Executive Summary

The world economy has entered a dangerous period. Some of the financial turmoil in Europe has spread to developing and other high-income countries, which until earlier had been unaffected. This contagion has pushed up borrowing costs in many parts of the world, and pushed down stock markets, while capital flows to developing countries have fallen sharply. Europe appears to have entered recession. At the same time, growth in several major developing countries (Brazil, India and, to a lesser extent, Russia, South Africa and Turkey) is significantly slower than it was earlier in the recovery, mainly reflecting policy tightening initiated in late 2010 and early 2011 in order to combat rising inflationary pressures. As a result, and despite a strengthening of activity in the United States and Japan, global growth and world trade have slowed sharply.

In this context, prospects are very uncertain…

Indeed, the world finds itself, in January 2012, living a version of the downside scenarios discussed as a risk just 6 months ago when the June edition of *Global Economic Prospects* (GEP) was released. As a result, forecasts have been significantly downgraded in this edition of GEP.

- The global economy is now expected to expand 2.5 and 3.1 percent in 2012 and 2013 (3.4 and 4 percent when calculated using purchasing power parity weights), versus the 3.6 percent projected in June for both years.
- High-income country growth is now expected to come in at 1.4 percent in 2012 (-0.3 percent for Euro Area countries, and 2.1 percent for the remainder) and 2 percent in 2013, versus a June forecast of 2.7 and 2.6 percent for 2012 and 2013 respectively.
- Developing country growth has been revised down to 5.4 and 6 percent versus 6.2 and 6.3 percent in June.
- Reflecting the growth slowdown, world trade, which expanded by an estimated 6.6 percent in 2011, will grow only 4.7 percent in 2012, before strengthening to 6.8 percent in 2013.

However, even achieving these much weaker outturns is very uncertain. The downturn in Europe and the slow growth in developing countries could reinforce one another more than is anticipated in the baseline scenario, resulting in even weaker outturns and further complicating efforts to restore market confidence. Meanwhile, the medium-term challenge represented by high debts and slow trend growth in other high-income countries has not been resolved and could trigger sudden adverse shocks. Additional risks to the outlook include the possibility that political tensions in the Middle East and North Africa disrupt oil supply, and the possibility of a hard landing in one or more important middle-income countries.

While the situation in high-income Europe is contained for the moment, if the crisis expands and markets deny financing to several additional European economies, outturns could be much worse, with global GDP more than 4 percent lower than in the baseline. Although such a crisis, should it occur, would be centered in Europe, developing countries would feel its effects deeply, with developing country GDP declining by 4.2 percent by 2013.

In the event of a major crisis, the downturn may well be longer than in 2008/09 because high-income countries do not have the fiscal or monetary resources to bail out the banking system or stimulate demand to the same extent as in 2008/09. Although developing countries have some maneuverability on the monetary side, they could be forced to pro-cyclically cut spending – especially if financing for fiscal deficits dries up.

Contagion spreads to developing countries…

The heightened market volatility since August 2011 has differed qualitatively from earlier ones because this time the credit default swaps (CDS) spreads have increased by an average of 117 basis points (bps) between the end of July 2011 and early January 2012, as did those of almost all Euro Area countries, including France and Germany, and those of non-Euro Area countries, such as the United Kingdom.

For developing countries, the contagion has been broadly based. In addition to higher bond spreads and CDS rates, developing-country stock markets have lost 8.5 percent of their value since July-end. This, combined with the 4.2 percent drop in high-income stock-market valuations, has translated into \$6.5 trillion, or 9.5 percent of global GDP, in wealth losses.

Perhaps more importantly, capital flows to developing countries have weakened sharply as investors withdrew substantial sums from developing-country markets in the second half of the year. Overall, gross capital flows to developing countries plunged to \$170 billion in the second half of 2011, only 55 percent of the \$309 billion received during the like period of 2010. Equity issuance plummeted 80 percent to \$25 billion with exceptionally weak flows to China and Brazil accounting for much of the decline. Bond issuance almost halved to \$55 billion, due to a large fall-off in East Asia and emerging Europe. The decline in syndicated bank loans was much less marked, largely because such activity remained very depressed following the 2008/09 crisis.

The real-side effects of the post-August turmoil are somewhat difficult to discern, in part because the slowing of industrial production growth in several large middle-income countries preceded the resurgence of financial tensions in August. Indeed, activity in Europe and Central Asia, the United States and Japan has accelerated since August. Trade data, on the other hand, suggests a clearer impact from the post-August turmoil and weakness in Europe. Global trade volumes declined at an annualized pace of 8 percent during the three months ending October 2011, mainly reflecting a 17 percent annualized decline in European imports. Developing-country exports declined at a 1.3 percent annualized pace in the third quarter of 2011 and have continued to decline through November, with the sharpest contractions in South Asia (following very rapid export growth in the first half of the year). Exports from East Asia have also been falling at double-digit annualized rates, in part because of disruptions to supply chains caused by the flooding in Thailand.

Developing countries are more vulnerable than in 2008…

Whatever the actual outcomes for the world economy in 2012 and 2013, several factors are clear. First, growth in high-income countries is going to be weak as they struggle to repair damaged financial sectors and badly stretched fiscal balance sheets. Developing countries will have to search increasingly for growth within the developing world, a transition that has already begun but is likely to bring with it challenges of its own.

One of the most positive elements of the recession of 2008/09 was the speed with which developing countries (other than those in Central and Eastern Europe) exited the crisis. By 2010, 53 percent of developing countries had regained levels of activity close to, or even above, estimates of their potential output. This time, developing countries look to be more vulnerable if there is a sharp deterioration in global conditions.

Even though fiscal conditions are still generally better in developing countries than in high-income countries, government balances have deteriorated by two or more percent of GDP in almost 44 percent of developing countries and some 27 developing countries have government deficits of 5 or more percent of

GDP in 2012. As a result, developing countries have much less fiscal space available to respond to a new crisis.

Should conditions in high-income countries deteriorate and a second global crisis materializes, developing countries will find themselves operating with much less abundant capital, less vibrant trade opportunities and weaker financial support for both private and public activity. Under these conditions, prospects and growth rates that seemed relatively easy to achieve during the first decade of this millennium may become much more difficult to attain in the second, and vulnerabilities that remained hidden during the boom period may become visible and require policy action.

In this highly uncertain environment, developing countries should evaluate their vulnerabilities and prepare contingencies to deal with a downturn.

- *If global financial markets freeze up, governments and firms may be unable to finance growing deficits.* Countries should engage in contingency planning, prioritizing social safety nets and infrastructure spending to assure longer-term growth. Problems are likely to be particularly acute for developing countries with external financing needs that exceed 5 percent of GDP. Where possible, they should pre-finance to avoid abrupt cuts in government and private-sector spending.
- *A renewed financial crisis could accelerate the ongoing financial-sector deleveraging process.* Several countries in Eastern Europe and Central Asia, reliant on high-income European banks, are particularly vulnerable to a sharp reduction in wholesale funding and domestic bank activity. Deleveraging of banks in high-income countries could result in a forced sell-off of foreign subsidiaries, and affect valuations of foreign and domestically-owned banks in countries with large foreign presences. And slower growth and deteriorating asset prices could rapidly increase non-performing loans throughout the developing world. To prevent domestic banking crises, countries should engage in stress testing of their domestic banking sectors.
- *A severe crisis in high-income countries could put pressure on the balance of payments and government accounts of countries heavily reliant on commodity exports and remittance inflows.* A severe crisis could cause remittances to developing countries to decline by 6 or more percent, with particularly acute impacts among the 24 countries where remittances represent 10 or more percent of GDP. Oil and metal exporting countries would also be affected in a major crisis. The fiscal balances of major oil and metal exporters could deteriorate by 4 or more percent of GDP. Although lower food prices would reduce incomes of producers (partially offset by lower oil and fertilizer prices), it would benefit consumers.

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

	2009	2010	2011e	2012f	2013f
Global Conditions					
World Trade Volume (GNFS)	-10.6	12.4	6.6	4.7	6.8
Commodity Prices (USD terms)					
Non-oil commodities	-22.0	22.4	20.7	-9.3	-3.3
Oil price $.bbl	61.8	79.0	104.0	98.2	97.1
International capital flows to developing countries (% of GDP)					
Developing countries					
Net private and official inflows	4.2	5.8	4.5		
Net private inflows (equity + debt)	3.7	5.4	4.3	3.3	3.7
East Asia and Pacific	3.7	6.0	4.7	3.4	3.7
Europe and Central Asia	2.7	5.0	3.6	2.0	2.9
Latin America and Caribbean	3.9	6.0	4.8	4.1	4.3
Middle East and N. Africa	2.8	2.4	2.0	1.2	1.6
South Asia	4.6	5.0	3.9	3.3	3.7
Sub-Saharan Africa	4.0	3.7	3.9	3.5	4.4
Real GDP growth [5]					
World	**-2.3**	**4.1**	**2.7**	**2.5**	**3.1**
Memo item: World (PPP weights) [6]	-0.9	5.0	3.7	3.4	4.0
High income	**-3.7**	**3.0**	**1.6**	**1.4**	**2.0**
Euro Area	-4.2	1.7	1.6	-0.3	1.1
Japan	-5.5	4.5	-0.9	1.9	1.6
United States	-3.5	3.0	1.7	2.2	2.4
Developing countries	**2.0**	**7.3**	**6.0**	**5.4**	**6.0**
East Asia and Pacific	7.5	9.7	8.2	7.8	7.8
Europe and Central Asia	-6.5	5.2	5.3	3.2	4.0
Latin America and Caribbean	-2.0	6.0	4.2	3.6	4.2
Middle East and N. Africa	4.0	3.6	1.7	2.3	3.2
South Asia	6.1	9.1	6.6	5.8	7.1
Sub-Saharan Africa	2.0	4.8	4.9	5.3	5.6

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