# FINANCING DEVELOPMENT

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## Energy, development and the world economy

**A brake on growth**
High oil price dampens euphoria

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"An opportunity to reconsider policies"

**Need for reforms**
Stumbling blocks in Brazil and India

# New limits to growth

**The world economy is still expanding – although at a slightly slower pace. China, India, Brazil and Russia are all on solid growth paths, but the high oil price dampens any sense of euphoria. The prospect of internationally rising interest rates is also worrisome. In view of more expensive fossil fuels, renewable sources should be made more use of. As the effects of climate change become increasingly apparent, it is obvious that future growth must be environmentally sustainable.**

Photo: Claus Meyer / Lineair

**Copper exploration in Chile: many Latin American countries benefit from high commodity prices.**

## By Roland Bunzenthal

International trade increased by about 6.5% in 2005. This figure, while still significant, was about 2.5 points lower than that of the year before. According to the World Trade Organisation (WTO), the surging oil price was the main reason for the slow down. Oil is currently more expensive than at any time in the past 20 years. It costs approximately twice as much as in 2003. The World Bank expected the world economy to grow by 5.9% in 2005, its forecast for 2006 is 5.7%. Although these figures stay below the 6.8% reported for 2004, developing countries continue to show very robust levels of growth – more than twice those of the developed Western countries.

However, the World Bank estimates that higher oil expenditure will account for an average three percent of GDP in poor countries. This figure roughly matches the foreign aid they receive. If nothing is done to support these countries, they could be forced to restrict non-oil imports to compensate for higher oil bills. Quite likely, less money will be available for other pressing tasks in national budgets. The possible disruption to oil supplies caused by external shocks (military/political conflict, terrorism) poses one of the major threats to the world economy. Oil prices would soar even further, with possibly devastating impacts on industries all over the world. In any case, if experts are reading the global signs correctly, it is extremely unlikely that the oil price will ever again drop below $45 per barrel.

Meanwhile, long-term interest rates continue to be low by historical standards. These low rates make investment relatively inexpensive, stimulate business and help to cushion off the high oil prices. In affluent countries, however, there are already signs of interest rates slowly creeping up again. This trend may take the impetus out of the global expansion.

The second major factor of uncertainty is escalating public debt in some advanced nations. This trend, according to the World Bank, could raise the interest rates for long-term loans much faster than expected. In addition, the huge current account deficit of the USA could trigger a rapid devaluation of the dollar and compromise the exports of the developing countries, which are settled predominantly in US currency.

The currently robust economic output of developing countries suggests that free-market reforms have led to the desired results. Progress has even been made in Africa, where per-capita income has increased by an annual 1.8% recently, rather than declining as happened in the 1980s and 1990s. Debt relief has helped to stabilise highly-indebted countries, as was the case in Uganda, for example.

Despite such progress, much remains to be done. While growth has stepped up in Sub-Saharan Africa, triggering a decrease in poverty rates, the equally rapid population growth means that the absolute number of people surviving on a dollar a day has steadily increased nonetheless since the early 1980s. This number is expected to expand even further in future.

**Cover:** Tanker. Photo: E.PP / Rep / Lineair

Of all major regions, only the Euro zone is out of tune with the global business up-swing. In the long run, however, Europe should benefit considerably from globalisation. According to the latest EU business report, globalisation means low consumer prices and business costs for EU members.

Although economic conditions are unlikely to improve appreciably this year in comparison with 2005, most experts anticipate that they will not deteriorate much either. The Chinese economy – presently considered the second engine driving the global business cycle (behind that of the USA) – is even stronger than was expected early last year. India and other emerging Asian markets also keep up their strong development momentum, although much-needed reforms are still being blocked politically in India.

Brazil and Russia, two economies which were in the doldrums for a long time, have also emerged as globally driving forces recently. Russia benefits from rising energy prices. Brazil benefits from both the high-quality industrial goods it produces, as well as from exports of various commodities, which are in strong demand in Asia. Both countries are attracting investor attention. Like Russia, some other oil-exporting countries are also providing an international growth stimulus. That is also true of the very robust economies of Central and Eastern Europe, as well as of much of Spanish-speaking Latin America.

The boom in Latin America, however, has slowed down considerably in the course of 2005. In many countries, inflation risks had impacts on the business cycle. The central banks of Brazil and – temporarily – Mexico tightened monetary policy to restrict domestic spending. The high levels of public debt in the region still pose risks, according to a joint report by leading German economics institutes.

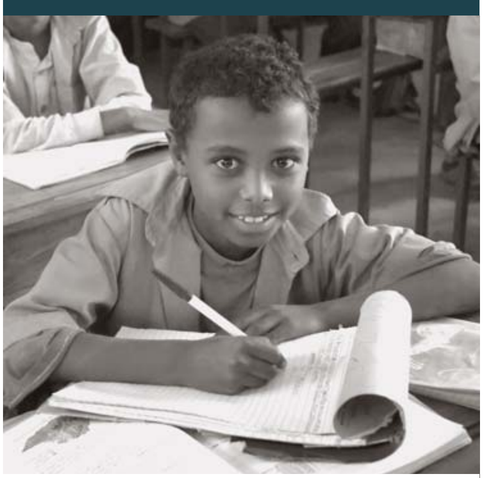

Photo: Sean Sprague / Lineair

**Schoolchildren in Ethiopia: high oil costs mean fewer budget funds for other purposes.**

## German policy focus

The Federal Republic of Germany is committed to promoting the use of renewable energy sources worldwide. Accordingly, the Federal Ministry for Economic Cooperation and Development and the Federal Environment Ministry hosted the international conference renewables2004 in Bonn. Subsequently the REN21, the international Renewable Energy Policy Network for the 21st Century, was created. With German support, a follow-up conference was held in Beijing last year. Germany's Federal Government has set up a special facility for renewable energy and energy efficiency at KfW Entwicklungsbank, with a volume of Euro 500 million.

**Further information:**
*http://www.renewables2004.de; http://www.bmz.de*

Aided by high commodity prices (relative to those of the recent past), many Latin American countries are experiencing growing trade surpluses. However, export prices for raw materials – with the exception of energy – have not substantially increased in recent months. Experts expect that massive demand from Asia will continue to hold up prices, and perhaps even inflate them again. One recurring theme permeates forecasters' expectations. Prices for agricultural commodities (including coffee, cocoa and sugar) are still very low, both in absolute and relative terms, compared with those for manufactured goods. Analysts therefore conclude, that prices may well rise this year – without even taking into account the possibility of crop failures due to climate change.

Indeed, environmental problems limit growth – though not in the sense of dwindling resources, as the Club of Rome had prophesied a generation ago. Despite the increased prosperity enjoyed by many, the economic progress in countries such as China and India cannot compensate for the environmental damage done. Toxic effluents still flow into rivers and lakes without any treatment. In many cases, antiquated coal-fired power stations, derelict chemical production facilities and other industrial factories without filter systems continue to be the sobering reality behind impressive growth rates. As this year's hurricane season sadly demonstrated, the dramatic increase in extreme weather events threatens not only business growth, but human lives, too. This fact, in itself, would provide reason enough to reconsider higher energy efficiency and the use of renewable sources – regardless of volatile oil prices.

# "Reconsider policies"

**Almost all developing countries rely on imported oil. Rising commodity prices strain their economies. Resource-saving energy policies would help to offset negative effects. It makes sense to enhance efficiency and use renewable sources.**

Photo: KfW Entwicklungsbank

**Bruno Wenn**
heads the Policy Department at KfW Entwicklungsbank.

## Interview with Bruno Wenn

**Which countries are particularly hurt by high oil prices?**
The oil price essentially affects all countries that have to import oil. The extent to which that happens depends on a wide range of factors, including the degree of self-sufficiency, the ratio of oil imports to gross domestic product, energy efficiency as well as macro-economic conditions such as the level of indebtedness, access to capital markets and foreign exchange reserves. High prices hit developing countries that import oil particularly hard. Oil continues to be a fundamental base for industrial growth. This statement applies to emerging giants of the world economy such as China and India, but also to all other developing countries. Whereas production in these regions is normally oil-intensive, energy efficiency tends to be low. This dichotomy exacerbates the problem.

**What are the typical effects of a higher oil price?**
First of all, rising prices mean more capital flows into export countries. If prices continue to climb, importers have to spend ever more to get the required oil supplies. Such spending has negative consequences for economic growth, and it increases the national debt. Of course, consumers also get to feel higher prices. This is true of the poor in developing countries in particular. High energy prices have dramatic, even life-threatening consequences. Not only do the costs of living rise, transportation to markets, schools and hospitals also becomes more expensive. The transport sector, which makes market access easier for the poor in developing countries, accounts for approximately two thirds of the demand for oil worldwide. Expensive energy therefore curtails the budding economic potential of the socially weak.

**Will hopes for attaining development goals be dashed because of high oil prices?**
Yes, they will as the macro-economic environment is getting worse almost everywhere. This is especially so in countries that subsidise energy, for example in Asia. Indonesia is probably the model case. This country subsidised oil prices so heavily that, in 2005, the enormous price rise meant that almost a third of the national budget was spent on energy. This dynamic meant that there simply was no money left for other issues, which were urgent from a developmental point of view.

**Are you saying you're fundamentally opposed to subsidising energy?**
Yes, these subsidies set the wrong signals. They offer no incentive whatsoever to use energy efficiently or to tap renewable sources. Doing both, in my view, is essential. Cutting subsidies is necessary for real competition to develop. The more prices paid correspond to the real price, the greater the marketing opportunities become for new products and alternative forms of energy provision. At the levels of government, investors and consumers, we need a clear incentive system. Otherwise, new options will not be implemented. The pressure of rising oil prices proves that policies need to be reconsidered. Indonesia has already gone down this track and radically cut the bulk of subsidies in October. However – and this is interesting – that step was due to the unfavourable macro-economic conditions. It did not stem from reconsidering the sense and nonsense of subsidies. Domestically, this issue is very sensitive in the countries concerned.

**You want subsidies to be cut in spite of higher consumer prices especially affecting the poor?**
Targeted aid can and must absorb such negative consequences at the micro-level. The problem with blanket price-subsidies, however, is that they benefit other sections of the population much more than they help the poor. One

mustn't forget that. Cross-subsidising the poor by charging those better-off higher prices, is, of course, a completely different matter. In the short-term, doing so is an option to stop the poor from becoming even more disadvantaged.

**Oil is likely to remain expensive in the long term. Yet it seems to be business as usual almost everywhere.**

I think that's only the case at the moment. It is obvious that the oil price will remain high. But we will only see the tangible effects and consequences for developing countries after some business cycles. Many countries are still trying to stick to their usual level of oil consumption, simply by spending more. This strategy will not work out in the long term, but rather cause the countries concerned severe economic difficulties.

**In view of their tight budgets, however, many developing countries can hardly invest in new infrastructure.**

All conventional energy sources are finite. Therefore, a rethink is inevitable. In a way, the high oil prices are an opportunity to consider new modes of supply. International and bilateral development cooperation could assist this trend. The people in charge have to focus on the long-term advantages offered by efficient resource-use. Sometimes, huge investment is not even required at the outset. I'll give you an example: simply rewiring the generators of an existing power station can lead to efficiency gains of one third.

Photo: Johnny Hendarta / UNEP / Lineair

**Recycling oil containers: Indonesia has modified its subsidy policy.**

**How do energy efficiency and renewable sources relate to one another?**

Both are essential. Energy-saving measures are generally easier to put in place. I am thinking first and foremost of power stations and industry, which have to raise technological standards due to the pressure of international competition anyway. However, I am also thinking of the transport sector as well as of energy-efficient buildings. Thanks to biogas or energy-saving kilns, energy efficiency is a relevant buzzword at the level of poor households, too.

**Do local funds suffice to finance those changes?**

It is not easy to find suitable sponsoring agencies in this field. In Germany, we subsidise renewable sources, but we also tax petrol. Developing countries cannot afford this policy – and certainly not as long as they subsidise oil products. Therefore, the private sector is the most important investor for new forms of energy. An appropriate institutional setting must provide incentives for the private sector to participate.

**How does KfW Entwicklungsbank support reform projects in developing countries?**

KfW Entwicklungsbank has been implementing projects on behalf of the German Development Ministry for a long time. These projects contribute to environmental sustainability by promoting renewable sources such as biogas, sunlight or wind. We also support measures that increase the efficiency of energy production. In order to support even more projects in these two areas, KfW Entwicklungsbank grants low-interest loans to governmental or semi-governmental institutions in the partner countries. We do this thanks to a special facility, which amounts to Euro 500 million over a five-year period. Because of grants from the Development Ministry, this sum can also be offered as low-interest loans to developing countries. In addition, we are engaged in an intensive dialogue with our partner countries on issues such as sensible tariffs, higher efficiency and better opportunities to promote renewable energies. All the time, we make sure that the issues of the poorer sections of the population are taken into account.

**Which specific projects do you support?**

KfW Entwicklungsbank supports wind power generation in Morocco, India, China and Egypt, the development of geothermal power stations in Kenya, biogas plants in Turkey and Nepal as well as photovoltaics in South Africa, Morocco, China and Bangladesh. Another key focus of KfW Entwicklungsbank is to increase energy efficiency in developing countries. In this context, we concentrate on both modernisation and a reduction of losses.

*Questions by Hans Dembowski and Antje Mangelsdorf.*

# Dynamic exports, slow reforms

**Brazil is benefiting from high commodity prices, but the price of oil is putting a strain on the economy.**


Photo: Ron Giling / Lineair

**Bio-fuel at the petrol station –
Brazil presents many opportunities.**

Brazil's economy continued to develop reasonably well in 2005. However, according to KfW Entwicklungsbank estimates, last year's growth rate was less than three percent, considerably below the 2004 level of 4.9%. The export of commodities and industrial goods were key factors for expansion. Brazil benefits greatly from the high commodity prices brought about by the growing Asian demand. While the USA is still the leading export market by far, China is also becoming an increasingly important trade partner.

Despite the appreciation of the Brazilian Real against the US dollar by 28% within one year, exports have flourished. The ratio of exports to gross domestic product (GDP) was 18%. However, the record trade and current account surpluses reached thanks to strong exports and low interest rates for foreign debt are expected to moderate in the current year from the record levels reached in 2005.

Foreign direct investments continue to be extremely important for Brazil's economy. In 2005, they probably amounted to less than the 2004 figure of $18.5 billion. Although the country almost has a break-even balance sheet with respect to oil, Brazil is also feeling the disadvantages of rising commodity prices. This, along with the high exchange rate for the Real, is causing investors to act with a certain restraint. Foreign investments will not increase as vigorously in 2006 as they did in 2004.

Brazil's high level of foreign debt also continues to contribute to caution. However, the ratio of due debt servicing to exports has sunk because of the strong foreign-trade performance and the recent reduction of interest rates. Furthermore, the rising exchange rate of the Real, still very high domestic interest rates and the political uncertainty after recent corruption scandals and the forthcoming presidential elections are slowing down the growth of the Brazilian economy as investment activity and consumer demand are levelling off.

Since the beginning of the 1990s, Brazil's economic policy has been predominantly geared towards stabilisation, liberalisation and opening markets. Luis Ignacio da Silva ("Lula"), the social-democrat president since 2003, has essentially stuck to this strategy. Although the reform policy certainly led to more competitiveness and less dependency on foreign financial speculation, it has not yet significantly lowered the high level of unemployment, which, according to official figures, was around ten percent in 2005.

Brazil's high governmental debt at home and abroad puts a great strain on the budget – and particularly so, as some of it goes along with high interest rates over relatively short terms. Even though the overall trend looks positive, there is room for improvement in the business climate and in particular for infrastructure investments. Social and political reforms are difficult because the government cannot act as a redistribution agency in times of tight budgets. To a large extent, the long-term reform momentum is hampered by a popular sense of entitlement.

In order to improve the investment climate, KfW Entwicklungsbank considers micro-economic reforms to be useful. Such reforms should be directed towards improving public investment activity – especially via public-private partnerships (PPP) –, reducing red tape, enhancing transparency, promoting high technology and modernising the regulation of the energy sector. It would make sense to reform both the judiciary and labour laws, gradually introducing more flexibility. However, it seems that the reform process has come to a standstill. *(ama)*

# Neither tiger nor elephant

**Reforms would invigorate India's economy.**

Since the early 1990s, India's economy has been growing by an average rate of six percent per annum. Foreign exchange reserves of $130 billion are another proof of this country's emerging potential. Experts predict that, within the next 15 years, India will rank as the world's third largest economy (behind the USA and China).

The stimulus for growth in the sub-continent can be traced back to the reform policies implemented in the early 1990s. Liberalisation encouraged foreign trade and boosted investment in industry. India also derives enormous economic benefit from its qualified engineers and computer scientists. IT hardware and software account for 11% of today's exports of goods and services. The 2004 year saw an impressive 24% increase in goods exports. It is anticipated that both manufacturing and service industries will continue to expand rapidly.

In the view of KfW Entwicklungsbank, however, not all the news is rosy. This is particularly true as not all sectors are on the road to modernisation. For example, agricultural productivity continues to be poor. Agriculture absorbs some 60% of the workforce, but accounts for only 20% of economic output.

"This country has phenomenal business and political potential," says KfW Entwicklungsbank economist Martin Raschen. "But bold and resolute reforms still remain necessary." Government action limits growth as well as the success in the fight against poverty. The high level of national debt is an enormous burden, for instance. For an extended period of time, budget deficits at central and state levels have amounted to approximately 10% of annual GDP. Debt servicing accounts for about a third of all governmental expenditure.

According to KfW Entwicklungsbank, India's budgetary problems stem from the mismatch between revenue and expenditure. A mere two million Indians pay income tax – with negative impacts not only on the tax yield, but also on the principle of equitable taxation. The tax base should be expanded as soon as possible. India also wastes money on subsidies. Rich farmers are provided with fertilisers and power free of charge. Power stations can access coal at prices under world

Photo: Michael Bader / Lineair

Low productivity is typical of Indian agriculture.

market levels. State-owned enterprises are losing money. The arrears of the electricity sector alone amount to $5.6 billion.

The policies behind such spending distort the allocation of resources and are of little benefit to the poor. On the other hand, money is not available for the urgently-needed upgrading of infrastructure. Labour laws are too rigid. Further privatisation would encourage competition and would make sense in the financial sector, for instance.

KfW Entwicklungsbank expert Raschen no longer believes India to be a "lumbering elephant" of low growth rates, a mere also-ran on the global market. On the other hand, in his opinion, this country of a billion people has neither become a "sprinting tiger" yet, catching up fast with rich developed nations. While low labour costs and high-level technical expertise in selected fields are making India increasingly attractive in a global perspective, the high oil price – along with some home-grown problems – is dampening the prospects of this energy-importing country. *(dem)*


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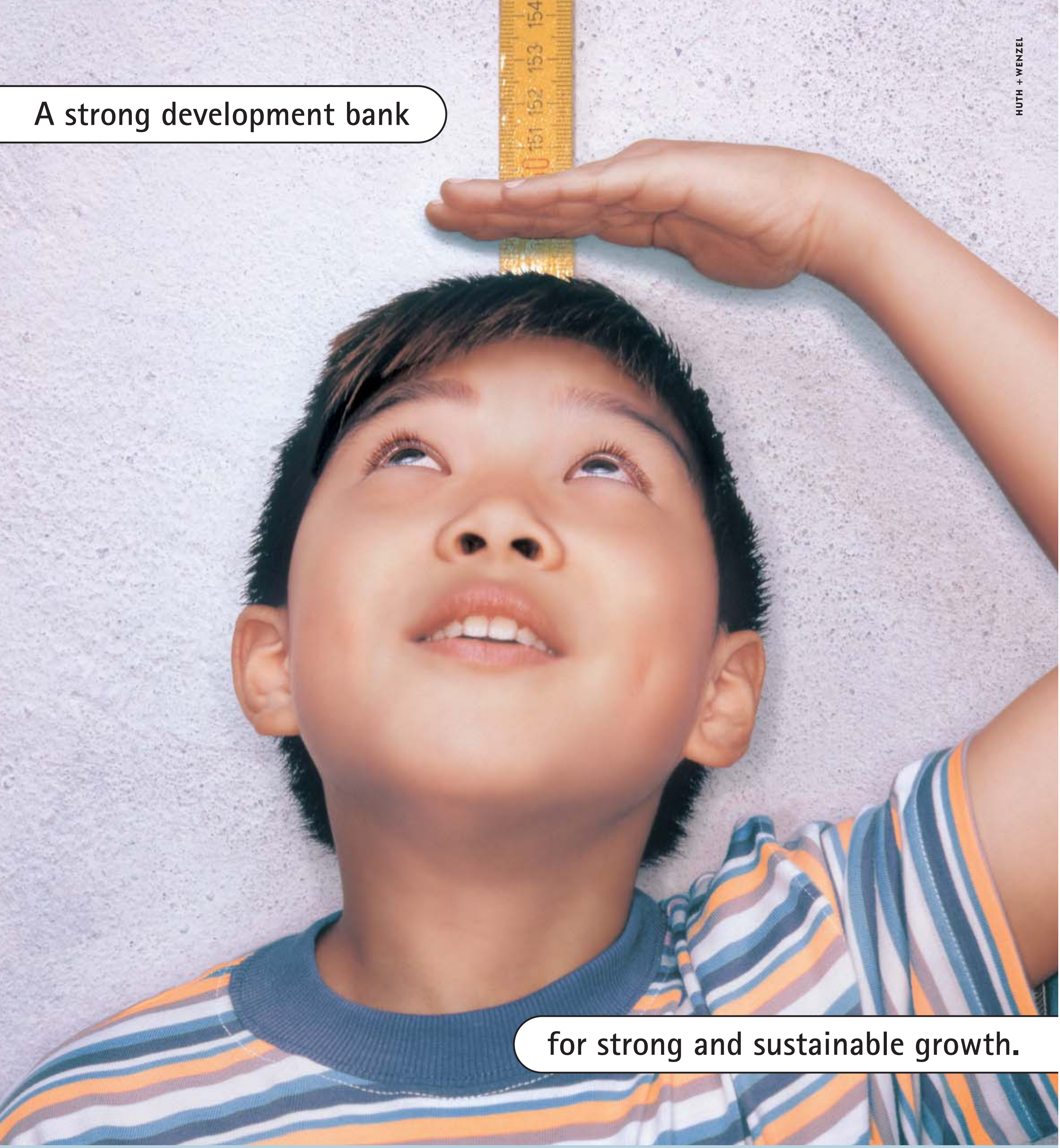


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