP growth, developing countries’ GDP growth, developing countries capital inflows (in percent of GDP), the VIX index, G4 short-term interest rates and the yield curve (potentially responding to all other variables in real time).

Figure A2.1 Impulse response

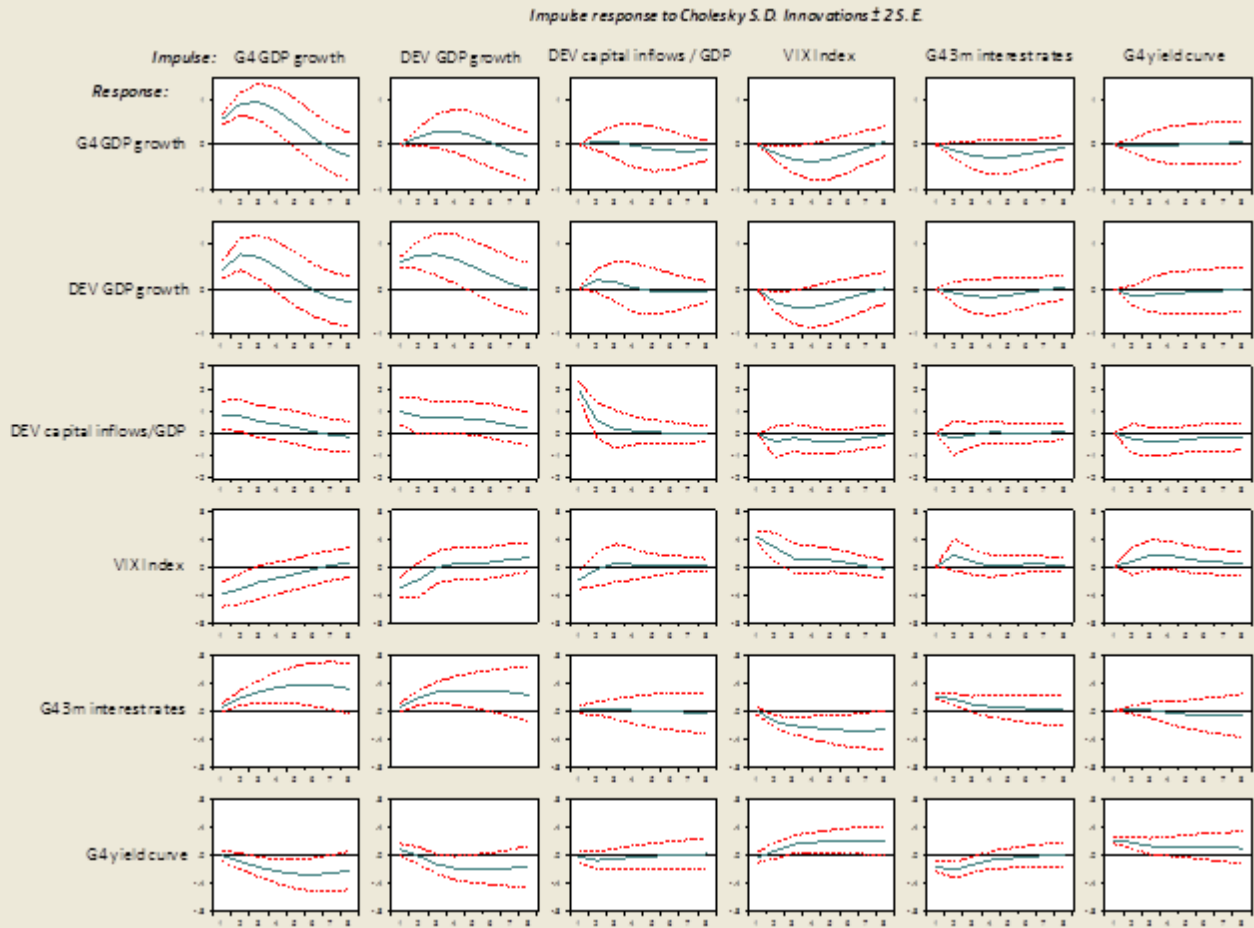


Table A2.3 Variance decomposition

	G4 GDP Growth	DEV GDP Growth	DEV Capital Inflows / GDP	VIX Index	G4 3m Interest rate	G4 yield curve
Variance decomposition of:						
G4 GDP Growth						
4 quarters	80	6	0	9	5	0
8 quarters	72	8	2	11	7	0
DEV GDP Growth						
4 quarters	37	48	2	10	2	1
8 quarters	35	48	2	12	2	1
DEV Capital Inflows / GDP						
4 quarters	19	27	46	3	1	4
8 quarters	18	32	39	6	1	5
VIX Index						
4 quarters	39	13	5	31	4	7
8 quarters	37	17	5	29	4	9
G4 3m Interest rate						
4 quarters	35	30	0	21	13	0
8 quarters	41	27	0	25	5	1
G4 yield curve						
4 quarters	22	14	3	14	23	24
8 quarters	35	19	1	21	10	15

Interest rate assumptions and alternative scenarios

Baseline scenario:

QE Tapering by the US FED starts in 2014Q1 and has a very gradual effect. It adds 50bp to US long term interest rates by the end of 2015 and a cumulative 100bp by the end of 2016 (assuming that anticipation has already taken out half of the overall QE effect from May to November 2013).

The ECB, Bank of Japan and Bank of England, start to unwind their own quantitative / qualitative policies in the course of 2015/16, adding 50bp to their long term yields by the end of the forecast horizon. Only the US Fed starts to increase policy rates by 2015Q2, from 0,25% to 2% by the end 2016. The ECB, Bank of Japan and Bank of England follow broadly the same tightening path, but a full year later.

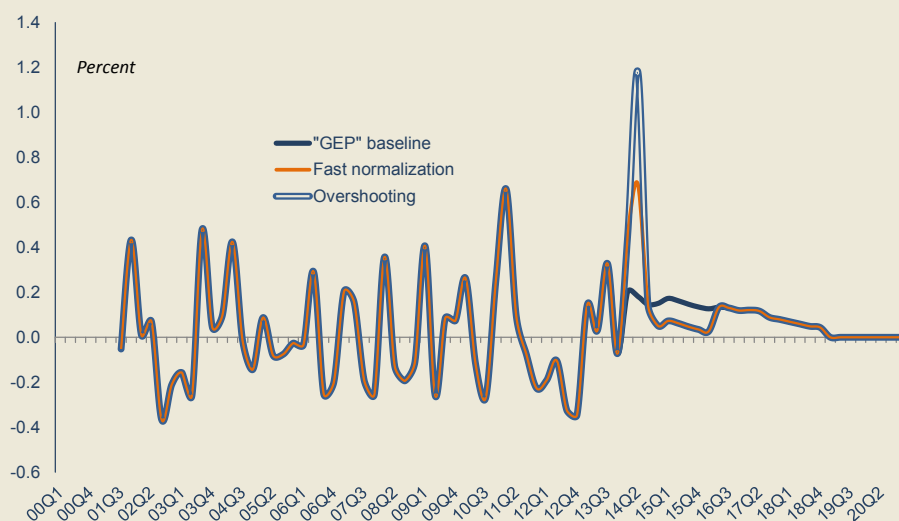
As a result, G4 long term interest rates are expected in the baseline to increase from 2.5% in 2013Q4 to 3.7% by end 2016. The corresponding “add factor” in the VAR equation under this baseline scenario is presented in Figure A2.2m, showing slightly positive residuals from the purely model-based prediction over the projection horizon (10 to 15bp).

“Fast normalization” and “overshooting” scenarios:

"Fast normalization" is a scenario in which the unwinding of QE specific effects on the yield curve (100bp) is front loaded and happens within the first two quarters of 2014. The add factor to the yield curve equation is adjusted upwards in 2014Q1 and 2014Q2 by a cumulative 100bp, but is lowered back to zero afterwards. This assumes that only the timing of the adjustment is affected, but with an unchanged cumulative impact. The model is run on the alternative add factor series and simulations for all six endogenous variables reported as the “fast normalization” scenario.

"Overshooting" is a scenario in which the yield curve steepens by a further 200bp compared to the baseline. In this context, the add factor to the yield curve is shifted upwards by a cumulative 200bp from the baseline, the model is run on the alternative add factor series and simulations for all six endogenous variables reported as the “overshooting” scenario

Figure A2.2 G4 yield curve equation: residual / add factor under different normalization scenarios



Source: World Bank

Appendix 3.**Data description and technical note for Crisis risks in developing countries***Data sources and coverage*

The analysis is based on the banking crisis data compiled by Laeven and Valencia (2012), which identifies 147 banking crisis in 162 countries for the period 1970–2011. The analysis focuses on the banking crisis in developing countries by excluding the OECD country observations. Table A3.1 reports country and time coverage statistics. The primary data source for the explanatory variables are World Bank’s World Development Indicators (WDI) and Global Economic Prospects (GEP), the IMF’s World Economic Outlook (WEO), International Finance Statistics (IFS), and Direction of Trade Statistics (DOTS), and the Bank of International Settlements (BIS) datasets. Table A2.1 reports the definition of the variables and data sources.

Table A3.1 Countries in estimation samples

(Number of time-series observations on the right)

Country Name	Obs.	Country Name	Obs.	Country Name	Obs.
1. Albania	10	41. Guinea-Bissau	5	81. Rwanda	20
2. Algeria	4	42. Guyana	17	82. Senegal	20
3. Angola	9	43. Haiti	10	83. Seychelles	23
4. Argentina	11	44. Honduras	23	84. Sierra Leone	20
5. Armenia	10	45. India	20	85. Solomon Islands	22
6. Azerbaijan	10	46. Indonesia	20	86. South Africa	14
7. Bangladesh	20	47. Jamaica	17	87. Sri Lanka	20
8. Belarus	10	48. Jordan	20	88. St. Lucia	23
9. Belize	21	49. Kazakhstan	9	89. St. Vincent and the Grenadines	23
10. Benin	20	50. Kenya	18	90. Sudan	23
11. Bolivia	14	51. Kyrgyz Republic	8	91. Syrian Arab Republic	23
12. Botswana	23	52. Lao PDR	12	92. Tanzania	16
13. Brazil	13	53. Latvia	10	93. Thailand	20
14. Bulgaria	10	54. Lebanon	3	94. Togo	20
15. Burkina Faso	11	55. Lesotho	20	95. Tunisia	20
16. Burundi	17	56. Lithuania	11	96. Turkey	14
17. Cambodia	11	57. Macedonia, FYR	9	97. Uganda	13
18. Cameroon	17	58. Madagascar	17	98. Ukraine	7
19. Cape Verde	20	59. Malawi	23	99. Uruguay	14
20. Central African Republic	6	60. Malaysia	20	100. Vanuatu	23
21. Chile	23	61. Mali	20	101. Venezuela, RB	20
22. China	20	62. Mauritania	2	102. Vietnam	9
23. Colombia	16	63. Mauritius	9	103. Yemen, Rep.	10
24. Comoros	9	64. Mexico	20	104. Zambia	14
25. Congo, Dem. Rep.	4	65. Moldova	10		
26. Congo, Rep.	19	66. Mongolia	9		
27. Costa Rica	17	67. Morocco	15		
28. Cote d'Ivoire	20	68. Mozambique	15		
29. Dominica	22	69. Nepal	20		
30. Dominican Republic	20	70. Nicaragua	13		
31. Ecuador	20	71. Niger	23		
32. Egypt, Arab Rep.	23	72. Nigeria	20		
33. El Salvador	14	73. Pakistan	23		
34. Ethiopia	23	74. Panama	13		
35. Gabon	20	75. Papua New Guinea	19		
36. Gambia, The	14	76. Paraguay	15		
37. Georgia	8	77. Peru	17		
38. Ghana	17	78. Philippines	20		
39. Guatemala	23	79. Romania	8		
40. Guinea	11	80. Russian Federation	7		

Table A3.2 List of Variables Used in the Regression Analysis

Variable	Definition	Source
Dependent Variable		
Banking crisis	Indicator variable that equals 1 if the country experiences a systemic banking crisis for the first year	Laeven and Valencia (2012)
Explanatory Variables		
<i>Global Variables</i>		
Global risk	Volatility Index (VXO) calculated by the Chicago Board Options Exchange, in annual inter-quartile range	Datastream
Global interest rate	Change in global interest rate give by the first principal component of the G4 (US, UK, Japan, and EU) long-term interest rates	IFS
Global liquidity	M2 as a share of GDP in US	Datastream
Global growth	First principal component of G4 real GDP growth	Datastream
Agricultural Commodity Price index	Global commodity price index	GEP
Energy commodity price index	Global commodity price index	GEP
<i>Contagion Variables</i>		
Openness	Exports plus imports as a share of GDP	WDI
Trade linkage	Bilateral trade (export plus import) as a share of total exports, multiplied by a dummy variable that equals =1 if the trade partner experiences a banking crisis	DOT
Financial linkage	External position vis-à-vis BIS Reporting Banks as a share of GDP	BIS
Regional contagion	Dummy variable that equals 1 if the country in the same region experiences a banking crisis	WDI
<i>Domestic Variables</i>		
External debt	Total external debt as a share of GDP	WDI
Current account balance	Change in current account balance as a share of GDP over last 5 years	WDI, WEO
Short term debt	Short term external debt plus amortization due within a year as a share of total external debt	WDI, WEO, IFS
Domestic credit growth	Change in domestic credit as share of GDP over last 5 years	WDI
Inflation	Change in the consumer price index	WDI, WEO
Per capita GDP growth	Growth rate of real per capita GDP	WDI
Import cover	Reserves as a multiple of monthly imports	WDI, WEO, IFS, GEP
Ratio of M2 to reserves	M2 as a share of total reserves	WDI, IFS
Fiscal blance	Net borrowing/ lending by the government as a share of GDP	WDI, WEO
REER overvaluation	Real effective exchange rate minus long term trend (estimated by 10 year moving average)	WDI, GEP

Empirical methodology

In line with the literature, we estimate the relationship between the onset of banking crisis and the global, contagion, and domestic factors using a pooled probit model:

$$P(\text{Crisis}_{it} | W_{t-1}, X_{it-1}, Z_{it-1}) = F(\beta'W_{t-1} + \lambda'X_{it-1} + \theta'Z_{it-1})$$

where $P(\cdot)$ is the probability that a country i will be in banking crisis in time t , conditional on global factors W , contagion factors X , and domestic factor Z . $F(\cdot)$ is the standard normal distribution function that transforms a linear combination of the explanatory variables into the $[0,1]$ interval.

A pooled regression involves pooling observations across country- and time-dimensions such that a unit of

observation becomes a country-year, not a country. To allow for the fact that same countries are repeatedly observed in the sample, such that errors in the model are not *iid*, we use robust standard errors with clusters, where the cluster is defined as a country, to allow errors of a given country to be correlated over time.

We exclude observations three years following each crisis observation for a given country to avoid double counting and endogeneity. In all estimations, we also use lagged explanatory variables to reduce endogeneity concern. Similar approach has been used by Eichengreen et al (1996, 1998, 2000) and Forbs and Warnock (2011). The general to specific approach is applied to arrive at the final probit specifications. Results are reported in Table [A3.3].

Column 4 in Table [A3.3] evaluates the relative importance of all three sets of factors. The results generally confirm the strong influence of both global and domestic factors in the onset of banking crisis found in the separate models (columns 1–3), although not all factors remain significant in the combined model. A consolidated model, applying the general-to-specific method to eliminate the insignificant variable for later analyses, is reported in column 5. The general-to-specific modeling refers to the process of simplifying initially general (over-parameterized) model that adequately characterizes the empirical evidence within a theoretical framework and reducing the number of variables and parameters to be estimated to achieve greater statistical efficiency without causing significant problems of model misspecifications and omitted variable bias. Central aspects of this approach includes the model selection procedures based on across-model comparison and parameter constancy, as well as evaluation of selection criteria such as adjusted pseudo-R squares, Akaike Information Criterion (AIC), and Bayesian Information Criterion (BIC), all of which are reported in the bottom of Table [A3.3]. Given two models, a higher adjusted pseudo-R², or a smaller AIC or BIC indicates a better-fitting model.

In the final version of the model (column 5), all the significant impact of global and domestic variables remains. Among the global factors, we continue to find the strong influence of low global risk aversion, high global liquidity, and rising global interest rates. The positive coefficient on the global liquidity and long term interest rate and the negative coefficient on the global risk variable are all consistent with a view that crises in individual developing countries tend to be preceded by periods of ample liquidity and suppressed risk. The positive coefficient on the agricultural commodity prices is consistent with the argument by Reinhart and Rogoff (2009) who find that commodity booms tend to increase the likelihood of a crisis, while the negative and significant coefficient on energy price remains a puzzle—possibly relating to the relative persistent of momentums in energy price compared to year-on-year volatility in agricultural commodity prices as discussed earlier. Most contagion variables are not statistically significant, although the trade linkages variable (the share of trade with other countries that are in crisis) remain significant. Among the domestic factors, a high external and short-term debt, rapid growth in domestic credit, low levels of international reserves, and overvaluation in real exchange are all significantly associated with heightened risk of banking crisis, with expected signs.

Bottom of Table [A3.3] reports alternative measures of predictive accuracy of the models:

Percent of Correct Positive – Let p_j be the predicted probability of a positive outcome and y_j be the actual outcome (0 or 1). Let c be the cutoff value which we specify as equal to the observed risk of positive outcome in the estimation sample. A prediction is classified as “positive” if $p_j \geq c$, and classified as “negative” otherwise. Percent of Correct Positive is the fraction of $y_j=1$ observations that are correctly classified as “positive” ($p_j \geq c$). This is also known as “sensitivity” of the model.

Percent of Correct Negative – This is the fraction of $y_j=0$ observations that are correctly classified as “negative” ($p_j < c$). This measure is also known as “specificity” of the model.

Area Under the Receiver Operating Characteristic Curve (AUROC) – The ROC curve is a graph of Specificity against (1-Sensitivity) as the cutoff c is varied from 0 to 1. The curve starts at (0; 0), corresponding

Table A3.3 Alternative specifications of banking crisis probit model

	(1) Global	(2) Contagion	(3) Domestic	(4) All	(5) Parsimonious2
Global risk	-0.21 *** (-3.07)			-0.227 ** (-2.30)	-0.230 ** (-2.40)
Global interest	1.21 *** (2.88)			0.932 * (1.92)	0.961 * (1.95)
Global growth	-0.723 ** (-2.51)			-0.154 (-0.50)	-0.195 (-0.67)
Global liquidity	0.243 *** (3.64)			0.355 *** (3.53)	0.387 *** (3.92)
Agri. commodity price	0.173 *** (0.37)			0.0896 ** (2.20)	0.096 ** (2.37)
Energy commodity price	-0.0677 *** (-7.84)			-0.033 ** (-2.17)	-0.039 *** (-2.60)
Openness		-1.20 ** (-2.54)		-0.635 (-1.23)	
Tradelinkage		0.26 *** (4.04)		0.257 *** (2.92)	0.287 *** (3.21)
Financial linkage		-0.09 (-0.86)		-0.074 (-0.44)	
Regional contagion		0.17 *** (2.70)		0.0578 (0.63)	
External debt			0.856 ** (2.04)	0.586 (1.49)	0.642 * (1.88)
Current account balance			-0.0371 (-0.81)	-0.038 (-0.93)	-0.037 (-0.98)
Short term debt			0.798 ** (2.47)	0.48 ** (1.98)	0.450 * (1.86)
Credit growth			0.0851 *** (2.66)	0.0841 *** (3.99)	0.076 *** (3.75)
Inflation			0.0301 ** (2.07)	0.0065 (0.54)	
Per capita GDP growth			-0.106 (-1.62)	-0.036 (-0.82)	
Import cover			-0.169 * (-1.69)	-0.001 ** (-2.20)	-0.001 * (-2.33)
Ratio of M2 to reserves			0.0122 (0.92)	0.0038 (0.46)	
Fiscal balance			-0.0416 (-0.93)	-0.031 (-0.68)	-0.045 (-0.98)
REER overvaluation			0.000318 (0.73)	0.0005 * (1.87)	0.0006 * (1.92)
Observations	3438		1855		1631
Observed risk	2.9%		3.2%		3.2%
Percent of Correct Positive†	79.6%		64.4%		77.4%
Percent of Correct Negative†	59.3%		65.1%		68.6%
AUROC††	0.711		0.666		0.813
Pseudo R-squared	0.059		0.051		0.144
AIC	851.7		518.2		430.2
BIC	894.7		579.0		511.2

Note: Dependent variable is a binary indicator for a banking crisis. Explanatory variables are in one-period lag (t-1) unless otherwise indicated.

Reported coefficients are marginal effects of a variable on the probability of a banking crisis in percentage points. Robust clustered standard errors are used. T statistics in parentheses.

* significant at 10%. ** significant at 5 percent. *** significant at 1%.

†Cut-off =observed risk in the data.

Notes

1. Here and in the remainder of this chapter, the post-crisis period is referred to as the period after 2010 and the boom period as 2003-07. While the evolution of capital flows during the period 2008-09 is of great interest, developments during this period were dominated by disequilibrium effects, including the liquidity freeze up in 08 and its subsequent thawing in 2009, that have dissipated now and are not the primary focus of this chapter.
2. The analysis presented throughout this section is specifically focused on the behavior of gross capital inflows by foreign investors into developing countries - i.e. the evolution of gross foreign liabilities of developing countries according to the Balance of Payment methodology. An alternative methodology would focus on net flows (and indeed it is this data that is presented in Chapters 1 and 2). The focus on gross flows reflects their dominant role in the increased intermediation of developing countries over the past two decades (see World Bank, 2012) and their close relationship to international conditions.
3. The use of a time series model focusing on the short term dynamics of capital flows and interactions with global factors allows to capture transitory costs and overshooting risks, but at the expense of overlooking country specific factors and variations. Simulations drawing from both modeling strategies are presented.
4. Recent work includes Fratzscher (2011), which finds that push factors were dominant during the crisis but pull factors were more important in the immediate recovery phase after the global crisis, while Forbes and Warnock (2012) identify global factors, especially global risk (VIX) as a determinant of surges. Bruno and Shin (2013) identify global factors are dominant determinants of cross-border bank flows, particularly bank leverage and VIX . This last result may be explained by the close relationship between banks' value-at-risk and the VIX (Adrian and Shin, 2010).
5. Most of the research that has been conducted on the impact of capital flows has looked at its impact on economic activity in the United States, and there is very little consensus on those impacts. IMF (2013) provides a useful review of this literature, which suggests that impacts on GDP could range between 0.13 percent growth to 8 percentage points and long-term interest rate effects that range from 75 to 200 basis points in the USA, and less than 50 to 160 basis points in the United Kingdom.
6. Estimates of the relative contribution of different factors in Figure xx were calculated by multiplying the observed changes in short-term policy rates, yield curve, the QE episode dummy, and the risk index between the first half of 2009 and the first half of 2013 by the coefficient estimates obtained from the benchmark model.
7. The model is robust to several different specifications of the explanatory variables, as well as the inclusion of other variables that may plausibly explain capital flows. Lagged ratios of private credit as a share of GDP (financial depth), trade/GDP (trade openness), external debt/GDP, and real exchange rate appreciation were included in alternative specifications but did not prove to be statistically significant.
8. Regarding the lag selection procedures, the Hannan and Quinn information criterion (HIC) and Schwartz bayesian information criterion (BIC) suggested one lag (Hannan-Quinn 1979, Schwarz 1978), but the Final Prediction Error and Likelihood Ratio test Statistics recommended two, while the Akaike information criterion (AIC) recommended four. A two period lag structure was decided upon, with all eigenvalues being significant less than one. A formal Johansen Test rejects the presence of co-integration, so the system was estimated the model was estimated as an unrestricted VAR
9. To compute impulse responses and variance decompositions, a structural identification was derived by imposing a Cholesky decomposition on the covariance matrix. The Cholesky restrictions were imposed by ordering the variables so that the first variable cannot respond to contemporaneous shocks (in the same quarter) of any other variables, the second one responds to contemporaneous shocks affecting only the first variable, and so on. The following order was suggested by expected time lags in the reaction of "real" variables to financial shocks: "G4"

GDP growth, developing countries' GDP growth, developing countries capital inflows (in percent of GDP), the VIX index, G4 short-term interest rates and the yield curve (potentially responding to all other variables in real time).

10. While the panel regression presented above has the advantage of identifying the relative importance of country-specific and global drivers of capital flows to developing countries, it has limited dynamic properties. Especially in a disorderly adjustment scenarios, dynamic adjustments and temporary over-shootings can be critical. A VAR model is better suited to mapping out the adjustment process of aggregate capital flows to global financing shocks, but at the expense of overlooking country specific factors and variations.
11. Aizenman and Jinjarak (2009), Caballero (2010) and Reinhart and Reinhart (2009) find that that surges are correlated with real estate booms, banking crises, debt defaults, inflation, and currency crises, while Edwards (2005), Freund and Warnock (2007) find that sudden stops are correlated with currency depreciations, slower growth, and higher interest rates. Claessen and Ghosh (2013) where they look at the link between sudden stops and different crisis events but without establishing the direction of causality.
12. Several methodologies exist for identifying surge and stop episodes in capital flows. The one followed here is that of Forbes and Warnock (2012), who define surge (stop) episodes as occurring when the annual changes in gross capital inflows exceed (fall below) the upper (lower) band formed by the 5-year rolling standard deviation in capital flows around the 5-year rolling mean of capital flows. (see figure XX for an illustration for the case of Brazil). Gross capital inflow data were obtained from quarterly Balance of Payment statistics and cover 60 countries, among which 40 developing countries. The primary data source is the International Monetary Fund's International Financial Statistics (IFS), which is gap-filled using source-country information accessed through Haver Analytics. The data used here differs from Forbes and Warnock (2011), by extending coverage beyond 2009 through 2013Q2.
13. The remaining 47 percent of crises occurred in the absence of a surge in external capital flows either in the two years before or after a crisis.
14. Thus, in the two years following a banking crisis a country has a 28 percent chance of having a currency or sovereign debt crisis. Moreover, 30 percent of the countries that had a currency crisis endured an earlier banking crisis. In contrast, the likelihood of a banking or sovereign debt crisis following a currency crisis is broadly the same (c. 20 percent) as is the likelihood of one occurring before the crisis or after the currency crisis. Taken together, this data suggests that banking crises tend to cause currency and sovereign debt crises in a way that those kinds of crises do not cause bank crises – an intuition that formal tests of granger causality confirm.
15. Eichengreen and Rose (1998) and Eichengreen and Arteta (2000) provide extensive review of the cross-country empirical literature on banking crisis with focus on developing countries. See also Reinhart and Rogoff (2009) for more recent discussion of the developments in the literature.
16. Earlier literature which emphasized the importance of global factors in explaining financial crises are, among others, Frankel and Rose 1996, Eichengreen, Rose, and Wyplosz 1996, Eichengreen and Rose 1998, Frankel and Roubini 2001, and Reinhart and Rogoff 2009. Forbes and Warnock (2010) examines the importance of global, contagion, as well as domestic factors in explaining extreme episodes of capital flows, although it tends to focus on high income and emerging economies. For a recent treatment of global and contagion factors in the literature of financial stress transmission, see for example IMF (2013).
17. Much of the empirical studies of banking crisis focuses on a relatively limited number of high income and emerging countries given their greater data availability. However, as we noted above, most banking crisis occurs in a developing countries, many of them in Africa. In order to retain them in the estimation sample and draw lessons relevant to them we focus on a relatively parsimonious list readily available on an annual basis.
18. See appendix for detail.
19. Unsurprisingly, because episodes of capital flow surges and stops are studied as a trigger for crises in developing

- countries, a similar group of global factors that were outlined in the preceding section as determinants of international capital flows also feature among the determinants of banking crisis in developing countries.
20. Specifically, the VIX calculates the implied volatility of S&P 500 index options to gauge the market's expectation of stock market volatility over the next 30 day period. Thus the higher value of VIX index implies greater "fear" and therefore greater risk aversion (diminished risk appetite) among the global investors. See Appendix for more detail.
 21. Similar list of measures are used to capture the global monetary conditions in, among others, Forbes and Warnock (2011), Eichengreen and Rose (1998), Eichengreen and Arteta (2000), and Bordo, Hargreaves, and Kida (2010).
 22. We initially used first two principal components of a large number of commodity price indexes. The first principal components, which explains x percent of the variations in the commodity price indexes, tracks closely the energy (oil and natural gas) commodity index, while the second principal components, which explains y percent of the variation, tracks closely the agricultural commodity price index. For ease of interpretation, we decided to use agricultural energy commodity indexes instead of the principal component indices although doing so somewhat reduces the predictive power of the estimated models.
 23. Same or similar measures are used in, for example, Forbes and Warnock (2011) and IMF (2013). See Appendix x for more detail
 24. The ratio of M2 to reserves measures in general a relative development in the banking sector. It also tends to increase rapidly following financial liberalization or loosening of financial regulation.
 25. The list most closely corresponds to that of Eichengreen et al (1996, 1998, 2000) who, based on an extensive review of and experimentation with various measures of domestic macroeconomic and financial characteristics, find them reasonably robust and significant in a number of different specifications in a large sample of developing countries. These measures are also standard in capturing domestic fundamentals more generally in macroeconomic monitoring and vulnerability assessment work both in the World Bank and the IMF.
 26. A pooled regression involves pooling observations across country- and time-dimensions such that a unit of observation becomes a country-year, not a country. This strategy is commonly used in unbalance panel data like one we are dealing with. Many of the countries in the sample have limited time series observations, so a panel regression would severely limit the number of countries remaining in the estimation sample. To allow for the fact that same countries are repeatedly observed in the sample, such that errors in the model are not independently and identically distributed, we use robust standard errors with clusters, where the cluster is defined as a country, to allow errors of a given country to be correlated over time. Table x in the appendix report countries in the estimation sample and time series observation available for each.
 27. The graph shows the "standardized coefficients" (see Chuhan, Classens, and Mamingi, 1993, and IMF, 2013) from the regression analysis in the annex, which are derived by multiplying the absolute value of the estimated coefficients in regression 5 of Table Annex xx by the standard deviation of the independent variable – using the absolute value of coefficients means facilitates comparison of variables where risk rises with increasing values with variables where risk declines with rising values.
 28. The contribution to overall risk is explained both by the sensitivity of risk to the variable in question, but also the extent to which the variable has fluctuated during the sample period. Should variability in the future differ from the past, then the weightings in Figure xx would also change – even if the sensitivity of crises to changes were constant.
 29. In the Laeven and Valencia (2012) data, 8 developing countries had banking crisis in 2008-09 (compared to 15 in high income countries): Hungary, Kazakhstan, Latvia, Mongolia, Nigeria, Russia, Slovenia, and Ukraine. Hungary and Slovenia were not included in the prediction sample because of missing data in external debt (Slovenia) and short-term debt (Hungary and Slovenia).

30. Of the remaining countries, using the same metric (higher than average estimated likelihood of crisis) the model predicted a crisis in x countries that did not have one.
31. The model with both global and local determinants of capital flows is consistent with the recent policy and academic literature (see, for instance, IMF 2013, Ahmed and Zlate 2013, Fratscher 2011, Bruno and Shin 2013, Forbes & Warnock 2012). This approach is also consistent with an earlier literature on capital flows (Chuhan, Claessens & Mamingi 1996, Taylor and Sarno 1997, Calvo Leiderman & Reinhart 1996, Montiel & Reinhart 1999).
32. Note, as well, that our use of M2 as the measure of the money supply ensures that it overlaps only minimally with changes in the monetary base that result from QE operations. Pairwise correlations between the two are relatively low.
33. Although the coefficient on high-income growth can be ambiguous, since faster growth in advanced economies can render financial assets there more attractive, and hence reduce inflows to the developing world.
34. The IFS data include a residual category, “other investments,” that includes loans as a subcomponent. However, this category also includes other forms of cross-border finance (such as trade credit and cash) that are of a fundamentally different nature from bank loans, which make it harder to draw inferences when we disaggregate by flow type. We therefore use the more clearly-delineated LBS data instead.
35. Note also that the insignificant coefficient on the uninteracted QE episode variable in most of the specifications need not be a real cause for concern; the total effect has to be inferred from the sum of both the uninteracted and interaction terms, and some weighted standard error computed for proper inference.
36. There is some dispute as to whether the ECB's Long-Term Refinancing Operations constitute a form of quantitative easing; we stay with the convention here and exclude this program as a form of QE. Note as well that while the SMP has resulted in a substantial expansion of the ECB balance sheet, the OMT has in fact never been used, despite widespread acknowledgment that the program engendered confidence effects.
37. For the episode indicator, we drew on qualitative information in Neeley (2013) concerning G4 central bank unconventional monetary policy actions, and coded additional quarters as QE periods if at least two additional central banks engaged in QE.
38. We construct this factor from the varimax orthogonal rotation of the first principal component of the vector of global variables. We also considered an alternative, the proportion-weighted sum of the first three principal components (all possessed eigenvalues greater than unity).
39. Moreover, the Kaiser-Meyer-Olkin test of sampling adequacy indicates that the underlying variables are sufficiently distinct that partial correlations between them are low, and hence are not particularly well-suited for factor analysis.
40. This result also corroborates with evidence from gravity-type models of FDI (which finds larger FDI flows between bilateral pairs with larger pairwise GDP), and the more general stylized fact that gross FDI inflows tend to be countercyclical and the least volatile among different financial flows (Contessi, DePace, and Francis 2013).
41. This coefficient is negative, which indicates that inflows into debt decrease when global growth prospects improve. This outcome is consistent with substitution into riskier assets when growth outlooks turn upward.

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