

World Bank Says Economic Recovery Globally Has 'Peaked'

By **JOSEPH REBELLO**
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WASHINGTON – The World Bank warned Wednesday that the global economic recovery has "peaked" and said the severity of the coming slowdown will depend on the extent to which foreign investors lose their nerve about buying U.S.-dollar-denominated assets.

In an annual report on the risks confronting developing economies, the bank said the global recovery of the last three years has masked cracks that can't be left unattended for much longer.

The fragility, it said, was highlighted by "brisk sell-offs" of the dollar after some Asian central banks announced last month that they might "diversify" their currency portfolios. (See [related article](#).)

"The global economy is at a turning point," said Francois Bourguignon, the bank's chief economist, in a foreword to the report. "Growth has peaked, and pressures to address global imbalances are growing, exposing important risks facing both developed and developing countries as the needed adjustments occur."

The bank said its best-case scenario calls for a mild slowdown in global economic growth over the next few years. The annual growth rate of gross domestic product, 3.8% in 2004, is likely to drop to 3.1% this year and hover about that level through 2007. Among developing countries, the rate is likely to slip from 6.6% last year to 5.7% in 2005, and 5.2% in 2006.

Still, the bank said, a new global recession is a possibility. "A reduction in the pace at which central banks are accumulating dollars, a weakening in investors' appetite for risk, or a greater-than-anticipated pickup in inflationary pressures could cause interest rates to rise farther than projected, providing a deeper-than-expected slowdown or even a global recession," it said.

Governments around the world should plan a "coordinated response" to minimize the risk of a crisis, the bank said -- the U.S. government should shrink its record budget deficits, Europeans should ensure that their monetary policy doesn't get tighter than that of the U.S., and major Asian nations should permit their currencies to rise against the dollar in a "managed appreciation." The bank said the U.S.'s need to borrow from foreigners accounts for much of risk in the global outlook.

Last year, the U.S. current-account deficit -- the broadest measure of its trade balance -- reached a record \$666 billion, or 5.6% of the gross domestic product. That gap used to be

financed mainly by foreign private investors. But such investors have been retreating since 2001, making the U.S. increasingly reliant on foreign central banks.

Last year, "most of the current-account deficit was financed by sales of public-sector assets and securities," the bank said. Foreign central banks, "notably those of developing countries," accounted for "a substantial share of these purchases."

But rising world interest rates could alter the incentive for some central banks to make such purchases. Through their dollar purchases, some developing countries have amassed foreign-currency reserves far in excess of what they need to stave off financial crises or obtain favorable credit terms, the bank said.

Those countries, which include China, India, Thailand, Malaysia, Venezuela, the Czech Republic and Pakistan, incur a "sizable cost" to maintain their reserves, the bank said. "Each \$10 billion of reserve holdings costs the central bank about \$250 million in annual carrying charges," it said. Those costs, moreover, are "likely to increase" in coming years.

Those developments have made foreign investors jittery about the outlook. "Recent suggestions by some Asian authorities that they might be diversifying their reserve portfolios sparked brisk sell-offs that ceased only when firm denials of such diversification were subsequently issued," the bank said. If foreign central banks were to cut their holdings of dollars, U.S. interest rates might have to rise more than financial markets now expect, it said.

Because U.S. short-term interest rates are likely to stay well above European rates over the next year, the bank said it expects the dollar's decline to be mild for now. "These higher returns on dollar-denominated assets should be sufficient to induce additional private-sector purchases of dollar-denominated bonds," it said. As a result, it said, the dollar is likely to decline just about 10%.

So far, the dollar's slide against other major currencies has had little effect on the terms of trade for developing countries. "More than half" of the 69 countries for which the bank calculated the real effective exchange rate showed a currency depreciation, the bank said. Such countries, the bank said, risk "overheating their economies" unless "compensating policy measures are taken."

The bank expressed guarded optimism about the outlook for crude-oil prices, which this week hit a record of more than \$58 a barrel. The average price for 2005, the bank said, is likely to be a more moderate \$42 a barrel. "As the growth of demand moderates and new supplies come on stream, prices are expected to decline slowly, reaching \$33 by 2007," the bank said.

Write to Joseph Rebello at joseph.rebello@dowjones.com