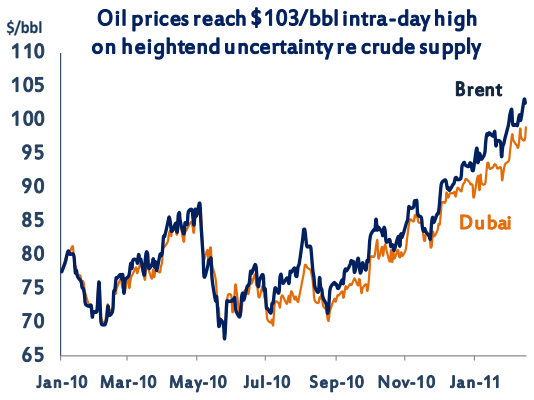
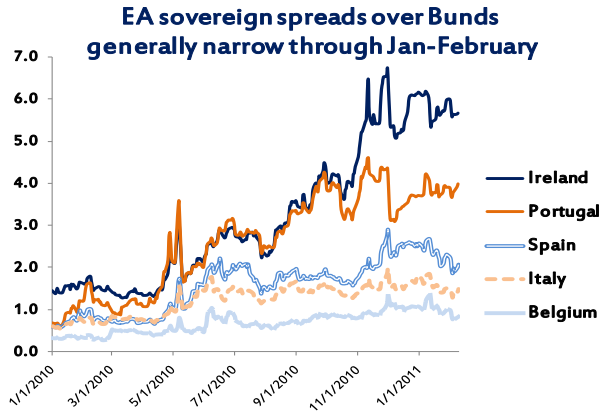
# Developing Trends: February 2011

## Overview

**The dramatic turn of events in the MENA region has been a watershed** for social and political-economy developments in Tunisia, notably in Egypt, and potentially beyond— with demonstrations in varying degree of intensity calling for political change in other countries in the region. Heightened uncertainty and possible 'contagion' within the region raised Brent crude oil prices above $103/bbl. Oil prices are likely to remain elevated in the near term, with negative consequences for the global economy, as risk perceptions about oil supply have increased. Within MENA, disruption to economic activity, adverse terms of trade effects for oil importers and a decline in tourism are likely to dampen 2011 growth outturns. It should be noted, however, that attempts to estimate economic effects under current circumstances can be indicative at best [See 'Focus'].




Source: Thomson/Datastream.




Source: Bloomberg and Thomson/Datastream.

**Food prices increased for a seventh month in January, with prices averaging just 3% below June 2008 peaks.** The price rally, which includes most commodities-not food alone-generated concern regarding food availability and security. Despite this season's production shortfalls in wheat and maize, grain markets (especially rice) are better supplied now than during the 2007/08 spike. *Yet additional up-side risks for food markets could emerge.* Further energy price increases would not only raise production costs (directly and indirectly through fertilizer prices) but also make biofuels more profitable. Weather shocks could induce further production shortfalls which could ignite defensive trade policies as they did in 2007/08. And high food prices could induce- or worsen political unrest in food importing countries, should governments be unable to contain emerging inflation pressures [See 'A closer look at food prices'].

**Despite these headwinds global economic recovery continues,** underscored by a revival in industrial production led by developing countries and expectations for stronger growth in the United States and prospectively for the Euro Area. On the European sovereign debt front, conditions improved in the last month: risk premiums for most affected countries narrowed; Portugal issued a bond at much reduced spreads, and importantly the EFSF (fund established for Euro Area countries in financial stress), issued a €5 billion bond which was 9 times oversubscribed. Further, activity in high-income countries is broadening to services industries from a base of recovery in manufacturing. And fourth quarter GDP outturns were robust in East Asia following a third-quarter slowdown (e.g., Indonesia 11.3% and the Philippines 12.7% (saar)).

**MENA weighing more heavily on emerging markets.** Share prices in Egypt and Tunisia declined 21%-and 14% respectively in the last month, while global equities posted gains. There is increasing evidence that investors are shifting funds from EM to OECD economies in search of "safe haven" investments; moreover, EM equities have underperformed relative to developed markets so far in 2011 [See 'EM equity valuations']. In brighter news, bond issuance by developing countries surged to $17 billion in January, the strongest on record.

Developing Trends was prepared by the Development Economics Prospects Group (DECPG) with colleagues from PRMTR and IFC (Risk/Economics). The team is comprised of Mick Riordan (OECD, currencies), Mariem Malouche and Mohini Datt (Trade), Shane Streifel and John Baffes (Commodities), Eung Ju Kim (Finance), Allen Dennis (IP) and Sabah Mirza (Annex). Lucio Vinhas de Souza authored the Focus segment this month on developments in MENA. Jean Pierre Lacombe and Facundo Martin of IFC authored a piece on EM equity valuations; and John Baffes expanded the Commodities section to look more closely at food prices. The report was prepared under the guidance of Andrew Burns of DECPG. This note reflects the views of the team, but is not formally cleared by the World Bank Group.

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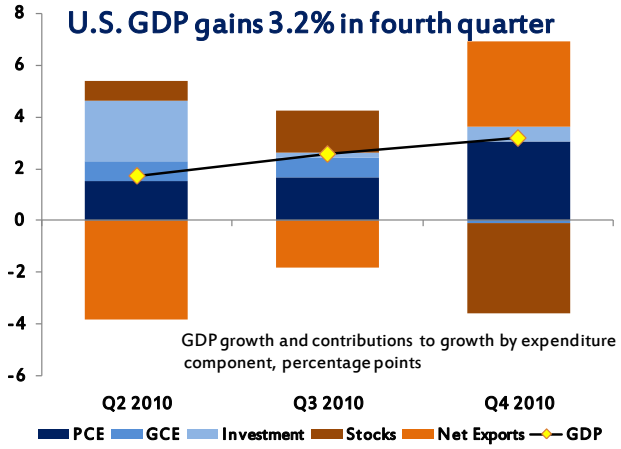
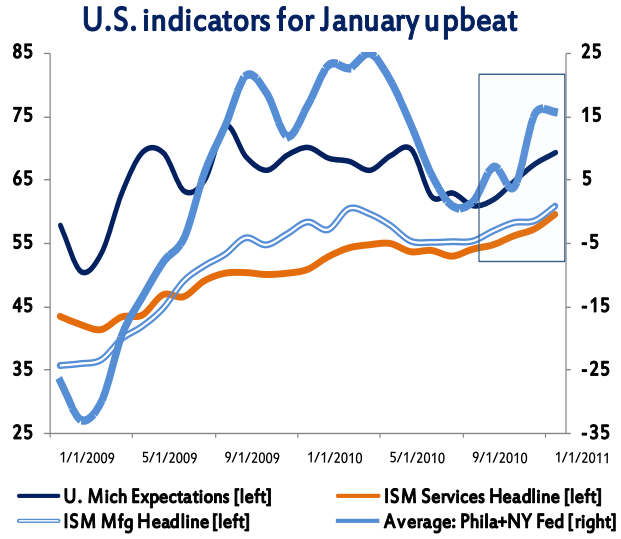
## United States

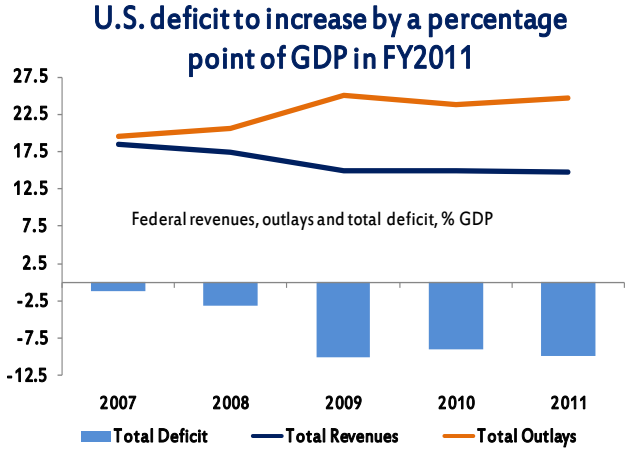
**U.S. GDP growth accelerated for a third consecutive quarter in the fourth of 2010—moving to gains of 3.2% from 2.6% (saar), on the back of exuberant consumer spending and a turnaround in net exports. The composition of GDP, and broadly upbeat indicators for January (despite inclement weather), raised Consensus forecasts for 2011 to a range of 3-3.5%. More stimulus means the fiscal deficit will rise by a percentage point of GDP in 2011 to 9.8%.**




Source: U.S. Department of Commerce.




Source: Various through Thomson/Datastream.




Source: Congressional Budget Office, January 2011.

**Consumer spending underpins step-up in GDP.** A buoyant holiday shopping season saw nominal retail sales surge by *15%* in the fourth quarter (saar), lifting real consumption growth to 4.4%, the strongest since 2006. Together with an upturn in fixed investment to 4.2% growth from 1.5% (Q3), domestic demand scored a third consecutive quarter of solid gains (3.1%)—and GDP moved up to 3.2% from 2.6% in the third quarter. A much weaker build in inventories diminished growth by 3.5 points in the quarter. But at the same time, U.S. net exports shifted from drag of 1.8 points of GDP in the third quarter to a fillip of 3.3 points in the fourth, as exports responded to increased global demand while imports contracted. The step-up in GDP offers promise of substantial positive 'carryover' for the first months of 2011.

**January indicators upbeat..despite weather.** Earliest snapshots of activity recorded in Federal Reserve surveys in Philadelphia/New York found conditions still vibrant, despite debilitating weather across three-quarter of the country. Headline PMIs for service industries (ISM) showed the fastest pace of expansion since 2005, underscoring that recovery is broadening from a manufacturing base to a wider array of non-manufacturing industries. U.S. job growth was affected by weather conditions however, with private employment restrained to an increase of 50,000. But population revisions released by Census lowered the unemployment rate to 9% from 9.4% in December. The Fed, though likely pleased with overall developments, has announced its intent to finish the current QEII round of $600 billion in Treasury purchases. Meanwhile benchmark 10-year yields increased 45 basis points from the first of January to mid-February, standing at 3.71%.

**Fiscal woes.** The Congressional Budget Office released its forecast of Federal budget shortfalls on a "current policy" basis, pointing to a deficit of nearly $1.5 trillion (9.8% of GDP) for FY2011, a widening by $200 billion from FY2010 outturns (8.9% of GDP). The budget outlook includes the effects of the negotiated set of tax measures (including the extension of the 'Bush' tax cuts for a further 2 years), unemployment insurance provisioning and other stimulus/safety net measures enacted in December. From this base, the new Republican majority in the House of Representatives has set sights on cutting domestic spending sharply; while the overall tone of policy after the December package is shifting toward austerity—highlighted by the Administration's imposition of a 2-year wage freeze for Federal civilian workers.

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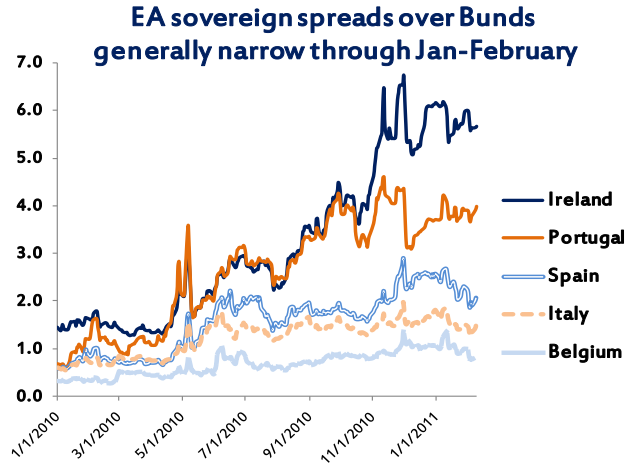
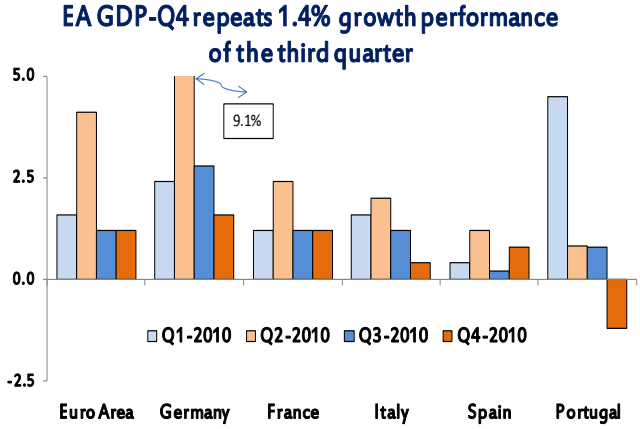
## Euro Area

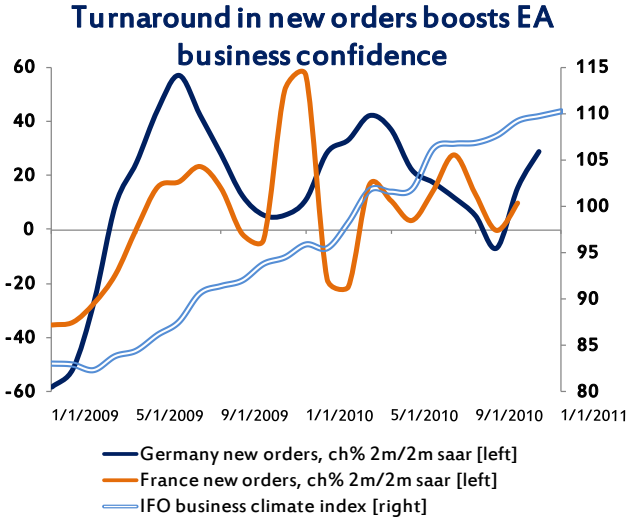
**European financial markets improved in the last weeks (euro and equity markets up), as concerns about the sovereign debt crisis subsided somewhat. The first bond sale by the European Financial Stability Facility was oversubscribed by 9 times. Q4-GDP disappointed by registering 1.4% gains, the same as in the previous quarter. But business sentiment soared in January on stronger factory orders and hoped-for stronger growth.**




Source: Bloomberg and Thomson/Datastream.




Source: National Agencies thorugh Eurostat.




Source: IFO and National Agencies a through Thomson/Datastream.

**Euro Area markets calmer.** The sovereign debt front in Europe witnessed generally encouraging developments in the last weeks, evidenced in narrowing spreads for 'peripheral' country bonds over the German 10-year bund. A key was issuance of the first bond, €5 billion ($6.8 billion) from the European Financial Stability Facility (EFSF), the fund established for Euro Area countries in financial stress, which was nearly 9 times oversubscribed. This was viewed as a sign of confidence in the Facility, and by extension, to the EU, in efforts to contain the crisis. In addition, Portugal was able to issue a bond at much reduced spreads; and though Ireland's credit rating was cut by S&P, the markdown was less severe than anticipated. At an EU Summit on February 4, ministers discussed an overhaul of the EFSF (expiring 2013), with a focus on the Fund's authority to purchase debt of countries under stress.

**GDP registers sluggish 1.4% gains in both third and fourth quarters.** The "flash" release for Euro Area GDP (headline figures only) showed that winter weather exacted a toll on Area output (now reported for "EA-17" following Estonia's accession to the group in January). Growth at an annualized rate amounted to 1.4% (saar) the same pace as in the third quarter. Germany eased to a sluggish 1.6% rate from 2.8% in the previous period, with construction and trade sectors hit hard by the cold snap. Growth in France held steady at 1.2%, while Italy saw a slowdown from 1.2% to 0.4% (saar). For countries near the epicenter of the sovereign debt crisis (and reporting returns), GDP contracted by 5.5% in Greece and by 1.2% in Portugal (saar), in large part a reflection of austerity measures.

**Business sentiment surges...real activity less buoyant.** IFO's respected survey of German business produced a striking result in January—assessment of the business climate jumped to highest readings since reunification of the country in 1999. INSEE (France), BNB (Belgium) and the EC's business confidence index for the Euro Area also moved higher in January. A driving force relates to a recent upturn in factory orders. Manufacturing orders growth in Germany and France is now increasing at improved rates: for Germany, 45% for export orders and 11% for domestic (2m/2m, saar); with 10% gains for France. German export performance continues to deteriorate however, with export volumes registering 0.6% growth in the fourth quarter of 2010, down from 15% in the third (saar). And consumer spending across the Area is weak, as government stimulus is being withdrawn across most countries.

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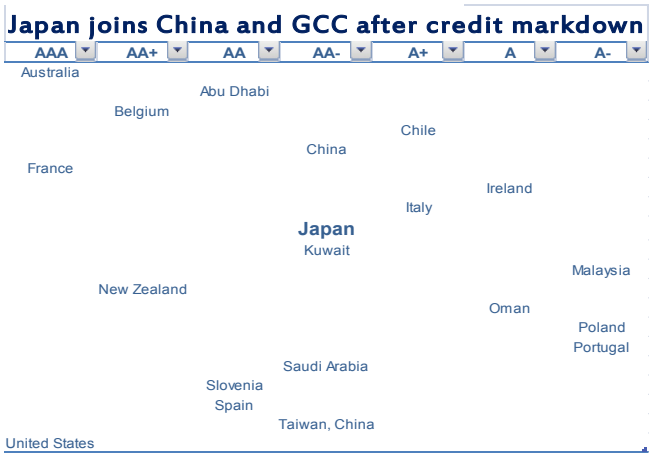
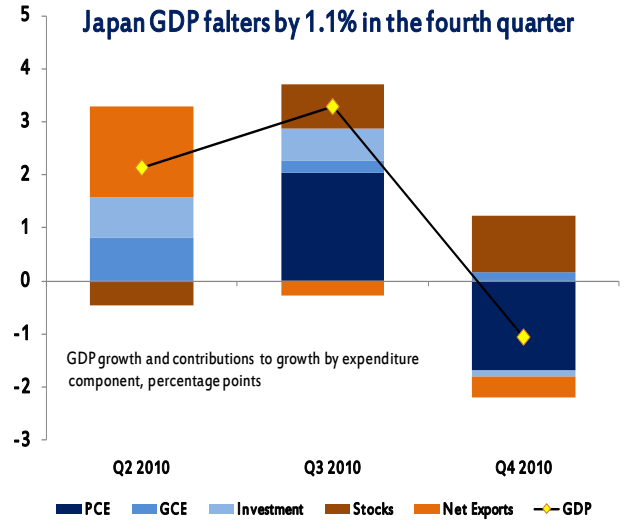
## Japan

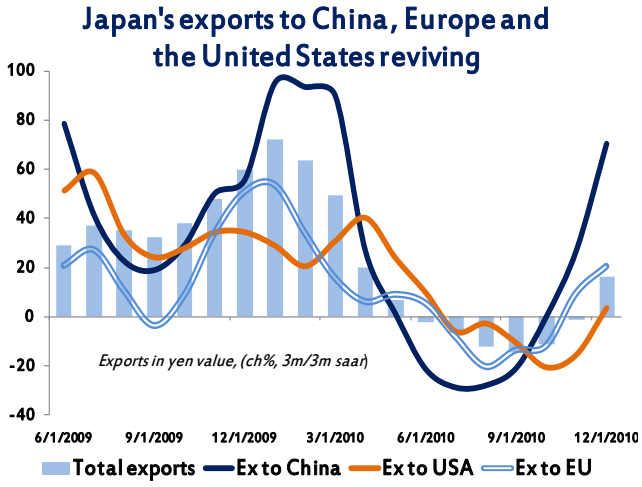
**The decision by Standard and Poor's to mark down Japan's sovereign credit rating by a notch to AA– from AA, grounded in its assessment that insufficient progress is being—or is likely to be made in addressing Japan's debt problem had a negative impact on financial markets. GDP declined 1.1% in the fourth quarter on a relapse in consumer spending and negative trade outturns. But there are increasing signs of an export revival.**




Source: Standard and Poors




Source: Japan Cabinet Office.




Source: Bank of Japan.

**Credit mark down.** For the first in nine years Japan saw its sovereign credit rating cut, as persistent deflation and apparent political gridlock undercut efforts to reduce a ¥943 trillion ($11 trillion) debt burden. S&P shifted Japan down a notch to AA-, the fourth highest rating, placing the country on par with China and several GCC countries. In the wake of the announcement, Prime Minister Naoto Kan proposed a package of stringent reforms, including a plan to overhaul social security, and to increase Japan's consumption tax as a means of stabilizing government finance. Mr. Kan also wishes to take a hard look at Japan's possible role in a new FTA called the Trans-Pacific Partnership. Prospects for passage are weak however, given current widespread opposition.

**Consumers retrench.** Over the middle months of 2010, generous government subsidies for the purchase of energy efficient autos, appliances and other goods were taken up by Japanese households with enthusiasm—real spending jumped 3.6% in the third quarter (saar) accounting for more-than total GDP growth of 3.3%. Sales relapsed into the final quarter of the year with withdrawal of public support, contributing to a 1.1% decline in GDP in the period (saar). Consumer spending retrenched 2.9% in the quarter; business investment fell 0.8%, and net exports contribution to growth registered drag for a second consecutive period at 0.4 points of growth. Of concern for the authorities, export volumes fell 2.8% in the quarter (saar), with imports contracting 0.5%. Deflation continued, as nominal GDP eased 2.5% against a volume fall of 1.1 points. Nonetheless, Japan registered strong 4% growth for 2010 as a whole, grounded in earlier strength in government spending, private investment and net trade.

**Long-awaited turnaround in exports.** Japan's exports have been declining since June 2010, falling 15% in nominal terms during the third quarter (saar), before showing recent signs of recovery. Variable demand in China, the United States and Europe in the course of recovery over 2009 and 2010, plus a near 25% appreciation of the yen's real effective exchange rate from late-2008 to end-2010 played a role. Recent data indicate a revival in export growth to 16% for the fourth quarter (saar), clearly led by a surge in shipments to China (70%, saar), to Asia excluding China (25%), Europe (20%) and to a lesser degree to the United States (3.5%). This development is one of only few sources of encouragement in Japan's economic outlook, but if continued, could set the stage for an emergence to stronger GDP growth in the second half of 2011.

February 17, 2011

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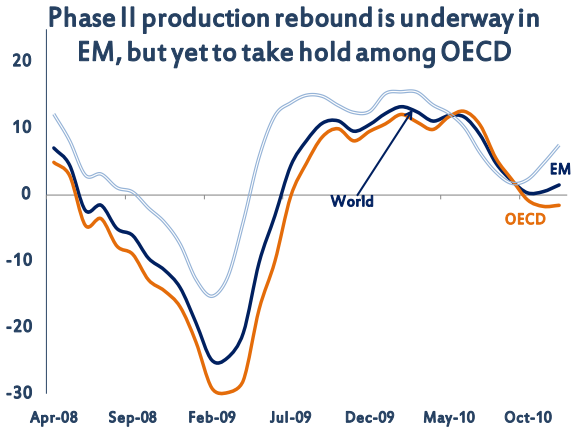
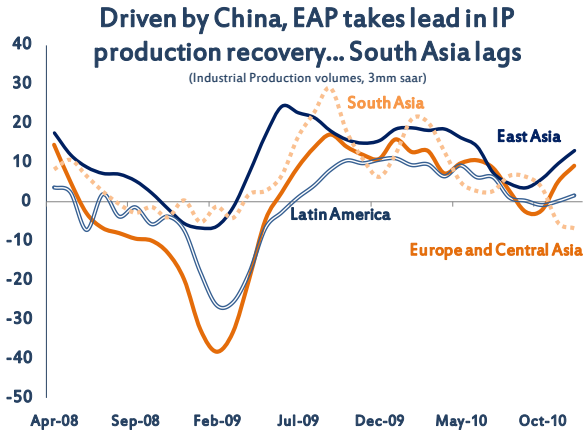
## Industrial Production

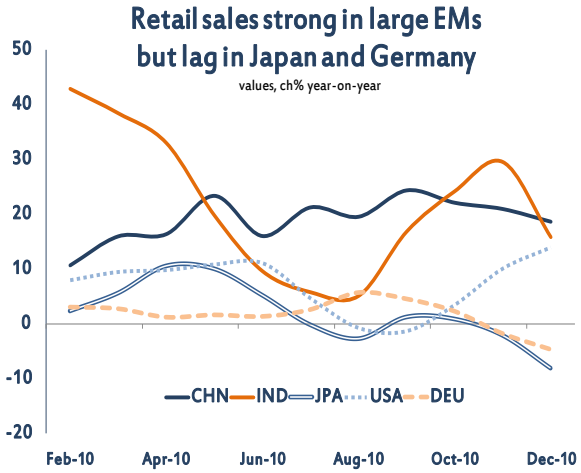
**Among developing regions, East Asia and the Pacific is leading recovery in industrial production; South Asia has yet to pick-up. Though production is increasing in high-income countries, the slump in Japan's output has dampened aggregate growth. Retail sales remain strong in the BRIC economies and the United States, but are currently easing in other OECD countries as stimulus measures are being withdrawn.**



Source: Development Prospects Group.



Source: Development Prospects Group.



Source: Development Prospects Group.

**Japan's slump weighs on OECD production.** Although world production is in recovery mode again, advancing 1.5% (3m/3m, saar) in November, output gains for the aggregate of high-income countries remains in the red (-1.4%). For both the United States and Germany, production has retained a positive tenor since October 2010. In contrast, production volumes in Japan have dropped consecutively for at least four months. Japan's production growth in November carried momentum to a decline of 11.5% (saar), its quickest falloff since June 2009. Though global demand is beginning to provide support for Japan's exports following a long slump, the softening of domestic demand continues to drag on industrial activity.

**Revival in production diverges across developing regions.** Output growth is picking up once more, with developing countries taking the lead. Still, across developing regions there remain large differences in performance. Driven by a strong Chinese rebound, production in East Asia and the Pacific ticked up by 17.2% in December 2010 (3m/3m, saar). Similarly, a revival of fuels and related product output in Russia boosted production in Europe and Central Asia by 12% (saar). In contrast, the pullback in infrastructure (construction) output and a scaling back of production to clear inventories stocked during October festivities in India, dragged industrial output in South Asia down by 6.7% in December (saar).

**Retail sales robust in the BRICs and the United States; but softening in other high-income economies.** Retail sales, an important driver for industrial production growth, continued to advance strongly in the BRIC economies. In December 2010, China, India and Russia recorded sales growth of 15.9%-, 19.2%-, and 15% respectively (3m/3m, saar). Brazil's retail turnover in November was 9%. In contrast with the United States- which registered 15% gains in December sales (3m/3m, saar) thanks in part to an improving job market, sales in the world's second and third largest high-income economies, Japan and Germany, declined (6.6% and 11.1% respectively). Retail sales in the United States advanced by 6.8% for 2010 as a whole, the highest in a decade, and has being echoed in the large contribution of private consumption to GDP in the year.

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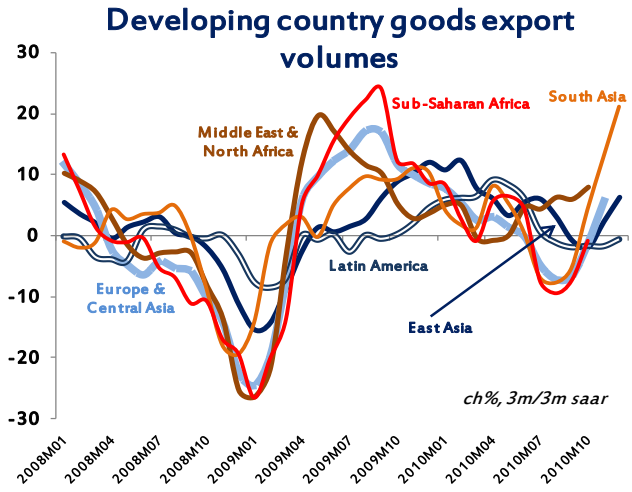
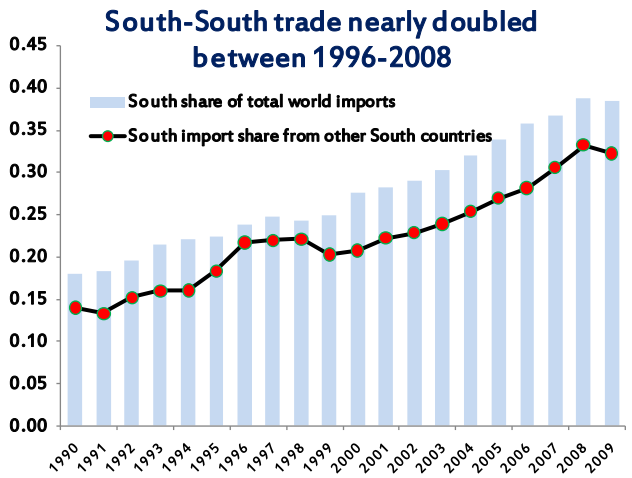
## International Trade

**Exports for all developing regions ended 2010 in recovery, rising back to pre-crisis levels. Recent political turmoil in the MENA threatens already fragile tourism, a sector that generates substantial revenues and employment for the region. Increasing South-South trade suggests that trade between developing countries can help mitigate the impact of crises. Developing countries should consider refraining from trade protectionist measures that harm other developing countries, and promote regional integration and trade facilitation.**




Source: Development Prospects Group.


Source: WTTC and World Bank DDP




Source: Comtrade data via WITS

**Developing export volumes in December 2010 exceeded start-of-year levels, led by soaring shipments from South Asia.** Export volumes posted strong recovery in the fourth quarter for most regions in the wake of faltering in the third quarter. Latin America's exports were plagued by weather-related agricultural shocks, but showed revival in December led by Mexico and Brazil. Rising external demand underpinned ECA's recovery in late 2010. And Sub-Saharan African volumes also recovered pre-crisis levels by the third quarter. Developing countries are posting more vibrant import growth than high-income countries, led by China. In value-terms, global imports are rising even more rapidly, echoing rising food and fuel prices, but contributing to a deterioration in trade balances among energy-importers. Goods trade is expected to grow by 8.2% in 2011 and 9.5% in 2012. Developing countries' share of total imports is projected to ease from 35% in 2010 to 29% by 2012, as import demand recovers in the high income countries.

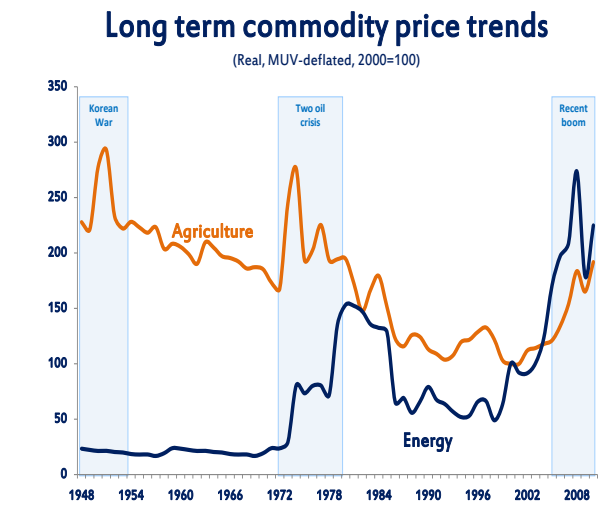
**Unrest in MENA is threatening fragile recovery in tourism.** Travel and tourism contribute significantly to an economy and generate sizable foreign exchange and employment in MENA, in particular for Egypt, Morocco and Tunisia (between 10% and 15% of GDP and employment; and up to 30% of total exports). The 'Jasmine Revolution' in Tunisia in January 2011 and the current turmoil in Egypt, Yemen, and to a lesser degree in Jordan and Lebanon, are expected to depress tourism revenues considerably and increase already high unemployment rates. These developments affect a fragile sector, only just recovering from the 2008 recession, when outbound travel from Europe and the United States plummeted. Oil importing countries in MENA will be doubly hit by the decline in tourism and higher oil price.

**Rising trade openness among developing countries can help mitigate the impact of crises and global volatility.** The increased resilience shown by developing countries to the trade effects of the financial crisis is partly attributable to the growing importance of South-South trade, especially for small, open, developing countries with strong links to China. BRICs can play a key stabilizing role due to their large internal markets. But it is crucial that emerging economies refrain from trade protectionist measures that harm developing country exports. The WTO's 2010 Trade Policy Review notes that 62% of all trade restrictive measures implemented between November 2009 and October 2010 were imposed by G-20 nations, half of which BRICs, with India in the lead; and a quarter by other developing countries, led by Indonesia & Argentina.

# Developing Trends: February 2011

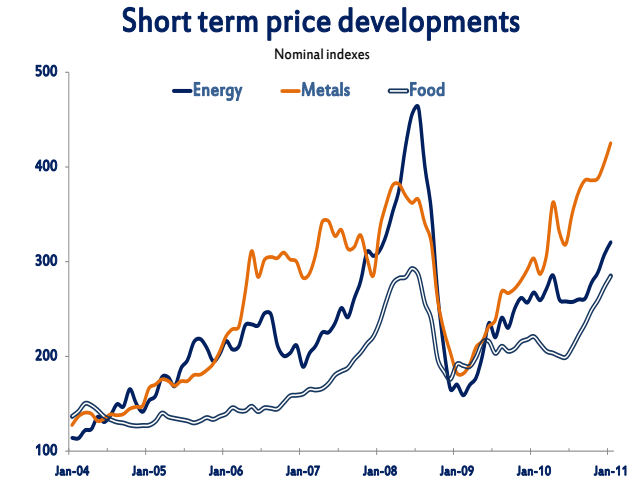
## Commodities: A closer look at food prices (1)

**After a long decline food (and most other) prices doubled in the last decade. Several factors have contributed, constituting a "perfect storm". Most frequently mentioned macro factors: dollar weakness, low interest rates, and investment fund activity. Sector-specific factors: low past investment, low stocks, more-frequent adverse weather events, biofuels, demand from emerging economies, and defensive trade policies. A key factor—*perhaps the most important*—has been increasing costs of production due to high energy prices.**




Source: World Bank

***Longer term trends.*** **Most agricultural commodity prices increased during the better part of the last decade, in contradiction to longer term productivity-induced declines estimated at about 1.5% per annum.** The recent commodity price boom is the third during the post-WWII period. It shares a number of similarities with the two earlier booms (during the Korean War and in the oil crises of the 1970s). A similarity is concern regarding food security and natural resource depletion, which generated discussion to address these through global actions. In contrast with the earlier booms, the current one is more broadly based (with real energy and metals prices exceeding historical highs, and agricultural prices breaching 30-year peaks) and longer lasting, entering its 9th year (if one excludes the 2008 recession and commodity downturn). It appears that costs due to higher energy prices have played a critical role.




Source: World Bank

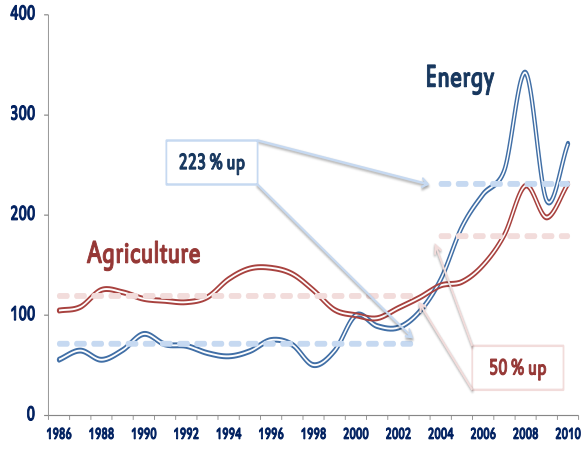
***Short-term movements.*** **Most commodity prices have been moving in similar fashion during the recent boom.** Commodity prices began to increase in 2003, with energy and metals price gains accelerating into the middle of the decade; agricultural prices followed suit a bit later. All prices reached peaks levels in the summer of 2008; and all declined sharply (with most commodities halving their price level) in less than six months. Commodity prices began to increase once more, and most have breached earlier peaks. By January 2011 metals stood 11% above its April 2008 peak, while food prices were 3% below their June 2008 highs; still, energy remains 31% below its July 2008 peak. A key characteristic of the recent boom (compared to earlier boom and non-boom periods) is the *co-movement among almost all commodity prices,* suggesting that common factors are playing a critical determining role—and that movements in energy prices have influenced most other commodity prices.

# Developing Trends: February 2011

## Commodities: A closer look at food prices (2)

### Energy and agricultural prices: 1986-2010

(nominal indexes, 2000 = 100)




Source: World Bank

### Nominal price changes

(% changes, July 2010 to January 2011)

| Commodity | % | Commodity | % |
|---|---|---|---|
| Cotton | 113 | Tin | 51 |
| Palmkernel oil | 101 | Urea (fertilizer) | 50 |
| Coconut oil | 100 | Coal | 43 |
| Sorghum | 86 | Copper | 42 |
| Sugar | 70 | Lead | 42 |
| Rubber (natural) | 69 | Groundnut oil | 38 |
| Wheat | 67 | Iron ore (spot) | 37 |
| Maize | 62 | Soybeans | 33 |
| Silver | 59 | TSP (fertilizer) | 32 |
| Palm oil | 58 | Nickel | 31 |
| Soybean oil | 53 | Coffee (arabica) | 30 |

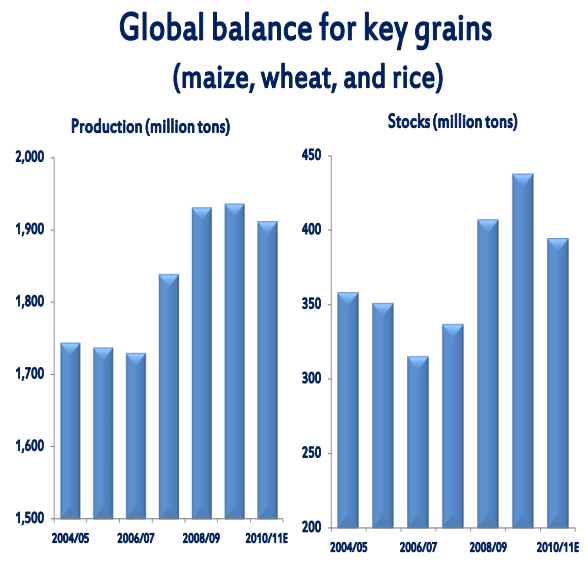
Source: World Bank

***Costs.*** **Several factors have contributed to the increase in agricultural prices—comprising what many have called the "perfect storm".** The most frequently mentioned macroeconomic factors include U.S. dollar weakness, low interest rates, and investment fund activity; sector specific factors include low past investment due to persistently low prices (especially during the 1990s), low stocks, more-frequent-than normal adverse weather events, biofuels demand, increasing demand from emerging economies, and defensive trade policies. A key factor—perhaps the most important—has been *increasing costs of production due to high energy prices.* Between 1986-2004 and 2005-10, nominal energy prices more-than-tripled, while agricultural prices increased 50%. This implies a 0.23 transmission elasticity, consistent with what has been reported in the early literature on the subject (before biofuels became a source of demand for food commodities). Indeed, agriculture is an energy intensive industry. The direct energy component in U.S. agricultural production has been estimated to be four times higher than that for manufactures. It becomes larger still when including the indirect impact of fertilizers, an energy-intensive product as well.

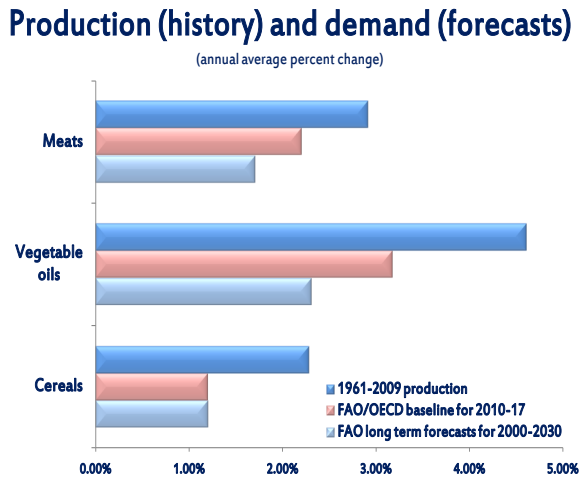
***The recent spike.*** **Contrasted with 2007/08, the recent price rally includes most commodities, not just food.** Food price increases, especially those for maize and sugar (up 70-and 62% during the past six months, respectively) reignited discussion of whether biofuels have been underpinning the surge, since maize and sugar are feedstocks to the manufacture of ethanol in the United States and Brazil, respectively. But as of mid-2010, most commodity prices had increased considerably and continuously, including energy, base metals, precious metals, raw materials, and fertilizers—with prices of a few commodities doubling within just six months. For example, of the more-than 40 commodities including in the World Bank's energy and non-energy price indices, prices of 15 commodities increased by more-than 50% during the six month period between July 2010 and January 2011. In fact, the broad-based nature of price rise is a key difference between the recent price spike and that of 2007/08, which was fueled by fewer commodities.

# Developing Trends: February 2011

## Commodities: A closer look at food prices (3)




Source: U.S. Department of Agriculture (February 10, 2011 update)




Source: FAO (history) and FAO/OECD (forecasts)

***Risks.*** **Despite recent production shortfalls, grain markets are better supplied now than during the 2007/2008 spike—but risks persist.** Though global production and stocks of the three key grains (wheat, maize, rice) are together expected to be 3% lower than last season, they are still well above their 2007/08 levels. The decline is due largely to the recent shortfall in maize production (especially in the United States), and to the weather-induced wheat supply shortfall in early summer in Russia and key Central Asian suppliers. In contrast, the rice market is well-supplied. *Yet additional up-side risks for food prices could emerge.* An energy price spike not only would increase production costs, it would make biofuels more profitable or less costly (depending on the type of biofuel) exerting further upward pressure on food prices. Weather shocks (similar to the Central Asia drought or the recent floods in Australia) could induce further production shortfalls. And such shortfalls have the capacity to reignite defensive trade policies, including export bans and export taxes, as they did in 2007/08. Moreover, further food price increases could induce political unrest in food-import dependent countries, should governments be unable to contain food price inflation pressures.

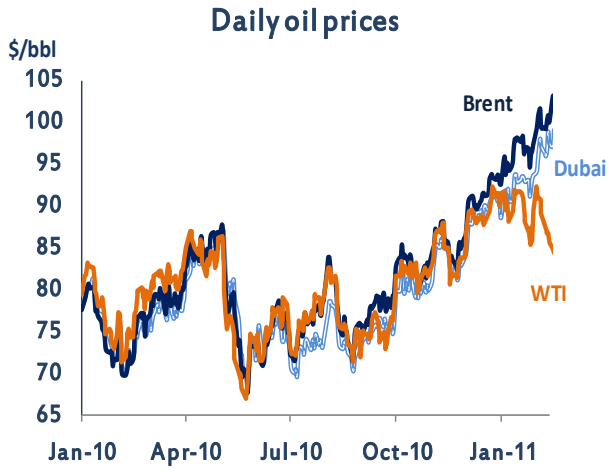
***Long-term demand prospects.*** **As was the case during the food price spike of 2007/2008, recent price increases have re-ignited discussion of longer-term food availability and supplies.** Historically, income elasticities for cereals are low (very close to zero for per capita incomes above $500). Not surprisingly then, the United Nations Food and Agricultural Organization (FAO) projects-both in their 2030 reports (1), and in the most recent joint FAO/OECD baseline, that cereal demand is expected to grow along the same lines as population growth (near 1.2% per annum). Meat products, and more so, edible oils, are faster growing commodity groups, as their response to income changes is much higher. During the past half century meat and edible oils production has been growing at average rates of 2.9-and 4.6% respectively. But, as population growth slows and incomes increase, they are anticipated to ease to gains of 2.2-and 3.2% for most of the current decade; and to 1.7-and 2.3% for the next 30 years.

(1) FAO, (Food and Agricultural Organization). 2006. *World's Agriculture towards 2030/2050*. Interim Report. Rome: FAO.

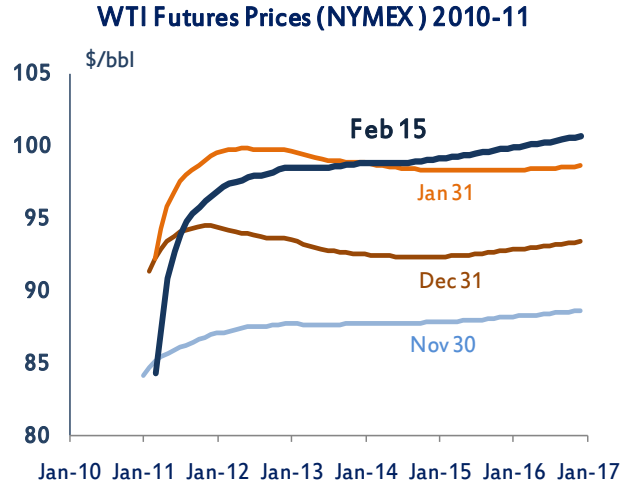
# Developing Trends: February 2011

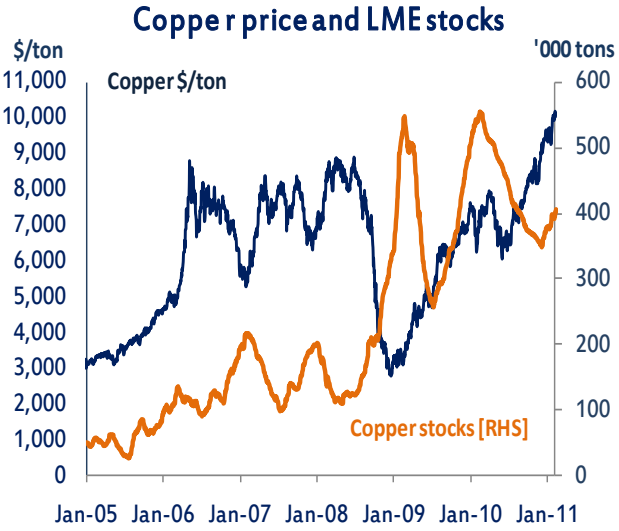
## Commodities: Oil & metals

**Brent oil prices topped $102/bbl, largely on fears of possible supply disruption emanating from political unrest in Egypt. However, the price of WTI fell a large $15/bbl below Brent, due to a stock build-up from higher Canadian crude imports into mid-continental United States. Copper and tin prices hit record nominal highs, with heavy rains in Indonesia reducing tin exports, while copper mine supply continues its struggle to expand.**




Source: Thomson/Datastream




**Oil prices surge on risk of supply disruption.** Crude oil prices (World Bank average) increased above $96/bbl in early February, on fears about supply disruption resulting from political changes in Egypt- and possible contagion to other oil producing countries in the region. About 1.9mb/d of crude oil flowed through the Suez Canal and SUMED pipeline in 2010—about 4.5% of global oil supply shipped in tankers. The oil market had been tightening in the second half of 2010 due to strong demand growth of almost 4% and declining inventories—though stocks remain high in the United States. Cold weather has also bolstered winter demand. The price of Brent—the main international marker—topped $102/bbl this month, while the price of land-locked WTI has dropped an unprecedented $18/bbl below Brent due to a build-up of stocks in the U.S. mid-continent, that could well worsen.

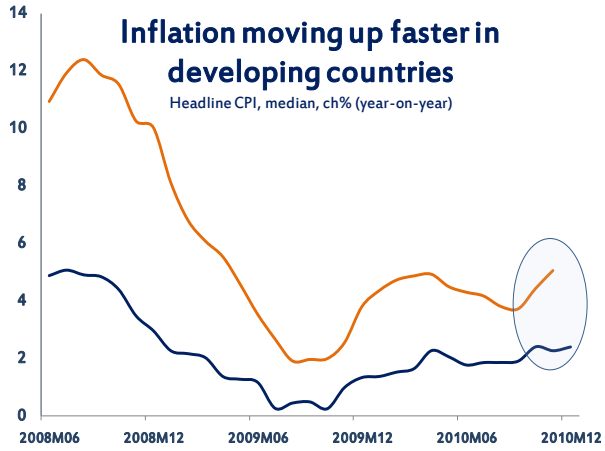
**WTI futures fall into steep contango due to inventory build.** Spot-and near-by WTI crude oil futures prices plummeted due to increased crude from Canada flowing through the new Keystone Pipeline into Cushing OK—the delivery point for WTI futures contracts. The bottlenecks at Cushing are expected to remain in place until new pipeline capacity moves crude from Cushing to the U.S. Gulf Coast, which is not expected before 2013. Additionally, a pipeline that will ship Alberta crude through British Columbia to the Pacific coast is not expected before 2015. The contango (near-by prices below distant prices) has widened substantially and is expected to endure depending on the pace of refining runs and the inflow of crude volumes from Canada. Refinery utilization in the region is above 90% currently and is helping alleviate some of the stock build-up.

**Metals prices rise on expectations of strong demand growth and supply constraints in some sectors.** Base metal prices have gained for 7 straight months, reflecting continued confidence in global economic expansion, though there is some concern about slowing in China. Supply constraints have also affected tin and copper markets, with both metals hitting record nominal highs in February. Tin supplies out of Indonesia continue to fall short because of heavy rains, and a global market deficit is expected this year. Copper prices topped $10,000/ton this month, as constrained mine supply growth is also expected to generate a market deficit this year. Higher prices will undoubtedly lead to more use of scrap materials, thrifting-, and substitution to other metals by end-users, though the volume impacts are quite uncertain.

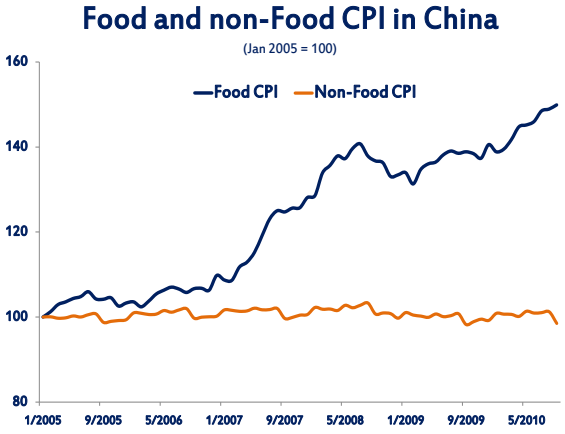
# Developing Trends: February 2011

## Inflation

**Consumers in low-and middle-income countries spend as much as half of their income on food items. Thus even moderate increases in the food component of the CPI can be a cause of concern. Indeed, since September 2010, median inflation rates have stepped up, particularly in developing countries. Moreover the gap between non-food and food price components of the CPI appears to have widened in several emerging (and populous) countries, including China, Indonesia and Bangladesh.**




Source: Development Prospects Group.




Source: World Bank calculations based on ILO data

### Food and non-food CPI changes for selected developing countries

(from 2009:Q3 to 2010:Q3, y-o-y percentage change)

| Country | Food | Non-food | Country | Food | Non-food |
|---|---|---|---|---|---|
| Sierra Leone | 3.6 | 50.2 | Bangladesh | 9.7 | 3.9 |
| Egypt, Arab Rep. | 19.6 | 0.9 | Tunisia | 6.3 | 1.3 |
| Indonesia | 12.6 | -1.0 | India | 8.4 | 12.3 |
| Uganda | -1.4 | 11.1 | Pakistan | 14.3 | 10.9 |
| Burkina Faso | 1.7 | -6.6 | South Africa | 1.3 | 4.3 |
| Argentina | 15.8 | 7.6 | Nigeria | 14.7 | 11.9 |
| Niger | 0.6 | -6.1 | Mexico | 2.0 | 4.8 |
| Ghana | 5.8 | 12.2 | Philippines | 3.3 | 4.8 |
| China | 6.7 | 0.7 | Turkey | 7.1 | 8.2 |

Source: World Bank calculations based on ILO data

Note: Countries have been ranked according to the food / non-food gap (from largest to smallest)

**Current inflation pick-up is faster in developing countries.** With the collapse in global demand in the recession of 2008-09, headline inflation rates dropped significantly across both high-income and developing regions. With economic recovery in the first half of 2010, inflation rates picked-up once more. Global growth momentum dissipated to a degree in the third quarter of 2010, as 'bounce-back factors' and public stimulus measures supporting growth faded; and inflation moderated in step. But since September 2010, inflation rates have stepped up, particularly for developing countries. Median inflation in high-income economies increased from 1.9-to 2.4% (0.5 points) between September and December 2010 (yr-on-yr); while median inflation in developing countries accelerated from 3.7% in September to 5.1% in November 2010 (1.4 points). Food prices are important elements in this development.

**Increasingly food price inflation has become a concern for many countries.** Acceleration of food price inflation is now a concern in many low-and middle-income countries where consumers often spend more-than half of their incomes on food. For example, the food price component of the CPI in China—the world's largest producer and consumer of many food and non-food commodities—increased by 7.5% between August 2009 and August 2010. This occurred against a meager non-food price increase of 0.5%. In response, the government lifted quantitative restrictions on several commodities, and released publically-held reserves. At the same time China is accelerating efforts to increase domestic production by expanding the use of biotechnology in maize and rice with the expectation that it will significantly increase crop yields.

**Food price inflation is not just a problem for countries like China,** but has increasingly become a key concern in a number of other developing countries as well. Between 2009-Q3 and 2010-Q4 (just before the recent spike in world grain prices) the food component of the CPI in China, Indonesia, and Bangladesh increased by 6.7-, 12.6 and 9.7% respectively (yr-on-yr), contrasted with non-food CPI component changes of 0.7-, -1.0 and 3.9% respectively. Of note, food price inflation has not been much of a problem in most countries in Sub-Saharan Africa, not surprisingly, since last year's good weather conditions and smaller reliance on energy inputs in agriculture generated a considerable supply response for most food commodities.

# Developing Trends: February 2011

## International Finance

**Flows started 2011 on a solid note, supported by record bond sales-largely reflecting seasonal patterns. Corporate issuers dominated with 90% of bond sales. Political turmoil in the MENA region has carried limited effects on global stock markets to date. But the crisis is weighing more on EM equities than on developed ones. MENA risk premiums widened at the onset of crisis; uncertainty persists following Mubarak's departure.**

### Bond issuance off to a record pace in 2011

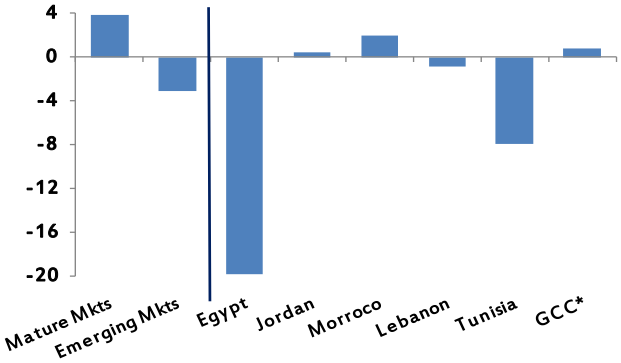
| *$ billion* | 2009 | | | | 2010 | | | | | 2011 |
|---|---|---|---|---|---|---|---|---|---|---|
| | Jan | H1 | H2 | Total | Jan | H1 | H2 | Dec | Total | Jan |
| Total | 24 | 110 | 243 | 353 | 38 | 197 | 316 | 42 | 512 | 41 |
| Bonds | 9 | 36 | 80 | 115 | 22 | 86 | 98 | 4 | 184 | 29 |
| Banks | 9 | 43 | 86 | 129 | 9 | 54 | 87 | 15 | 141 | 2 |
| Equity | 6 | 32 | 77 | 109 | 7 | 57 | 131 | 23 | 188 | 10 |
| Lat. America | 10 | 37 | 100 | 137 | 9 | 66 | 98 | 10 | 164 | 17 |
| Bonds | 5 | 15 | 47 | 62 | 8 | 37 | 45 | 3 | 82 | 14 |
| E. Europe* | 4 | 22 | 50 | 72 | 13 | 53 | 70 | 4 | 123 | 10 |
| Bonds | 2 | 13 | 20 | 33 | 7 | 31 | 33 | 1 | 64 | 9 |
| Asia | 9 | 44 | 78 | 122 | 13 | 64 | 133 | 27 | 197 | 11 |
| Bonds | 2 | 6 | 10 | 16 | 7 | 13 | 15 | 1 | 28 | 4 |
| Others | 1 | 7 | 15 | 22 | 2 | 14 | 15 | 1 | 28 | 3 |

** Including Poland & Croatia*

Source: DECPG

### Egyptian crisis not weighing on global equites

Year-to-date changes in stock price indices (%)

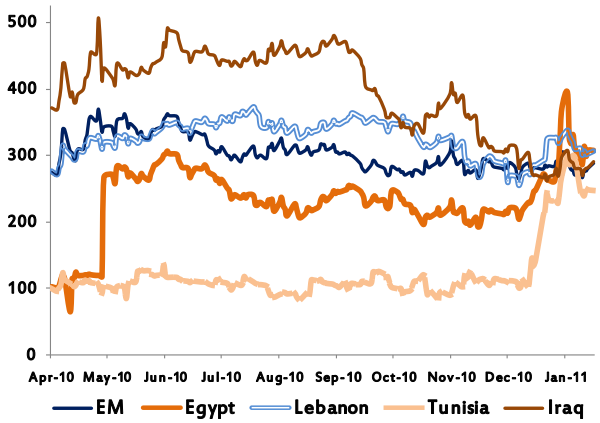



**Source: Morgan Stanley**

* including Bahrain, Kuwait, Oman, Qatar, Saudi Arabia, United Arab Emirates

### Risk premium for MENA bonds easing, but elevated

JP Morgan's EMBIG spreads (*basis points*)




**Source: JPMorgan -Chase, Bloomberg.**

**Bonds underpin flows in January.** Capital flows to developing countries started the year on a strong note, boosted by record bond flows. Total flows in January stood 69%-and 8% above the like month of 2009 and 2010, respectively; but less-than the $43 billion monthly average of last year. Bond issuance surged, with deals from 17 countries coming to market, bringing total volume to $29 billion (including a $6 billion deal from Brazil's *Petrobras*), the highest monthly level on record. With sovereign and commercial borrowing plans typically front-loaded, January tends to be one of the busiest months for EM borrowers. Corporate issuers continued to dominate the market, accounting for 89% of total borrowing, as many firms took advantage of favorable market conditions. Meanwhile, bank lending fell to the lowest monthly volume since February 2009, reversing an uptrend witnessed in the second half of 2010; and equity issuance was down sharply from December, with East Asia accounting for much of the decline.

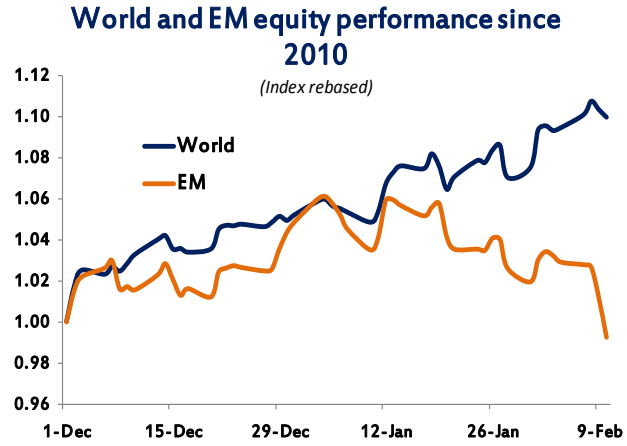
**Egypt's political unrest has imparted limited spillover to global equities to date.** Despite the ongoing political crisis in MENA, world bourses have been surprisingly stable thus far this year. While shares in Egypt and Tunisia declined by 21-and 14% respectively over the last month, global equity indexes posted gains, in part as the region accounts for a very small portion of world stock-market capitalization. But the MENA crisis appears to be weighing more heavily on emerging markets than on mature ones. There are signs that investors are migrating from developing markets to developed economies: despite risk aversion, an important factor may be that EM equities have underperformed during 2011 relative to developed markets (see "EM Equity Valuations", following for more on this issue).

**MENA risk aversion appears to ease, but uncertainty persists.** Political turmoil in Egypt had prompted a sharp increase in risk premiums across the MENA region in late-January, with spreads on all of the region's global bonds widening substantially. Market sentiment, highly volatile given the flux of the situation, turned slightly less pessimistic recently. Egypt's risk premium dropped to 287 basis points (bps) in February from this year's high 396 bps of late -January. And after the dramatic departure of Hosni Mubarak from the Presidency of Egypt, the sovereign spread for Egyptian bonds showed no further deterioration, standing at 308 basis points on February 14.

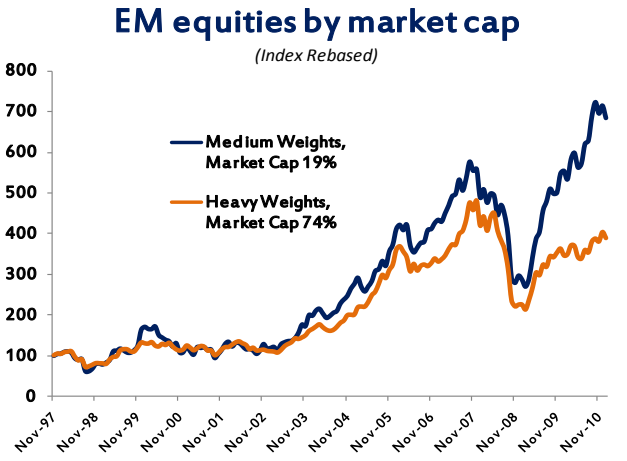
# Developing Trends: February 2011

## EM equity valuations*

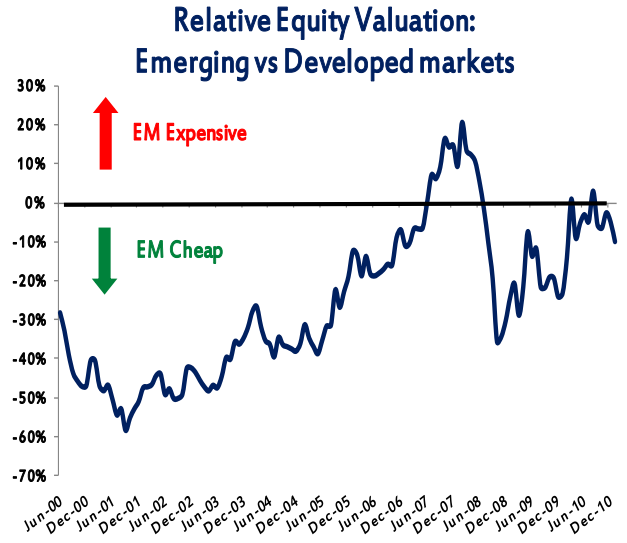
**EM equity returns outperformed developed markets since the bottom of the financial crisis; this came to an end in December 2010. Improved growth expectations for high-income economies, notably the United States, played a role, as did uncertainty over inflation- and associated policy responses in EM. Cyclical sectors have been top performers in DM; defensive sectors in EM. Medium-weight market caps[1] in EM continue to perform better than large market caps[2] . EM equities show early signs of trading at a slight discount to DM.**




Source: CCSDR based on MSCI data.




Source: CCSDR based on MSCI data.




Source: CCSDR based on MSCI data.

**Emerging market equities have underperformed developed markets since December.** Equities in EM significantly outperformed those in developed markets since the bottom of the global crisis; but performance since early December 2010 has reversed. Uncertainty over inflationary pressures in EM—and in particular over future anti-inflationary policies— underlie investor concerns. As growth expectations for developed economies have increased in the last months, it is "cyclical" sectors (industrials, materials and IT) that are driving returns in the rich world.

**EM driven by "medium caps" and defensive sectors.** Performance in EM has been driven by the so called "medium-weight market caps" and by "defensive" sectors such as telecoms, health care, and consumer staples. "Large caps" are no longer driving returns. In fact, BRICs performance peaked in early November 2010. Outperformance in medium caps is explained by their higher reliance on defensive sectors since they are less exposed to the global economy; and to the fact that capital inflows have affected prices and valuations in larger proportions due to their smaller capital market size. However, mid-cap valuations in developing countries are already quite expensive, and represent only 19% of market capitalization among EM. The energy sector was subdued within developing countries in 2010.

**Are emerging market equities becoming more attractive relative to developed markets?** All relative measures of valuation (P/E, P/B, P/Sales, and Dividend Yields) lead to the conclusion that EM equities were no longer cheap relative to developed market shares since mid 2010—EM equities were trading at a premium over developed markets. However, there are already signs that EM equities may be starting to trade at a slight discount. The story of higher returns in emerging markets has gone "mainstream" as many investors have considerable exposure to them as evidenced by last year's substantial increase in institutional investors exposure to EM funds. As noted and shown above, performance in the last 2 months has reversed and returns in EM over 2011 to date have been disappointing—only the once-lagging Eastern European countries are posting positive returns.

*Footnotes:*

[1] *Argentina, Indonesia, Mexico, Thailand, Turkey, Chile, etc.*

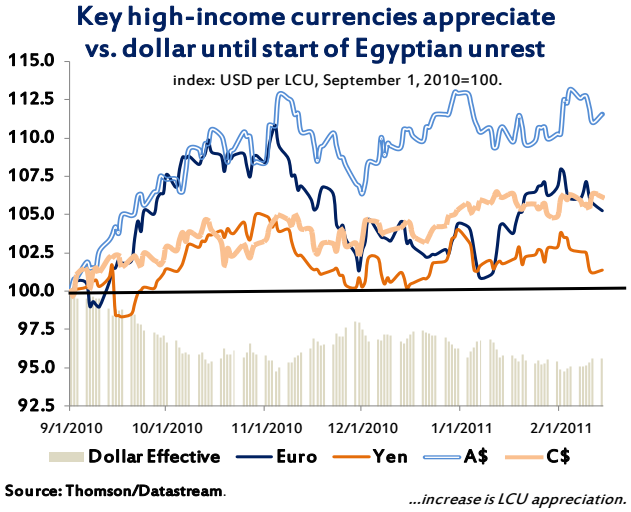
[2] *Russia, Brazil, China, India, South Africa , Korea, Saudi Arabia.*

*Jean Pierre Lacombe and Facundo Martin, IFC (Economics/Risk).

# Developing Trends: February 2011

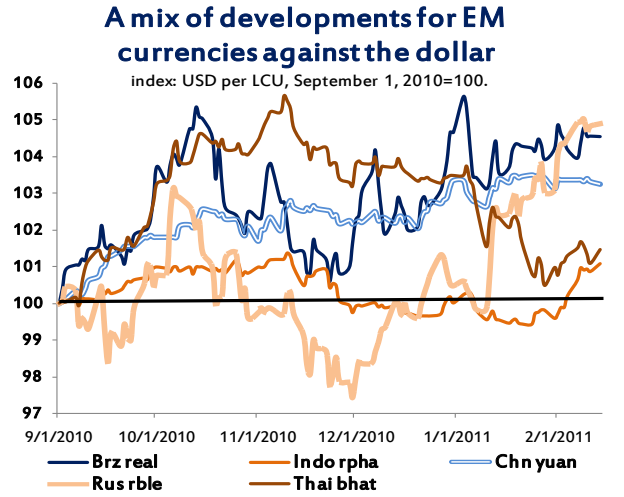
## Currencies

**Currency markets have had much to digest in the last weeks and turned quite volatile in January-February trading. The dollar's trades vs. the majors were mixed, echoing developments in commodity markets, European sovereign debt and the recent political unrest in MENA. Emerging market units displayed still more volatility, with several currencies continuing to run-up vis-à-vis the greenback; others depreciating as capital flows begin an apparent exit for better returns/less risk. U.S./German yield gap is widening- a plus for USD.**



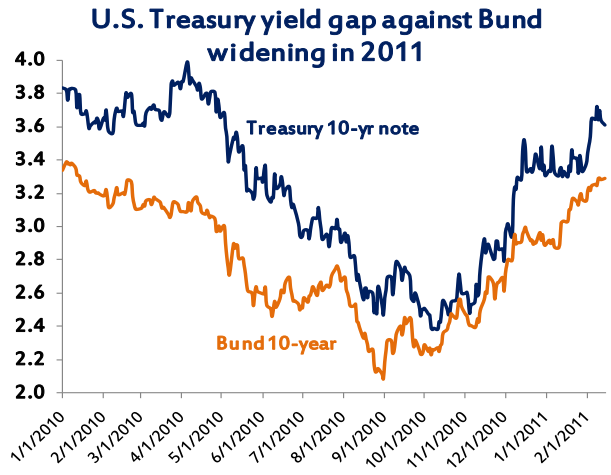

Source: Thomson/Datastream.

*...increase is LCU appreciation.*




Source: Thomson/Datastream.

*...increase is LCU appreciation.*




Source: Thomson/Datastream

**Dollar mixed against the majors on a host of factors.** Volatility in foreign exchange markets came to the fore in the last month, with the greenback falling against 'commodity currencies', appreciating versus the yen while trading in a highly uneven fashion versus euro. The Australian and Canadian dollars picked up 1.2% against the U.S. unit, as oil, raw materials and agricultural prices continued to escalate. The yen has depreciated since January (¥81.7 to ¥83.3, [Feb-14] a decline of 2%), with the unit hit by S&P's credit markdown, faltering GDP and policy gridlock. Trades in dollar-euro were especially volatile, with the euro gaining in early January—to recoup losses tied to the sovereign debt crisis as conditions improved—only to fall 2.5% during February as events in MENA underlined the risk to Europe's oil supply through Suez. The dollar's effective rate increased by 0.7% in February's first half.

**EM currencies volatile, with increasing divergence in direction.** A ratcheting of energy prices played an important role in ruble appreciation of 7% since begin-December 2010; while the Brazilian real is up 2.2% in the period, with continued capital inflows (attracted to higher interest rates) and strong terms of trade gains in agriculture. The Chinese yuan remained essentially flat over 2010 to date at Y6.60 per dollar; while the Thai baht and Indonesian rupiah have softened in broader terms, as a portion of earlier capital inflows is unwinding moderately. It seems likely from recent developments—strong growth in the United States, and the spate of protests in the MENA region—that capital may continue to exit emerging markets for improved returns in newly buoyant OECD bourses– as well as in a search for safer havens in a time of greater uncertainty.

**U.S. Treasury yield increases on expectations of stronger economy and higher inflation.** Despite continuing implementation of the Federal Reserve's QEII policy—completing purchase of the remainder of $600 billion in Treasuries in coming months—the yield on the ten-year Treasury note has increased by 135 basis points from trough at 2.38% in October 2010 to 3.71% recorded on February 8, 2011. This returns U.S. long-term rates to the levels of early 2010. The differential vis-à-vis the yield on 10-year Bunds has also widened recently, but stands well below earlier gaps—in part as the ECB is anticipated to tighten policy at some point in 2011. The current differential (ranging between 35 to 50 basis points in favor of the dollar) would seem to be a fundamental factor supporting the dollar over coming months.

# Developing Trends: February 2011

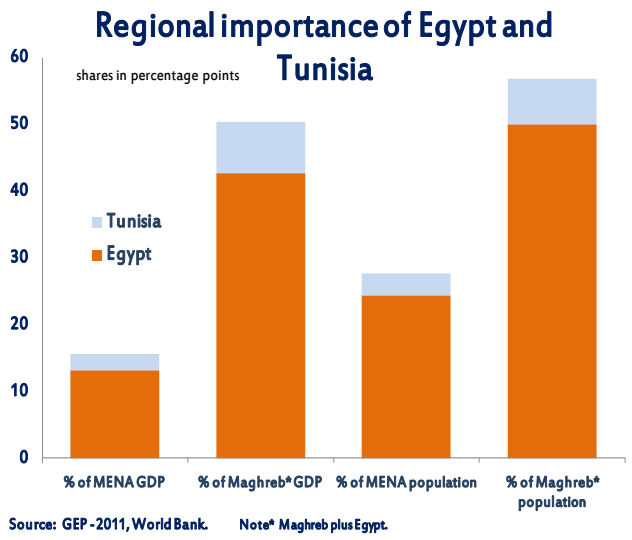
## FOCUS: MENA (1)

## Potential economic effects stemming from political instability in MENA (1)

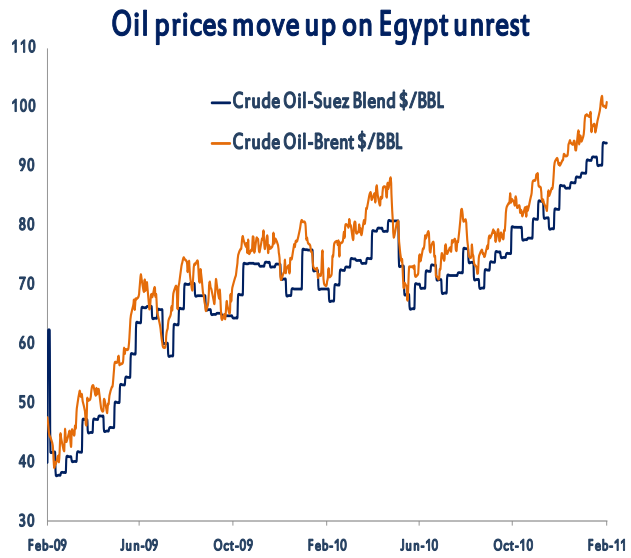
Lucio Vinhas da Souza (DECPG)

With inputs and support from World Bank MENA region, Chief Economist's office and PREM unit (MNSED)

**Political change –or at least the possibility of it- swept through the MENA region in early 2011. The wave started with the removal of a long-standing political leadership in Tunisia by a popular movement, and soon spread to other countries in the region, most notably to Egypt, where an authoritarian regime was also toppled, but also (to a lesser degree at present) affecting countries like Bahrain, Jordan, Iran, Lebanon and Yemen. The critical concern for the global economy and the region lies in the potential for the spread of instability to large oil exporting economies. It is important to stress that any attempt to estimate economic effects from this instability episode can only have an indicative nature at this stage.**




Source: GEP -2011, World Bank. Note* Maghreb plus Egypt.




Source: Datastream.

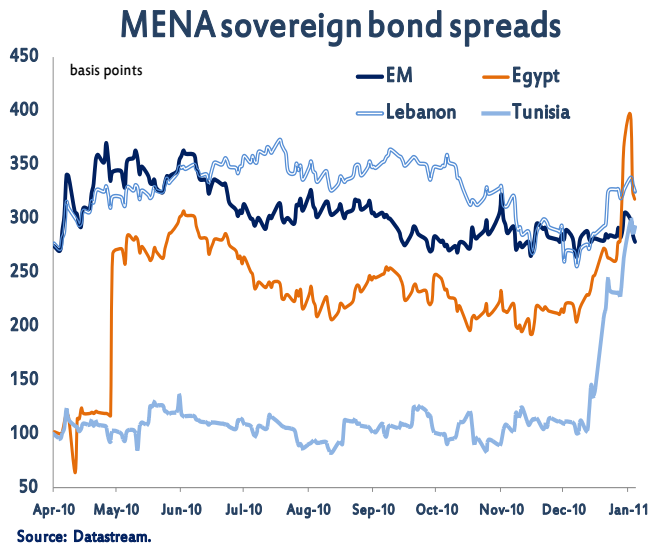
**How important are the countries so far affected?** Economically speaking the countries directly affected to date are relatively small, especially from a global point of view: the two economies at the heart of the instability, Egypt and Tunisia, represent about 15% of the GDP of the MENA geographic region (2). However from a 'Maghreb plus Egypt' perspective, the share is much larger: Egypt represents over 40% of this aggregate's GDP. And from a population point of view, these two countries contain almost 28% of all MENA geographic region's inhabitants-Egypt representing 25% of the total.

**Higher oil prices represents a risk for the global economy.** While Egypt is a relatively important oil and LNG producer, Tunisia is a marginal one, with combined output of the two countries of some 0.84/mbd. Egypt is also a net oil importer (albeit of rather marginal amounts). But Egypt is an important oil and gas *transport hub* via the Suez Canal and the SUMED (Suez-Mediterranean) Pipeline (3). Combined, these two routes are responsible for nearly 4.5% of total crude oil transported globally in 2010, or 1.89/mbd (of this amount about 16% travelled *southward* through the Canal—the bulk of which Russian fuel oil shipments to Africa and elsewhere). Of the total that transits through the Suez/SUMED complex, the 0.73/mbd of refined products moving northward is equivalent to 21% of all of Europe's oil-product imports (albeit no detailed information is available about the final destinations of the northward flow).

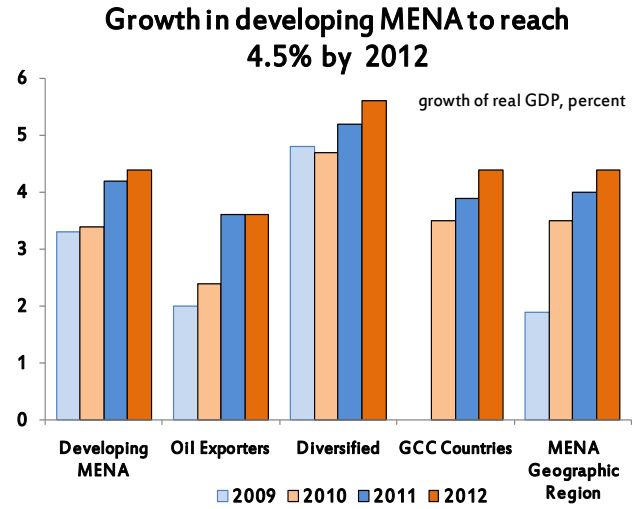
**Closure of the canal and the pipeline** could potentially lead to delays of up to two weeks in deliveries to the EU market and 8-10 days to the U.S. market, as vessels would be forced to go around the Cape of Good Hope. This would represent a 75% increase in transit time (or alternatively a 75% increase in required shipping capacity to maintain the same flow of deliveries to Europe), and a 24% increase for U.S. shipments (idem). Fortunately, there is significant excess supply of required vessels currently, so that the impact of a disruption—in the now smaller likelihood of an occurrence (with the departure of Hosni Mubarak from Egypt's Presidency)—could be mitigated over the course of weeks.

# Developing Trends: February 2011

## FOCUS: MENA (2)



Source: Datastream.



Source: World Bank, Global Economic Prospects 2011.

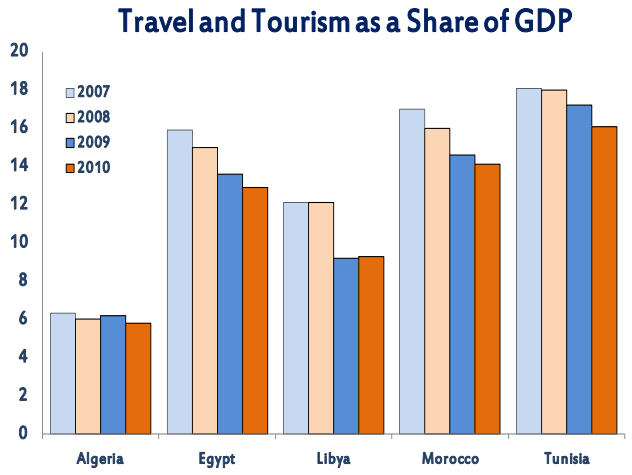
**There is also a substantial margin for the reorganization of shipping delivery routes.** Namely, oil/LNG from West African sources that are currently supplying eastern markets switching to supply the EU and U.S. markets; while tankers originally bound for Europe via Suez being rerouted to Asia (to the main source of additional global energy demand). This would reduce potential increases in time/cost of deliveries, and the rebalancing process would be helped by a global tanker market still well oversupplied due to lingering effects of the global recession. In any case, underlying global oil and gas production capabilities *would not* be affected by potential closure of the Suez/SUMED system.

**Nevertheless, *oil prices*–the most immediate channel of transmission of this regional shock to the global economy**–did increase by some 5% between early-January and early-February 2011. (Even here, the increase should be put into the context of a pre-existing trend rise in oil prices which started already in the second quarter of 2010). Another potential channel of global (and regional) contagion would be via *financial markets*: here, no significant increase in risk *premium* for developing countries in general (outside of the two economies immediately affected, which were also downgraded by international rating agencies) has so far been observed (4).

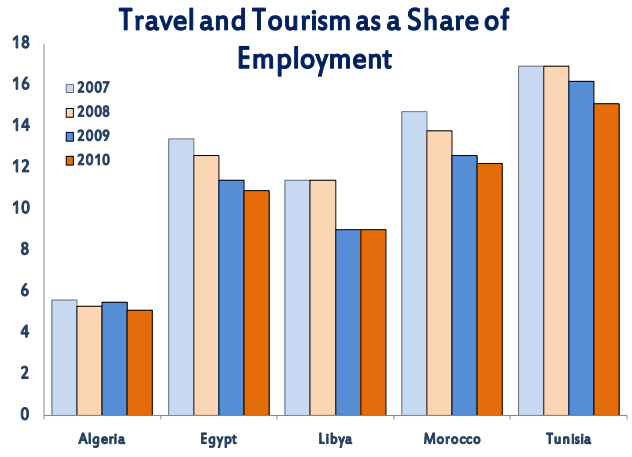
**The critical concern for the global economy and the region lies in the spread of instability.** The disruptive capacity for global markets in a scenario where larger regional oil producers are affected is naturally much greater: to provide an indication of this potential: the GCC countries (Bahrain, Kuwait, Oman, Qatar, Saudi Arabia and the United Arab Emirates) produce almost 48 times the total oil output of Egypt (2009 data, IEA), and were responsible for over a third of global crude oil exports. But it is important to stress once more that any attempt to estimate economic effects from this episode of instability can only have an indicative nature at this stage.

# Developing Trends: February 2011

## FOCUS: MENA (3)




Source: World Travel and Tourism Council




Source: World Travel and Tourism Council

**The economic effects on the regional economy, and especially on individual countries, could be more substantial.** The last World Bank projections for the MENA region and the individual countries affected (see Global Economic Prospects (GEP–2011)) foresaw a relatively robust performance going forward after a respectable 2010. For MENA as whole, following 3.4% growth in 2010, 4.2% on average over 2011-12; for Egypt after 5.1% in 2010, close to 6% in 2011-12; and for Tunisia, after almost 4%, close to 5% in the next two years. Due to the relatively small importance of GDP for the region described at the start of the section, *unless the situation were to deteriorate further and instability spread,* it is unlikely that the economic performance of the region as whole would be significantly affected (5). On the other hand, Egypt and Tunisia could be adversely affected, especially if uncertainty and instability were to be more prolonged.

**Concerning the financial channel,** beyond higher financing costs (as represented by the increase in spreads) the stability of domestic financial systems and capital flight are of potential concern. To prevent that banks and stock markets were (and remain) closed in Egypt. The national Central Banks have relatively comfortable international reserves to cushion shocks, at near $36 billion in Egypt and at an estimated $10 billion in Tunisia (or 16-and 24% of estimated 2010 GDPs, respectively); and 110-and 50% of total 2009 external debt) (6). Suez Canal dues alone are responsible for an estimated $5.4 billion (over 11% of total estimated Egyptian fiscal proceeds during 2010). Should this revenue source be reduced, the fiscal position of Egypt would be directly affected (even before the turmoil, the Government of Egypt was expected to post a budget deficit of close to 8% of GDP in 2011).

**Tourism is an important part of GDP for most MENA countries**–at 13-and 16% respectively for Egypt and Tunisia in 2010; and also central for employment generation–responsible for 11-and 15% of total employment in 2010 for these two countries (according to WTTC (7)), which are already afflicted by double digit unemployment rates. The sector is also a main provider of hard currency revenues (for Egypt, these were estimated at over $14 billion in 2010, or almost two thirds of all services exports and close to 30% of all exports). Any prolonged instability can carry serious adverse short-run effects for this key economic sector—as tourists can easily switch to alternative holiday destinations.

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## FOCUS [notes]

1. DECPG would like to acknowledge substantial inputs and other support from the Bank's MENA region, Office of the Chief Economist and the PREM Unit (MNSED).

2. The MENA geographic region is comprised of the low-and middle income countries of the region, as well as the group of GCC economies. For developing MENA: (oil exporters) Algeria, Iran, Syria and Yemen; (oil importers) Egypt, Jordan, Lebanon, Morocco and Tunisia. For the GCC countries included in the DECPG database: Bahrain, Kuwait, Oman and Saudi Arabia.

3. The 320-km long SUMED system provides an alternative to the tanker transport of energy products, as the Suez Canal is too narrow and shallow to handle the new generation VLCCs and ULCCs (respectively, Very *and* Ultra Large Crude Carriers). Due to this, the SUMED system actually transported over *three times* more northbound crude to the markets in the wider Mediterranean basin and the United States than did the Canal itself.

4. A certain retrenchment of capital inflows to developing countries in general may be starting, as markets signal expectations of a curtailing of the very loose monetary policy in high income countries, as was noted in Global Economic Prospects 2011 (see World Bank, 2011).

5. Also because a further increase in risk would be reflected in even higher oil prices, which would benefit the economic performance of the largest economies of the region, as those are mostly energy commodity exporters.

6. Plus, the Tunisian dinar is still a non-convertible currency and there are extensive capital controls.

7. World Travel and Tourism Council (WTTC). 'Tourism economic data and forecasts— Summary'. 2010. London. United Kingdom.