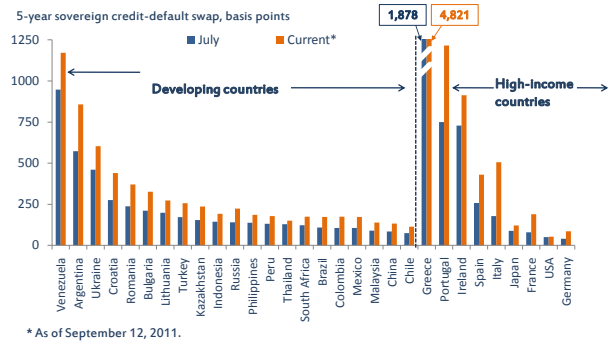
Developing Trends: September 2011

Developing Country Vulnerabilities and Prospects

Current financial turmoil is qualitatively different from earlier market concerns over European fiscal sustainability. Unlike prior phases of uncertainty in the Euro Zone crisis, this episode features substantial contagion, with credit default swap rates for *developing countries* rising by more than 70 basis points (earlier they were unaffected). Even spreads for core-European economies (France, Germany, the United Kingdom) have risen. World equity-wealth losses amounted to $6.1 trillion (10% of global GDP) from late-July through mid-September 2011; and signs of elevated counterparty risk in European banking are now in evidence. Despite the worsening of the financial context, consensus among policymakers appears difficult to achieve. Worryingly, earlier discussions of 'downside' scenarios were grounded in processes of this kind– contagion from high-spread countries to the European core– to developing countries, with spillovers through banking systems.

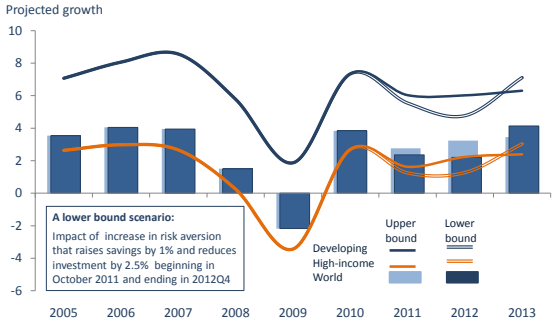
Contagion has increased sovereign credit default swap rates worldwide



* As of September 12, 2011.

Sources: Bloomberg and World Bank DEC Prospects Group

Wealth and confidence effects could result in a pronounced global slowdown



Source: World Bank DEC Prospects Group

Amid signs of contagion, the economic outlook has become much less certain. The extent and depth of "confidence effects" in both developing and high-income countries will be critical in shaping economic outturns. Prospects will depend on the extent to which firms and households react to financial market volatility, wealth losses, labor markets, and uncertainty associated with each of these. Already, global purchasing manager surveys suggest weakening prospects since August. Depending on how serious confidence effects are, growth for high-income countries in 2012 could range between 1.2 and 2.2 percent (at market exchange rates), and for developing countries, from between 4.8 and 6 percent — with the lower-bound estimates assuming a 1 percentage point increase in precautionary saving world-wide and a 2.5 percentage point reduction in investment growth rates.

Developing countries are more vulnerable to an unfavorable outturn than they were in 2007. Although developing countries' fiscal positions are healthier than those of high-income countries, they have less fiscal space available than in 2007. Following discretionary fiscal measures and automatic stabilizers implemented in 2008 and 2009, more-than 40 percent of developing countries carried fiscal deficits in excess of 4% of GDP in 2010. In a slower growth scenario, developing countries will find themselves faced with declining revenues, and may be squeezed out of capital markets, and as a result, forced to cut spending in a pro-cyclical manner. Weaker conditions could also lead to a resurgence in non-performing loans — potentially exposing hitherto unrecognized vulnerabilities in developing-country banking sectors. Households in several ECA countries carry worrisome levels of foreign-currency debt, which could be difficult to repay given currency fluctuations (large shares of Central European household debt are denominated in Swiss francs).

Developing Trends was prepared by the Development Economics Prospects Group (DECPG) with colleagues from PRMTR and IFC (Risk/Economics). The team is coordinated by Mick Riordan (OECD and currencies) and is comprised of Mariem Malouche (Trade), Shane Streifel and John Baffes (Commodities), Eung Ju Kim (Finance), Cristina Savescu (IP and inflation) and Irina Kogay (Annex). This month, under the guidance of Andrew Burns, the traditional layout of the report is altered in order to focus more directly upon the highly state of the global economy.

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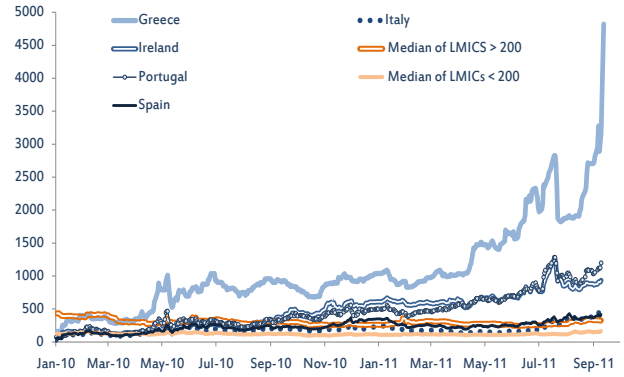
Contagion: living a downside scenario

Contagion from the European sovereign debt crisis has been a concern for the last several years. For the first time, the resurgence of market jitters in August and September has affected developing country financial markets, and even increased borrowing costs for core European countries, such as France and Germany. Moreover, concerns that market pressures may impact the private banking system have also grown, evidenced in a pick-up in counterparty risk. These are developments to be watched closely.

Market concerns about European sovereign debt amplify yet again

5-yr sovereign credit-default swap rates, basis points, Jan 2010-Aug 2011



Sources: Datastream and World Bank DEC Prospects Group

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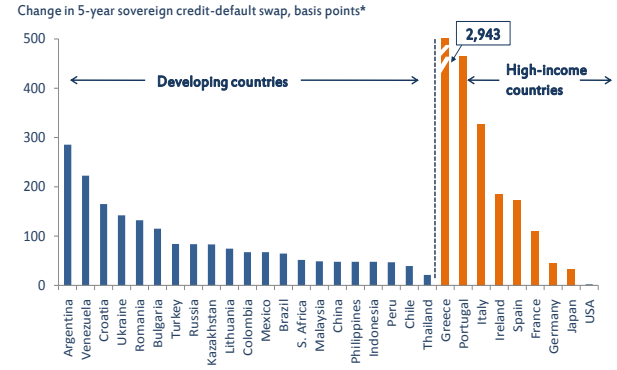
Contagion has increased sovereign credit default swap rates worldwide

Change in 5-year sovereign credit-default swap, basis points*



* Change since the beginning of July.

Sources: Bloomberg and World Bank DEC Prospects Group

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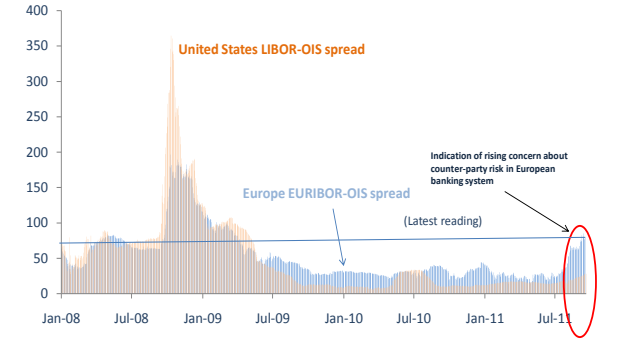
European banking counterparty-risk at highest levels since 2009

Libor-OIS spreads, basis points



Sources: Datastream and World Bank DEC Prospects Group

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Escalation in CDS spreads affecting core-Europe and commercial banks. What had earlier been confined to high-spread Euro Area countries, has now spread to important core-European countries. CDS spreads have risen for France, Germany, and notably for Italy, following a September 19th downgrade of the country's credit rating by S&P. Moreover, contagion of market pressures has moved to include European commercial banks holding substantial quantities of "risky" sovereign debt. CDS spreads for European banks have increased 120 basis points since the end of July. Importantly, Moody's cut ratings for two of the largest French banks on September 12th; S&P did the same for seven Italian banks on September 21st (noting possible downgrades for eight more institutions); and for the three largest U.S. commercial banks. These developments, if continued, auger poorly for financial stability and growth.

Increased sovereign debt risk perceptions now spread well beyond Europe. Contrasted with earlier episodes of financial tensions in Europe, global risk perceptions have broadened to include Japan, and a number of emerging markets. The more adversely affected developing countries are grouped in the ECA region, and carry strong trade and financial links with high-spread Euro-Area members (Croatia, Ukraine, Romania, and Bulgaria). CDS rates on the debt issued by these countries have risen by more-than 100 basis points since the start of July. And for several of these economies (also Hungary and Poland) financial difficulties are compounded by substantial proportions of household debt and business liabilities denominated in Swiss francs–a currency which has appreciated sharply of late as a "safe-haven" asset. Several Latin American countries also have been affected by CDS contagion, including Brazil, Colombia, and Mexico.

A downside scenario in the making would include freezing-up of short-term funds, as commercial bank counterparty risk mounts. As of September 20th, European banks' Euribor-EONIA lending spread had increased to 80 basis points (of which 20 points during September alone), above levels prior to Lehman Brothers, amid substantial perceptions of counterparty risk. And worryingly, the similar spread for U.S. banks has also started to creep up. As additional commercial banks find credit ratings marked down due to potential losses on soured sovereign debt holdings, a tendency to avoid the interbank market may increase, and availability of funds for short-term lending diminish.

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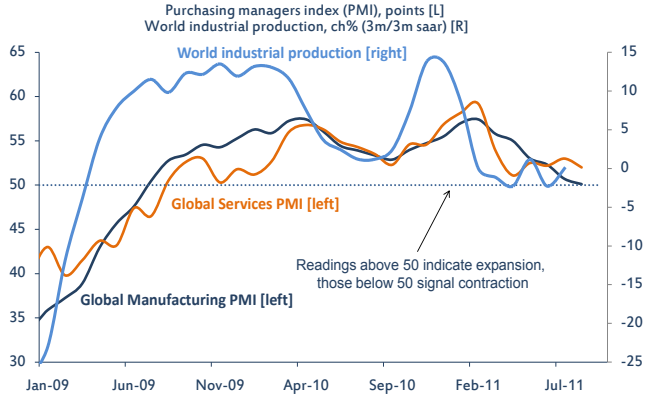
Post-August uncertainty clouds the outlook

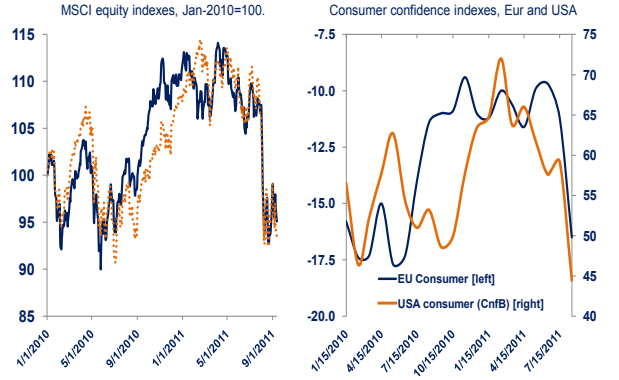
Since August, equity-wealth losses, increasing doubt about policy efficacy, and plummeting consumer and business confidence have clouded the near-term outlook. Global growth in the first half of 2011 came in at 'recessionary' rates of 1.5% (at market exchange rates, saar). Depending on how hard financial market uncertainties affect sentiment–and thus spending–GDP growth for developing countries in 2012 could be as strong as 6% or as weak as 4.8%.

Recent turmoil has dampened outlook



Sources: Haver and World Bank DEC Prospects Group

Equity market losses, intense uncertainty carry confidence to fresh lows



Sources: Bloomberg and World Bank DEC Prospects Group

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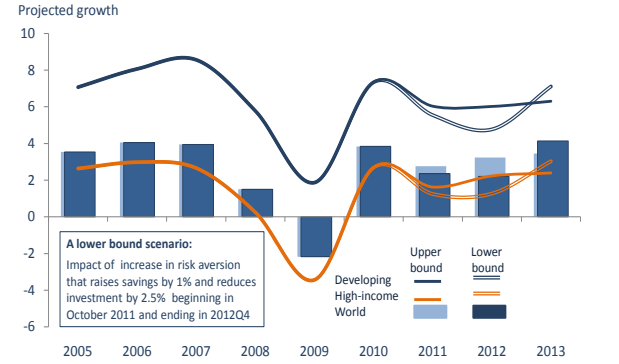
Wealth and confidence effects could result in a pronounced global slowdown



Source: World Bank DEC Prospects Group

Global growth disappointed in the first half of 2011 and August uncertainty has dampened the outlook. Global GDP registered a recessionary 1.1% gain during the second quarter of 2011, down from a weak 1.9% pace in the first (saar). The falloff was linked to the Tohoku disaster in Japan and high oil prices. And developing country growth slowed from 6.7% in the first quarter to 4.7% in the second (saar). By the end of July, temporary effects from Tohoku were starting to fade and global industrial production was rising. However, the financial turmoil of August is likely to cut into the rebound, though to what degree remains uncertain. Early indicators are not promising, as the post-Tohoku pick-up in global Purchasing Manager Indexes (and industrial production) weakened again in August and September.

Wealth losses are crimping consumer sentiment and outlays. European and U.S. equity markets have declined 15%-and 7% respectively since late July, with the largest losses concentrated among European commercial banks. The banking-sector component of the European Stoxx-600 index is down 24% since July. Emerging market equities are declining in tandem with high-income bourses, down 15% since recent peaks. Since late July global equity-wealth loss has amounted to $6.1 trillion, or *10% of world GDP*. This development, together with a general frustration among consumers and business with the apparent "dysfunction" of the policy process in the United States and Europe, has yielded rapid decline in consumer confidence on both sides of the Atlantic (the U.S. Conference Board and EU sentiment indexes reaching lows last seen in late 2009). A deepening retrenchment in household spending and investment outlays could serve as a driving force for slower global growth.

In this environment, prospects are very uncertain. If financial market uncertainty has relatively small impacts on consumption and investment, then global growth could amount to about 3.2% in 2012. However, World Bank analysis suggests that even in the absence of a credit "event" in Europe, persistent uncertainty will dampen business and household spending. Depending on how serious confidence effects are, growth for high-income countries in 2012 could range between 1.2-and 2.2% (at market exchange rates), and for developing countries from between 4.8-and 6%.

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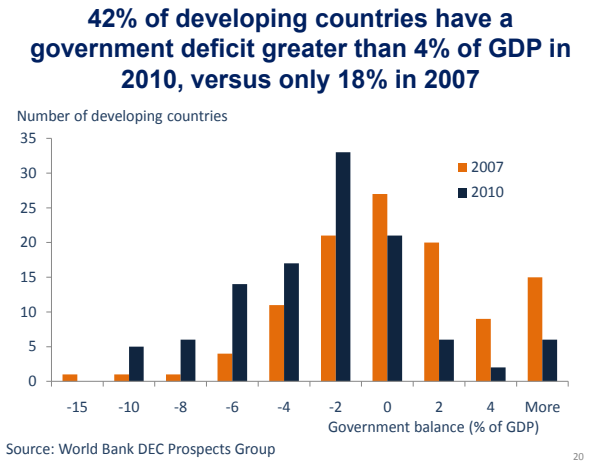
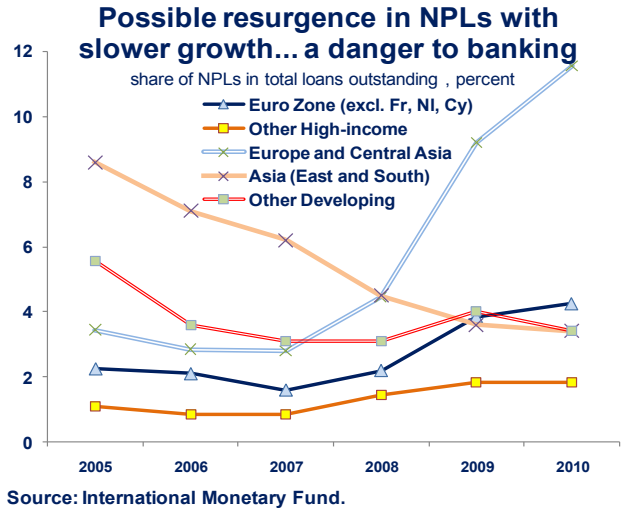
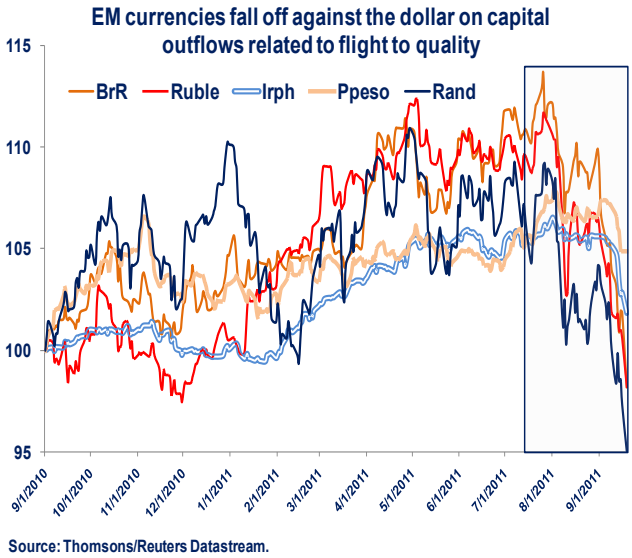
Developing countries more vulnerable to slowdown

Many developing countries are less well situated to respond to a global growth slowdown, notably on the fiscal side. For economies that undertook aggressive monetary policy steps to dampen inflation there may be some scope for monetary policy easing; but others continue to face high inflation or already have very low interest rates. Rising NPLs in a slow growth environment represents a further risk. On the plus side, many developing countries have high levels of international currency reserves.







Fiscal policy is less well positioned to respond to a downturn in growth. Fiscal balances are on average healthier in developing countries than in high-income economies. But due to implementation of stimulus spending packages (in some cases, higher subsidies for food and fuel) there is less fiscal space to counteract a slowdown than there was in 2007. Since then, fiscal deficits in more than half of developing countries have deteriorated by two percentage points of GDP or more, and deficits now exceed 4% of GDP in more than 40% of countries. There may be scope for monetary policy easing in countries (like Brazil) that have tightened policy sharply, but elsewhere, negative real interest rates or high inflation limit the scope for further interest rate cuts — even in the face of a slowdown in growth.

Domestic banking sectors may also be vulnerable to a slowdown. Although non-performing loans (NPLs) remain low in most developing regions, they could shoot up in the event of a sharp slowdown in growth. Given rapid credit expansion in recent years (loans to GDP ratios increased by more-than 10 percentage points between 2005 and 2010 in Brazil, China and Nigeria), commercial banks could see a marked deterioration in loan performance in the face of slowing growth, heightened risk aversion and restricted access to finance. In some countries, NPLs and provisioning are already an issue. The share of NPLs in outstanding bank lending in the ECA region lofted to 12% in 2010 from 3.8% in 2007. Governments need to take steps now–including macro-prudential reforms and stress tests to ensure that banks are best placed to deal with a deterioration in credit quality and much tighter liquidity conditions.

High foreign currency reserves should allow developing countries to resist unwarranted currency movements. Although reserve levels have declined somewhat since 2007, more than 40 percent of developing countries have reserves in excess of 20 percent of GDP. Of course, reserves remain low in many other economies. After holding steady for much of August, emerging market currencies have fallen sharply more recently. Foreign investors have pulled a total of $12.6 billion out of the equity markets of East-and South Asia so far this year, according to Credit Agricole, and international capital flows to developing countries eased significantly in August, coming in at levels 16 percent lower than their long-term average for July and August.

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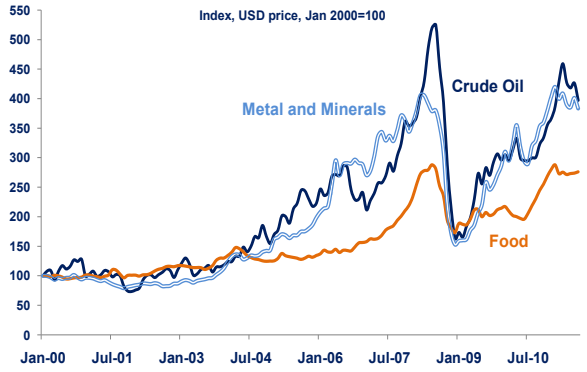
Inflation improving but food price risks remain

Commodity markets are increasingly affected by market concerns of falling demand. After the run-up of 2010 and early 2011, prices have either stabilized, or are falling. This is mixed news for producers of internationally traded commodities, but all countries will benefit from the step-down in inflation already in evidence, boosting real incomes and spending. Food prices are turning down, helping to reduce the pace of "headline" inflation. Risks of higher grain prices persist however, evidenced in low maize stocks.

Commodity prices have stabilized or are falling



Sources: Datastream and World Bank DEC Prospects Group

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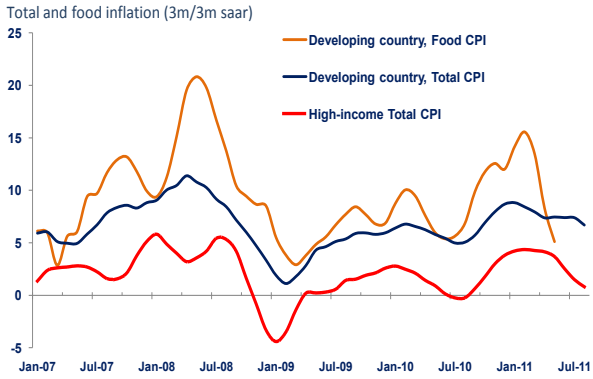
Local food inflation is no longer pushing headline inflation upwards



Source: World Bank DEC Prospects Group, ILO.

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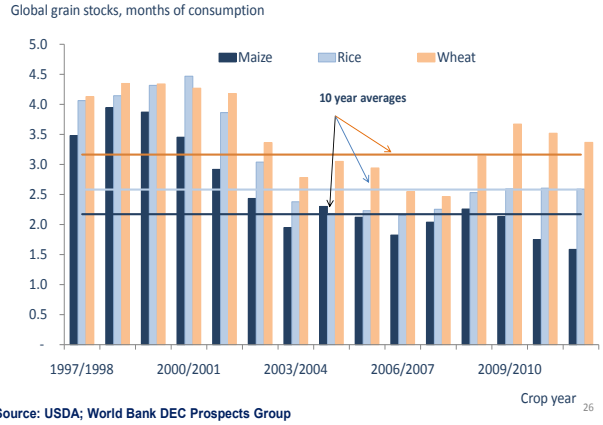
Except for maize, grain stocks are close to long-term averages



Source: USDA; World Bank DEC Prospects Group

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Commodity prices hit by slower demand growth. Crude oil prices (World Bank average) dropped 6.9% in August, averaging $100.5/bbl, on deepening concerns about demand. The prices of WTI and Brent continue to diverge, given increasing oil flows from Canada. *Oil demand in the OECD has turned negative* due to high oil prices and slowing economic activity; non-OECD demand remains robust, underpinned by strong power demand in the Middle East. Agricultural prices edged up 0.1% in August on technical factors, but over the first weeks of September the gains were retraced. Rice prices rose 5% as Thai producers began holding back sales after the new government announced it will increase farm-gate prices. And metals and minerals prices dropped 4.4% in the month due to increasing worries about the effects of slowing economic growth on demand.

Earlier worries about inflation persist but are less pronounced, as pressures moderate in most developing regions and high-income countries. The stabilization of oil prices, policy tightening, and weaker demand have contributed to an easing of headline price pressures. Food price inflation in developing countries has dropped from a 15% annualized pace in February 2011 to 5% by May. And "headline" inflation eased from 8.4% to 6.7% over the May-August period (3m/3m, saar). For the OECD, inflation has softened from 4% annualized rates to below 1% by August. However, in some developing countries, severe localized food shortages persist, with food prices standing at historic highs. The Horn of Africa remains a grave concern, where crop failure threatens the livelihoods of over 13 million people.

Grain production has recovered; but stocks are unlikely to regain levels that would prevent further price hikes should conditions deteriorate. Global grain output is expected to rise 3.3% in the 2011/12 crop year, with wheat, maize, and rice production up 4.6%, 3.7%, and 1.6%, respectively, according to the U.S. Department of Agriculture's September estimates. Grain stocks are anticipated to remain at 2010/11 levels (about 400 million tonnes), with 2.3% and 2.8% increases in the stocks of wheat and rice offsetting a projected 8% falloff for maize. Though world grain prices have been broadly stable since early-2011, the uptick during August reflected tighter-than-expected maize and wheat supplies. Stock levels of wheat and rice are close-to or above long-term average levels, but those for maize is exceptionally low.