The World Bank

PREMnotes

ECONOMIC POLICY

APRIL 2000

NUMBER 38

Global Development Finance projects a brighter outlook for developing countries

Developing countries are recovering from the recent crisis more quickly than expected, but the adjustment is far from complete.

Prospects for developing countries have improved considerably in the past six months finds the World Bank's just-released *Global Development Finance 2000*. Industrial country output and world trade growth have become stronger and more broadly based. Although prices for primary commodities have firmed, inflationary pressures in the world economy remain contained. And while interest rates in some industrial countries have risen, spreads on lending to developing countries have fallen sharply—and capital flows to developing countries have stabilized.

Developing countries grew an estimated 3.3 percent in 1999, up 0.6 percentage points from the estimate in last fall's *Global Economic Prospects* and more than twice the pace in 1998 (table 1). Developing country growth is expected to rise to 4.5–5.0 percent in 2000–02. During the recent financial crisis 45 developing countries containing 1.6 billion people experienced a drop in per capita income. But in 2000 those numbers are expected to fall to 14 countries with 140 million people.

Still, the developing world's adjustment to the recent crisis is far from complete. Growth in 2000–02 will likely remain below trends before the crisis because frailties exposed and exacerbated by the crisis will take time to address. Moreover, the process of recovery varies greatly by country.

Growing momentum in industrial countries and in world trade

Growth in high-income countries is expected to rise to 3.2 percent in 2000, 0.7 points faster than envisaged last fall. In 1999 U.S. growth reached about 4 percent for the third year in a row, and this momentum is expected to carry through 2000. Sustained tightening by the Federal Reserve to ward off inflation should slow growth to less than 3 percent in 2001–02, however.

Europe saw a strong rebound in growth in the second half of 1999 to near 4 percent in annual terms, drawing strength from robust exports and high consumer and business confidence. Growth in Europe is expected to continue at about the same pace in 2000. Even Japan, where output fell in the second half of 1999, is expected to see growth pick up to 1.0–1.5 percent over the next two years as resumed fiscal stimulus, rising business confidence, and stabilization in consumer markets offset the costs of corporate and financial restructuring.

Sharp swings in world trade growth have helped transmit the impact of the financial crisis through the global economy both during the downswing in 1997–98 and during the current recovery. World import growth rose to about 6.5 percent in 1999—up nearly 3 points from 1998—due to a sharp recovery in Japanese and East Asian demand

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TABLE 1 REAL GDP GROWTH AND THE GLOBAL ECONOMIC ENVIRONMENT
(percentage change from previous year except LIBOR)

Indicator	*Estimate 1999*	*Current forecasts* 2000	2001	2002	Global Economic Prospects 1999/2000 *forecasts* 2000	2001	2002
World GDP growth	2.9	3.5	3.1	3.1	2.9	2.8	3.0
High-income countries	2.7	3.2	2.7	2.6	2.5	2.3	2.5
Low- and middle-income countries	3.3	4.6	4.8	4.8	4.2	4.5	4.8
Sub-Saharan Africa	2.5	3.2	3.7	3.8	3.1	3.4	3.4
East Asia and Pacific	6.5	6.6	6.3	6.1	6.2	6.2	6.2
East Asia crisis countries[a]	5.8	5.7	5.4	5.1	5.3	5.1	5.1
South Asia	5.8	5.9	5.8	5.5	5.5	5.3	5.3
Europe and Central Asia	1.0	2.5	3.4	3.6	2.5	3.3	3.6
Latin America and Caribbean	0.0	3.6	3.8	4.4	2.7	3.5	4.4
Middle East and North Africa	2.2	3.5	3.6	3.6	3.2	3.5	3.6
World trade volume	5.2	8.3	6.9	6.5	6.4	6.3	6.3
Inflation in G–7 countries[b]	1.3	1.8	1.9	2.0	1.6	1.8	2.0
Commodity prices (except oil)[c]	–11.2	5.6	3.9	3.3	3.0	4.6	3.8
Oil prices[c]	38.3	27.3	–17.4	–5.3	2.8	–2.7	0.0
Manufactures export unit value[d]	–0.6	2.5	2.5	2.6	2.5	2.5	2.6
Six-month LIBOR[e]	5.5	6.5	6.5	5.5	6.0	6.0	5.5

a. Indonesia, Republic of Korea, Malaysia, Philippines, and Thailand.
b. Canada, France, Germany, Italy, Japan, United Kingdom, and United States. In local currency, aggregated using 1998–2000 weights.
c. In nominal U.S. dollars.
d. Unit value index of manufactures exports from G–5 (France, Germany, Japan, United Kingdom, and United States) to developing countries, expressed in U.S. dollars.
e. London interbank offered rate.

and continued double-digit growth in the United States.

World imports are projected to rise much faster than previously anticipated, by 8–9 percent in 2000 and by nearly 7 percent in 2001–02, fueled by stronger growth in industrial countries and by the recovery in developing Asia and large Latin American countries. Broader import growth in Europe and Japan is helping reduce excessive dependence on the United States as an engine of world growth. As a result developing country exports are expected to rise 7.5–8.5 percent in 2000–02, up 1.5–2.0 points from 1998–99.

Firming commodity prices

Falling world demand during the international financial crisis contributed to large declines in prices for many primary commodities, exacerbating the burden of adjustment in commodity-exporting developing countries. In 1998 energy prices fell 30 percent and nonenergy commodity prices, 16 percent. Nonenergy commodity prices fell another 11 percent in 1999, with agricultural goods experiencing especially severe declines. Most commodities, however, began to recover in 1999, due to rising demand for industrial commodities such as metals and petroleum products and to cuts in supply by producers—especially for oil, the price of which surged nearly 40 percent.

Most major commodity groups are expected to strengthen further in 2000. But except for oil and metals, few increases are expected to be especially robust. The skewed pattern of price recovery has affected developing countries in different ways. Terms of trade gains boosted oil exporters' real incomes by 5 percent in 1999 and should yield another 3 percent in 2000. But terms of trade shifts cut nonoil commodity exporters' income by more than 1 percent in 1999, and some agricultural exporters suffered much larger losses. Diversified exporters experienced—and should continue to experience—only minor effects, because higher prices for commodity imports are offset by higher prices for manufactured exports.

Gradual recovery in private flows

Gross flows from international capital markets to developing countries fell 14 percent in 1999, though by the second half of the year they were stabilizing around the levels of a year earlier. Flows are projected to rise 15 percent in 2000, to $185 billion, and to $220–230 billion in 2001—as high, relative to GDP, as in 1995, though still less than during the extraordinary surge in 1996–97, just before the financial crisis. The stabilization of flows in 1999 was accompanied by a 6 percentage point drop in spreads on lending to developing countries, reflecting improving perceptions of risk.

Foreign direct investment to developing countries proved resilient during the crisis and is expected to increase from $183 billion in 1999 to $200 billion in 2000 and $215 billion in 2001. This growth rate would be more modest than in the first half of the 1990s. But it would be consistent with a natural stock adjustment process in which, after a decade of rapidly growing flows, multinational corporations are closer to desired levels of investment in target developing countries.

A diverse outlook for developing regions

Developing country output is estimated to have increased 3.3 percent in 1999, and is projected to rise 4.5–5.0 percent in 2000–02. But several factors may prevent a more rapid return to the growth rates before the crisis. First, domestic adjustment to the crisis, especially in the financial sector, is far from complete in a number of Asian and Latin American countries. Fiscal consolidation in the crisis countries and in some large developing economies less affected by the crisis is also likely to be difficult and protracted.

Second, growth in several large, highly indebted developing countries remains vulnerable to renewed volatility in capital flows. Third, the terms of trade for agricultural exporters are likely to worsen in the short term as prices for agricultural commodities recover more slowly than prices for oil, metals, and manufactured goods.

East Asia's five crisis countries saw a much faster than anticipated aggregate recovery in 1999, boosted by strong growth in exports and domestic demand. Slow progress on corporate and financial restructuring and continued political uncertainty in Indonesia are expected to restrain growth in these countries to below precrisis levels, however. Overall, East Asia's growth is expected to reach 6–7 percent in 2000–02.

The financial crisis had less effect on *Latin America* than was feared. Regional output was flat in 1999 and is expected to grow 3.6 percent in 2000—nearly 1 point more than expected, supported by a strong U.S. market and higher prices for exports. But several factors weigh against a stronger rebound in 2000–01, including higher U.S. interest rates, lower terms of trade for the region's oil importers, and high current account deficits, which may deter foreign investors. Still, growth is expected to strengthen as countries make progress on adjustment.

At 5.8 percent, growth in *South Asia* turned out higher than expected in 1999, reflecting stronger results in agriculture and improving business confidence, due in part to better prospects for political stability and continued economic reforms in India. Regional growth is expected to approach 6 percent in 2000–01. Several factors will prevent growth from reaching higher, including slow progress on correcting large fiscal deficits, an erosion of cost competitiveness relative to Southeast Asia, and high tensions between India and Pakistan.

Europe and Central Asia's growth of 1 percent in 1999 was about 0.7 points higher than forecast. Central European exports benefited from the recovery in Western Europe, while growth in the Commonwealth of Independent States was boosted by higher oil prices and large import substitution effects in Russia. Problems arose, however, including the August earthquake in Turkey, the war in Kosovo, and weak consensus on reform in the Balkans and Romania. Projections for regional growth of 2.5–3.5 percent in 2000–02 are in line with the previous forecast.

Several factors may prevent a more rapid return to the growth rates before the crisis

Though the outlook has improved, significant risks remain

Although the jump in oil prices in 1999 led to better short-term fiscal positions and real incomes for oil exporters in the Middle East and North Africa, regional GDP growth slowed to 2.2 percent. Growth should rise to 3–4 percent in 2000, however, supported by recovery in Europe, higher oil prices, and an expansion of oil production. Tight fiscal polices aimed at strengthening longer-term fiscal sustainability will restrain near-term growth, but continued privatization and policy reforms should help sustain growth of 3–4 percent in 2001–02, an improvement over the past two decades.

A number of factors slowed growth in Sub-Saharan Africa to about 2.5 percent in 1999: low commodity prices, weak export demand, bad weather, renewed civil strife, and higher interest rates in South Africa. In 2000 stronger agricultural and export performance are expected to raise growth to just over 3 percent. In 2001–02 growth is expected to strengthen to nearly 4 percent—assuming that governance and policies continue to improve.

Risks to the forecast

The risks to the outlook presented in *Global Development Finance 2000* are less than they were six months or a year ago. But they remain significant, originating in the need to achieve four transitions:

- A transition to a soft landing in the United States. Sustained monetary tightening to curb excessive demand growth could provoke a major correction in U.S. equity markets, leading to sharp drops in consumption and investment.
- A transition to private demand–led growth in Japan. Japan's anemic growth is dependent on an unsustainable fiscal stimulus. Inadequate progress on financial and corporate restructuring could prevent a restoration of investor confidence and an adequate flow of private credit.
- A transition from strong cyclical recovery to sustained high growth in East Asia, which will depend on restoring balance sheet health in the financial and corporate sectors. Corporate restructuring appears to be progressing slowly, leaving countries vulnerable to a downturn in investor sentiment.
- The projected transition to lower oil prices would help oil importers, but it would hurt recovery prospects for several oil exporters hit hard by the global financial crisis, including Ecuador, Indonesia, Nigeria, Russia, and the Republica Bolivariana de Venezuela.

Except for a severe hard landing in the United States, a failure to complete any one of these transitions is unlikely to derail the global expansion. But each failure would leave various groups of developing countries exposed to shocks and would contribute to problems that accumulate over time.

This note is based on chapter 1 of Global Development Finance 2000. *The chapter was written by a Development Prospects Group team comprising Robert Lynn (team leader), Annette de Klein, Caroline Farah, Robert Keyfitz, Mick Riordan, Dominique Van Der Mensbrugghe, and Bert Wolfe. Questions on the forecasts should be addressed to Robert Lynn (x33961). Swaminathan Aiyar, Sandeep Mahajan, and Milan Brahmbhatt prepared the summary in this note.*

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