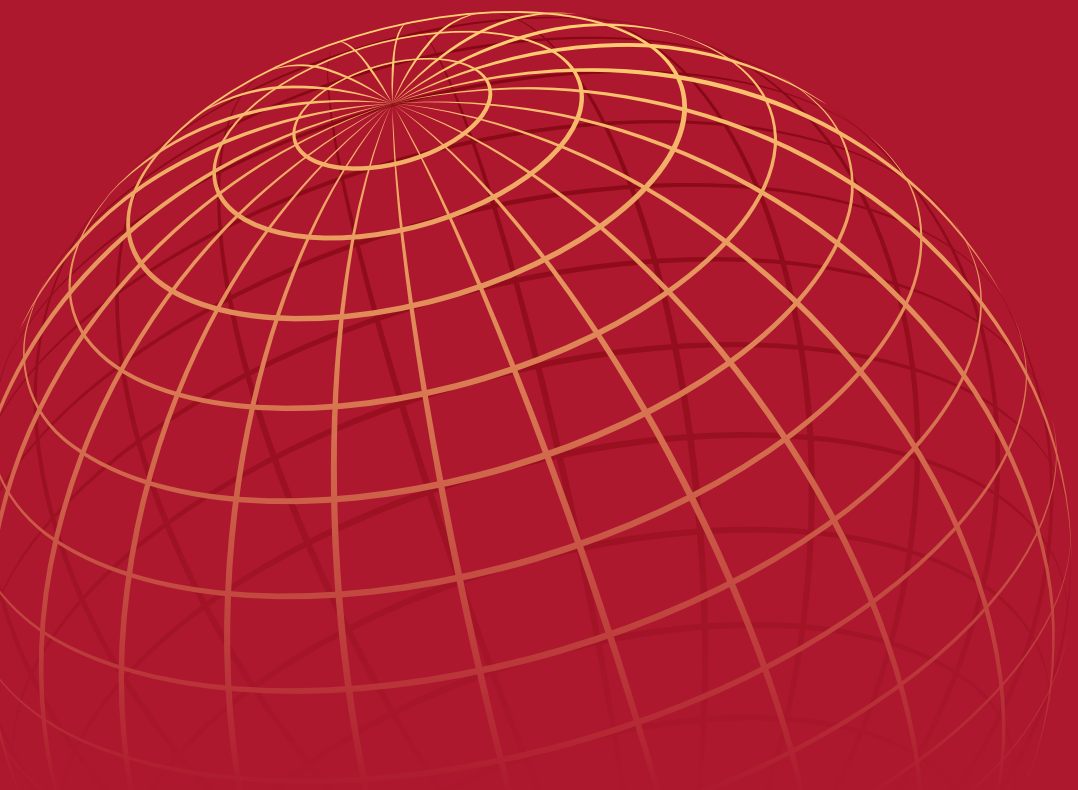
A World Bank Group Flagship Report

JUNE 2019

Global Economic Prospects

Heightened Tensions, Subdued Investment



WORLD BANK GROUP

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Foreword

Global growth has continued to weaken and momentum remains fragile. As this edition of the *Global Economic Prospects* report documents, investment is sluggish. Downside risks to growth predominate, including rising trade barriers, a build-up of government debt, and deeper-than-expected slowdowns in several major economies.

Substantial challenges are clouding the global economic outlook in both the near and long term. For emerging market and developing economies (EMDEs), lackluster investment is particularly concerning. Investment growth in these economies is expected to remain weak and below historical averages, held back by sluggish global growth; limited fiscal space; and structural constraints that misallocate or discourage investment such as poor business environments, labor and product market controls, and weak governance. Subdued investment weakens the foundations for the sustained growth that is needed to alleviate extreme poverty and advance shared prosperity.

In an era of low interest rates, government borrowing might appear to be an attractive option to finance growth-enhancing investment projects. Debt is often an important tool for development and poverty reduction, and sustainable borrowing can help countries finance investments in infrastructure, health, education, and other essential areas. To be additive to growth, however, debt has to be transparent and well managed. Otherwise, it becomes more of a burden than a benefit by increasing vulnerability to crises, eroding the effectiveness of macroeconomic policy, and weighing on investment and growth.

Unsustainable debt levels have become increasingly troublesome in the last few years, with incentives often working against transparency. As this report highlights, EMDE government debt is higher than before the global financial crisis by an average of 15 percentage points of GDP. The bottom line is that EMDEs need to strike a careful balance between acquiring debt to promote investment growth and avoiding risks associated with excessive levels and hidden forms of debt.

This report also details the difficulties low-income countries face in the effort to improve living standards. A number of these countries achieved middle-income status between 2000 and 2018, but current low-income countries face a steeper road to deliver the same progress. Relative to countries that made the earlier leap to middle-income ranks, many of today's low-income countries are poorer, more fragile, constrained geographically, and heavily reliant on subsistence agriculture. It will take comprehensive policy changes to tackle these difficulties.

Policymakers have a wide range of options to bolster investment and growth. In light of the formidable challenges, big policy adjustments are urgently needed, including decisive action to undertake structural reforms for growth that will lead to stronger development outcomes for countries.

David Malpass
President
The World Bank Group

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Global and regional surveillance work was coordinated by Carlos Arteta. The primary authors of this report were Jongrim Ha, Patrick Kirby, Rudi Steinbach, Marc Stocker, Naotaka Sugawara, Temel Taskin, Ekaterine Vashakmadze, Dana Vorisek, Collette M. Wheeler, and Lei Sandy Ye.

Other contributors included John Baffes, Csilla Lakatos, Peter Nagle, Franz Ulrich Ruch, and Hakan Yilmazkuday.

Research assistance was provided by Liu Cui, Ishita Dugar, Mengyi Li, Maria Hazel Macadangdang, Claudia Marchini, Julia R.R. Norfleet, Jinxin Wu, and Heqing Zhao. Modeling and data work were provided by Rajesh Kumar Danda and Julia R.R. Norfleet.

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The analysis benefited from comments and suggestions by staff members from World Bank Group country teams and other World Bank Group Vice Presidencies as well as Executive Directors in their discussions of the report on May 23, 2019. However, both forecasts and analysis are those of the World Bank Group staff and should not be attributed to Executive Directors or their national authorities.

Executive Summary

Global growth has continued to soften this year. Momentum remains weak and policy space is limited. A subdued recovery in investment growth in emerging market and developing economies (EMDEs) dampens potential growth prospects and hampers progress toward achieving the Sustainable Development Goals. Risks remain firmly on the downside, including the possibility of escalating trade tensions, sharper-than-expected slowdowns in major economies, and renewed financial stress in EMDEs. Meanwhile, rising debt constrains the ability of EMDE governments to support economic activity in the event of adverse developments, as well as finance growth-enhancing investments. This highlights the need for policy actions to undertake reforms to boost private investment and productivity growth. These reforms are particularly urgent in low-income countries, which face more significant challenges today than they did in the early 2000s.

Global Outlook. Global growth in 2019 has been downgraded to 2.6 percent, 0.3 percentage point below previous forecasts, reflecting weaker-than-expected international trade and investment at the start of the year. Growth is projected to gradually rise to 2.8 percent by 2021, predicated on continued benign global financing conditions, as well as a modest recovery in emerging market and developing economies (EMDEs) previously affected by financial market pressure. However, EMDE growth remains constrained by subdued investment, which is dampening prospects and impeding progress toward achieving development goals. Risks are also firmly on the downside, in part reflecting the possibility of destabilizing policy developments, including a further escalation of trade tensions between major economies; renewed financial turmoil in EMDEs; and sharper-than-expected slowdowns in major economies. It is therefore urgent for EMDEs to reinforce policy buffers and build resilience to possible negative shocks, and to implement reforms that promote private investment and improve public sector efficiency. Efforts to strengthen access to markets and technology while boosting the quality of infrastructure and governance should be prioritized and be implemented through cost-effective and private-sector-led solutions. Structural reforms aimed at improving the business climate would also boost growth prospects. Well-designed social safety nets and active labor market policies are key to managing risks and protecting vulnerable groups.

This edition of *Global Economic Prospects* includes analytical essays on the benefits and risks of government borrowing, recent investment weakness in EMDEs, the pass-through of currency depreciations to inflation, and the evolution of growth in low-income countries (LICs).

Debt: No Free Lunch. Government debt has risen substantially in EMDEs, by an average of 15 percentage points of GDP since 2007 to 51 percent of GDP in 2018. The current environment of low global interest rates and weak growth may appear to mitigate concerns about elevated debt levels. Considering currently subdued investment additional government borrowing might also appear to be an attractive option for financing growth-enhancing initiatives such as investment in human and physical capital. However, history suggests caution: the cost of rolling over debt can increase sharply during periods of financial stress and result in financial crises; high debt levels can limit the ability of governments to provide fiscal stimulus during downturns; and high debt can weigh on investment and long-term growth, especially at a time when investment momentum is already weak. Hence, EMDEs need to strike a careful balance between taking advantage of low interest

rates and avoiding the potentially adverse consequences of excessive debt accumulation. This is particularly critical at present given the set of risks facing the global economy, which will require EMDEs to have adequate fiscal policy space and build resilience to financial market disruptions.

Investment: Subdued Prospects, Strong Needs. Investment growth in EMDEs over the next three years is expected to be subdued and below historical averages. This continues a prolonged, broad-based slowdown after the global financial crisis, notwithstanding a modest recovery between 2016 and 2018. During the forecast period, EMDE investment growth is expected to be held back by weak global growth, limited fiscal space against the backdrop of elevated debt, and the presence of several structural constraints. Weak investment is a concern because it will further dampen potential growth, and make achieving the Sustainable Development Goals more difficult. Depending on country circumstances, the use of appropriate fiscal and structural reforms could generate upside potential for investment in the medium and long term. For EMDEs with limited fiscal space, institutional reforms to improve business conditions could help attract private investment. In light of elevated debt levels, policymakers should also ensure resources are allocated to high quality investment projects and improve the transparency and efficiency of public investment management systems where necessary.

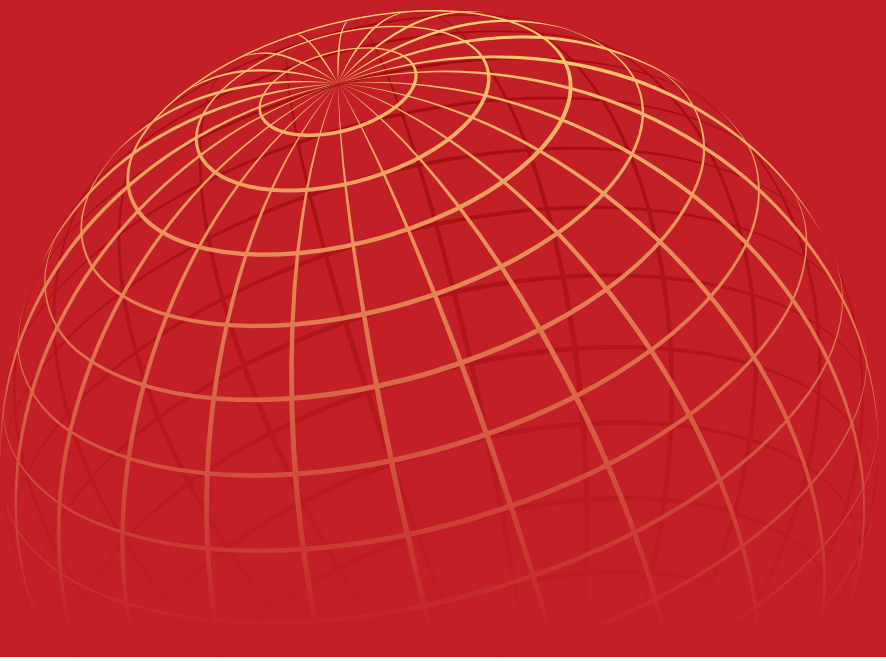
Currency Depreciations, Inflation and Central Bank Independence. Financial market turbulence in 2018 illustrated, once again, that EMDEs continue to face the risk of destabilizing exchange rate movements. These stress episodes often compel central banks to tighten policy to lessen currency pressures and fend off inflationary pressures despite slowing growth. To design appropriate policies it is important to quantify the exchange rate pass-through to inflation associated with different shocks and with different country characteristics. The pass-through to inflation tends to be largest when currency movements are triggered or amplified by monetary policy action. In contrast, the pass-through is significantly smaller when central banks pursue a credible inflation target, operate in a flexible exchange rate regime, and are independent from fiscal authorities. This highlights the critical importance of central bank credibility, given the self-reinforcing feedback loop between credibility, the exchange rate and price stability. These episodes also serve as a reminder of the risks posed by excessive levels of foreign currency debt, and EMDEs can foster resilience to periods of financial stress by issuing debt contracted at longer maturities, at fixed interest rates, and denominated in local currency, where possible.

Growth in Low-Income Countries: Evolution, Prospects and Policies. There are currently 34 countries classified as low-income, about half the number in 2001. Rapid growth in low-income countries from 2001-18 allowed many to progress to middle-income status, supported by a pre-crisis commodity price boom, the MDRI and HIPC debt relief initiatives, increased investment in human and physical capital, improved economic policy frameworks, and recoveries from the deep recessions in transition economies during the 1990s. However, the prospects for today's LICs appear much more challenging. Compared to the LICs in 2001 that became middle-income countries, today's LICs are further below the middle-income threshold and more often fragile than were LICs in 2001. Their heavy reliance on agriculture makes them vulnerable to climate change and extreme weather events, and their scope to boost external trade is limited by geography. Coordinated and multi-pronged policy efforts are required to address these challenges.

Abbreviations

ACP	African, Caribbean and Pacific Group of States
AE	advanced economy
CDS	credit default swap
CPTPP	Comprehensive and Progressive Agreement for Trans-Pacific Partnership
DR-CAFTA	Central America-Dominican Republic Free Trade Agreement
EAP	East Asia and Pacific
ECA	Europe and Central Asia
ECB	European Central Bank
ECI	Economic Complexity Index
EMBI	Emerging Market Bond Index
EMDE	emerging market and developing economies
ERPTR	exchange rate pass-through ratio
EU	European Union
FAVAR	Bayesian factor-augmented vector autoregression
FCV	fragility, conflict, and violence
FDI	foreign direct investment
GCC	Gulf Cooperation Council
GDP	gross domestic product
GEP	*Global Economic Prospects*
GMM	generalized methods of moments
GNFS	goods and nonfactor services
GNI	gross national income
GST	goods and services tax
GVCs	global value chains
HIPC	Heavily Indebted Poor Countries
ICE	Intercontinental Exchange
ICRG	International Country Risk Guide
IMF	International Monetary Fund
IT	inflation targeting
LAC	Latin America and the Caribbean
LFPR	Labor force participation rate
LIC	low-income country
LSAP	Large-Scale Asset Purchase
MDRI	Multilateral Debt Relief Initiative
MENA	Middle East and North Africa
MEP	Maturity Extension Program
MIC	middle-income country

NEER	nominal effective exchange rate
NPL	nonperforming loan
ONI	Oceanic Niño Index
OPEC	Organization of the Petroleum Exporting Countries
PMI	Purchasing Managers' Index
PPP	purchasing power parity
REER	Real Effective Exchange Rate
RHS	right-hand side (in figures)
RMB	renminbi
SAR	South Asia Region
SSA	Sub-Saharan Africa
SSE	Shanghai Stock Exchange
TFP	total factor productivity
TiVA	Trade in Value Added
USMCA	United States-Mexico-Canada Agreement
VAT	Value-added tax
WAEMU	West African Economic and Monetary Union
WGI	World Governance Indicators
WTO	World Trade Organization



CHAPTER 1

GLOBAL OUTLOOK

Weak Momentum, Heightened Risks

Global growth in 2019 has been downgraded to 2.6 percent, 0.3 percentage point below previous forecasts, reflecting weaker-than-expected international trade and investment at the start of the year. Growth is projected to gradually rise to 2.8 percent by 2021, predicated on continued benign global financing conditions, as well as a modest recovery in emerging market and developing economies (EMDEs) previously affected by financial market pressure. However, EMDE growth remains constrained by subdued investment, which is dampening prospects and impeding progress toward achieving development goals. Risks are also firmly on the downside, in part reflecting the possibility of destabilizing policy developments, including a further escalation of trade tensions between major economies; renewed financial turmoil in EMDEs; and sharper-than-expected slowdowns in major economies. It is therefore urgent for EMDEs to reinforce policy buffers and build resilience to possible negative shocks, and to implement reforms that promote private investment and improve public sector efficiency. Efforts to strengthen access to markets and technology while boosting the quality of infrastructure and governance should be prioritized and be implemented through cost-effective and private-sector-led solutions. Structural reforms aimed at improving the business climate would also boost growth prospects. Well-designed social safety nets and active labor market policies are key to managing risks and protecting vulnerable groups.

Summary

Global economic activity continued to soften at the start of 2019, with trade and manufacturing showing signs of marked weakness (Figures 1.1.A and B). Heightened policy uncertainty, including a recent re-escalation of trade tensions between major economies, has been accompanied by a deceleration in global investment and a decline in confidence (Figure 1.1.C). Activity in major advanced economies—particularly in the Euro Area—as well as in some large emerging market and developing economies (EMDEs) has been weaker than previously expected. Recent high-frequency indicators suggest this period of weakness may be receding; however, global activity remains subdued.

Amid low global inflation and a deterioration of the growth outlook, the prospect that the U.S. Federal Reserve and other major central banks will tighten monetary policy in the near term has faded, leading to an easing in global financing conditions and a recovery of capital flows to EMDEs. However, weakening external demand has weighed on export growth across EMDE regions. Although demand for industrial commodities has generally softened, prices have partially recovered because of tightening supply conditions. EMDE growth momentum continues to be generally subdued, as slowing global trade and persistent policy uncertainty in key economies are only partially offset by recent improvements in external financing conditions.

Global growth in 2019 has been downgraded to 2.6 percent—0.3 percentage point below previous projections—reflecting the broad-based weakness observed during the first half of the year, including a further deceleration in investment amid rising trade tensions. In particular, global trade growth in 2019 has been revised down a full percentage point, to 2.6 percent—slightly below the pace observed during the 2015-16 trade slowdown, and the weakest since the global financial crisis.

As recent softness abates, global growth is projected to edge up to 2.7 percent in 2020 and to 2.8 percent in 2021. Slowing activity in advanced economies and China is expected to be accompanied by a modest cyclical recovery in major commodity exporters and in a number of EMDEs affected by recent pressure related to varying degrees of financial market stress or idiosyncratic headwinds such as sanctions (Figure 1.1.D).

EMDE growth is projected to pick up from a four-year low of 4 percent in 2019—0.3 percentage point below previous projections—to 4.6 percent in 2020-21. This recovery is predicated on the waning impact of earlier

Note: This chapter was prepared by Carlos Arteta, Patrick Kirby, and Marc Stocker, with contributions from Ekaterine Vashakmadze and Collette M. Wheeler. Additional inputs were provided by John Baffes, Csilla Lakatos, Peter Nagle, Franz Ulrich Ruch, and Rudi Steinbach. Research assistance was provided by Liu Cui, Ishita Dugar, Claudia Marchini, Julia R.R. Norfleet, and Jinxin Wu.

TABLE 1.1 Real GDP[1]

(Percent change from previous year)

	2016	2017	2018e	2019f	2020f	2021f	Percentage point differences from January 2019 projections: 2019f	2020f	2021f
World	**2.6**	**3.1**	**3.0**	**2.6**	**2.7**	**2.8**	**-0.3**	**-0.1**	**0.0**
Advanced economies	**1.7**	**2.3**	**2.1**	**1.7**	**1.5**	**1.5**	**-0.3**	**-0.1**	**0.0**
United States	1.6	2.2	2.9	2.5	1.7	1.6	0.0	0.0	0.0
Euro Area	2.0	2.4	1.8	1.2	1.4	1.3	-0.4	-0.1	0.0
Japan	0.6	1.9	0.8	0.8	0.7	0.6	-0.1	0.0	0.0
Emerging market and developing economies	**4.1**	**4.5**	**4.3**	**4.0**	**4.6**	**4.6**	**-0.3**	**0.0**	**0.0**
Commodity-exporting EMDEs	1.5	2.1	2.2	2.1	3.1	3.0	-0.4	0.1	0.0
Other EMDEs	6.0	6.1	5.8	5.2	5.5	5.5	-0.3	-0.1	-0.1
Other EMDEs excluding China	5.1	5.4	4.9	4.2	4.8	5.0	-0.5	-0.1	-0.1
East Asia and Pacific	6.3	6.5	6.3	5.9	5.9	5.8	-0.1	-0.1	0.0
China	6.7	6.8	6.6	6.2	6.1	6.0	0.0	-0.1	0.0
Indonesia	5.0	5.1	5.2	5.2	5.3	5.3	0.0	0.0	0.0
Thailand	3.4	4.0	4.1	3.5	3.6	3.7	-0.3	-0.3	-0.2
Europe and Central Asia	1.9	4.1	3.1	1.6	2.7	2.9	-0.7	0.0	0.0
Russia	0.3	1.6	2.3	1.2	1.8	1.8	-0.3	0.0	0.0
Turkey	3.2	7.4	2.6	-1.0	3.0	4.0	-2.6	0.0	-0.2
Poland	3.1	4.8	5.1	4.0	3.6	3.3	0.0	0.0	0.0
Latin America and the Caribbean	-0.3	1.7	1.6	1.7	2.5	2.7	-0.4	-0.2	0.0
Brazil	-3.3	1.1	1.1	1.5	2.5	2.3	-0.7	0.1	-0.1
Mexico	2.9	2.1	2.0	1.7	2.0	2.4	-0.3	-0.4	0.0
Argentina	-2.1	2.7	-2.5	-1.2	2.2	3.2	0.5	-0.5	0.1
Middle East and North Africa	5.1	1.2	1.4	1.3	3.2	2.7	-0.6	0.5	0.0
Saudi Arabia	1.7	-0.7	2.2	1.7	3.1	2.3	-0.4	0.9	0.1
Iran	13.4	3.8	-1.9	-4.5	0.9	1.0	-0.9	-0.2	-0.1
Egypt[2]	4.3	4.2	5.3	5.5	5.8	6.0	-0.1	0.0	0.0
South Asia	8.1	6.7	7.0	6.9	7.0	7.1	-0.2	-0.1	0.0
India[3]	8.2	7.2	7.2	7.5	7.5	7.5	0.0	0.0	0.0
Pakistan[2]	4.6	5.4	5.8	3.4	2.7	4.0	-0.3	-1.5	-0.8
Bangladesh[2]	7.1	7.3	7.9	7.3	7.4	7.3	0.3	0.6	0.5
Sub-Saharan Africa	1.3	2.6	2.5	2.9	3.3	3.5	-0.5	-0.3	-0.2
Nigeria	-1.6	0.8	1.9	2.1	2.2	2.4	-0.1	-0.2	0.0
South Africa	0.6	1.4	0.8	1.1	1.5	1.7	-0.2	-0.2	-0.1
Angola	-2.6	-0.1	-1.7	1.0	2.9	2.8	-1.9	0.3	0.0
Memorandum items:									
Real GDP[1]									
High-income countries	1.7	2.3	2.1	1.8	1.6	1.6	-0.2	-0.1	0.0
Developing countries	4.4	4.8	4.6	4.2	4.7	4.8	-0.3	-0.1	0.0
Low-income countries	4.8	5.6	5.6	5.4	6.0	6.1	-0.5	-0.2	-0.2
BRICS	4.6	5.3	5.4	5.1	5.3	5.3	-0.1	0.0	0.0
World (2010 PPP weights)	3.3	3.7	3.7	3.3	3.5	3.6	-0.3	-0.1	0.0
World trade volume[4]	2.8	5.5	4.1	2.6	3.1	3.2	-1.0	-0.4	-0.2
Commodity prices[5]									
Oil price	-15.6	23.3	29.4	-3.4	-1.5	0.7	-0.5	-1.5	0.7
Non-energy commodity price index	-2.8	5.5	1.7	-2.1	-0.1	1.4	-3.1	-1.3	0.2

Source: World Bank.

Notes: PPP = purchasing power parity; e = estimate; f = forecast. World Bank forecasts are frequently updated based on new information. Consequently, projections presented here may differ from those contained in other World Bank documents, even if basic assessments of countries' prospects do not differ at any given moment in time. Country classifications and lists of emerging market and developing economies (EMDEs) are presented in Table 1.2. BRICS include: Brazil, Russia, India, China, and South Africa. Due to lack of data, the World Bank has ceased producing a growth forecast for Venezuela and has removed Venezuela from all growth aggregates in which it was previously included.

1. Aggregate growth rates calculated using constant 2010 U.S. dollar GDP weights.

2. GDP growth values are on a fiscal year basis. Aggregates that include these countries are calculated using data compiled on a calendar year basis. Pakistan's growth rates are based on GDP at factor cost. The column labeled 2019 refers to FY2018/19.

3. The column labeled 2018 refers to FY2018/19.

4. World trade volume of goods and non-factor services.

5. Oil is the simple average of Brent, Dubai, and West Texas Intermediate. The non-energy index is comprised of the weighted average of 39 commodities (7 metals, 5 fertilizers, 27 agricultural commodities). For additional details, please see http://www.worldbank.org/en/research/commodity-markets.

Click here to download data.

financial pressure currently weighing on activity in some large EMDEs, and on more benign global financing conditions than previously expected. It also assumes no further escalation in trade restrictions between major economies and stability in commodity prices. Despite this projected recovery, per capita growth in a large number of EMDEs will remain insufficient to narrow income gaps with advanced economies—including in Sub-Saharan Africa, a region with a high concentration of poverty (Figure 1.1.E).

Moreover, EMDE investment growth will remain soft, particularly in commodity exporters and countries affected by recent pressures (Figure 1.1.F). Factors contributing to the weak pace of EMDE investment growth include elevated debt levels, limited fiscal space, lack of clarity about policy direction, and inadequate business climates. Subdued investment will weigh on EMDE growth prospects directly through slower capital deepening and indirectly through its dampening impact on productivity, which will make achieving the Sustainable Development Goals more difficult.

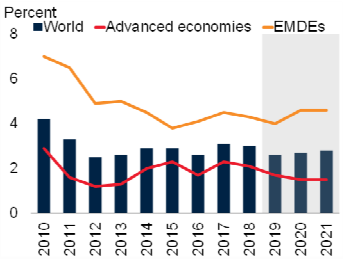
Amid a low probability of substantial near-term policy improvements in major economies, risks remain firmly on the downside (Figure 1.2.A). Confidence and investment could be markedly impacted by a sudden rise in policy uncertainty—triggered, for instance, by substantial new trade barriers between major economies resulting in cascading trade costs and a lack of clarity about future trading rules (Figure 1.2.B). If this rise is persistent, the impact on global investment and activity could be severe. An increase in uncertainty could also be related to a heightened possibility of a disorderly exit of the United Kingdom from the European Union (EU). Similarly, a sustained dissipation of these uncertainties—for instance, due to a comprehensive resolution of trade tensions between the United States and China—could significantly buttress global growth prospects. The potential gains associated with such a resolution highlight the large opportunity costs that additional trade tensions would entail.

A weakening of financial market sentiment could lead to sudden increases in risk premiums and be amplified by high and rising debt levels, corporate sector vulnerabilities, and increasing refinancing

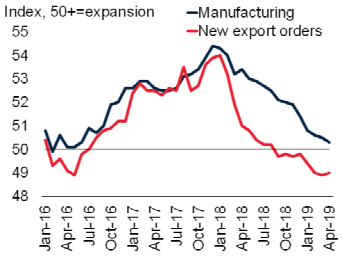
FIGURE 1.1 Global growth prospects

Global growth softened further in the first half of the year, as trade and manufacturing decelerated. Amid heightened policy uncertainty, confidence has declined. A more dovish stance by major central banks has led to some easing in financing conditions. After weakness in 2019, EMDE growth is expected to recover in 2020-21, as headwinds in key economies fade. In many EMDEs, this recovery will not be enough to narrow per capita income gaps with advanced economies. Subdued investment will continue to weigh on EMDE growth prospects.

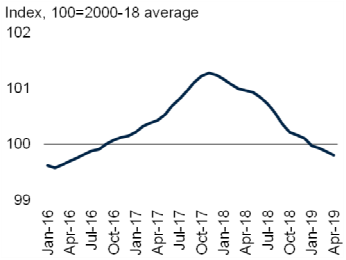
A. Global growth



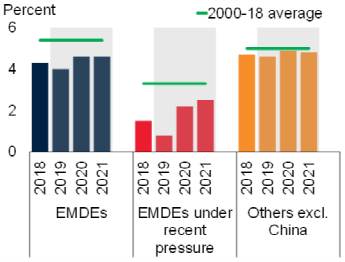
B. Global manufacturing and new export orders



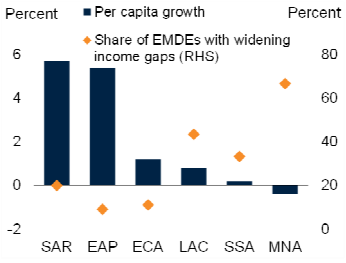
C. Global business confidence



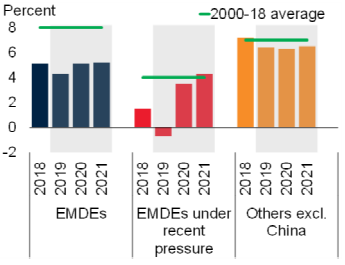
D. Growth in EMDEs



E. Per capita growth and share of EMDEs with widening income gaps in 2019



F. Investment growth in EMDEs



Source: Haver Analytics, J.P. Morgan, Organisation for Economic Co-operation and Development, World Bank.

Note: EMDEs = emerging market and developing economies.

A.D.F. Shaded areas indicate forecasts. Aggregate growth rates calculated using constant 2010 U.S. dollar GDP weights. Data for 2018 are estimates.

B. Manufacturing and new export orders are measured by Purchasing Managers' Index (PMI). PMI readings above 50 indicate expansion in economic activity; readings below 50 indicate contraction. Black horizontal line indicates expansionary threshold. Last observation is April 2019.

C. Average business confidence across major advanced economies and EMDEs, including Brazil, Canada, France, Germany, Italy, Japan, Russia, Turkey, the United Kingdom, and the United States. Last observation is April 2019.

D.F. EMDEs under recent pressure include: a) countries that have had an increase in their J.P. Morgan EMBI credit spread of at least one standard deviation above the 2010-19 average at any time since April 2018 (Argentina, Brazil, Egypt, Gabon, Jordan, Lebanon, Mexico, Nigeria, South Africa, Sri Lanka, Tunisia, Turkey); or b) countries that have been subject to recent sanctions (Iran, Russia).

E. EAP = East Asia and Pacific, ECA = Europe and Central Asia, LAC = Latin America and the Caribbean, MNA = Middle East and North Africa, SAR = South Asia, SSA = Sub-Saharan Africa. Countries with widening income gaps are those with per capita GDP growth at least 0.1 percentage point lower than advanced-economy per capita GDP growth.

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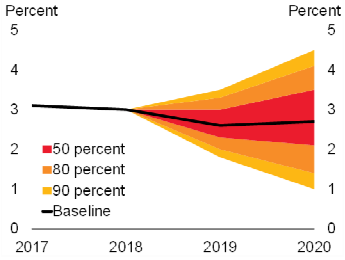
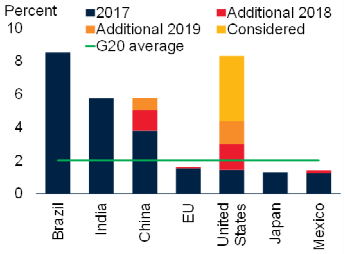
FIGURE 1.2 Global risks and policy challenges

Downside risks continue to dominate. A further escalation of trade tensions involving major economies could lead to a sharp increase in trade barriers and weigh on confidence and investment. The risk of financial stress in EMDEs could be exacerbated by increasing debt-refinancing needs. A sharp deceleration in major economies would have large spillover effects for EMDEs and increase the probability of a marked global downturn. Rising public debt levels are reducing the effectiveness of fiscal policy in EMDEs. Structural reforms, such as improvements in institutional quality, can help boost growth and reduce poverty.

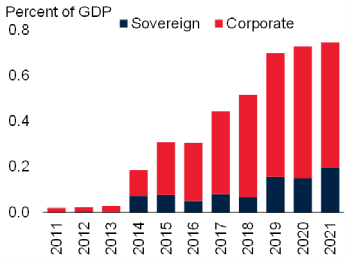
A. Probability distribution around global growth forecasts



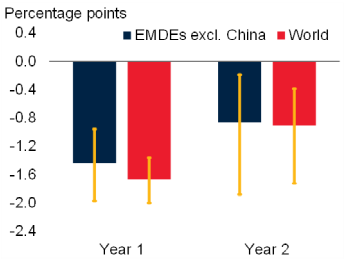
B. Average import tariffs in G20 countries



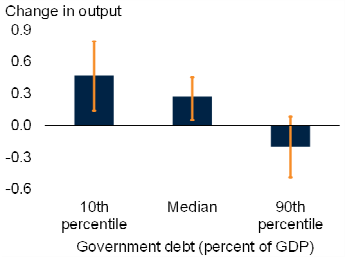
C. International bond redemptions in EMDEs



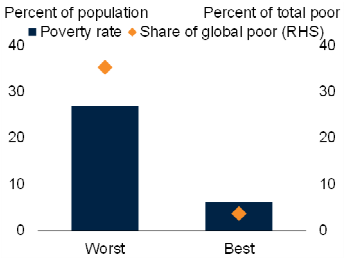
D. Impact of 1 percentage point growth slowdown in the United States, Euro Area, and China



E. Fiscal multipliers in EMDEs



F. Poverty, by regulatory quality



Source: Bloomberg; Dealogic; International Monetary Fund; World Bank.

A. The fan chart shows the forecast distribution of global growth using time-varying estimates of the standard deviation and skewness extracted from the forecast distribution of three underlying risk factors: Oil price futures, S&P 500 equity price futures, and term spread forecasts. Each of the risk factor's weight is derived from the model described in Ohnsorge, Stocker, and Some (2016). Values for 2019 are computed from the forecast distribution of 6-month-ahead oil price futures, S&P 500 equity price futures, and term spread forecasts. Values for 2020 are based on 18-month-ahead forecast distributions. Last observation is May 21, 2019.

B. Blue bars are the trade-weighted averages for 2017 tariffs. "Considered" reflects announcements of possible tariffs as of May 23, 2019, including an additional 25 percent tariff on U.S. imports from China not subject to 2018 tariff hikes and on selected U.S. imports of motor vehicles and parts.

C. Data are as of May 22, 2019.

D. Bars are impulse responses to a 1 percentage point decline in the United States, Euro Area, and China. Yellow lines are 16-84 percent confidence intervals. Based on the vector autoregression model in World Bank (2016). Sample includes 22 advanced economies and 19 EMDEs.

E. Bars are the median conditional fiscal multipliers after two years. Fiscal multipliers are the cumulative change in output relative to cumulative change in government consumption to a 1-unit government consumption shock. Orange lines are 16-84 percent confidence bands.

F. Poverty rate is the unweighted average in each group. "Best" indicates quartile of EMDEs with the strongest regulatory quality (2017 or for year with latest poverty data); "Worst" indicates the weakest regulatory quality. The back data for regulatory quality are from the World Governance Indicators.

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pressures in many EMDEs (Figure 1.2.C). The risk of a sharper-than-expected deceleration in major economies—such as the Euro Area, the United States, or China—would result in considerably weaker global and EMDE growth (Figure 1.2.D). Meanwhile, climate change poses ever-growing risks to various EMDE regions.

Moderating global activity and heightened downside risks highlight the need for policymakers in advanced economies and EMDEs to reinforce policy buffers against possible negative shocks, and to shore up both short-term and long-term growth prospects.

For advanced economies, the associated challenges include the appropriate use of automatic fiscal stabilizers and discretionary spending, when feasible, as well as clear and credible monetary policy guidance that reduces the risk of abrupt market adjustments. Productivity-enhancing reforms are also crucial to deal with slowing labor force growth.

In EMDEs, policymakers need to use the opportunity provided by still benign financing conditions to rebuild fiscal and monetary policy buffers to confront future shocks. Even if borrowing costs are currently low, countries with constrained fiscal positions may find that rising debt levels limit the effectiveness of public spending and make them more vulnerable to crises (Box 1.1; Figure 1.2.E). Amid adverse debt dynamics and narrowing fiscal space, authorities need to urgently strengthen domestic resource mobilization, prioritize growth-enhancing spending, and improve debt management and transparency.

While growth prospects are subdued, there is a substantial upside potential from the implementation of structural reforms that improve the business climate and encourage job creation. Increased public sector efficiency and measures to foster private sector investments will be key to meet large infrastructure needs in electricity, transport, water supply and sanitation, and climate change prevention and mitigation. Estimates of the infrastructure spending required to meet the Sustainable Development Goals in those areas by 2030 range between 4.5 to 8.2 percent of EMDE

GDP, depending on policy choices. Improving access to reliable and affordable electricity, enhancing the quality of logistics and transport infrastructure, leveraging digital technologies, and improving institutional quality could help unlock a large untapped growth potential and contribute to poverty alleviation (Figure 1.2.F).

Raising agricultural productivity could also help boost development opportunities and increase resilience to extreme weather events in regions with large exposed populations. Strengthening the role of social safety nets and active labor market policies is also key to manage risks and promote access to productive employment.

Finally, amid soft growth prospects and heightened risks, both advanced economies and EMDEs need to be prepared to undertake coordinated policy action in the event of a severe global slowdown that threatens to inflict major economic losses and set back progress on poverty alleviation. International coordination would magnify the effectiveness of available fiscal and monetary policy buffers. International financial institutions and the G20 can play an important role in fostering such coordination.

Major economies: Recent developments and outlook

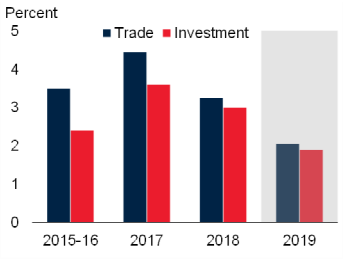
Activity in advanced economies is slowing, especially in the Euro Area, in part due to weakening exports and investment. Amid subdued inflation and decelerating activity, major central banks have signaled a more dovish stance. In the United States, the effects of recent fiscal stimulus are waning. In China, growth appears to be stabilizing following weakness at the start of the year, but it faces heightened risks.

Recent data for advanced economies point to decelerating activity, especially in the Euro Area. Investment has lost momentum and trade growth has declined markedly (Figure 1.3.A). Private consumption has so far been resilient, however, supported by ongoing job creation and higher real wages (Figure 1.3.B). In response to subdued inflation and decelerating activity, monetary policy has become more accommodative.

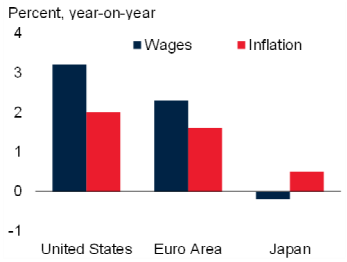
FIGURE 1.3 Advanced economies

Trade and investment in advanced economies have lost momentum. In contrast, rising real wages are supporting consumption in most countries.

A. Trade and investment growth, volumes



B. Wage growth and inflation in early 2019



Source: Haver Analytics, World Bank.

A. Trade calculated as the average of imports and exports of goods and services. Shaded area indicates forecasts.

B. Last observation is April 2019 for U.S. wages and Consumer Price Index, and Euro Area Harmonized Index of Consumer Prices; March 2019 for Japan wages and Consumer Price Index; and 2018Q4 for Euro Area wages. Wages are average hourly earnings of private nonfarm employees for the United States, average monthly earnings for Japan, and nominal hourly wages and salaries for the Euro Area.

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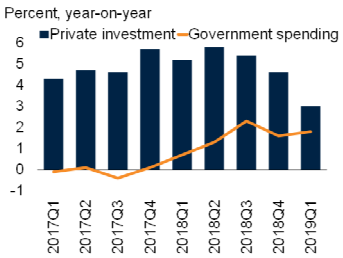
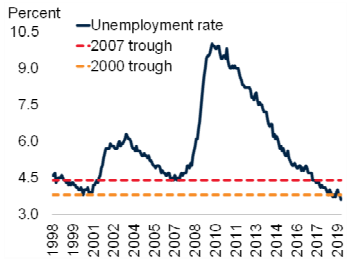
FIGURE 1.4 United States

U.S. activity is still being bolstered by government spending and corporate tax cuts, but the boost is fading. Unemployment recently reached its lowest level in nearly five decades. Amid heightened trade tensions, exports have slowed, especially those to Europe and Asia. Rising productivity and labor force participation are supporting activity.

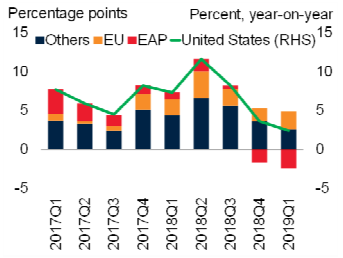
A. Private investment and government spending



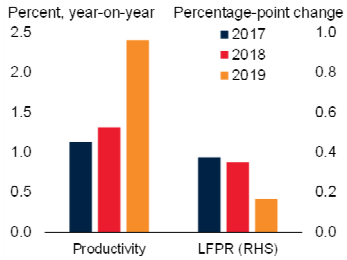
B. Unemployment rate and previous troughs



C. Contribution to export growth, by trading partner



D. Productivity and labor force participation



Source: Bureau of Economic Analysis, Federal Reserve Bank of St. Louis, Haver Analytics, U.S. Census Bureau, World Bank.

A. Government spending is government consumption and investment spending. Last observation is 2019Q1.

B. Data for civilian unemployment rate are seasonally adjusted. Last observation is April 2019.

C. EU = European Union, EAP = East Asia and Pacific. Last observation is 2019Q1.

D. LFPR = Labor force participation rate. LFPR refers to civilian labor force participation rate of people aged 25 to 54 years. Data for 2019 are Q1 for Productivity and April for LFPR.

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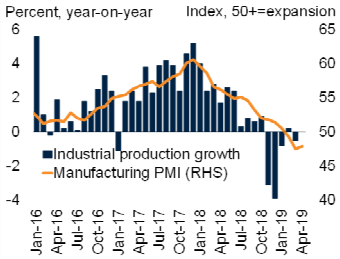
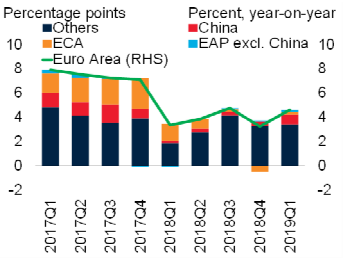
FIGURE 1.5 Euro Area

Euro Area economic conditions have deteriorated rapidly since early 2018, particularly in manufacturing and industrial activity. Exports have fallen sharply. Domestic demand has also slowed, but to a lesser degree. Fiscal policy is expected to be modestly stimulative in coming years.

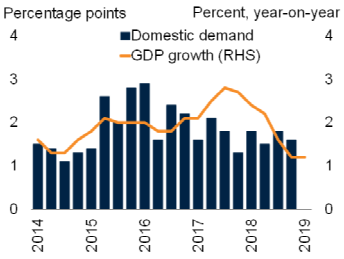
A. Industrial production growth and manufacturing PMI



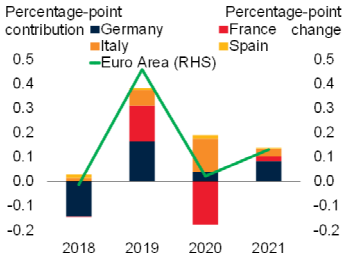
B. Contribution to export growth, by trading partner



C. Domestic demand contribution to GDP growth



D. Fiscal impulse in the Euro Area



Source: Eurostat, Haver Analytics, International Monetary Fund, World Bank.

A. PMI = Purchasing Managers' Index. Readings above 50 indicate expansion in economic activity; readings below 50 indicate contraction. Last observation is April 2019 for PMI and March 2019 for industrial production.

B. ECA = Europe and Central Asia, EAP = East Asia and Pacific. Data are seasonally and working day adjusted. Last observation is 2019Q1.

C. Final domestic demand is GDP less net exports of goods and services, less changes in inventories. Last observation is 2019Q1 for GDP growth and 2018Q4 for consumption and investment.

D. Changes versus previous year. A positive (negative) number indicates expansionary (contractionary) fiscal policy. Country contributions are calculated using nominal GDP weights. Fiscal impulse indicates the change in cyclically adjusted primary balance, namely the estimate of the fiscal balance that would apply under current policies if output were equal to potential. Data on the general government cyclically adjusted primary balance are published in the April 2019 edition of the *Fiscal Monitor* (IMF 2019).

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Aggregate activity in advanced economies is expected to decelerate over the forecast horizon.

United States

Growth in the United States remains solid. The Tax Cuts and Jobs Act of late 2017 and the Bipartisan Budget Act of early 2018 are supporting near-term growth, but their contribution is diminishing (Barro and Furman 2018; Figure 1.4.A). Unemployment is at its lowest level in nearly five decades, and inflation is hovering slightly below the 2-percent target (Figure 1.4.B). Export growth has slowed further, with an especially acute deceleration in goods going to the European Union and the East Asia and Pacific region (Figure 1.4.C). By raising costs on a variety of goods, recent tariff increases have so far modestly weighed on U.S. real incomes (Fajgelbaum et al. 2019; Amiti et al. 2019). In light of muted inflation, heightened risks from the external environment, and unresolved policy issues, the Federal Reserve has signaled a more gradual pace of tightening.

U.S. growth is expected to slow to 2.5 percent in 2019 and further decelerate to 1.7 percent in 2020 and 1.6 percent in 2021, as the effects of recent fiscal stimulus wane. These projections are unchanged from the previous forecast due to offsetting factors. On the one hand, recent tariff increases and associated retaliatory actions are expected to weigh on activity. On the other, growth is being supported by more accommodative monetary policy than previously assumed and by sustained increases in productivity growth and labor force participation (Figure 1.4.D). A continuation of these positive structural trends could result in higher medium- and long-term growth than currently predicted. In contrast, further increases in trade restrictions or policy uncertainty could hinder activity.

Euro Area

Economic conditions in the Euro Area have deteriorated rapidly since mid-2018, particularly in the manufacturing sector (Figure 1.5.A). This slowdown mainly reflects a decline in exports, especially to China and the Europe and Central Asia region (Figure 1.5.B). Domestic demand has also softened, albeit to a lesser degree, as it remains buoyed by declining unemployment and solid real wage growth (Figure 1.5.C).

In response to slowing activity, Germany, France, and Italy have announced plans for limited tax cuts and spending increases, equivalent to a combined 0.2 percent of Euro Area GDP per year during 2019-21 (Figure 1.5.D). In addition, the European Central Bank (ECB) has announced it will provide banks with additional low-cost credit, starting in September. Core inflation remains

around 1 percent, and the ECB is not expected to begin raising its main refinancing rate above zero until at least 2020.

Growth is projected to slow from 1.8 percent in 2018 to 1.2 percent in 2019 and to edge up to an average of 1.4 percent in 2020-21. Relative to previous projections, this represents a downgrade of 0.4 percentage point in 2019 and 0.1 percentage point in 2020, reflecting weakness in trade and domestic demand that will not be fully offset by more accommodative fiscal and monetary policy support.

Japan

Activity in Japan benefited from government support in the first half of 2019, as well as a rebound following natural disasters last year, but remains lackluster. Trade—particularly exports to China—has been especially weak. A value-added tax (VAT) hike in October is likely to dampen activity further. Nonetheless, unemployment is low, labor force participation continues to climb, and the services sector remains relatively healthy.

Growth in 2019 is expected to be 0.8 percent, down from previous projections due to weaker-than-expected external demand. A variety of fiscal measures are expected to soften the near-term impact of the VAT hike toward the end of the year. With the economy at close to full employment and potential output constrained by low labor force growth, capacity constraints will slow activity to a projected 0.7 percent in 2020 and 0.6 percent in 2021.

China

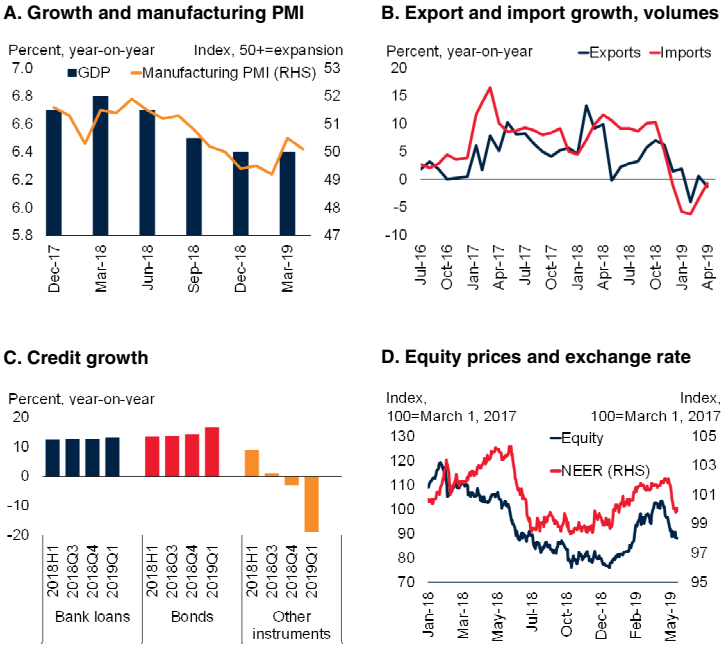
Following several quarters of broad-based deceleration, growth appears to be stabilizing (Figure 1.6.A). Trade flows have been weak, however, weighed down by softness in manufacturing output, trade tensions with the United States, and lackluster global growth (Figure 1.6.B).

Recent activity has been supported by monetary and fiscal stimulus. Bank credit and bond issuance have picked up, but other non-bank lending has moderated due to regulatory tightening (Figure 1.6.C). Equity prices and the renminbi, which rebounded in early 2019 partly due to policy support measures, have faced downward pressures amid the recent re-escalation of trade tensions (Figure 1.6.D). Consumer price inflation has picked up but remains below target.

Growth is projected to decelerate from 6.6 percent in 2018 to 6.2 percent in 2019, primarily reflecting softening manufacturing activity and trade. The recent increase in tariffs on trade with the United States is projected to weigh on growth in 2020, which has been revised down to 6.1 percent. This outlook is predicated on no further escalation of trade disputes with the United States.

FIGURE 1.6 China

Following several quarters of broad-based deceleration, growth appears to be stabilizing. However, trade flows remain weak. Bank credit is stable and bond issuance has picked up, but other non-bank lending has moderated due to regulatory tightening. Equity prices, which recovered in early 2019 thanks in part to stimulus measures, have faced downward pressures amid the recent re-escalation of trade tensions.



Source: Haver Analytics, World Bank.

A. Purchasing Managers' Index (PMI) readings above 50 indicate expansion in economic activity; readings below 50 indicate contraction. Last observation is April 2019 for manufacturing PMI and 2019Q1 for GDP.

B. Figure shows 3-month moving averages. Data include only goods. Export and import volumes are calculated as export and import values deflated by export and import price deflators. Export and import indices for some missing values and for April 2019 are estimates. Last observation is April 2019.

C. Figure shows average of monthly data for periods indicated. Bonds include local government special bonds and net financing of corporate bonds. Other instruments include entrusted loans and trust loans. Last observation is March 2019.

D. NEER = nominal effective exchange rate. An increase in the NEER denotes an appreciation. Equity index is represented by the Shanghai Stock Exchange Composite. Last observation is May 20, 2019 for equity prices and May 21, 2019 for NEER.

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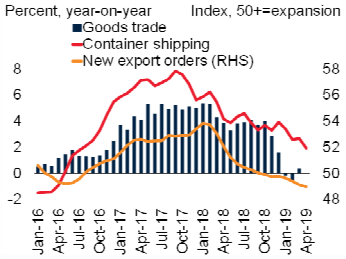
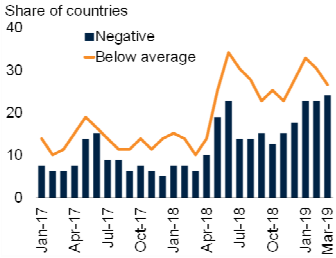
FIGURE 1.7 Global trade

Global goods trade growth weakened substantially in late 2018 and early 2019. While trade in Asia was markedly affected, the slowdown in industrial activity was widespread across countries. The softness reflected in part slowing demand for capital goods amid elevated trade policy uncertainty. Exports in most EMDE regions are expected to decelerate this year. Global trade growth is projected to slow to 2.6 percent this year, the weakest pace since the global financial crisis.

A. Goods trade volume, container shipping, and export orders

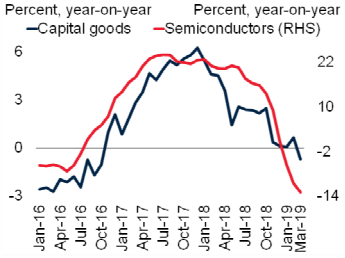


B. Share of countries with negative or below-average industrial production growth

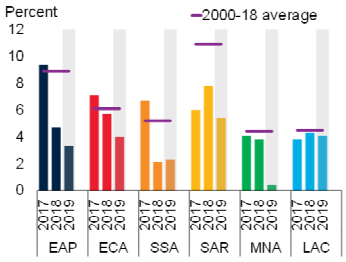


C. Nominal merchandise import growth in China and export growth in Asia

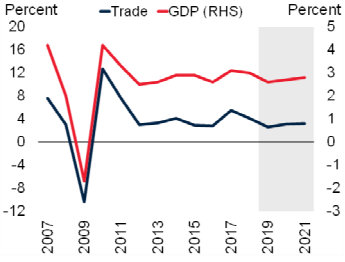
D. Capital goods production and semiconductor sales growth



E. Export volume growth, by region



F. Global GDP and trade growth



Source: CPB Netherlands Bureau for Economic Policy Analysis; Haver Analytics; Institute of Shipping Economics and Logistics; Semiconductor Industry Association; World Bank.

A. Data are 3-month moving averages. New export orders measured by Purchasing Managers' Index (PMI). PMI readings above 50 indicate expansion in economic activity; readings below 50 indicate contraction. Last observation is March 2019 for goods trade and April 2019 for container shipping and new export orders.

B. Share of countries for which industrial production growth (3-month on 3-month change) was negative or below their 2012-17 average for two consecutive quarters. Sample includes 39 EMDEs and 29 advanced economies. Last observation is March 2019.

C. Import and export data are merchandise imports and exports in U.S. dollars, respectively, and is expressed as 3-month moving averages. "Asia" comprises Bangladesh, India, Indonesia, Japan, Malaysia, Mongolia, Pakistan, Philippines, Republic of Korea, Singapore, Sri Lanka, Thailand, and Vietnam. Last observation is March 2019 for Asia exports and April 2019 for China imports.

D. Capital goods index weighted by gross domestic product at constant 2010 U.S. dollars. Sample includes the G20 countries for capital goods for which data are available. Semiconductor index is 3-month moving averages of global billings by semiconductor equipment manufacturers, including front-end and final manufacturing equipment. Last observation is March 2019.

E.F. Aggregate growth rates calculated using constant 2010 U.S. dollar GDP weights. Shaded area indicates forecasts.

E. EAP = East Asia and Pacific, ECA = Europe and Central Asia, LAC = Latin America and the Caribbean, MNA = Middle East and North Africa, SAR = South Asia, and SSA = Sub-Saharan Africa.

F. Trade is the average of export and import volumes.

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It also assumes that policy actions partly mitigate domestic and external headwinds to activity (SCPRC 2019).

Global trends

Global trade has weakened amid slowing investment growth and elevated trade policy uncertainty. As the short-term growth outlook has softened, international financing conditions have eased, providing a respite to countries with large external financing needs. Industrial commodity prices have partially recovered, with weaker demand offset by supply cuts.

Global trade

Global industrial activity and goods trade have lost considerable momentum in 2019. Goods trade growth and new export orders fell to levels comparable to those prevailing at the start of 2016, when concerns about the global economy were elevated (Figure 1.7.A). The deceleration was broad-based—the share of countries with industrial production in technical recession has tripled since the start of 2018, reaching nearly 25 percent in early 2019 (Figure 1.7.B). Trade in Asia—which contains major, tightly interconnected, global manufacturing hubs—was particularly affected, although recent indicators suggest some stabilization (Figure 1.7.C).

Weakness in global trade was concentrated in heavily traded capital goods, including electronic components such as semiconductors (Figure 1.7.D). These products are deeply embedded in international production networks and illustrate the links between global investment and trade (Bussière et al. 2013; Buelens and Tirpák 2017). Increased tariffs by the United States and retaliatory actions by China and other trading partners that were implemented last year have affected bilateral trade flows and prices of the targeted products; however, they resulted in limited effects on aggregate trade volumes and activity in these countries (Constantinescu, Mattoo, and Ruta 2019; Fajgelbaum et al. 2019). Nevertheless, the increase in tariffs by the United States and China that were announced in May represents a substantial re-escalation in trade tensions and are likely to have more severe effects. Beyond economic losses for the affected exporters,

BOX 1.1 Debt: No free lunch

"[In the United States], if the future is like the past, this implies that debt rollovers, that is the issuance of debt without a later increase in taxes, may well be feasible. Put bluntly, public debt may have no fiscal cost." Olivier Blanchard (2019)

"High debt levels make it more difficult for governments to respond aggressively to shocks." Kenneth Rogoff (2019)

Government debt has risen substantially in emerging market and developing economies (EMDEs), by an average of 15 percentage points of GDP since 2007 to 51 percent of GDP in 2018. The current environment of low global interest rates and weak growth may appear to mitigate concerns about elevated debt levels. Considering currently subdued investment, additional government borrowing might also appear to be an attractive option for financing growth-enhancing initiatives such as investment in human and physical capital. However, history suggests caution: the cost of rolling over debt can increase sharply during periods of financial stress and result in financial crises; high debt levels can limit the ability of governments to provide fiscal stimulus during downturns; and high debt can weigh on investment and long-term growth, especially at a time when investment momentum is already weak. Hence, EMDEs need to strike a careful balance between taking advantage of low interest rates and avoiding the potentially adverse consequences of excessive debt accumulation.

Introduction

Government debt has risen sharply in advanced economies, reaching levels not seen in the past six decades. Yet, low interest rates and subpar growth have led to an intense debate about whether the rapid increase in debt is reason for concern.[1] Some argue that countries, especially those that issue reserve currencies, should take advantage of low interest rates to borrow more to finance priority expenditures. Others caution that high debt weighs on long-term growth, by increasing the risk of crises, limiting the scope for countercyclical fiscal stimulus, and dampening private investment.

Although the focus of this debate has been mainly on advanced economies, many EMDEs have also borrowed heavily and their hard-won cuts in public debt ratios prior to the global financial crisis have largely been reversed. The tradeoffs EMDEs face are even starker, in light of their history of severe debt crises and their more pressing current spending needs to achieve development goals and improve living standards.

This box seeks to provide a basis for assessing the merits of additional debt accumulation in EMDEs by addressing two specific questions. First, how has EMDE debt evolved since 2000? Second, what are the benefits and costs associated with rapid debt accumulation?

Evolution of EMDE debt since 2000

Pre-crisis improvements in fiscal positions. Prior to the global financial crisis, rapid growth helped narrow fiscal deficits and reduce government debt ratios, especially in EMDEs (Figure 1.1.1.A and B; Kose, Kurlat, et al. 2017). In addition to robust growth, debt relief in the Multilateral Debt Relief Initiative (MDRI) and the Highly Indebted Poor Countries initiative (HIPC) contributed to the decline in debt in low-income countries (LICs) and lower middle-income countries. Fiscal deficits that reached 3 percent of GDP in EMDEs, on average, in 2001 turned into fiscal surpluses amounting to 0.7 percent of GDP, on average, by 2007. Over the same period, EMDE government debt fell by 13 percentage points of GDP to 36 percent of GDP.

Post-crisis debt accumulation. EMDE fiscal positions have weakened partly because of sharp growth slowdowns that pushed government debt up by an average of 15 percentage points to 51 percent of GDP by 2018. This deterioration was broad-based—by 2018, government debt was 10 or more percentage points of GDP higher than in 2007 in about 60 percent of EMDEs, with commodity exporters, which account for almost two-thirds of EMDEs, being hit the hardest (World Bank 2015, 2018a). In LICs, government debt rose by 14 percentage points of GDP, to 46 percent of GDP in 2018 after falling to a trough of 32 percent of GDP in 2012.

Post-crisis shifts in debt composition. In many EMDEs, financing of debt has shifted toward higher-risk sources,

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Note: This box was prepared by M. Ayhan Kose, Franziska Ohnsorge, and Naotaka Sugawara.

[1] Blanchard (2019), Blanchard and Summers (2019), Furman and Summers (2019), and Krugman (2019) provide reasons for additional borrowing in advanced economies, and the United States in particular, whereas Auerbach, Gale, and Krupkin (2019), Mazza (2019), Riedl (2019), and CRFB (2019) caution against adding to debt, citing in particular the example of the United States. For a detailed discussion of these issues, see Kose, Ohnsorge, and Sugawara (forthcoming).

BOX 1.1 Debt: No free lunch *(continued)*

including debt held by nonresidents, issued on non-concessional terms, or at shorter maturity (Figure 1.1.1.C). Debt held by nonresidents accounted for about 50 percent of government debt in the median EMDE in 2018, making these countries more vulnerable to a deterioration in global investor sentiment. As a result, sovereign ratings have been downgraded for many EMDEs, and 40 percent of LICs are now classified as at high risk of debt distress (World Bank 2019a). The composition of LIC debt has become increasingly non-concessional as they have accessed capital markets and borrowed from non-Paris Club creditors (World Bank 2018a, 2019a).

Simultaneous buildup of private and public sector debt. Whereas the private sector has deleveraged in most advanced economies since the crisis, private sector debt has risen in EMDEs in tandem with mounting government debt. As a result, total debt in EMDEs has risen to 169 percent of GDP, on average, in 2018, from 98 percent of GDP in 2007 and its highest level in two decades (Borensztein and Ye 2018; World Bank 2018b). Even in EMDEs excluding China, where corporate debt has soared post-crisis, total debt has risen to a near-record 107 percent of GDP in 2018. Although the increase in EMDE private debt partly reflects growth-enhancing financial deepening, elevated private debt represents a fiscal risk. Past experience illustrates that private sector debt may shift onto government balance sheets during financial crises as governments provide support to private institutions in difficulty (Kose, Ohnsorge, and Sugawara 2018; World Bank 2017a). For example, government debt rose by more than 30 percentage points of GDP in Indonesia and Thailand during the Asian financial crisis in the late 1990s (Figure 1.1.1.D; World Bank 2015, 2017a).

Debt: How much is too much?

Several strands of literature have attempted to identify how much debt is "too much"—a threshold level of debt below which it is sustainable or not harmful to growth (Kose, Ohnsorge, and Sugawara forthcoming). For example, one strand of the literature has estimated the sustainable level of debt in advanced economies if fiscal deficits remain consistent with past performance or if sovereign bond yields move consistent with past movements. Some studies have identified debt thresholds above which the likelihood of a financial crisis increases. A third strand of the literature has explored the debt levels above which debt burdens become detrimental to long-term growth.[2]

In a nutshell, the empirical evidence suggests that the optimal level of debt depends on a wide range of trade-offs. This in part reflects a broader theoretical challenge in the literature. The basic insight from theory is that debt increases output in the short-run but reduces it in the long-run (Elmendorf and Mankiw 1999). Debt can be beneficial in the short-run to smooth macroeconomic fluctuations and, in the long-run, to finance long-term investments that yield a higher rate of return than the cost of debt. However, elevated debt levels can lead to sustainability challenges, increase vulnerability to crises, erode the size and effectiveness of fiscal expansion, and weigh on investment and growth (Figure 1.1.1.E and F).

When weighing benefits against cost of debt, political-economy forces may tilt the scale towards underestimating the cost of borrowing while overestimating its benefits. Disagreements over spending preferences or short-lived government tenures generate incentives to expand government spending envelopes, financed by debt (Alesina and Tabellini 1990; Drazen 2000; Aguiar and Amador 2011). Especially ahead of elections, the absence of full information may create a conflict of incentives that encourages political incumbents to employ debt-financed fiscal stimulus to improve short-term growth prospects (Shi and Svensson 2006; Aidt, Veiga, and Veiga 2011). As a result, government expenditures, public debt and deficits tend to increase statistically significantly albeit modestly around elections (Philips 2016). Such political cycles in budget pressures tend to be stronger in countries with weaker fiscal transparency (Alt and Lassen 2006 a,b; Klomp and De Haan 2011), without balanced-budget requirements (Alt and Rose 2009; Cioffi, Messina, and Tommasino 2012) and with poorer governance (Shi and Svensson 2006; Streb, Lema, and Torrens 2009).

Benefits of debt

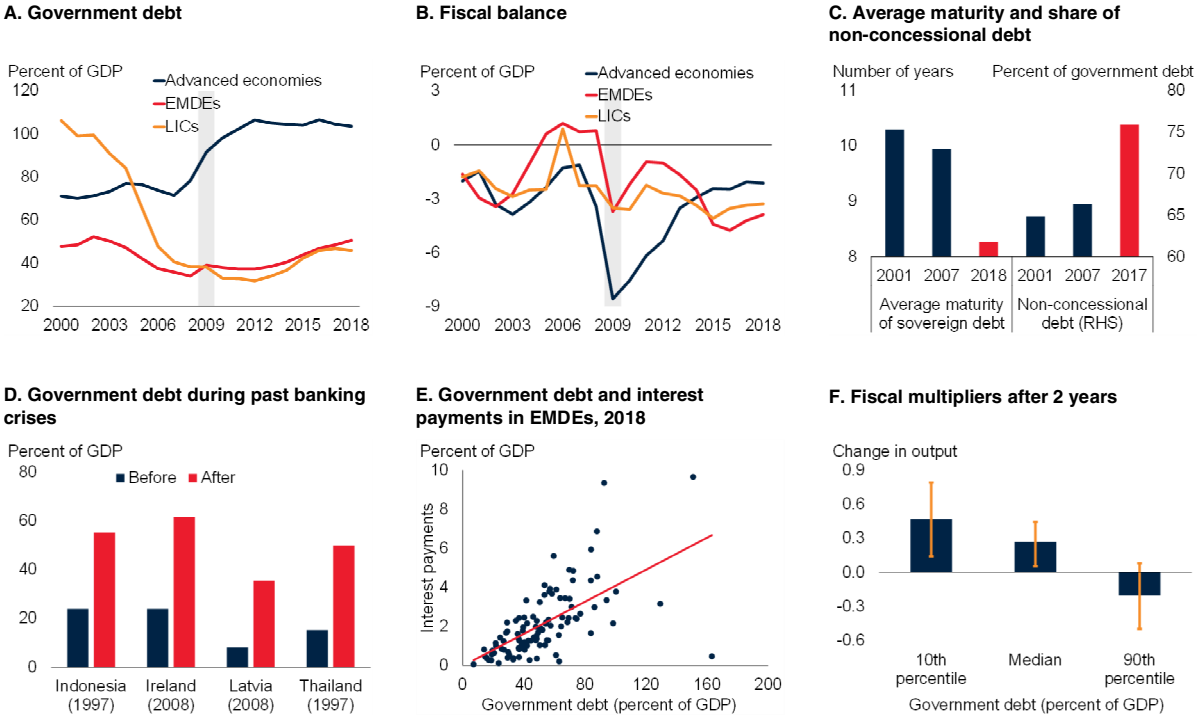
Additional debt accumulation by EMDEs could be justified because of their need to invest in growth-enhancing projects, such as infrastructure, health and education, and to protect vulnerable groups. During periods of weak growth, it may also be appropriate to employ expansionary fiscal policy to stimulate activity.

[2] For studies on the sustainable level of debt, see Ghosh et al. (2013) and Greenlaw et al. (2013). For studies that examine debt as an early warning indicator, see Manasse and Roubini (2009) and Kraay and Nehru (2006). For a discussion of safe debt thresholds, see Reinhart, Rogoff, and Savastano (2003). Some studies report that higher debt is associated with lower growth when government debt is larger than 80-100 percent of GDP (Reinhart and Rogoff 2010; Cecchetti, Mohanty, and Zampolli 2011; Baum, Checherita-Westphal, and Rother 2013). That said, others found no such effects (Panizza and Presbitero 2014).

BOX 1.1 Debt: No free lunch *(continued)*

FIGURE 1.1.1 Government debt, deficits, and multipliers

Government debt has risen from pre-crisis levels, and fiscal balances have deteriorated. It has shifted toward financing sources that are more vulnerable to exchange rate and interest rate risks, as well as changes in global investor sentiment. Higher debt levels are associated with larger interest payments and they tend to render fiscal policy less effective.



Source: Huidrom et al. (2019); International Monetary Fund; Kose, Kurlat, et al. (2017, data available at http://www.worldbank.org/en/research/brief/fiscal-space); Laeven and Valencia (2018).
A.B. Averages computed with current U.S. dollar GDP as a weight.
A. Sample includes 37 advanced economies, 151 EMDEs, and 32 LICs.
B. Sample includes 38 advanced economies, 154 EMDEs, and 32 LICs.
C. Median of up to 65 EMDEs for average maturity and 122 EMDEs for non-concessional debt, though the sample size varies by year.
D. "Before" and "after" denote, respectively, one year before and after the onset of banking crisis, as shown by numbers below the corresponding country names, taken from Laeven and Valencia (2018). Indonesia refers to central government debt only.
E. General government gross debt on the horizontal axis and interest payments on the vertical axis. Sample includes 104 EMDEs, excluding small states as defined by the World Bank.
F. Bars show the conditional fiscal multipliers for different levels of government debt after two years. Fiscal multipliers are defined as cumulative change in output relative to cumulative change in government consumption in response to a 1-unit government consumption shock. They are based on estimates from the interacted panel vector autoregression model, where model coefficients are conditioned only on government debt. Values shown on the x-axis correspond to the 10th to 90th percentiles in the sample. Bars represent the median, and vertical lines are the 16-84 percent confidence bands.
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Promoting long-term growth. Government investment in physical and human capital can provide an important foundation for stronger growth over the long-term. These investments have taken on greater urgency in light of the expected slowdown in potential growth—the rate of growth an economy can sustain at full employment and capacity—over the next decade (World Bank 2018c). In EMDEs, in particular, potential growth is expected to slow by 0.5 percentage point to 4.3 percent during 2018-27, well below the average rate of 6.7 percent during 2002-07. Moreover, EMDEs have large investment needs to meet the Sustainable Development Goals (SDGs): low- and middle-income countries face aggregate investment needs of $1.5–$2.7 trillion per year—equivalent to 4.5–8.2 percent of GDP—between 2015 and 2030 to meet infrastructure-related SDGs, depending on policy choices (Rozenberg and Fay 2019). Infrastructure investment can have particularly large growth benefits if it connects isolated communities with input and output markets, allows companies to realize economies of scale by

BOX 1.1 Debt: No free lunch *(continued)*

increasing market size, and increases competitive pressures (Égert, Kozluk and Sutherland 2009; Calderón and Servén 2010). To the extent that debt-financed investment spending stems the slowdown in potential growth, it also helps preserve the revenues required to service this debt (Fatas et al. 2018).[3]

Stabilizing short-term macroeconomic fluctuations. Temporary debt accumulation also plays an important role to stabilize short-term macroeconomic fluctuations. During recessions, borrowing for government spending or tax cuts can provide the necessary fiscal stimulus to support activity (World Bank 2015; Yared 2019; Figure 1.1.1.F). A large literature has estimated the output effects (fiscal multipliers) of additional government spending or tax cuts (Huidrom et al. 2016, 2019; Ramey 2019). The estimates vary widely—from a 1.1-dollar output decline to a 3.8-dollar output increase for every dollar of additional government spending or reduced revenues—depending on the cyclical position of the economy; structural country characteristics, including the coherence of fiscal frameworks; and the fiscal instrument employed. Broadly speaking, output effects tend to be larger during recessions than expansions, and larger for advanced economies than for EMDEs (Kraay 2012, 2014). In EMDEs, lack of fiscal space has often constrained fiscal policy during recessions, but there is some evidence that fiscal policy has become less procyclical during the 2000s (Frankel, Vegh, and Vuletin 2013).

Costs associated with debt

The main arguments against heavy borrowing, which may outweigh the benefits of borrowing in some countries, are that rollover costs can increase sharply during periods of financial stress and perhaps even trigger a financial crisis; and high debt levels can limit the size and effectiveness of fiscal stimulus during downturns. In addition, they can constrain growth by crowding out productivity-enhancing private investment over the long term, especially if the costs of debt outweigh its benefits.

Deteriorating debt sustainability. During the post-crisis period, the cost of government borrowing has been historically low, for both advanced economies and EMDEs (Figure 1.1.2.A and B). Looking ahead, demographic shifts and slowing productivity growth are expected to contribute to a further secular decline in both real interest rates in advanced economies, continuing this multi-year trend (Holston, Laubach, and Williams 2017). However, an increase in global borrowing cost, for example because of a decline in global savings rates, could test the sustainability of high debt in some countries (Henderson 2019; Rogoff 2019).

The recent discussion on debt has focused on the differential between interest rates and nominal GDP growth. If interest rates (the cost of capital) are below nominal output growth (the presumed rate of return on capital), then the real burden of the debt declines over time because the rate of return on debt-financed investment is more than sufficient to service the debt. However, the interest rate-growth differential has to be weighed against the accumulation of new debt—the primary fiscal deficit. If, every year, primary deficits add more to the debt than is repaid on past debt (even if high rates of return are more than sufficient to service the debt), then the debt stock will be on a rising trajectory.[4]

During 1990-2018, the interest-rate-growth differential has been negative in just over half (57 percent) of country-year pairs (54 percent of country-year pairs among 36 advanced economies and 60 percent of country-year pairs among 63 EMDEs). However, even in about one-quarter of these instances, the differential was not large enough to offset the increase in debt from primary balances and maintain the government debt ratio on a stable or declining path. As a result, during 1990-2018, primary balances, long-term interest rates and nominal GDP growth have been such that debt has been on a steadily rising trajectory about half of the time—in 44 percent of country-year pairs among 34 advanced economies and 49 percent of country-year pairs among 62 EMDEs.

Increasing vulnerability to financial crises. Higher spending on debt service implies some combination of further borrowing, or increased taxes, or less spending on critical government functions (Figure 1.1.1.E; Debrun and Kinda 2016). The challenge of mounting borrowing is that a growing debt-to-GDP ratio could erode investor confidence, requiring a government to pay a rising risk premium on its debt. Eventually, these pressures can culminate in a debt crisis if investors fear that the accumulation of government debt is no longer sustainable (Henderson 2019; Rogoff 2019; Blanchard 2019).

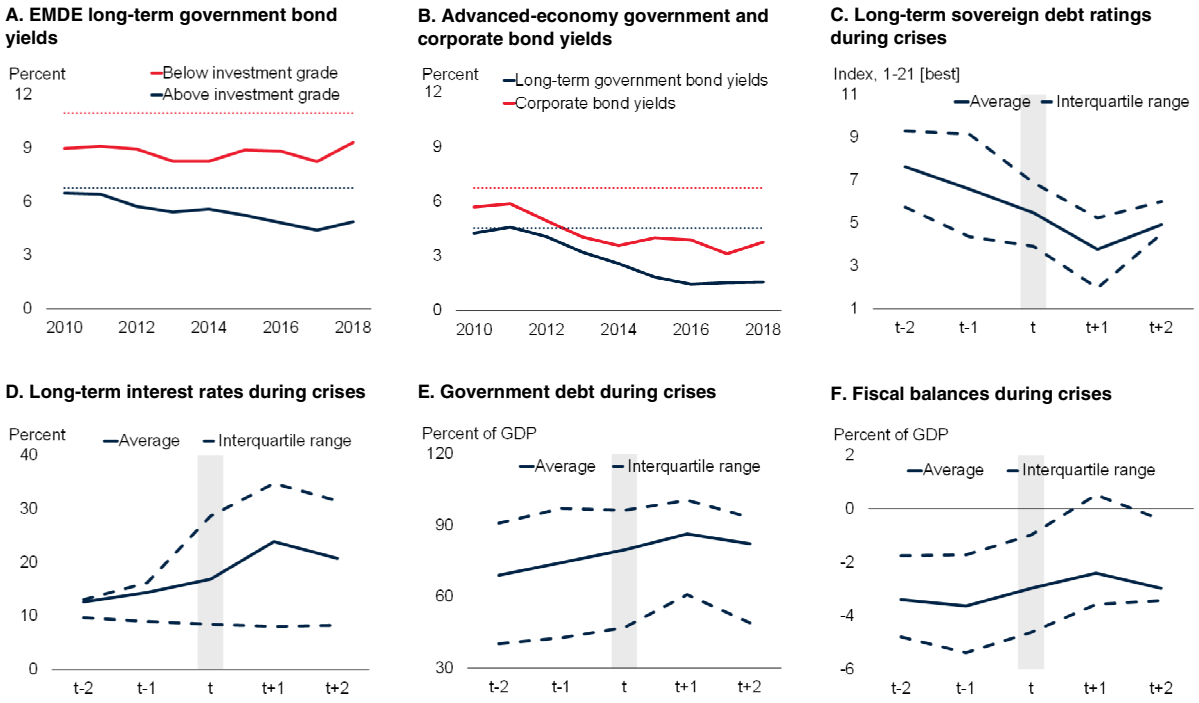
[3] In EMDEs, debt can also play an important role in financial deepening by establishing a safe asset for use as collateral and as benchmark for non-government debt (Hauner 2009; World Bank and IMF 2001).

[4] The balance between these two forces is captured in the sustainability gap, defined as the difference between the primary balance and the debt stabilizing primary balance at specific interest rates and growth rates (Kose, Kurlat, et al. 2017).

BOX 1.1 Debt: No free lunch *(continued)*

FIGURE 1.1.2 Borrowing costs and fiscal positions

Borrowing costs in advanced economies and EMDEs have been historically low since the global financial crisis, despite a slight increase in 2018. However, the spread between investment and non-investment grade borrowing cost has widened in 2018. Financial stress events, especially sovereign debt crises, worsen debt dynamics, lead to credit downgrades, and tend to be associated with higher borrowing costs.



Source: Bloomberg; Kose, Kurlat, et al. (2017, data available at http://www.worldbank.org/en/research/brief/fiscal-space); Laeven and Valencia (2018).
A. Average long-term government bond yields (with maturity of 10 years or close) for EMDEs with long-term foreign-currency sovereign ratings below investment grades and above investment grades in each year. Dotted lines show averages over 2002-07. Sample includes 61 EMDEs.
B. Average long-term government bond yields (with maturity of 10 years) for 36 advanced economies, and corporate bond yields computed as simple averages of U.S. high yield, U.S. investment grade, Euro high yield, and Euro investment grade corporate bond yields.
C.-F. Simple averages, as well as interquartile ranges, based on balanced samples. Crises refer to debt crises, as defined in Laeven and Valencia (2018). When there are multiple crises identified within five years, the one with the lowest real GDP growth is counted as an event. Sample includes 16 crisis episodes (Panels C and E), 11 episodes (Panel D), and 21 episodes (Panel F).
C. The sovereign ratings are converted to a numerical scale ranging from 1 to 21 (higher = better rating).
D. Long-term interest rates refer to nominal 10-year government bond yields, or bond yields with similar maturities.
Click here to download data and charts.

For reserve currency-issuing advanced economies, like the United States, it has been argued that such a spike in risk premia is unlikely, since these countries are often viewed as safe havens during periods of market turbulence (Furman and Summers 2019; Krugman 2014). For EMDEs, however, this risk is more acute. History has shown that EMDE borrowing costs tend to rise sharply during episodes of financial stress, and higher debt servicing costs can cause debt dynamics to deteriorate (Figure 1.1.2.C to F). A recent example is the case of Argentina, where its five-year U.S. dollar-denominated sovereign bond yields more than doubled during 2018 to over 11 percent in early September. Indeed, every decade since the 1970s has witnessed debt crises in EMDEs, often combined with banking or currency crises (Kose and Terrones 2015; Laeven and Valencia 2018).

Constraining government action during downturns. High debt constrains governments' ability to respond to downturns, in part because debt service crowds out other important government spending needs, including growth-enhancing public investment or social safety nets (Obstfeld 2013; Reinhart and Rogoff 2010; Romer and Romer 2018). This was also the case during the global financial crisis: fiscal stimulus during 2008-09 was considerably smaller in countries with high debt than in those with low

BOX 1.1 Debt: No free lunch *(continued)*

government debt (World Bank 2015). Moreover, weak fiscal positions tend to be associated with deeper and longer recessions, a situation that worsens if the private sector also falls into distress and its debt migrates to government balance sheets.

Reducing the effectiveness of fiscal policy. High government debt tends to render fiscal policy less effective (Figure 1.1.1.F). High government debt can reduce the size of fiscal multipliers through two channels. First, when a government with a high level of debt implements fiscal stimulus, consumers expect that tax increases will soon follow (Sutherland 1997). This expectation leads consumers to cut consumption and save more (the "Ricardian" reaction to government dis-saving). Second, when the level of debt is higher, fiscal stimulus can increase creditors' concerns about sovereign credit risk. This raises sovereign bond yields and, hence, borrowing costs across the whole economy (Corsetti et al. 2013). This, in turn, crowds out private investment and consumption, reducing the size of the fiscal multiplier ("interest rate channel"). Indeed, empirical evidence suggests that, regardless of the time horizon considered, fiscal multipliers are smaller when government debt is higher (Figure 1.1.1.F; Huidrom et al. 2016, 2019). Similarly, evidence points to less effective monetary policy in the presence of high debt because of poorly anchored inflation expectations in high-debt countries (Kose et al. 2019).

Slowing investment and growth. High and rising government debt may eventually raise long-term interest rates (Rubin, Orszag, and Sinai 2004; Laubach 2009). High debt could also create uncertainty about macroeconomic and policy prospects, including the possibility that governments may need to resort to distortionary taxation to rein in debt and deficits (IMF 2018; Kumar and Woo 2010). Higher interest rates and uncertainty would tend to crowd out productivity-enhancing private investment and weigh on output growth.[5] The empirical evidence for the association between debt and growth is, however, mixed (Panizza and Presbitero 2014).

Conclusion

EMDE governments need to put in place frameworks that help them strike a careful balance between taking advantage of the present low interest rate environment and avoiding the risks posed by excessive debt accumulation. For countries with sound fiscal positions and with frameworks that help ensure long-term sustainability, the balance may tip toward debt-financed spending to boost growth prospects if the cyclical position is appropriate. But for those countries with constrained fiscal positions, alternative policies exist to expand the fiscal resources needed to finance growth-friendly policies.

These alternatives include better spending and tax policies, in an improved institutional environment. Spending can be shifted toward areas that lay the foundation of future growth, including education and health spending as well as climate-smart investment to strengthen economic resilience. Government revenue bases can be broadened by removing special exemptions and strengthening tax administration (Gaspar, Ralyea, and Ture 2019; IMF 2019; World Bank 2017b). Business climates and institutions can be strengthened to support vibrant private sector growth that can yield productivity gains and expand the revenue base.

Greater debt transparency and better debt management can mitigate some of the costs associated with debt buildups and some of the political-economy pressures for rapid debt accumulation. The buildup in LIC debt has not been accompanied by necessary improvements in the quality of debt management. Better debt management and transparency can help reduce borrowing costs, enhance debt sustainability, and dampen fiscal risks. For example, a sound debt management system would keep short-term and foreign currency exposures to prudent levels. Greater transparency—as well as institutional constraints on fiscal policy, including robust fiscal rules, and better governance—can mitigate some of the political-economy forces that are biased towards rapid debt accumulation.[6] Over time, improved debt management and transparency would help foster macroeconomic stability.

Regardless of the desired level of debt, prudent debt management favors debt contracted on terms that preserve macroeconomic and financial resilience—preferably at longer maturities, at fixed (and favorable) interest rates, are denominated in local currency and transparently disclosed. A debt composition that is less vulnerable to market disruptions reduces the likelihood that a decline in market

[5] Auerbach, Gale, and Krupkin (2019); Gale and Orszag (2003); Croce et al. (2018); Huang, Pagano, and Panizza (2017); and Panizza, Huang, and Varghese (2018).

[6] Alt and Lassen (2006 a,b); Klomp and De Haan (2011); Alt and Rose (2009); Cioffi, Messina, and Tommasino (2012); Shi and Svensson (2006); and Streb, Lema, and Torrens (2009).

BOX 1.1 Debt: No free lunch *(continued)*

sentiment, sharp depreciations, or interest rate spikes erode debt sustainability. This is particularly important in EMDEs, which tend to suffer sharp capital flow stops or reversals during times of financial stress.

EMDEs should avoid the temptation of the "this-time-is-different" syndrome in the current period of low interest rates (Reinhart and Rogoff 2009). Even if the cost of debt is currently low, the historical record suggests that it could increase sharply during periods of financial stress, as some EMDEs have painfully learned once again in recent years. Excessive debt burdens may make governments more vulnerable to crises, limit the size and effectiveness of fiscal stimulus during future cyclical downturns, and weigh on investment and longer-term growth. As the long history of financial crises in EMDEs has repeatedly shown, debt cannot be treated as a free lunch.

these new tariffs are contributing to heightened policy uncertainty, which is expected to dent confidence and investment.

As demand from major economies continues to moderate, export growth is expected to decelerate across EMDE regions in 2019. An exception is Sub-Saharan Africa, where export growth is expected to recover modestly from supply disruptions in key commodity-producing sectors in 2018 (Figure 1.7.E). The weakness in export growth this year is projected to be particularly pronounced in the Middle East and North Africa, reflecting oil production cuts in OPEC countries and U.S. sanctions on the Islamic Republic of Iran. Overall, export growth in 2019 is expected to be below historical averages in more than 80 percent of EMDEs.

In all, global trade growth is projected to weaken from 4.1 percent in 2018 to 2.6 percent this year—a full percentage point below previous forecasts, slightly below the pace observed during the 2015-16 trade slowdown, and the weakest since the global financial crisis (Figure 1.7.F). As the weakness in manufacturing abates, global trade is expected to stabilize to an average of 3.2 percent in 2020-21. This assumes no further escalation in trade tensions between major economies; new stimulus measures implemented in China and, to a lesser degree, the Euro Area; and firming domestic demand in some EMDEs. However, global trade is projected to be weaker than previously envisaged over the forecast horizon. This reflects a softer outlook for global investment and evidence of a lower income elasticity of trade. The post-crisis decline in the income elasticity of trade reflects slower value chain integration and trade liberalization (UNCTAD 2018).

While the global trade growth forecast assumes that new tariffs imposed continue to apply throughout the forecast horizon, trade relations between the United States and China remain fragile and could deteriorate further. Meanwhile, trade agreements that recently entered into force, such as the Comprehensive and Progressive Agreement for Trans-Pacific Partnership and the EU-Japan Economic Partnership Agreement, could help boost trade and foster deeper integration between signatory countries. The recently signed, but yet to be ratified, United States-Mexico-Canada Agreement (USMCA) could impact trade in agricultural products, automobiles, textiles and apparel; however, it is expected to have limited effects on economic activity (Chepeliev, Tyner and van der Mensbrugghe 2018; Burfisher, Lambert, and Matheson 2019). Potential tariffs on U.S. imports from Mexico announced in late May—not included in baseline forecasts—could weigh on North American trade.

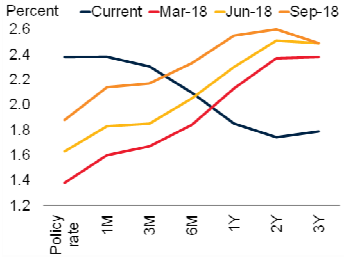
Financial markets

Amid signs of deterioration in global economic prospects and persistently low inflation, major central banks have adopted more accommodative monetary policy stances for the near term. The U.S. Federal Reserve has placed its tightening cycle on hold, while the European Central Bank has delayed the end of its negative interest rate

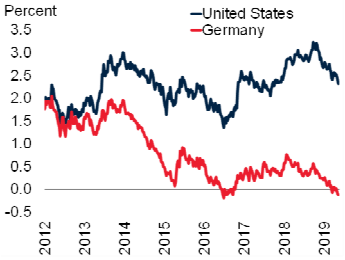
FIGURE 1.8 Global finance

Major central banks have adopted a more dovish stance as a response to low inflation and deteriorating growth prospects. As a result, advanced-economy bond yields have fallen, and the share of debt trading at negative interest rates has increased. Search for yield has supported a recovery in EMDE portfolio flows, a compression of bond spreads, and robust bond issuances; however, renewed trade tensions are weighing on risk appetite.

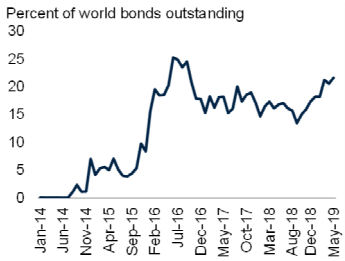
A. Federal funds rate expectations



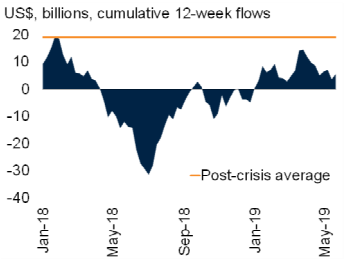
B. U.S. and German 10-year government bond yields



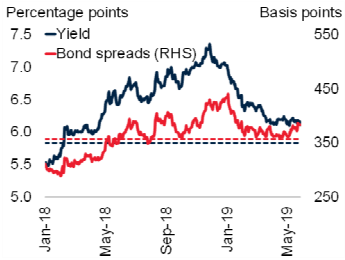
C. Share of bonds trading with negative interest rates



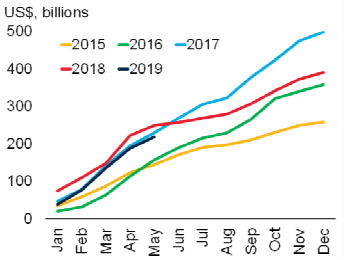
D. EMDE portfolio flows



E. EMDE bond yields and spreads



F. EMDE international bond issuances



Source: Bloomberg, Dealogic, Institute of International Finance, J.P. Morgan, World Bank.
A. Last observation is May 23, 2019.
B. Figure shows weekly data. Last observation is May 23, 2019.
C. Last observation is May 2019, which includes data through May 23, 2019.
D. Cumulative weekly flows since January 1, 2018. Equity flows include Brazil, India, Indonesia, Pakistan, Philippines, Qatar, Sri Lanka, South Africa, Thailand, Turkey, and Vietnam. Debt flows include Hungary, India, Indonesia, Mexico, Poland, South Africa, Thailand, and Turkey. Post-crisis average over January 1, 2010, to December 29, 2017. Last observation is May 23, 2019.
E. Bond yields are computed summing the J.P. Moran Emerging Market Bond Index (EMBI) spread and the U.S. 10-year bond yield. Dashed lines represent post-crisis average over period January 1, 2010, to December 31, 2018. Last observation is May 23, 2019.
F. Figure shows cumulative sum. Last observation is May 2019, which is estimated using month-to-date volume as of May 23, 2019.
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policy and implemented new measures to stimulate credit and activity. Shifting market expectations about monetary policies contributed to a drop in long-term yields—to their lowest levels since mid-2017 in the United States, and to below zero in Germany for the first time since late 2016 (Figures 1.8.A and B).

In this context, the share of bonds yielding negative market interest rates increased to its highest level since end-2017, reaching more than 20 percent globally and around 40 percent in Europe and Japan (Figure 1.8.C). While bank profitability does not appear to have been unduly affected so far, a long-lasting period of negative interest rate policies in the Euro Area and Japan could eventually pose challenges for bank profitability and financial intermediation (Arteta et al. 2016).

As long-term yields in advanced economies have eased, external financing conditions for EMDEs have improved, supporting a recovery in portfolio flows into EMDEs following persistent net outflows over most of 2018 (Figure 1.8.D). Notwithstanding recent reversals related to trade policy uncertainty, equity market valuations have risen, and aggregate EMDE sovereign bond spreads have dropped about 50 basis points since the start of 2019 (Figure 1.8.E). International debt issuance has been robust this year, as many borrowers have taken advantage of more favorable market conditions to meet growing refinancing needs (Figure 1.8.F). Some easing of external financing pressures, combined with moderating inflation, allowed many EMDE central banks to cut interest rates, or put their tightening cycles on hold.

Gains in both equity and bond portfolio flows this year may be partly offset by subdued bank-related flows, including in trade finance amid the deceleration in global trade (BIS 2014). Foreign direct investment (FDI) trends remain mixed, with a rebound in flows to China, and some Latin American countries, including Brazil, offset by weak flows in Europe and Central Asia, Middle East and North Africa, and Sub-Saharan Africa.

Global financing conditions are expected to remain supportive in the near term and tighten only gradually later in the forecast period. This assumes that monetary policy accommodation in major advanced economies will be gradually

removed, but at a slower pace than previously expected. The eventual rise of advanced-economy yields would, however, have a negative effect on capital flows to EMDEs. In Sub-Saharan Africa, persistent governance and regulatory impediments on investment, together with relatively subdued growth prospects, are expected to continue to weigh on FDI flows (Laudicina, Peterson, and McCaffrey 2018). Policy uncertainty, geopolitical risks, and security concerns could also continue to adversely impact EMDE capital inflows (World Bank 2018d).

Commodity markets

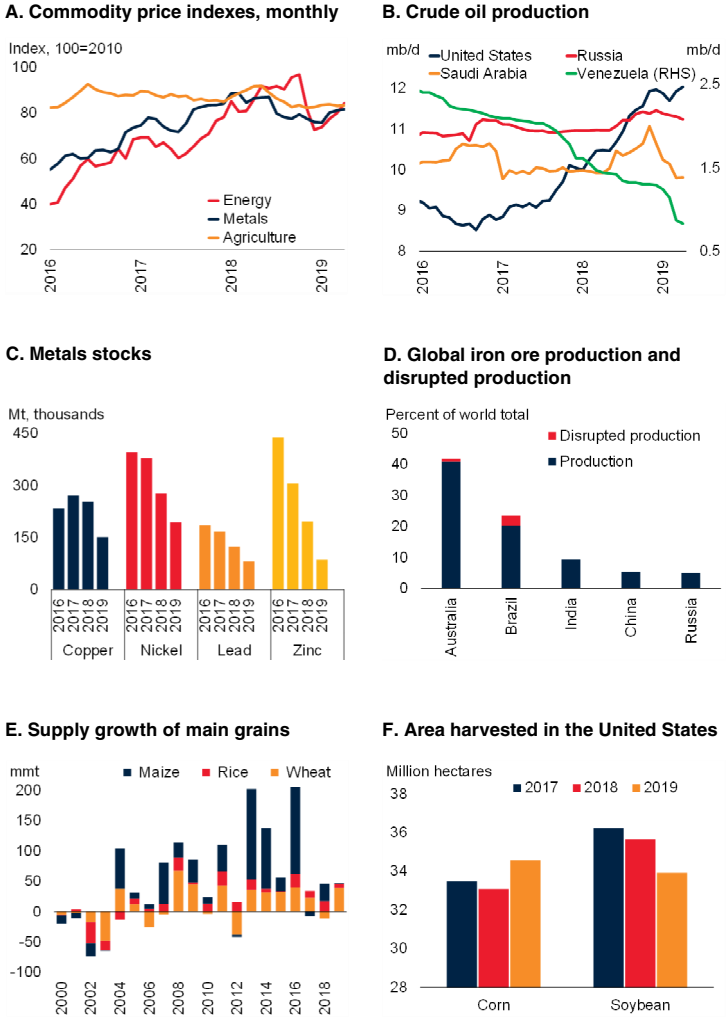
Prices of most industrial commodities picked up in the first half of 2019, but remained well below peak values from last year, while agricultural prices were mostly flat (Figure 1.9.A). Supply constraints and production cuts have supported prices since the start of the year; however, heightened trade tensions have recently weighed on prices of some commodities, particularly metals. Price forecasts for the year as a whole have been downgraded due to weaker-than-expected global growth.

Crude oil prices recovered over the first half of the year, averaging $64 per barrel (bbl), supported by production cuts among OPEC and its non-OPEC partners, as well as the United States' decision to terminate waivers for its sanctions on Iran. Saudi Arabia has contributed the most to the fall in supply, reducing output by 1 million barrels per day (mb/d) relative to late-2018 levels, while the Russian Federation has cut production by 0.2 mb/d (Figure 1.9.B). In contrast, production in the United States has continued to grow, and the country maintained its position as the world's largest oil producer. Venezuela's crude oil output has dropped further, to about 0.8 mb/d by mid-2019, from 1.4 mb/d in 2018 (IEA 2019).

Oil prices are expected to average $66/bbl in 2019 and $65/bbl in 2020, a slight downward revision relative to January reflecting softening global activity. The outlook remains highly uncertain and dependent on policy decisions, particularly whether the production cuts among OPEC and its partners will be extended into the second half of 2019. However, the supply cuts by OPEC members have resulted in substantial spare production capacity, which lessens the likelihood of spikes in oil prices in the near term.

FIGURE 1.9 Commodity markets

Most industrial commodity prices have recovered in 2019 following notable declines late last year. Against a backdrop of weaker global growth and growing U.S. production, crude oil prices have been supported by production cuts, mostly in Saudi Arabia, and the United States' decision to terminate waivers for its sanctions on Iran. Amid low inventories, metals prices have been supported by supply disruptions, notably in iron ore production in Brazil. Agricultural supply continues to rise, with U.S. farmers reducing plantings of soybeans in favor of corn.



Source: Bloomberg, International Energy Agency, London Metals Exchange, Vale S.A., U.S. Department of Agriculture, World Bank, World Steel Association.
A. Indexes are based on nominal U.S. dollars. Last observation is April 2019.
B. Last observation is April 2019.
C. Last observation is April 19, 2019.
D. Red bars show the percent of disrupted iron ore production that has occurred in 2019 so far. In Australia, the disrupted production has resulted from adverse weather events. In Brazil, production has been restricted following the Vale mining disaster.
E. Supply is the sum of beginning stocks and production. Years represent crop seasons (for example, 2018 refers to 2018-19 crop season). Data reflect the May 10, 2019 USDA update.
F. Data for 2019 are estimates and as of May 9, 2019.
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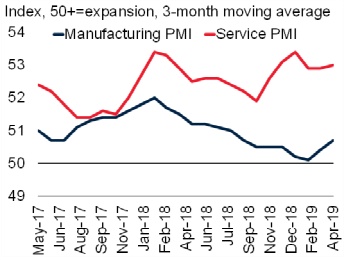
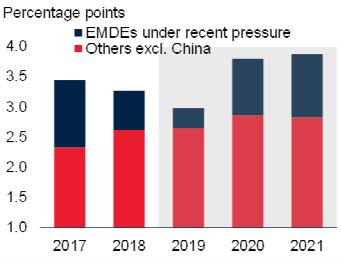
FIGURE 1.10 Activity in EMDEs

EMDEs experienced broad-based weakness in manufacturing at the start of 2019, followed by some recent signs of stabilization. Growth in countries recently affected by financial stress or sanctions has been particularly subdued, weighing on aggregate EMDE growth. In those countries, export growth has slowed and import compression is underway due to weak domestic demand—particularly investment. In other EMDEs, growth is generally near potential. In many countries, especially commodity exporters, activity has been weaker than previously expected.

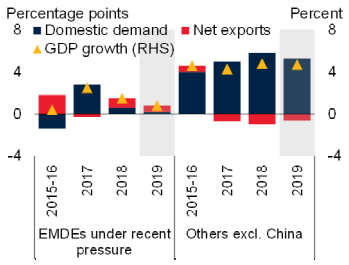
A. Manufacturing and services PMIs



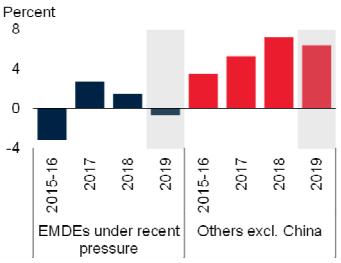
B. Contribution to EMDE growth excluding China



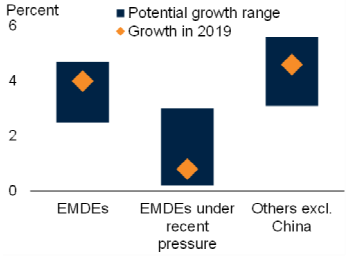
C. Contribution to growth



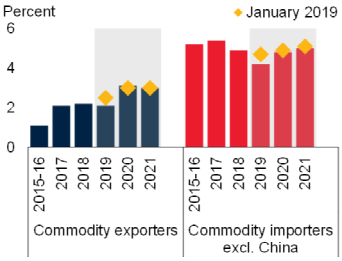
D. Investment growth



E. Projected and potential growth in 2019



F. Growth



Source: Haver Analytics, International Monetary Fund, J.P. Morgan, Organisation for Economic Co-operation and Development, World Bank.

A. Horizontal line is the expansionary threshold for the Purchasing Managers' Index (PMI). Last observation is April 2019.

B.-E. EMDEs under recent pressure include: a) countries that have had an increase in their J.P. Morgan EMBI credit spread of at least one standard deviation above the 2010-19 average at any time since April 2018 (Argentina, Brazil, Egypt, Gabon, Jordan, Lebanon, Mexico, Nigeria, South Africa, Sri Lanka, Tunisia, Turkey); or b) countries that have been subject to recent sanctions (Iran, Russia). "Others excl. China" is EMDEs excluding China and EMDEs under pressure.

B.-F. Aggregate growth rates are based on constant 2010 U.S. dollar GDP weights. Shaded areas indicate forecasts.

C. Domestic demand includes government consumption, private consumption, and gross capital formation, which includes the changes in inventories. Net exports are export minus import volumes.

C.D.F. Data for 2015-16 are simple averages. Data for 2018 are estimates.

E. Potential growth estimates based on eight different methodologies (production function approach; multivariate filter; three univariate filters, including Hodrick-Prescott filter, Christiano-Fitzgerald filter, and Butterworth filter; IMF *World Economic Outlook*; and OECD *Economic Outlook* and *Long-Term Baseline Projections*), as in the January 2018 *Global Economic Prospects* report. Blue bars show minimum-maximum range of potential growth. Orange diamonds show average projected growth.

F. Yellow diamonds are projections from the January 2019 *Global Economic Prospects* report.

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Supply bottlenecks for metals such as copper, nickel, lead, and zinc supported prices in the first half of 2019, which was accompanied by sharp declines in inventories (Figure 1.9.C). Iron ore prices rose sharply at the start of the year due to temporary mine closures following the Vale mining disaster in Brazil and weather-related disruptions in Australia (Figure 1.9.D). More recently, however, the re-escalation of trade tensions have contributed to declining prices for most base metals. Overall, metals prices are expected to decline slightly in 2019 and 2020, a downward revision relative to the January forecast reflecting a weaker outlook for global metals demand.

Agricultural prices were stable, on average, in the first half of 2019, amid high stock levels and favorable crop conditions for the fourth consecutive year (Figure 1.9.E). Wheat prices, which had risen relative to other agricultural prices, fell sharply on positive supply news, particularly in Europe and Russia. Soybean prices also dropped amid rising trade tensions and the spread of African Swine Fever to pig populations in China, which are a key source of demand. In response to weaker soybean prices, U.S. farmers reduced plantings of soybeans and increased plantings of corn (Figure 1.9.F; World Bank 2018e). Agricultural prices are expected to decline in 2019 and stabilize in 2020.

Emerging market and developing economies: Recent developments and outlook

EMDE activity has been weaker than expected amid softening external demand and investment. As a result, EMDE growth is expected to slow further, to 4 percent this year, before regaining some strength in 2020-21. This forecast depends on a rebound in the large EMDEs that have been recently affected by financial market pressures. In Sub-Saharan Africa, where extreme poverty is increasingly concentrated, per capita income growth remains insufficient to lead to substantial poverty alleviation.

Recent developments

EMDEs experienced broad-based weakness in manufacturing and exports at the start of the year, followed by some recent signs of stabilization (Figure 1.10.A). Activity in the services sector has remained resilient, reflecting continued growth in consumer spending.

Countries that experienced recent pressures related to varying degrees of financial market stress or idiosyncratic headwinds such as sanctions—a group that includes many commodity exporters—have faced a particularly sharp deceleration in activity this year (Figure 1.10.B).[1] Private consumption growth appears stable, but it remains weak. Investment growth has moderated further as policy uncertainty persists, dampening imports (Figures 1.10.C and D). Economic slack remains elevated in many countries in this group.

In EMDEs that did not suffer recent pressures—a group that includes many commodity importers as well as the more diversified commodity exporters—growth is stable or moderating. Activity in these countries is being restrained by a combination of capacity constraints and softening external demand. As a result, exports and domestic demand are decelerating in tandem, with private consumption still resilient but investment growth remaining subdued (Special Focus 1.1). Import growth is slowing as well, partly due to the high import content of many capital goods. Economic slack in this group of countries is generally limited, and growth is near its potential in many cases (Figure 1.10.E).

Commodity-exporting EMDEs

Growth in commodity exporters has been weaker than expected and remains lackluster (Figure 1.10.F). Notwithstanding a modest recovery from its 2015 low, investment growth in commodity exporters remains weak and below its long-term average. Notably, investment has deteriorated substantially in Argentina, where confidence and public spending retreated after severe financial stress, and Iran, where economic sanctions are weighing heavily on capital spending (Special Focus 1.1).

Slower-than-expected mining and oil production, combined with domestic policy uncertainties, has delayed the recovery in activity in some of the largest commodity exporters in Sub-Saharan Africa (Angola, Nigeria, South Africa; World Bank 2019b). Amid oil production cuts agreed by OPEC members and some key non-OPEC producers, growth in Saudi Arabia and Russia is moderating, while sanctions or political crises are expected to lead to sharp contractions in other oil exporters (Iran, Sudan; World Bank 2019c and 2019d).

Conditions are improving or stable elsewhere. Momentum in Brazil is gradually firming, although at a slower pace than previously expected. Rising commodity prices this year, along with improving business confidence, have helped lift investment and private consumption in some large economies. In several commodity exporters in East Asia and Pacific and Latin America, where earlier terms-of-trade shocks were less acute, growth is stable or only gradually decelerating from high levels (Chile, Malaysia, Peru; World Bank 2019e).

Commodity-importing EMDEs

Growth in commodity importers continues to decelerate, reflecting moderating external demand, increasing capacity constraints, and the lingering effects of financial stress in some countries—most notably Turkey. Among European EMDEs, slowing activity is particularly pronounced in economies with close ties to the Euro Area or facing ongoing domestic challenges (Belarus, Serbia, Turkey). In some countries, diminishing slack is putting a lid on growth (Hungary, Poland).

In Asia, activity is gradually decelerating but remains robust, with output in many countries expanding at a rate of 6-7 percent (Bangladesh, Cambodia, China, India, the Philippines,

[1] EMDEs under recent pressure include: a) countries that have had an increase in their J.P. Morgan EMBI credit spread of at least one standard deviation above the 2010-19 average at any time since April 2018 (Argentina, Brazil, Egypt, Gabon, Jordan, Lebanon, Mexico, Nigeria, South Africa, Sri Lanka, Tunisia, Turkey); or b) countries that have been subject to recent sanctions (Iran, Russia).

BOX 1.2 Short-term growth prospects for LICs

Growth in low-income countries (LICs) is projected to remain robust in 2019, at 5.4 percent. It is, however, more moderate than previously forecast, as weaker external demand has been accompanied by devastating extreme weather events and by a normalization of agricultural production in some large economies. Growth is projected to rise to 6.0 percent in 2020 and 6.1 percent in 2021, as domestic demand continues to strengthen and as increased oil and metals production supports activity among industrial-commodity exporters. These growth rates are, however, insufficient to markedly reduce poverty, particularly in LICs affected by fragility, conflict, and violence. Risks to the outlook include slower-than-expected growth in major trading partners, a resumption in the tightening of international financial conditions, adverse weather, and health crises.

Recent growth and prospects for 2019

Economic activity. Growth has remained robust in LICs, but lost some momentum. It is projected to decelerate to 5.4 percent in 2019—from 5.6 percent 2018—and is below previous forecasts (Figure 1.2.1.A). The downward revision reflects, in part, unexpectedly weak external demand from major trading partners, extreme weather events that dampened activity in several countries, as well as an earlier-than-expected normalization of agricultural production in some large LICs (Uganda, Tanzania) after strong recoveries from drought in previous years.

In non-resource-intensive LICs, growth has been supported by robust construction activity related to investment in infrastructure (Rwanda, Senegal) and rapidly growing services sectors amid continued urbanization (Ethiopia, Uganda). On the demand side, growth reflects strong household consumption supported by solid harvests (Benin, Burkina Faso) and expansionary monetary policy (The Gambia, Uganda), as well as sustained public investment (Comoros, The Gambia, Madagascar, Nepal, Uganda). Among some exporters of industrial commodities, growth has strengthened—despite weaker external demand—as oil and mining production has continued to benefit from investment in new capacity (Chad, Democratic Republic of Congo, Guinea).

However, several economies are facing severe strains. Output in Zimbabwe is expected to contract in 2019 with a sharp rise in inflation reducing real incomes and foreign exchange shortages constraining activity. The Southern and East African region was hit by two devastating tropical cyclones—Idai and Kenneth—in March and April 2019 that took a heavy human toll and caused severe damage to social and economic infrastructure in the Comoros, Malawi, Zimbabwe and, in particular, Mozambique. In this country, cyclone Idai in particular damaged a significant part of the port city of Beira and its surrounding area—affecting one of Mozambique's key export terminals.

Note: This box was prepared by Rudi Steinbach. Research assistance was provided by Maria Hazel Macadangdang and Mengyi Li.

Progress in poverty reduction. Despite declines in poverty rates over the past decade, more than 40 percent of the population in LICs still live in extreme poverty, and continued progress in poverty reduction in these countries remains challenging. The poverty headcount is rising in economies affected by fragility, conflict, and violence. In countries where progress is being made in reducing poverty, economic growth is concentrated in urban areas, yielding little benefit to the rural poor.

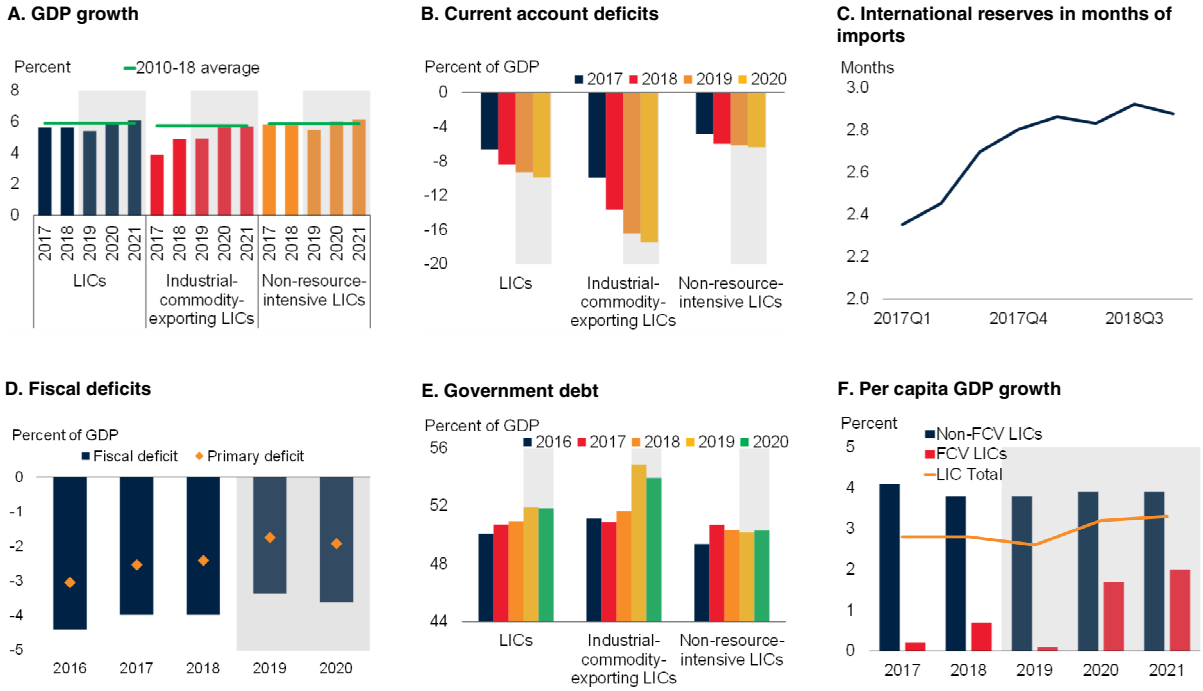
External positions. Current account deficits are widening in almost half of LICs, with the average deficit expected to increase to 9.3 percent of GDP in 2019 from 8.4 percent in 2018 (Figure 1.2.1.B). In some LICs (Afghanistan, Burundi, Guinea, Guinea-Bissau), widening external deficits reflect weaker external demand and slower export growth. Elsewhere (Mozambique, Nepal, Niger, Uganda), imports of capital goods related to large infrastructure investment projects have been contributing to larger deficits. The deficit in Mozambique will rise further during the cyclones' aftermath by weaker agricultural exports and with elevated imports of aid and reconstruction materials. In a few LICs (Benin, Ethiopia), current account deficits are narrowing despite weak external demand because past investments in export-oriented industries are supporting stronger export growth. While FDI inflows have been largely sufficient to finance current accounts deficits—especially in countries with large infrastructure investment programs—they have weakened somewhat amid last year's tighter external financing environment. This has contributed to a decline in LICs' international reserves relative to their imports. They now stand further below the commonly recommended minimum of three months' cover (Figure 1.2.1.C).

Fiscal positions. Fiscal deficits are gradually narrowing in LICs, with the average deficit expected to decline from 4 percent of GDP in 2018 to 3.4 percent in 2019 (Figure 1.2.1.D). Narrower deficits among many fast-growing LICs reflect fiscal consolidation (Benin, Ethiopia, Togo), as well as greater public spending efficiency and improved revenue collections (Benin, Togo). Among industrial-commodity-exporting LICs, rising government revenues related to increased oil and metals production (Chad),

BOX 1.2 Short-term growth prospects for LICs (*continued*)

FIGURE 1.2.1 Short-term economic prospects for LICs

Growth in LICs is projected to remain robust in 2019, at 5.4 percent, albeit more moderate than previously forecast. It is expected to rise to 6.0 percent in 2020 and 6.1 percent in 2021. Growth is being spurred by new oil and mining production capacity coming on stream among some large industrial-commodity exporters; public investment and strong agriculture performances should support growth in non-resource-intensive LICs. Per capita income growth will not be sufficient to markedly reduce poverty. Current account deficits are widening, amid weaker external demand and strong capital goods imports, while financing of these deficits has been under pressure. Fiscal deficits remain large, contributing to elevated government debts.



Source: Haver Analytics; International Monetary Fund, *World Economic Outlook*; World Bank; World Development Indicators.
Note: LICs = low-income countries. Industrial-commodity exporting countries include energy- and metal-exporting economies, and the sample includes 8 countries. Non-resource-intensive countries include agricultural-exporting countries and commodity importers, and the sample includes 22 countries.
A. Aggregate growth rates calculated using 2010 U.S. dollar GDP weights.
B.D.E. Simple averages of country groups.
C. Simple averages. Sample includes 23 countries.
F. FCV = fragility, conflict, and violence. FCV and Non-FCV LICs samples each include 14 countries. Weighted averages of country groups.
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greater tax revenue mobilization (Sierra Leone), and fiscal consolidation (Tajikistan) are improving fiscal balances. However, in some LICs, fiscal deficits are widening, amid weak economic growth that weighs on government revenues (Liberia), election-related fiscal pressures (Mozambique), and scaled up public consumption and investment by a new government (Democratic Republic of Congo).

After increasing sharply in recent years, government debt ratios are elevated among LICs, with debt expected to reach 52 percent of GDP, on average, in 2019—a 15 percentage point increase since 2013 (Figure 1.2.1.E). However, in some LICs, increased fiscal discipline and more effective revenue mobilization have begun to stabilize debt ratios. Among non-resource-intensive LICs, indebtedness has remained broadly unchanged, or even declined somewhat, in Benin, the Comoros, Ethiopia, Haiti, and The Gambia. Similarly, increases in debt appear to have come to a halt in some industrial-commodity exporters, where revenues have been lifted by increased resource production (Chad, Democratic Republic of Congo). Nevertheless, debt continues to rise in many countries, driven by strong public investment (Rwanda, Tanzania, Uganda) and larger current spending, in some cases related to elections (Burundi, Mozambique).

BOX 1.2 Short-term growth prospects for LICs (*continued*)

In addition to elevated levels of debt, the composition of government debt has changed in recent years, as non-concessional and foreign-currency-denominated borrowing has increased amid greater access to international capital markets and increased non-resident participation in domestic debt markets (World Bank 2019a, 2019b).

While international financial conditions have eased in recent months, they are still tighter than in 2017, keeping debt-servicing costs elevated and making fiscal consolidation in countries with large debt burdens more challenging.

Outlook for 2020-21

Economic growth. Growth in LICs is expected to strengthen to 6.0 percent in 2020 and 6.1 percent in 2021. This projected pickup assumes that the recovery among oil and metals exporters will be bolstered by higher production as new capacity comes on stream, while domestic demand continues to strengthen (Chad, Democratic Republic of Congo, Guinea). In the Democratic Republic of Congo—the largest industrial commodity-exporting LIC and the country estimated to have the most cobalt reserves in the world—mining production accounts for more than 80 percent of exports and 25 percent of government revenues. Mining production is expected to increase by around 10 percent a year over the forecast horizon, driven by strong growth in cobalt demand from the expanding global electric vehicle industry (Alves Dias et al. 2018; Campbell 2019).

Growth is also expected to remain robust in several non-resource-intensive LICs. In particularly fast-growing LICs (Rwanda, Uganda, and Tanzania), expansions will be supported by public investment in infrastructure and continued strong agricultural growth. Similarly, agricultural production in Malawi is assumed to recover as the Fall Armyworm infestation of recent years recedes. Reconstruction efforts in the cyclone-affected countries in Southern and East Africa—the Comoros, Malawi, Mozambique, and Zimbabwe—are also expected to support activity over the next two years. In Afghanistan, greater political stability following an assumed peaceful transition after the upcoming election in July is expected to improve the business environment and deliver a growth spurt. Improved political stability is also expected to support the outlook for Guinea-Bissau and Zimbabwe. While growth in Ethiopia is expected to remain strong, it will be held back by a tighter fiscal stance, as the government continues its efforts to stabilize public debt.

Prospects for per capita income convergence. The growth recovery will help lift per capita GDP growth in LICs from 2.6 percent in 2019 to 3.2 percent in 2020 and 3.3 percent in 2021 (Figure 1.2.1.F). However, among LICs affected by fragility, conflict, and violence—which host about 56 percent of the LIC poor and 43 percent of the LIC population—prospects for convergence to middle-income country income levels are limited, as per capita income growth is expected to be significantly lower, averaging 1.9 percent in 2020-21. For these economies, growth is thus expected to remain insufficient to significantly reduce poverty rates, and the number of people in LICs living in extreme poverty (below the international poverty line for income of $1.90 per day) is expected to remain elevated.

Risks. Risks to the economic outlook for LICs are predominantly on the downside. Slower-than-expected growth in major economies—China, the United States, and the Euro Area—could set back LIC growth. These three countries account for 31 percent of LIC exports, 41 percent of LIC FDI, and 23 percent of remittances to LICs, leaving LICs highly exposed to developments in their economies. A slowdown in China would hit industrial-commodity-exporting LICs particularly hard, as China accounts for more than one-half of global metals demand (World Bank 2016 and 2018b).

Unexpected shifts in investor sentiment, or in economic developments or policies in major economies, could lead to a re-tightening of financial conditions. The impact would be amplified in LICs with larger debt burdens, weaker macroeconomic fundamentals, or elevated political risks. The disruptions to capital inflows and sharp currency depreciations that could result from a sudden deterioration in market sentiment would raise debt-servicing costs further—especially on debt denominated in foreign currency—and undermine fiscal consolidation efforts while constraining critical poverty-reducing expenditures.

Many LICs are vulnerable to weather-related shocks as climate change increases the frequency of extreme weather events such as tropical storms, floods, heatwaves, and severe and prolonged drought episodes. Crop damage events caused by a greater incidence of insect pests (e.g., the Fall Armyworm) could become more severe as warmer conditions fuel their population growth and metabolic rates (Deutsch et al 2018). In the average LIC, agriculture accounts for 29 percent of GDP. LICs that are most highly dependent on agricultural activity are most at risk

BOX 1.2 Short-term growth prospects for LICs (*continued*)

TABLE 1.2.1 Low-income country forecasts[a]

(Real GDP growth at market prices in percent, unless indicated otherwise)

	2016	2017	2018e	2019f	2020f	2021f	Percentage point differences from January 2019 projections: 2019e	2020f	2021f
Low Income Country, GDP[b]	**4.8**	**5.6**	**5.6**	**5.4**	**6.0**	**6.1**	**-0.5**	**-0.2**	**-0.2**
Afghanistan	2.3	2.7	1.0	2.4	3.2	3.6	-0.3	0.0	0.4
Benin	4.0	5.8	6.5	6.5	6.5	6.5	0.3	0.0	-0.1
Burkina Faso	5.9	6.3	6.8	6.0	6.0	6.0	0.0	0.0	0.0
Burundi	-0.6	0.5	1.6	1.8	2.1	2.0	-0.5	-0.4	-0.8
Chad	-6.3	-3.0	2.6	3.4	5.6	4.8	-1.2	-0.5	-0.1
Comoros	2.2	2.7	2.8	3.1	3.2	3.2	0.0	0.1	0.1
Congo, Dem. Rep.	2.4	3.7	5.8	5.9	6.5	6.8	1.3	1.0	0.9
Ethiopia[c]	7.6	10.2	7.9	7.9	8.2	8.2	-0.9	-0.7	-0.7
Gambia, The	0.4	4.6	6.6	5.4	5.2	5.0	0.0	0.0	-0.2
Guinea	10.5	10.6	5.8	5.9	6.0	6.0	0.0	0.0	0.0
Guinea-Bissau	6.3	5.9	3.8	4.3	4.8	5.5	0.1	0.4	1.0
Haiti[c]	1.5	1.2	1.5	0.4	1.6	1.3	-1.9	-0.8	-1.2
Liberia	-1.6	2.5	1.2	0.4	1.6	1.3	-4.1	-3.2	-3.5
Madagascar	4.2	4.3	5.2	5.2	5.3	5.1	-0.2	0.0	-0.2
Malawi	2.5	4.0	3.5	4.5	4.7	5.1	0.2	-0.6	-0.4
Mali	5.8	5.3	4.9	5.0	4.9	4.8	0.0	0.0	0.0
Mozambique	3.8	3.7	3.3	2.0	3.5	4.2	-1.5	-0.6	0.1
Nepal[c]	0.6	8.2	6.7	7.1	6.4	6.5	1.2	0.4	0.5
Niger	4.9	4.9	5.2	6.5	6.0	5.6	0.0	0.0	0.0
Rwanda	6.0	6.1	8.6	7.8	8.0	7.5	0.0	0.0	-0.5
Senegal	6.2	7.2	6.8	6.8	7.0	7.0	0.2	0.2	0.1
Sierra Leone	6.4	3.8	3.7	5.4	5.4	5.2	0.3	-0.9	-1.1
Tajikistan	6.9	7.1	7.3	6.0	6.0	6.0	0.0	0.0	0.0
Tanzania	6.9	6.8	6.0	5.4	5.7	6.1	-1.4	-1.3	-0.9
Togo	5.2	4.3	4.9	5.0	5.2	5.1	0.2	0.1	0.0
Uganda[c]	4.6	3.9	5.9	6.1	6.5	5.8	0.1	0.1	-0.7
Zimbabwe	0.8	4.7	3.5	-3.1	3.5	4.9	-6.8	-0.5	0.9

Source: World Bank.
World Bank forecasts are frequently updated based on new information and changing (global) circumstances. Consequently, projections presented here may differ from those contained in other World Bank documents, even if basic assessments of countries' prospects do not significantly differ at any given moment in time.
a. Central African Republic, Democratic People's Republic of Korea, Somalia, Syria, and Yemen are not forecast due to data limitations.
b. GDP at market prices and expenditure components are measured in constant 2010 U.S. dollars.
c. GDP growth based on fiscal year data. For Nepal, the year 2019 refers to FY2018/19.
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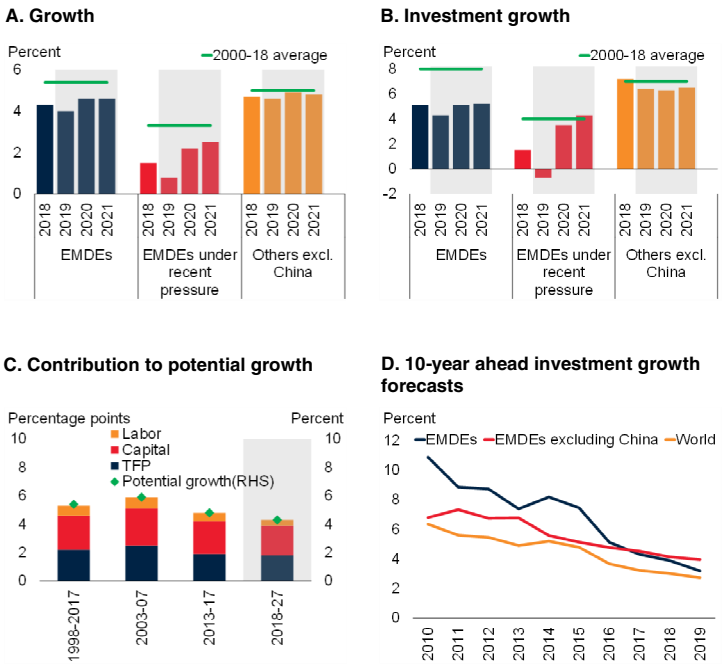
of increases in poverty rates as a result of these factors (World Bank 2019a).

Health crises remain a constant concern among LICs. The latest Ebola epidemic in the northeastern Democratic Republic of Congo has been ongoing since mid-2018 and could weigh heavily on activity in the country and the sub-region, especially if it were to spread to major urban centers and to neighboring countries (Burundi, Rwanda, South Sudan, Tanzania, Uganda).

FIGURE 1.11 EMDE growth prospects

Following a further deceleration in 2019, growth in EMDEs is expected to recover in 2020-21, as headwinds are assumed to dissipate in a number of key economies. However, investment growth will remain subdued. In the longer run, productivity and demographic trends point to weakening growth potential across EMDEs, further weighing on investment prospects.



Source: Consensus Economics, J.P. Morgan, Penn World Tables, World Bank.
A.-C. Aggregate growth rates are calculated using constant 2010 U.S. dollar GDP weights. Shaded areas indicate forecasts.
A.B. EMDEs under recent pressure include: a) countries that have had an increase in their J.P. Morgan EMBI credit spread of at least one standard deviation above the 2010-19 average at any time since April 2018 (Argentina, Brazil, Egypt, Gabon, Jordan, Lebanon, Mexico, Nigeria, South Africa, Sri Lanka, Tunisia, Turkey); or b) countries that have been subject to recent sanctions (Iran, Russia).
C. TFP = total factor productivity. Sample includes 50 EMDEs. Potential growth estimates are based on production function approach. For further details on potential growth estimates, refer to the January 2018 edition of the *Global Economic Prospects* report.
D. 10-year-ahead forecasts surveyed in indicated year. Constant 2010 U.S. dollar investment-weighted averages. Sample includes 23 advanced economies and 20 EMDEs (indicated by † in Table SF1.1.1). For 2010-18, the average of four projections during the year is shown; for 2019, the average of two projections during the first half of the year is shown.
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Vietnam), despite moderating export growth. In India, growth remains solid, supported by improved confidence, slowing inflation, and still robust investment (World Bank 2019e, 2019f). Other economies continue to benefit from pan-Asian infrastructure investments and expanding intra-regional trade (Bhutan, Cambodia, Vietnam). Activity is weaker in countries where policy uncertainty continues to discourage private investment (Mexico, Sri Lanka), and in countries that have tightened fiscal and monetary policies to reduce fiscal and current account deficits (Haiti, Pakistan, Tunisia).

Low-income countries

Growth remains robust in low-income countries (LICs; Box 1.2; Special Focus 2.1); however, it has lost some momentum amid weaker external demand from major trading partners and extreme weather events. Among non-resource-intensive countries, rising consumption growth and sustained public investment in infrastructure are supporting activity, offset by a modest slowdown in agricultural output (Uganda, Tanzania). Growth among exporters of industrial commodities has generally firmed due to investment in new resource production capacity (Chad, Democratic Republic of Congo, Guinea). In contrast, the Comoros, Malawi, Zimbabwe, and particularly Mozambique are facing severe strains after two devastating tropical cyclones—Idai and Kenneth—hit Southern and East Africa in March and April, taking a heavy human toll and causing severe economic damage. Current account deficits across LICs have widened, on average, due to strong capital goods imports related to public investment projects and slower export growth among some metals exporters (Guinea, Nepal, Niger). Strong public investment spending has, in part, kept fiscal deficits elevated; however, they have narrowed in some countries amid continued fiscal consolidation and improved revenue collection (Benin, Ethiopia, Sierra Leone).

Outlook

Growth outlook

EMDE growth is expected to slow from 4.3 percent in 2018 to 4 percent this year—0.3 percentage point lower than previously projected, with notable heterogeneity across regions (Box 1.3; Chapter 2). Almost 40 percent of EMDEs are expected to decelerate in 2019 relative to last year. Moreover, forecasts for 2019 growth have been downgraded for more than 40 percent of countries. For many countries, a substantial part of the forecast downgrade is attributable to continued weakness in investment, which remains well below historical averages.

Growth in EMDEs facing the lingering impact of earlier financial stress (Argentina, Brazil, Nigeria, South Africa, Turkey) and idiosyncratic head-

BOX 1.3 Regional perspectives: Recent developments and outlook

Growth in all EMDE regions has been weaker than expected amid softening external demand and, in some countries, persistent domestic headwinds. Activity in the East Asia and Pacific and South Asia regions remains buoyant, while growth in other EMDE regions is expected to recover in 2020-21.

East Asia and Pacific. Growth in the region is projected to slow from 6.3 percent in 2018 to 5.9 percent in 2019-20, and to ease further to 5.8 percent in 2021. This will mark the first time since the 1997-98 Asian financial crisis that EAP growth dropped below 6 percent. In China, growth is expected to decelerate from 6.6 percent in 2018 to 6.2 percent in 2019, and gradually decline to 6.0 percent by 2021, reflecting softening manufacturing activity and trade amid domestic and external headwinds. In the rest of the region growth is also expected to moderate to 5.1 percent in 2019, before rebounding modestly to 5.2 percent in 2020-21, as global trade stabilizes. Risks to regional growth remain tilted to the downside and have intensified with the re-escalation of trade tensions. They include a sharper-than-expected slowdown in major economies, including China; an intensification of global trade tensions; and an abrupt change in global financing conditions and investor sentiment.

Europe and Central Asia. Growth in the region is projected to fall sharply from 3.1 percent in 2018 to 1.6 percent in 2019. The slowdown partly reflects a sharp weakening of activity in Turkey, which fell into recession in the wake of acute financial market stress in 2018. Regional growth is projected to pick up in 2020-21 as Turkey recovers and Russian strengthens. Excluding these economies, the rest of the region is expected to moderate. In particular, growth in Central Europe is projected to soften as economies grapple with the slowdown in the Euro Area and binding domestic capacity constraints. Key external risks to the region include spillovers from weaker-than-expected activity in the Euro Area and from escalation of global policy uncertainty, particularly in relation to trade tensions and the United Kingdom's exit from the European Union. Renewed financial pressures in Turkey could also disrupt regional growth.

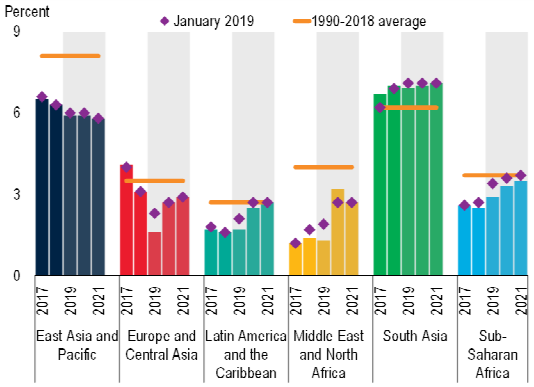
Latin America and the Caribbean. Growth in the region is expected to be subdued in 2019, at 1.7 percent, reflecting challenging conditions in several of the largest economies. Gradually building momentum in Brazil and a recovery in Argentina are projected to contribute to a pickup in

Note: This box was prepared by Patrick Kirby, with contributions from Rudi Steinbach, Temel Taskin, Ekaterine Vashakmadze, Dana Vorisek, Collette Wheeler, and Lei Ye. Research assistance was provided by Hazel Macadangdang.

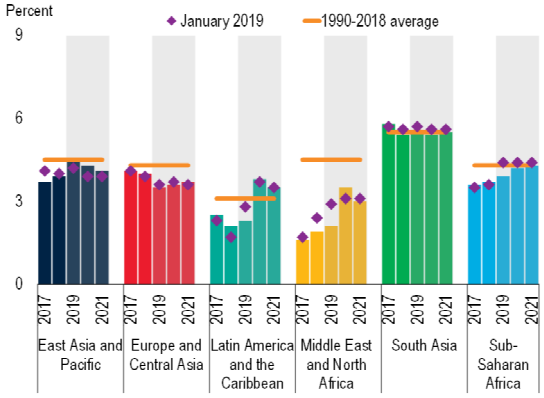
FIGURE 1.3.1 Regional growth

Growth in all EMDE regions has been weaker than expected, hindered by a combination of policy uncertainties, weak external demand, and the lingering impact of past financial stress. Activity is expected to recover in 2020-21.

A. Regional growth, weighted average



B. Regional growth, unweighted average



Source: World Bank.

A.B. Bars denote latest forecast; diamonds correspond to January 2019 forecasts in the *Global Economic Prospects* report. Average for 1990-2018 is constructed depending on data availability. For Europe and Central Asia, the long-term average uses data for 1995-2018 to exclude the immediate aftermath of the collapse of the Soviet Union.

A. Aggregate growth rates calculated using constant 2010 U.S. dollar GDP weights. Since largest economies account for about 50 percent of GDP in some regions, weighted averages predominantly reflect the developments in the largest economies in each region.

B. Unweighted average regional growth is used to ensure broad reflection of regional trends across all countries in the region.

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BOX 1.3 Regional perspectives: Recent developments and outlook (*continued*)

regional growth to 2.5 percent in 2020 and 2.7 percent in 2021. Financial conditions in the region have eased markedly since early 2019. Despite soft global trade, regional export growth has picked up, boosted by trade diversion in response to bilateral tariffs by the United States and China, and by solid growth in the United States. As these effects wane and global trade decelerates further, export growth in the region is projected to slow. Risks to the growth outlook remain tilted to the downside. Sharper-than-projected slowdowns in the United States and China could have negative spillovers on regional growth through trade, financial, and commodity market channels. Adverse market responses to weak fiscal conditions and disruptions from natural disasters are other important risks. The crisis in Venezuela also presents risks.

Middle East and North Africa. Growth in the region is projected to remain subdued in 2019, at 1.3 percent. Activity in oil exporters has slowed due to weak oil sector output and the effects of intensified U.S. sanctions on Iran, despite an easing of the fiscal stance and positive prospects for non-oil sectors in some countries. Many oil importers continue to benefit from business climate reforms and resilient tourism activity. Regional growth is projected to pick up to around 3 percent in 2020-21, supported by capital investment and policy reforms. Risks to the outlook are tilted to the downside, including geopolitical tensions, reform setbacks, and a further escalation of global trade tensions.

South Asia. The region continued to enjoy solid economic activity in 2018, posting 7 percent GDP growth due to robust domestic demand. Pakistan was a notable exception, with a broad-based weakening of domestic demand against the backdrop of tightening policies aimed at addressing the country's macroeconomic imbalances. Regional growth is projected to remain close to 7 percent over the forecast horizon, as it benefits from strong private consumption and investment. The main risks to the outlook include a re-escalation of political uncertainty and regional tensions, financial sector weakness due to nonperforming assets, fiscal challenges, and a sharper-than-expected weakening of growth in major economies.

Sub-Saharan Africa. The recovery in the region has disappointed, with weakening external demand, supply disruptions, and elevated policy uncertainty weighing on activity in major economies. Growth in the region is projected to pick up from 2.5 percent in 2018 to 2.9 percent this year and an average of 3.4 percent in 2020-21, as domestic demand gathers pace and oil production recovers in large exporting economies. However, this expected recovery is significantly slower than previously projected, reflecting persistent headwinds in major economies, and it is largely insufficient to make progress in poverty reduction. Downside risks to the outlook include weaker-than-expected external demand, lower commodity prices, renewed stress in global financial markets, fiscal slippages, political uncertainty, armed conflicts, and adverse weather conditions.

winds such as sanctions (Iran, Russia) is expected to remain subdued this year (Figure 1.11.A). Projections for 2019 were revised down in most of these countries, with particularly sizable downgrades for Brazil, Mexico, and Turkey. Forecasts for countries facing oil production cuts this year (Bahrain, Russia, Saudi Arabia, and United Arab Emirates) were also downgraded. In contrast, growth in EMDEs that did not face recent pressures is expected to remain solid.

EMDE growth is projected to firm to 4.6 percent in 2020-21, in line with previous forecasts. This assumes a waning drag from earlier financial pressures in some large countries, that global financing conditions remain generally benign, and that global trade growth stabilizes. In Argentina and Turkey, the impact of severe financial market turmoil is expected to diminish over the forecast horizon as investor confidence returns (World Bank 2019c). In Brazil, Russia, and South Africa, headwinds associated with elevated policy uncertainty are also expected to moderate. In Iran, the impact of U.S. sanctions is projected to peak this year, with growth resuming in 2020 (World Bank 2019d).

In EMDEs that did not suffer recent pressures, growth is expected to remain stable in 2020-21. Resilient domestic demand and still favorable global financing conditions should largely offset the negative impact of decelerating exports. However, there are some large divergences. Growth in India and Indonesia is expected to

remain steady and above EMDE averages, while capacity constraints and the projected deceleration in the Euro Area will slow activity in Poland and Hungary.

EMDE investment growth is expected to decelerate in 2019, primarily because of contractions in countries affected by recent pressures (Figure 1.11.B). While investment growth is projected to recover somewhat in 2020-21, it is expected to remain below long-term averages, reflecting elevated debt levels, limited fiscal space, lack of clarity about policy direction, and inadequate business climates (Special Focus 1.1).

Growth in LICs is expected to recover to an average of 6.1 percent in 2020-21, from 5.4 percent in 2019 (Box 1.2). In non-resource-intensive countries, the pickup assumes stronger private investment amid improving business environments (Rwanda, Uganda), continued robust public infrastructure spending, solid agricultural output (The Gambia, Malawi, Tanzania), and greater political stability (Afghanistan, Guinea-Bissau, Zimbabwe). Among exporters of industrial commodities, the recovery is predicated on rising oil and mining production amid continued investment in new capacity (Chad, Democratic Republic of the Congo, Guinea), and on stronger domestic demand. Despite the pickup in growth, LICs' prospects for progression to middle-income status will be challenged by a greater incidence of fragility; a heavy reliance on agriculture, which is vulnerable to climate change and extreme weather events; and the fact that many are land-locked, limiting the scope of involvement in global trade (Special Focus 2.1).

Over the medium term, challenges associated with demographics, productivity, and investment point to weakening growth potential in EMDEs (Figure 1.11.C; World Bank 2018c). Slowing labor force growth will be most pronounced in key economies in East Asia and Pacific and in Europe and Central Asia, while it is projected to be broadly neutral for growth in Latin America and the Caribbean, in the Middle East and North Africa, and in South Asia, and to remain supportive in Sub-Saharan Africa. Many of the drivers of the productivity slowdown seen across EMDEs in the post-crisis period are likely to persist, notwithstanding the promise of new technologies. Over the next decade, investment is expected to remain subdued, which will exacerbate the decline in potential growth directly through slower capital deepening and indirectly through its dampening impact on productivity (Figure 1.11.D).

Per capita income growth and poverty

Sustained per capita income growth has historically been the main driver of global poverty reduction (World Bank 2018f). Softening growth in EMDEs since the global financial crisis has been associated with a slower pace of global poverty reduction, as well as an increased concentration of extreme poverty in Sub-Saharan Africa. While extreme poverty has fallen substantially in some regions, such as East Asia and Pacific, addressing broader measures of poverty still remains an acute challenge (World Bank 2019f).

Near-term growth prospects will be insufficient to result in significant progress toward global poverty alleviation, with per capita income growth this year remaining below its long-term average in more than half of EMDEs. In about a third of EMDEs, per capita growth in 2019 will be below that of advanced economies, resulting in widening income gaps.[2] These EMDEs are mainly in commodity-reliant regions such as Sub-Saharan Africa, Latin America and the Caribbean, and the Middle East and North Africa (Figure 1.12.A).

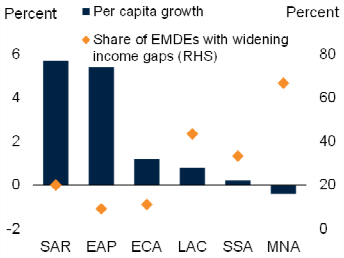
There are significant differences within regions, however. In the case of Sub-Saharan Africa, per capita growth is weak in the largest three economies (Nigeria, South Africa, and Angola), in some metals exporters, and in countries affected by fragility, conflict, and violence. In contrast, some non-resource-intensive countries in the region are experiencing solid per capita income growth rates (Côte d'Ivoire, Ethiopia, Rwanda, Senegal).

[2] Median per capita income growth is also expected to be weak, as the correlation between median household income growth and per capita GDP growth is 0.75 for those countries for which household income data are available.

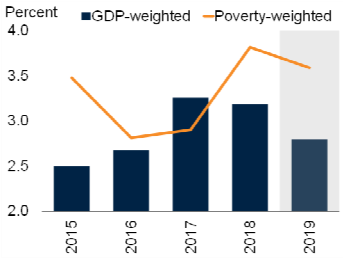
FIGURE 1.12 EMDE per capita income growth and poverty

Weakening growth this year suggests that, in many EMDEs, per capita income gaps with advanced economies will continue to widen. Per capita income in countries with the largest number of extreme poor is expected to grow at a somewhat faster clip than other EMDEs, but at less than half the pace needed to reduce global extreme poverty to 3 percent by 2030.

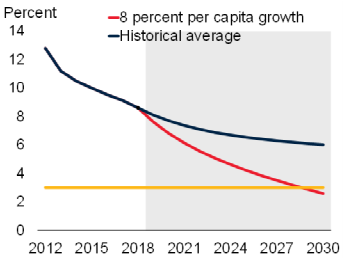
A. GDP per capita growth and share of EMDEs with widening income gaps, 2019



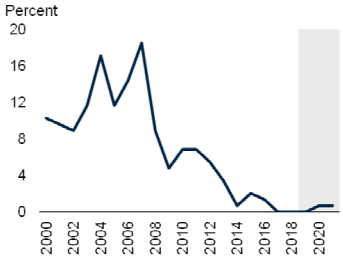
B. Per capita growth in EMDEs



C. Extreme poverty scenarios



D. Share of EMDEs with per capita growth at or above 8 percent per annum



Source: World Bank.
A. EAP = East Asia and Pacific, ECA = Europe and Central Asia, LAC = Latin America and the Caribbean, MNA = Middle East and North Africa, SAR = South Asia, SSA = Sub-Saharan Africa. Aggregate growth rates calculated using constant 2010 U.S. dollar GDP weights. Countries with a widening income gap are those with per capita GDP growth of at least 0.1 percentage point lower than advanced-economy per capita GDP growth.
B.-D. Shaded areas indicate forecasts.
B. Aggregate growth rates calculated using constant 2010 U.S. dollar GDP weights ("GDP-weighted") or number of extreme poor living at or below $1.90 a day ("poverty-weighted"). The poverty-weighted estimate of per capita GDP growth excludes countries for which poverty head counts are not available. Sample includes 104 EMDEs for poverty-weighted and 117 EMDEs for GDP-weighted per capita growth.
C. Data for 2016-18 are estimates. The blue line shows the poverty rate assuming that income per capita of the bottom 40 percent of the income distribution grows at the historical average from 2005-15; the red line shows this but assuming a rate of 8 percent per year. The yellow horizontal line indicates the 3 percent extreme poverty rate goal set for 2030. See World Bank (2018f) for details.
D. Share of EMDEs that reach or exceed 8 percent GDP per capita growth. Sample includes 146 EMDEs.
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Aggregate per capita income in countries with the largest numbers of extreme poor is expected to grow at a somewhat faster clip than that of other EMDEs over the forecast horizon (Figure 1.12.B). That pace will nevertheless remain well below what is needed to achieve poverty alleviation goals. To reduce global extreme poverty to 3 percent by 2030, income per capita growth in countries where extreme poverty concentrates would need to be sustained at about 8 percent per year (Special Focus 2.1; Figure 1.12.C). This is more than twice the rates projected over the next two years—and only a small and declining proportion of EMDEs have achieved such growth in any given year since the global financial crisis (Figure 1.12.D).

Risks to the outlook

Risks continue to be tilted to the downside. A further escalation in trade tensions and rising policy uncertainties could weigh on investment and contribute to financial market volatility. New financial stress episodes in EMDEs could be amplified by rising debt levels, corporate sector vulnerabilities, and increasing refinancing pressures. Sharper-than-expected slowdowns in major economies could have substantial spillover effects for EMDEs. These risks are compounded in some regions by the possibility of intensifying conflict and by the increased frequency of extreme weather events.

Baseline forecasts point to a deceleration of global growth from 3 percent in 2018 to 2.6 percent this year—0.3 percentage point below previous projections, amid a more broad-based slowdown in manufacturing activity and trade than previously anticipated. More accommodative monetary policy stances in major advanced economies, new fiscal stimulus measures in China, and the diminishing effect of financial pressures in some major EMDEs are assumed to help stabilize activity and prevent a further deterioration in global growth. On balance, global growth is predicted to edge up to a slightly weaker-than-expected 2.7 percent in 2020 and to 2.8 percent in 2021.

There is considerable uncertainty surrounding global growth projections, and risks to the global outlook continue to be firmly tilted to the downside (Figure 1.13.A). Intensifying policy and political uncertainty, including a further escalation of trade disputes between major economies, could weigh on sentiment and dampen investment and trade. Relative to the baseline assumption of no additional escalation going forward, a renewed deterioration in trade relations could therefore result in substantially lower global growth. The potentially large adverse effects associated with

such escalation highlight the opportunity costs of the absence of a comprehensive trade deal between the United States and China. A mutually beneficial resolution of trade disputes between the world's two largest economies would lead to a sustained dissipation of global policy uncertainty, support confidence and investment, and bolster the near- and long-term global growth outlook.

A renewed deterioration of EMDE financial market sentiment could be amplified by high levels of debt and spread through financial sector exposure to sovereign risk. A sharper-than-expected deceleration of activity in systemically large economies—such as China, the Euro Area, and the United States—could also have broad-ranging repercussions for EMDEs. The probability of growth in 2020 being at least 1 percentage-point below current projections is estimated at close to 20 percent (Figure 1.13.B). Such slowdown would be comparable to the 2001 global downturn.

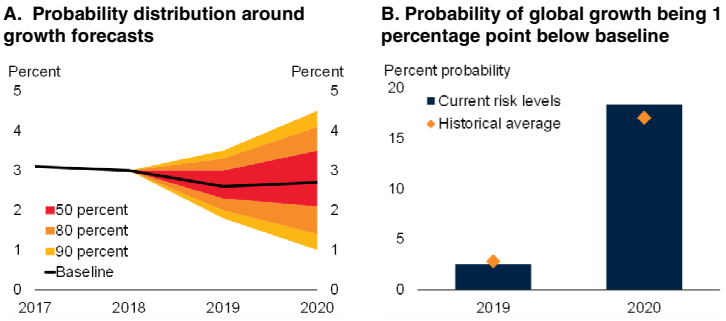
Renewed trade tensions and policy uncertainty

Rising policy uncertainty in major advanced economies and EMDEs has already contributed to weakening confidence and delayed investment plans (Figure 1.14.A). An intensification of such uncertainties—including a sharp escalation in trade tensions between the United States and China, a disorderly exit of the United Kingdom from the EU, and more fractious political landscapes after elections in major economies—could contribute to a continued deterioration in global activity, with particularly significant consequences for trade and investment. For instance, a sustained increase of 10 percent in an index of U.S. economic policy uncertainty could, after one year, reduce EMDE output growth by 0.2 percentage point and EMDE investment growth by 0.6 percentage point (World Bank 2017c).

Trade relations between the United States and several of its major trading partners remain fragile and could deteriorate further, leading to a proliferation of new tariffs and other trade barriers with broad-ranging consequences. An increase in U.S. tariffs on all remaining imports from China,

FIGURE 1.13 Balance of risks

The balance of risks to global growth remains tilted to the downside. The probability of global growth being 1 percentage point below forecast in 2020 is close to 20 percent.



Source: Bloomberg, World Bank.
A.B. The fan chart shows the forecast distribution of global growth using time-varying estimates of the standard deviation and skewness extracted from the forecast distribution of three underlying risk factors: oil price futures, the S&P 500 equity price futures, and term spread forecasts. Each of the risk factor's weight is derived from the model described in Ohnsorge, Stocker, and Some (2016). Values for 2019 are computed from the forecast distribution of 6-month-ahead oil price futures, S&P 500 equity price futures, and term spread forecasts. Values for 2020 are based on 18-month-ahead forecast distributions. Last observation is May 21, 2019.
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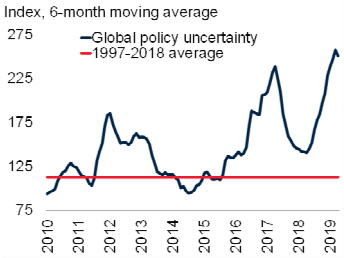
and retaliatory responses by China, would result in significant economic losses for exporters of the targeted products and lead to cascading trade costs to other sectors. While some countries could benefit from trade diversion in the short run, adverse effects from weakening growth and rising policy uncertainties involving the world's two largest economies would have predominantly negative repercussions (Freund et al. 2018). In addition, the risk of higher tariffs on U.S. imports of automobiles and parts remains elevated, and could cause severe disruptions to tightly integrated global value chains (GVCs; Figure 1.14.B).

The complex and discretionary nature of tariff measures and a lack of clarity about future trading rules could also be a notable barrier to firms' decisions to invest and export. In particular, U.S. policy uncertainty is found to significantly erode growth and investment prospects across EMDEs (Kose, Lakatos, et al. 2017). In the presence of GVCs, protectionist measures have widespread adverse implications not only on targeted sectors and countries but also on downstream industries and other trading partners (Bellora and Fontagne 2019; Blanchard, Bown, and Johnson 2016). If all proposed tariff increases were to be implemented, the average U.S. tariff rate would increase to levels not seen since the late 1960s and substantially

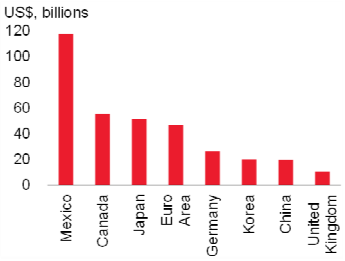
FIGURE 1.14 Risk of renewed trade tensions and policy uncertainty

Global policy uncertainty is close to record highs, reflecting increased risks of further escalation in trade tensions and rising political uncertainty. Additional U.S. tariff hikes, including in the automobile sector, could significantly disrupt tightly-integrated value chains and raise average U.S. tariffs substantially above those of most G20 countries. Amid increasingly divided political landscapes, elections in countries accounting for more than a third of global GDP could contribute to unpredictable policy changes.

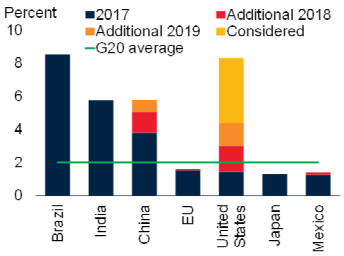
A. Global policy uncertainty



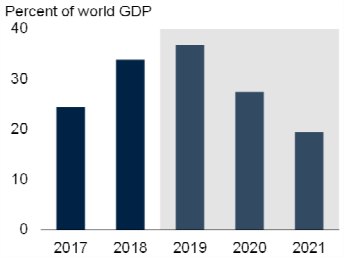
B. U.S. auto imports, by economy



C. Average import tariffs in G20 countries



D. Share of global GDP accounted for by countries with general elections



Source: Baker, Bloom, and Davis (2016); Election Guide; Haver Analytics; International Foundation for Electoral Systems; National Sources; Peterson Institute for International Economics; U.S. Census Bureau; World Bank.

A. The global policy uncertainty index is computed by Baker, Bloom, and Davis (2016), and is based on the frequency of words in domestic newspapers mentioning geopolitical tensions, including military, nuclear, war, and terrorism. Last observation is April 2019.

B. Data are as of May 23, 2019.

C. Blue bars are the trade-weighted averages for 2017 tariffs. "Considered" reflects announcements of possible tariffs as of May 23, 2019, including an additional 25 percent tariff on U.S. imports from China not subject to 2018 tariff hikes and on U.S. imports of motor vehicles and parts from non-North American trading partners.

D. Bars represent the share of global GDP accounted for by countries that held or are expected to hold general elections in the years 2017-21. Sample includes 33 advanced economies and 142 EMDEs. Share calculated using constant 2010 U.S. dollars GDP. Shaded area indicates forecasts.

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surpass the average tariff among G20 countries (Figure 1.14.C).

Intensifying trade tensions involving major economies could increase the likelihood of global escalation in protectionist measures. An escalation of tariffs up to legally allowed bound rates could translate into a decline in global trade flows amounting to 9 percent, similar to the drop observed during the global financial crisis (Kutlina-Dimitrova and Lakatos 2017; Devarajan et al. 2018). This could eventually jeopardize progress in international cooperation and undermine past gains from the multilateral trading system.

A no-deal Brexit from the EU could have a severe impact on the United Kingdom and, to a lesser extent, on its European trading partners, in the event of large disruptions and delays at border crossings (Crowley, Exton and Han 2019; Graziano, Handley, and Limão 2018). It could also be a source of financial stability risks if it leads to an abrupt interruption in financial relationships and cross-border financial flows (Bank of England 2018). While actions have been taken to mitigate some of these risks, including regulatory agreements to avoid disruption in the derivatives markets, significant financial market stress in a no-deal event is still possible (ECB 2018). In addition, the United Kingdom accounts for a large share of cross-border lending to some EMDEs, which could be negatively impacted by a sudden retrenchment.

More generally, increasingly divided political landscapes in key countries and rising support for more inward-looking policies could contribute to heightened policy uncertainty and geopolitical risks over time. Countries holding general or parliamentary elections this year account for 35 percent of global GDP (Figure 1.14.D). These include major advanced economies (all EU member states, Canada) and EMDEs (Argentina, India, Indonesia, South Africa).

Financial stress episodes

Renewed episodes of substantial financial market stress could have increasingly pronounced and widespread effects, in view of rising levels of indebtedness (Figure 1.15.A). Such episodes could be triggered or amplified by several factors.

First, an increase in corporate default rates amid slowing activity in major economies could lead to a rapid deterioration in financial market sentiment, a re-pricing of risks, and a spike in bond spreads for more vulnerable borrowers. The share of lower-rated corporate bond issuers has increased substantially in both advanced economies and EMDEs in recent years, indicating a drop in the quality of outstanding bond stocks

(Figure 1.15.B). A broad-based loss of investment-grade status could potentially trigger sudden pullbacks by investors (BIS 2019). Both corporate and sovereign borrowers could come under stress, especially given low interest coverage and large volumes of bond refinancing scheduled in coming years (Figure 1.15.C). A substantial re-escalation of trade tensions involving major economies could amplify this risk by dampening financial market sentiment, global trade, and investment prospects.

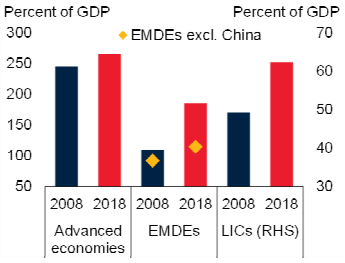
Second, shifting expectations about monetary policy across major economies could lead to disruptions in capital flows to EMDEs, particularly if accompanied by an appreciation of the U.S. dollar. This could be prompted, for instance, by markets repricing the possibility of additional U.S. interest hikes in the next couple of years, in contrast to current market expectations of interest rate cuts later this year and in 2020. While the risk of an abrupt increase in U.S. long-term yields has abated amid concerns about slowing activity, a faster-than-expected acceleration in U.S. wage growth or signs of an unexpected pickup in global growth could contribute to a sudden tightening of borrowing conditions. Reduced confidence in central banks' ability to deliver price stability, or perceived threats to their independence, could also contribute to greater financial and macroeconomic volatility (Berger, de Haan and Eijffinger 2001; Draghi 2018; Tucker 2018).

Third, large currency depreciations in EMDEs could amplify credit default risks. Although such events have become less frequent over time, they can still be triggered by shifts in U.S. monetary policy expectations, sharp commodity price movements, or concerns about debt sustainability or domestic policy uncertainties (Figure 1.15.D). Rising foreign ownership of local-currency bonds, and sizable shares of local-currency lending originating from foreign banks, have helped reduce immediate currency risks in some countries. However, foreign participation in local-currency debt markets can also amplify the transmission of external financing shocks to domestic borrowing conditions if liquidity dries up as investor risk sentiment deteriorates (Agur et al. 2018). A lack of central bank independence and rigid currency regimes also make it more

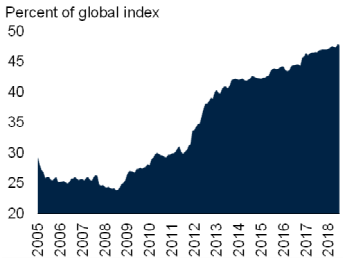
FIGURE 1.15 Risk of renewed financial stress

Elevated global debt levels and declining credit quality increase the likelihood of financial stress episodes in EMDEs, which could be amplified by mounting refinancing needs and the possibility of dislocating currency depreciations. Growing interconnections between financial sector and sovereign risks make banks in EMDEs increasingly vulnerable to distress of their sovereigns—and vice versa.

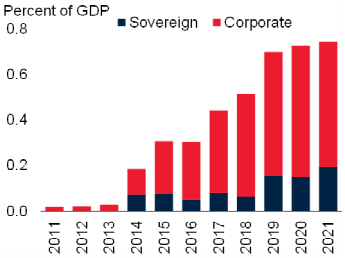
A. Credit to non-financial sectors



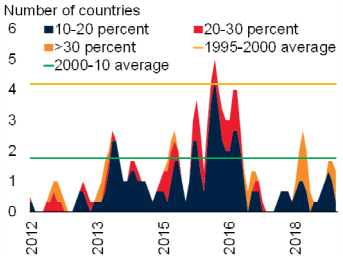
B. Share of global bonds rated BBB or below



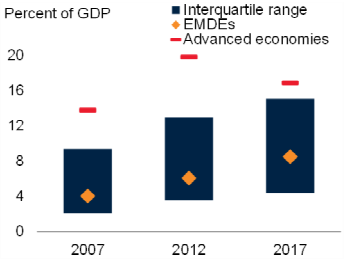
C. International bond redemptions in EMDEs



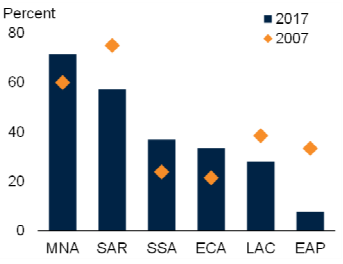
D. Number of countries with large currency depreciations



E. Bank claims on total government and public non-financial entities



F. Share of EMDEs with above-median government debt and bank claims on the government



Source: Bank for International Settlements; Dealogic; International Monetary Fund; Kose, Kurlat, et al. (2017); World Bank.

A. Aggregates are calculated using debt and GDP in U.S. dollars. Aggregates of advanced economies and EMDEs are based on 27 countries and 16 countries, respectively, and data for 2018 are for the third quarter. Data for 2018 in low-income countries (LICs) are for the latest available quarter and sample includes 22 LICs. Total credit is measured as total credit to general government and non-financial private sector for advanced economies and EMDEs and a sum of general government debt and domestic claims on the private sector for LICs.

B. Last observation is July 2018.

C. Sovereign bonds include central government and state and local authorities. Data are as of May 22, 2019.

D. Figure shows 3-month moving averages. Depreciations are defined as negative quarterly changes in the effective exchange rate. The sample is comprised of 138 EMDEs. Last observation is December 2018.

E. Data published in the October 2018 edition of the World Bank *Macro Financial Review*.

F. EAP = East Asia and Pacific, ECA = Europe and Central Asia, LAC = Latin America and the Caribbean, MNA = Middle East and North Africa, SAR = South Asia, SSA = Sub-Saharan Africa. Blue bars indicate the share of EMDEs within each region for which general government debt and total bank claims are simultaneously above the EMDE median of the respective indicators. The EMDE median statistic for 2007 and 2017 is 34.6 and 50.7 percent for general government debt and 4.1 and 8.5 percent for bank claims on government. Sample includes 147 EMDEs.

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difficult to adjust to sharp exchange rate movements, amplifying fluctuations in domestic prices and activity in the affected countries (Special Focus 1.2; Ha, Kose, and Ohnsorge 2019). Renewed financial stress in large EMDEs, such as Argentina or Turkey, could lead to significant contagion effects if accompanied by heightened investor risk aversion and portfolio relocations among broad asset classes.

Fourth, government guarantees to the financial system, alongside large bank holdings of government debt, can create self-reinforcing feedback effects between the banking sector and sovereign risks (Dell'Ariccia et al. 2018). This sovereign-bank nexus has become more pronounced in EMDEs since the global financial crisis (Figure 1.15.E). The share of countries with both elevated public debt levels and high banking sector exposure is particularly elevated in the Middle East and North Africa and South Asia (Figure 1.15.F). In Eastern Europe and Central Asia, as well as in East Asia and Pacific, a greater source of vulnerability is the level of private sector debt, and the risk that rising corporate defaults could weaken bank balance sheets. Public sector balance sheets would be eroded if the government were to support the banking sector—that is, if contingent liabilities become actual liabilities—in episodes of stress.

Sharper-than-expected slowdowns in major economies

Around 80 percent of advanced economies—including major European countries, Japan, and the United States—are expected to register slowing growth in 2019 (Figure 1.16.A). China's deceleration and rebalancing toward domestic consumption and services is also expected to continue. For all of these economies, however, downside risks have intensified.

In the Euro Area, the risk of a markedly sharper-than-expected slowdown has risen on the back of significant growth disappointments since mid-2018, decelerating global trade, and elevated policy uncertainty. A further deceleration could trigger renewed financial stress in more vulnerable countries, leading to slower investment, higher unemployment, and renewed concerns about banking sector health. Negative interest rate policies could weaken bank profitability over time and erode financial stability (Arteta et al. 2016).

In the United States, activity could be negatively affected by weaker-than-expected confidence and investment amid trade tensions with major trading partners. Deteriorating creditworthiness in the corporate sector could amplify negative shocks. A recession is unlikely in the short term, but the probability could increase as the effects of fiscal stimulus dissipate and trade policy uncertainty persists. Three of the last four U.S. recessions were triggered by financial shocks, which revealed underlying balance sheet weaknesses and led to a sudden retrenchment of activity, accentuated by the government's inability to agree on the implementation of countercyclical fiscal measures.

China faces both external risks associated with threats of rising U.S. tariffs and domestic risks related to high corporate indebtedness in sectors with deteriorating profitability. The total stock of non-financial-sector debt is above levels seen at the peak of previous credit booms in other major EMDEs. The materialization of these risks could have significant adverse repercussions on activity. Although the authorities hold policy levers to mitigate such repercussions in the near term, continued fiscal and monetary stimulus could become ineffective over time while adding further leverage to private and public sectors. Providing stimulus through highly indebted state-owned enterprises (SOEs) may eventually undermine economy-wide productivity growth.

A combined deterioration in the outlook for the United States, the Euro Area, and China—which together accounted for about 50 percent of global GDP and almost two-thirds of global growth in 2018—would have major spillover effects for EMDEs through trade, financial, commodity, and confidence channels (Figure 1.16.B). The growing use of GVCs could contribute to the propagation of shocks across countries (Duval et al. 2016). A 1-percentage-point growth shock for these three economies would curtail global growth by 1.7 percentage points and EMDE growth (excluding China) by 1.4 percentage points after one year (Figure 1.16.C).

A pronounced slowdown in the Euro Area would most severely affect countries in Central and Eastern Europe and North Africa, because of tight trade, remittance, and banking system linkages (World Bank 2016). Financial markets in Latin America could also be adversely affected by deleveraging and de-risking measures among weakened Euro Area banks. A substantial deceleration in China would lower commodity prices worldwide, with a widespread effect on commodity exporters (Figure 1.16.D). Exposure to risks in the United States is particularly pronounced for Latin America and the Caribbean, since the United States is the single largest export destination for more than half of the countries in the region. In addition, U.S. capital markets supply a substantial share of portfolio flows to many EMDEs and a drying up of these markets would cause equity values and exchange rates to weaken significantly.

Region-specific downside risks

In addition to global risks, a variety of region-specific risks could dampen growth (Box 1.3; Chapter 2). Many countries remain vulnerable to financial turmoil. Further declines in trade, whether caused by slowing manufacturing activity or increased trade barriers, would impact regions that are heavily invested in value chains, such as the manufacturing hubs in East Asia and Central Europe. A significant decline in commodity prices would weigh on activity in regions with a large number of commodity exporters, which account for half of the world's poor.

Renewed conflict in various parts of the world—the Korean Peninsula, the Middle East and North Africa, South Asia, the South China Sea, Sub-Saharan Africa, or Ukraine—could severely disrupt regional activity. Skirmishes between India and Pakistan in February are a reminder that latent geopolitical tensions can flare up at any time.

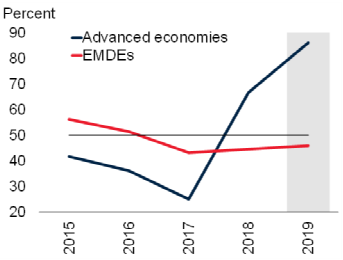
Climate change is contributing to a multitude of risks for more exposed EMDE regions (IPCC 2018). More extensive droughts and extreme heat are causing more frequent harvest failures and desertification. Rapidly spreading forest and grassland fires increasingly threaten built-up areas and resource-based industries. Cyclones of unprecedented power have already caused catastrophic floods in agricultural plains and heavily populated river deltas and mudslides in mountainous regions. Rising sea levels threaten low-lying islands and coastal regions.

Due to their location and topography, small island developing states are particularly vulnerable to extreme weather events, which is exacerbated by limited infrastructure and a lack of financial resources (World Bank 2017d). Countries with large populations working on agricultural lands with difficult terrain, poor soil quality, or limited rainfall, including many in Sub-Saharan Africa

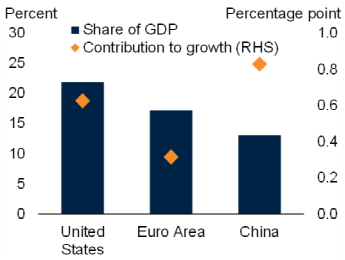
FIGURE 1.16 Risk of sharp slowdowns in major economies

A sharper-than-expected downturn in the United States, Euro Area, or China would have major spillover effects, with a slowdown in China having a disproportionate impact on commodity exporters.

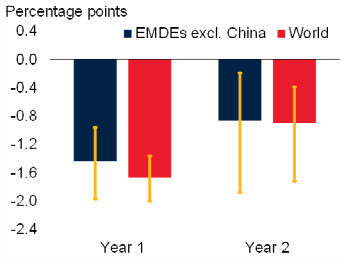
A. Share of countries experiencing growth slowdowns



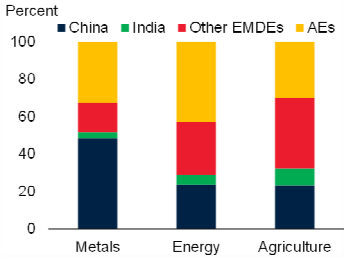
B. Share of global output and growth attributable to major economies in 2018



C. Impact of 1 percentage point growth slowdown in the United States, Euro Area, and China



D. Composition of global commodity demand



Source: World Bank.

A. Growth slowdowns are declines of at least 0.1 percentage point change in growth. Sample includes 36 advanced economies and 146 EMDEs.

B. Figure is calculated using constant 2010 U.S. dollar GDP. Major economies includes China, the Euro Area, and the United States

C. Bars are the impulse response to a 1 percentage point decline in the United States, Euro Area, and China. Yellow error lines are the 16-84 percent confidence intervals. Based on the vector autoregression model presented in World Bank (2016). The sample includes 22 advanced economies and 19 EMDEs.

D. AEs = advanced economies. Figure shows 2010-17 average. Sample for energy and metals includes 18 advanced economies and 33 "other" EMDEs. Agriculture includes 14 advanced economies and 117 "other" EMDEs.

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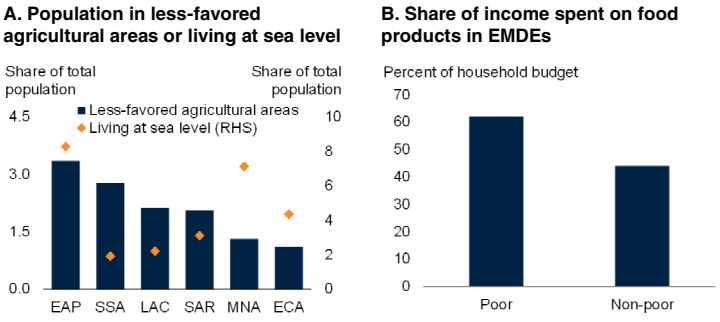
FIGURE 1.17 Climate risks and poverty

In several EMDE regions, populations in vulnerable rural and sea level areas are particularly exposed to climate risks. The extreme poor are more susceptible to food price shocks.



Source: Barbier and Hochard (2018); Laborde, Lakatos, and Martin (2019); World Bank.
A. EAP = East Asia and Pacific, ECA = Europe and Central Asia, LAC = Latin America and the Caribbean, MNA = Middle East and North Africa, SAR = South Asia, SSA = Sub-Saharan Africa. Less-favored agricultural areas are agricultural lands constrained by difficult terrain, poor soil quality, limited rainfall, or with limited access to markets. "Sea level" identifies areas where elevation is below 5 meters. Data are from 2010.
B. Simple averages across 31 countries. For further details, refer to Laborde, Lakatos, and Martin (2019).
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and South Asia, face growing risks from changing weather patterns (Figure 1.17.A). Poor people are disproportionally affected by climate change as they tend to live in riskier areas such as lower terrain in flood plain areas or on steep, eroded, and unstable hillsides. They also depend heavily on agriculture for income, and lack the savings and access to borrowing that can help them cope with disasters (Hallegate et al. 2016; World Bank 2019g). The poor also spend higher shares of their income on food, making them more vulnerable to food price spikes that follow local harvest failures (Figure 1.17.B; Laborde, Lakatos, and Martin 2019).

Policy challenges

Challenges in advanced economies

Many advanced economies have limited fiscal or monetary policy space to respond to a severe downturn. Low policy rates leave little room for further conventional monetary loosening. Elevated debt tends to limit the magnitude and effectiveness of fiscal stimulus. Coordinated policy action may be needed in the event of a severe slowdown. Policies to boost investment and productivity would bolster long-term growth prospects, and over time help restore space for effective macroeconomic policy.

Monetary and financial policies

With the notable exception of the United States, the room for conventional monetary policy easing is limited in most advanced economies, as policy rates remain at or near zero (Figure 1.18.A). Indeed, central banks have responded to recent weakness in growth principally by providing additional forward guidance, making inexpensive credit available to banks, and adjusting their balance sheets.

After the financial crisis, such unconventional policies were a necessary complement to central banks' conventional policy rate cuts amid weak aggregate demand and declining neutral interest rates (Christensen and Rudebusch 2019). Now, given the lack of conventional policy space in most advanced economies, central banks may again be forced to respond to a negative shock mostly or entirely with unconventional policies. It is not clear that they will be as effective as conventional policies in such a scenario. There is evidence of decreasing returns to scale in quantitative easing (Figure 1.18.B; Reza, Santor, and Suchanek 2015). Over time, negative interest rates can also pose problems for bank profitability, and hence for the availability of bank credit (Arteta et al. 2016). The effectiveness of forward guidance may be significantly reduced in the presence of borrowing constraints and uninsurable risks (McKay, Nakamura, and Steinsson 2016). Furthermore, any perceived loss of central bank independence could substantially reduce the effectiveness of monetary policy. Maintaining clear and credible monetary policy is key for macroeconomic and financial stability.

Protracted periods of low interest rates could encourage excessive risk taking which, combined with declining creditworthiness, may result in financial instability (Figure 1.18.C). Rigorous macroprudential monitoring and regulation is essential to prevent such outcomes.

Fiscal policy

Even though public debt is high and rising in most advanced economies, many governments can borrow money at near-zero or negative rates. Persistently low borrowing costs provide credit-

worthy countries with additional fiscal space—they can sustain small deficits without increasing debt-to-GDP ratios (Figure 1.18.D; Blanchard 2019; Rachel and Summers 2019; Kose, Kurlat, et al. 2017).

Fiscal space may, however, be eroded by a sudden fall in nominal growth or rise in borrowing costs. Moreover, even in the present low-interest-rate environment, many advanced economies have deficits that would put the ratio of government debt to GDP on a persistent upward path, a trend that is exacerbated by weak potential growth.

The debt-to-GDP ratio that is sustainable varies considerably by country and over time. A persistently rising debt ratio exposes public finances to the risk of a sharp rise in borrowing costs. It also reduces policymakers' ability to respond to a slowdown with deficit spending, both because there is less room for additional borrowing and because stimulus tends to be less effective when countries have weak fiscal positions (Huidrom et al. 2019).

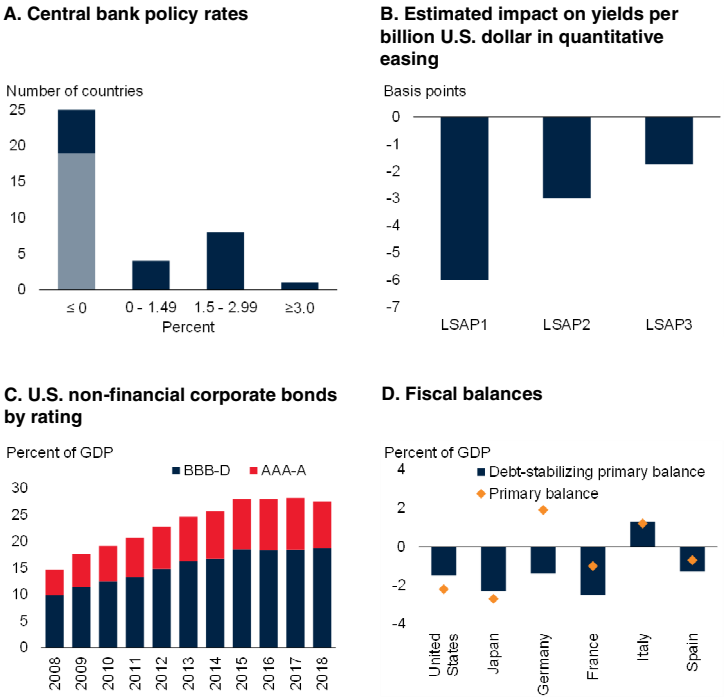
A severe slowdown in activity may require a strong, timely, and well-coordinated response, reminiscent to that undertaken during the global financial crisis. Simultaneous fiscal expansion can speed the recovery from crisis, as the positive impact of fiscal stimulus in one country spills over into its neighbors, thus magnifying the impact of limited fiscal space.

Structural policies

Expectations for long-term growth in advanced economies have fallen sharply in recent years due to a combination of demographic headwinds, weak productivity, and slowing investment (Figure 1.19.A; World Bank 2018c, 2018b). On the fiscal front, the prospect of slower growth implies less fiscal space to respond to shocks since government revenues will be reduced, and the primary balance needed to stabilize debt will be increased (Figure 1.19.B). For monetary policy, weak long-term investment growth lowers the underlying demand for funds, reducing equilibrium interest rates and providing less space for conventional monetary policy to respond to an economic slowdown (Laubach and Williams 2016).

FIGURE 1.18 Monetary and fiscal policies in advanced economies

Policy rates in most advanced economies remain at or near zero, limiting the conventional response to a downturn. Unconventional responses may exhibit diminishing returns. A rising share of lower-rated corporate debt calls for macroprudential vigilance. Many economies have deficits well in excess of debt-stabilizing levels.



Source: Bloomberg; European Central Bank; Haver Analytics; Krishnamurthy and Vissing-Jorgensen (2013); Kose, Kurlat, et al. (2017, data available at http://www.worldbank.org/en/research/brief/fiscal-space); National Sources; World Bank.

A. Sample includes 37 advanced economies. Light blue area indicates Euro Area countries. Last observation is April 2019.

B. Estimates from Krishnamurthy and Vissing-Jorgensen (2013). LSAP = Large-Scale Asset Purchase. LSAP1: December 2008-March 2010; LSAP2: November 2010-June 2011; LSAP3 = Maturity Extension Program (MEP): September 2011–December 2012.

C. Data are calculated using the ICE (Intercontinental Exchange) Merrill Lynch investment-grade and high-yield bond indexes, excluding cash and the issues of financial firms, as of the last trading day of December for each year shown. Face values as percentage of U.S. nominal GDP.

D. The debt-stabilizing primary balance is the primary balance needed to stabilize debt at its current level and is calculated as $\left(\frac{1+\gamma}{i-\gamma}\right)d^*$, where i is the nominal long-term interest rate, γ is nominal GDP growth, and d^* is the target debt ratio in percent of GDP. The nominal long-term interest rate is the country ten-year treasury bond yield at the cut-off date; nominal GDP growth is the seasonally adjusted year-on-year percentage change of GDP in local currency in 2018; the target debt ratio is the 2018 level of debt for each country.

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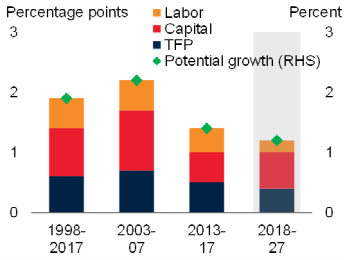
Governments can promote stronger long-term activity, and restore policy space, by pursuing growth-enhancing structural reforms that improve the business climate, build physical and human capital, promote labor market flexibility, encourage labor force participation, and foster the adoption of new technologies. A free, fair, and rules-based global trade system boosts global potential by allowing capital to flow to its most productive locale, lowering costs for both

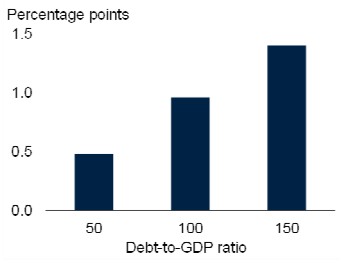
FIGURE 1.19 Structural policies in advanced economies

Declining labor force growth and weak productivity are reducing long-term growth expectations. Weak growth magnifies the burden of previously issued debt, eroding fiscal space.

A. Potential growth in advanced economies



B. Deterioration in debt-stabilizing primary balance caused by a 1 percentage point fall in growth



Source: Haver Analytics; Kose, Kurlat, et al. (2017, data available at http://www.worldbank.org/en/research/brief/fiscal-space); Organisation for Economic Co-operation and Development; World Bank.
A. TFP = total factor productivity growth. Figure shows potential growth estimates based on production function approach. For further details on potential growth estimates, refer to the January 2018 edition of the *Global Economic Prospects* report. Aggregates calculated using constant 2010 U.S. dollar GDP weights. Sample includes 30 advanced economies. Shaded area indicates forecasts.
B. The debt-stabilizing primary balance is the primary balance needed to stabilize debt at its current level and is calculated as $(\frac{i-\gamma}{1+\gamma})\, d^*$, where i is the nominal long-term interest rate, γ is nominal GDP growth, and d^* is the target debt ratio in percent of GDP. Calculations assume a country with 2 percent interest rates and nominal growth falling from 4 to 3 percent.

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businesses and consumers. By allowing economies to produce the goods and services in which they have a comparative advantage, such a system encourages the efficient use of resources and the growth of real incomes.

Challenges in emerging market and developing economies

EMDEs need to reinforce macroeconomic frameworks to improve resilience to shocks, particularly in countries with high debt levels. Given limited fiscal space and large investment needs to meet critical development goals, policymakers need to ensure that public spending is cost effective and growth enhancing and that policy environments are conducive to private-sector-led solutions. Structural reforms aimed at bolstering the business climate could also significantly bolster prospects. Improving access to reliable and affordable infrastructure, leveraging productivity-enhancing technologies, and buttressing institutional quality can help remove key bottlenecks to activity. Building resilience to extreme weather events, and boosting agricultural productivity is also a key priority in countries with large and poor rural populations. China's main policy challenges are to manage disruptions associated with heightened trade tensions and to gradually shift to a more balanced and sustainable growth path and support an orderly deleveraging process.

Policy challenges in China

In response to trade tensions with the United States, as well as softening exports and domestic demand, authorities have provided monetary and fiscal support, while stepping up structural reform efforts. Monetary policy loosening has mainly taken the form of cuts to bank reserve requirements. On the fiscal front, the authorities have reduced value added and social security tax rates, and boosted public investment spending by increasing the ability of local governments to issue bonds. The business environment is likely to benefit from new laws protecting foreign investors and strengthening intellectual property rights. The authorities' commitment to macroeconomic stability and structural reforms was reaffirmed in March (SCPRC 2019).

China's immediate policy challenge is to manage disruptions caused by trade tensions with the United States without exacerbating domestic vulnerabilities. In the longer term, the country's key challenge is to continue its gradual shift to more balanced growth, while reducing the financial stability risks stemming from high levels of corporate debt (World Bank 2019e). Continued reforms toward more sustainable growth need to be combined with efforts to improve the business environment, support innovation, strengthen intellectual property rights, enhance competition and financial discipline, reduce barriers to entry, boost productivity, and foster household consumption (World Bank 2018g). These reforms would also contribute to achieving a comprehensive resolution of trade disputes with the United States and bolster China's growth prospects.

The opening of China's financial system to international investors—as illustrated by the country's inclusion in various global bond and equity benchmark indexes—will require prudent management. Slowing growth in the working-age population is becoming an increasing drag on

long-term growth; however, this could be offset by productivity-enhancing investments in health, education, and research and development (World Bank 2018c).

EMDE monetary and financial policies

The waning impact of previous currency depreciations and of the 2017-18 rebound in energy prices has helped tame inflation in early 2019 (Figure 1.20.A). Monetary policy tightening has, therefore, paused in many EMDEs, and some have eased their policy stance (Figure 1.20.B). However, underlying inflationary pressures are still present in many countries and recent oil price increases are expected to add to these pressures. In addition, while external financing conditions have eased somewhat, the currently benign market sentiment could change abruptly. This could reignite short-term capital outflows and force procyclical monetary policy tightening.

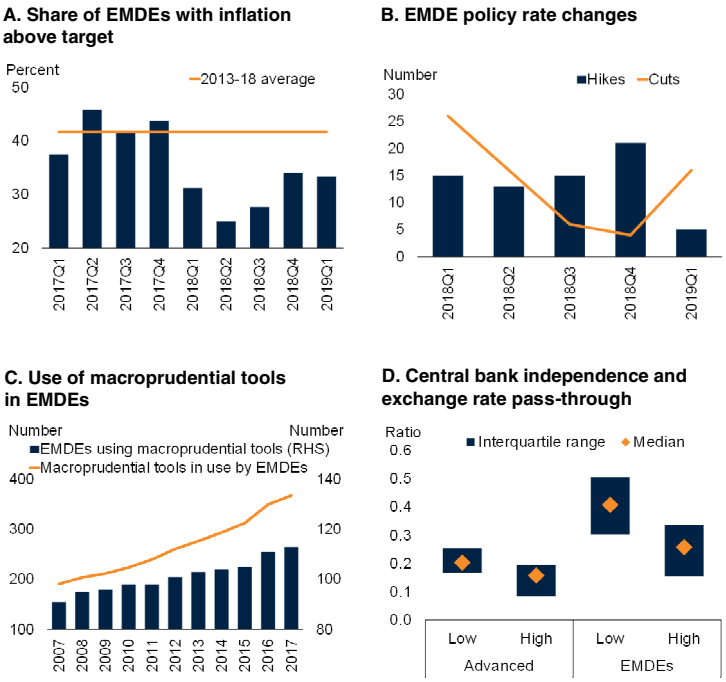
The most vulnerable EMDEs tend to be highly indebted, to have borrowed extensively in foreign currencies, or to rely on short-term capital inflows to finance their current accounts. Sharp depreciations that accompany short-term capital outflows are often contractionary, particularly in countries with elevated foreign-currency-denominated debt, as they both increase debt burdens and reduce the value of collateral on corporate balance sheets (Korinek 2018; Serena and Sousa 2018). The adverse impact of these disruptions can be amplified further by tight linkages between sovereign and private sector risks.

Central banks and regulators need to bolster policy frameworks in order to confront future shocks, particularly in countries where rising public and private debt-to-GDP ratios are increasing exposure to currency, interest rates, or debt-rollover risks. The resilience of banking and corporate sectors can be enhanced by implementing macroprudential policies that prevent the buildup of systemic risk. Since the global financial crisis, EMDEs have significantly increased the number and coverage of macroprudential measures, such as countercyclical capital buffers and limits on foreign-currency borrowing (Figure 1.20.C; Cerutti, Claessens, and Laeven 2017). Shoring up central bank independence and transparency could also help boost confidence and enhance the policy room to maneuver. This can be particularly effective in limiting the impact of currency depreciations on inflation (Figure 1.20.D; Carrière -Swallow et al. 2017; Eichler and Littke 2018; Special Focus 1.2). In turn, this reinforces the shock-absorbing capacity of market-driven exchange rate movements.

In LICs, monetary policy transmission channels are often weaker than in other EMDEs as financial markets are less deep. This underscores the need

FIGURE 1.20 EMDE monetary policy

Moderating inflation in EMDEs led some central banks to ease policy rates in the first half of 2019. Since the global financial crisis, there has been a substantial increase in the number and coverage of macroprudential measures across EMDEs. Greater central bank independence and transparency would help reduce the impact of currency movements on domestic inflation.



Source: Cerutti, Claessens, and Laeven (2018); Haver Analytics; World Bank.

A. The 2013-18 average is 41.7 percent. Last observation is 2019Q1, which includes available data through May 22, 2019. Unbalanced sample includes 48 EMDEs with announced inflation targets.

B. Unbalanced sample includes 70 EMDEs and excludes Argentina and Venezuela. Last observation is 2019Q1, which reflects available data up to May 22, 2019.

C. Data is based on the 2018 update of Cerutti, Claessens, and Laeven (2017). Sample includes 155 EMDEs.

D. Exchange rate pass-through after one year driven by a monetary policy shock. Estimated from factor-augmented vector autoregression models for 26 EMDEs over 1998-2017. A positive pass-through means that a currency depreciation associated with an easing of monetary policy leading to higher inflation after one year. Bars show the interquartile range and markers represent the median across countries. The central bank independence index is computed by Dincer and Eichengreen (2014). Low and high central bank independence are defined as below or above the sample average.

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for LIC central banks to provide a credible anchor in order to maintain price stability (Ha, Kose, and Ohnsorge 2019).

EMDE fiscal policy

Fiscal deficits and debt levels are rising in many EMDEs, increasing their vulnerability to tighter financing conditions and potentially constraining their capacity to implement countercyclical fiscal policy and growth-enhancing investments. Generally benign external financing conditions in recent years have allowed EMDE sovereigns and firms to notably increase the amount of debt issued on international bond markets (Figure 1.21.A; Fuertes and Serena 2018; Serena and Moreno 2016). However, rising debt is often associated with growing external vulnerabilities—a majority of countries that recently experienced pressures had deficits in excess of 4 percent of GDP (Figure 1.21.B).

Looking forward, EMDEs need to strike a balance between taking advantage of current low interest rates and the potentially adverse consequences of excessive debt accumulation (Box 1.1). Countries with sound fiscal positions and with fiscal frameworks that help ensure long-term sustainability can borrow at low interest rates to support growth-enhancing investments. However, countries with constrained fiscal positions should prioritize measures to reduce fiscal deficits, lengthen the maturity of existing debt, improve the quality of spending, and raise tax collection and compliance, particularly in LICs (World Bank 2019a).

In countries where sovereign default risks are high, undertaking fiscal consolidation to address long-term debt sustainability can help restore market confidence, and increase the space for future policy actions (Figure 1.21.C; Ilzetzki, Mendoza, and Végh. 2013; Aizenman et al. 2019). Just as stronger bank balance sheets reduce the risk of financial sector problems affecting the sovereign, a stronger government balance sheet can help reduce the risk that domestic banks are affected by sovereign distress.

While restoring fiscal space is an important priority, EMDE governments can minimize the negative consequences of tighter budgets by preserving growth-enhancing spending and implementing tax reforms that support investment and revenue mobilization (Ramey 2019). Such reforms may include broadening the tax base, eliminating loopholes and unnecessary preferences (for example, avoiding base erosion and profit shifting), and strengthening tax administration and collection to reduce avoidance or evasion (OECD 2017). Improving the effectiveness and efficiency of public spending can help governments provide important services without sacrificing fiscal space (Herrera and Ouedraogo 2018).

Restoring fiscal space ensures that EMDE policymakers are able to act should downside risks materialize. Government stimulus tends to elicit a weaker demand response when fiscal space is narrow and government debt is elevated (Figure 1.21.D; Brinca et al. 2016; Hagedorn, Manovskii, Mitman 2019; Huidrom et al. 2019). The introduction or improvement of fiscal stabilizers can also help smooth the business cycle (Amra, Hanusch, and Jooste 2019).

EMDE structural policies

Unless countered by comprehensive structural reforms, adverse demographic trends in an increasing number of countries, and weak productivity growth, are likely to result in a further deterioration in EMDE growth potential over the next decade (Figure 1.22.A). Weakening external demand from major economies and elevated trade policy uncertainty also highlight the need to address the most pressing impediments to domestic and regional growth and to renew commitments to trade liberalization. An improved multilateral rules-based trading system remains the first line of defense against protectionist tendencies and could yield previously untapped development opportunities for many EMDEs.

The implementation of structural reforms to improve the business climate and foster private investment and job creation would substantially bolster the growth outlook. This is particularly important given current fiscal constraints and large investment needs (Special Focus 1.1). Estimates of

the infrastructure spending required to meet the Sustainable Development Goals by 2030 range between 4.5 to 8.2 percent of EMDE GDP, depending on policy choices and the quality and quantity of infrastructure services (Rozenberg and Fay 2019). Business climates and institutions can be strengthened to support productivity and unlock private investments to meet future needs.

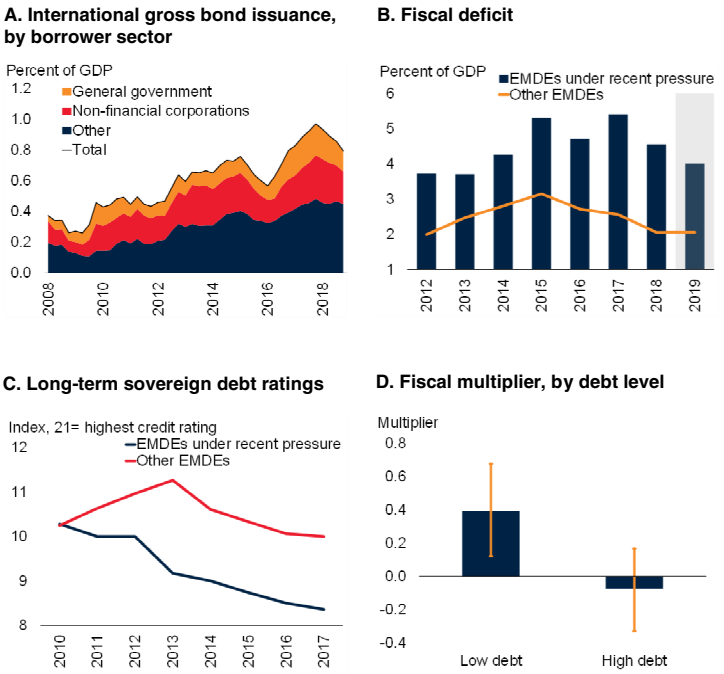
Key priorities include increasing access to reliable and affordable electricity, improving transport services, leveraging digital technologies, and improving business climates. Raising agricultural productivity could substantially boost development opportunities in countries with large rural populations, as well as increase the resilience of the rural sector to extreme weather events. Effective social safety nets and active labor market policies are also key to manage economic, social, and environmental risks.

Access to electricity. Limited access to electricity is a drag on economic activity in many EMDEs—particularly in LICs, as electricity infrastructure is either inadequate or plagued by frequent outages (Andersen and Dalgaard 2013; Blimpo and Cosgrove-Davies 2019; Special Focus 2.1). Policymakers in the affected countries should prioritize critical investment to ensure reliable, cost-effective, and sustainable power generation. Policy actions need to achieve both access to affordable electricity for the poor, as well as adequate profitability for power utilities. Such reforms include reviewing costly and regressive energy subsidies, minimizing losses in transmission and distribution, and ensuring payment of electricity bills (Kojima and Trimble 2016). Small-grid solutions and renewable energy may also expand access to electricity (World Bank 2018h). Moreover, operation and maintenance—an often-neglected component of effective power generation—need to be budgeted with a reliable source of funding (Rozenberg and Fay 2019).

Logistics and transportation. Inefficient logistics and inadequate transport infrastructure are key growth bottlenecks in many EMDEs, raising the cost of doing business and reducing the potential for domestic and international integration. Reform priorities include the removal of regulatory barriers such as impediments to entry in trucking, brokerage, terminal and warehousing operations; as well as greater reliance on market mechanisms and private sector participation (World Bank 2018i). Mobility and market access can also be bolstered by prioritizing cost-effective transport infrastructures. Appropriate land-use planning and urbanization policies can substantially reduce the cost of meeting transport needs, while minimizing carbon footprints (Rozenberg and Fay 2019; Figure 1.22.B).

FIGURE 1.21 EMDE fiscal policy

Low borrowing costs and ample availability of credit have allowed governments to borrow heavily on international markets. Fiscal deficits are declining, but persist at elevated levels in many countries, especially those that have recently faced financial pressures. Government stimulus tends to be less effective when debt is high.



Source: Bank for International Settlements; Huidrom et al. (2019); International Monetary Fund; J.P. Morgan; Kose, Kurlat, et al. (2017, data available at http://www.worldbank.org/en/research/brief/fiscal-space); World Bank.

A. Figure shows 4-quarter moving averages of gross-bond issuance. "Other" includes central banks and public and private financial institutions. Last observation is 2018Q4.

B. Shaded area indicates forecasts.

B.C. EMDEs under recent pressure include: a) countries that have had an increase in their J.P. Morgan EMBI credit spread of at least one standard deviation above the 2010-19 average at any time since April 2018 (Argentina, Brazil, Egypt, Gabon, Jordan, Lebanon, Mexico, Nigeria, South Africa, Sri Lanka, Tunisia, Turkey); or b) countries that have been subject to recent sanctions (Iran, Russia).

C. Sovereign ratings are converted to a numerical scale ranking from 1 to 21, as estimated by Kose, Kurlat, et al. (2017). A higher ranking indicates a better rating (in other words, less likely to have a sovereign default episode).

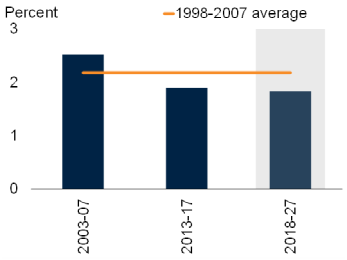
D. Figure shows fiscal multipliers 2 years from impact based on estimates from the IPVAR model of Huidrom et al. (2019). An economy is considered to have low debt when government debt is below 40 percent of GDP and high debt when it exceeds 60 percent of GDP. Orange lines represent 16-84 percent confidence bands.

Click here to download data and charts.

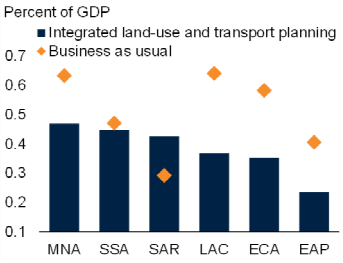
FIGURE 1.22 EMDE structural policies

Productivity growth is lackluster in EMDEs. Investment needs in transport are large but costs can be reduced with appropriate land-use planning in most regions. Upgrading economic complexity and government effectiveness closer to advanced-economy levels could yield large growth dividends, particularly in Sub-Saharan Africa. Weak governance and unfavorable business climates are also associated with significantly higher poverty rates, highlighting the importance of structural reforms that bolster the business climate in EMDEs.

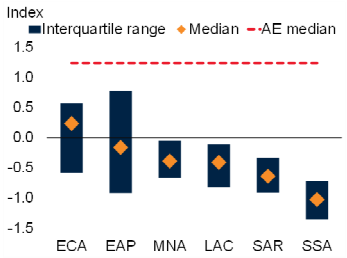
A. Total factor productivity growth in EMDEs



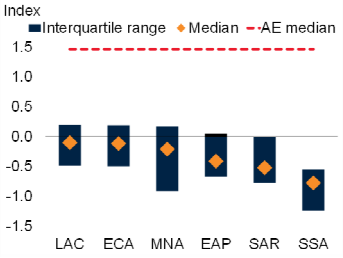
B. Investment needs in urban transport to meet Sustainable Development Goals



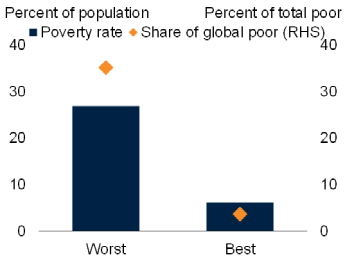
C. Economic Complexity Index, 2014-16



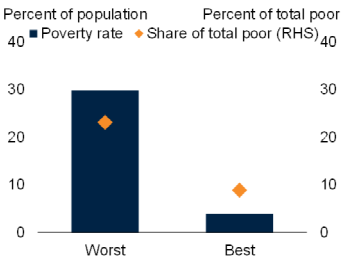
D. Government effectiveness, 2014-16



E. Poverty, by regulatory quality



F. Poverty, by Ease of Doing Business



Source: Observatory of Economic Complexity, Penn World Tables, Rozenberg and Fay (2019), World Bank.

Note: TFP = Total factor productivity. AE = Advanced economies, EAP = East Asia and Pacific, ECA = Europe and Central Asia, LAC = Latin America and the Caribbean, MNA = Middle East and North Africa, SAR = South Asia, and SSA = Sub-Saharan Africa.

A. Shaded area indicates forecasts. GDP-weighted averages of production function-based potential TFP growth estimates. Sample includes 50 EMDEs.

B. Figure shows estimates from Rozenberg and Fay (2019). Data cover the years 2015 to 2030.

C. The Economic Complexity Index (ECI) measures the relative knowledge intensity of exports. Higher values indicate higher degree of economic complexity. Sample includes 96 EMDEs and 31 AEs.

D. The indicator reflects the perceptions of the quality of public services, the quality of civil service and the degree of its independence from political pressures, the quality of policy formulation and implementation, and the credibility of the government's commitment to such policies. Higher values indicate better quality. Sample includes 150 EMDEs and 36 AEs.

E. The poverty rate is an unweighted average in each group. "Best" indicates quartile of EMDEs with the strongest regulatory quality (based on data for year with latest poverty data). "Worst" indicates quartile of EMDEs with the weakest regulatory quality. The back data for regulatory quality has been taken from the World Governance Indicators. The data is for 2017.

F. The poverty rate is an unweighted average in each group. "Best" indicates quartile of EMDEs with the highest 2019 Ease of Doing Business score (above 67.5). "Worst" indicates quartile of EMDEs with the lowest 2019 Ease of Doing Business score (below 51.6).

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Improved cross-border connectivity can also help foster intraregional trade and diversification, as well as encourage higher domestic value-added content in production. This may particularly help Sub-Saharan Africa—which, together with South Asia, has considerably lower export complexity than other EMDE regions and significantly higher intraregional trade costs (Figure 1.22.C; UNECA 2018).

Digital technologies. More widespread adoption of digital technologies, including in the delivery of financial and public sector services, could further boost productivity by helping spread innovation and improving both private sector and government efficiency (Baldwin 2019). In countries with large informal sectors, widespread adoption of these digital technologies could help expand tax bases through the fiscalization of informal sector transactions. New technologies are more likely to be adopted successfully if policies are in place to mitigate the costs of adjustment for both workers and firms, and if market failures are addressed (World Bank 2019h). Policy measures that prioritize investment in human capital are needed to ensure that digital technologies promote inclusive growth. Digital technologies are also expected to further contribute to the reduction of trade costs and an increase in trade flows (WTO 2018). However, the spread of digital technologies will also likely affect the composition of trade by increasing the services value-added component, changing patterns of comparative advantage, and affecting the complexity and length of global value chains.

Governance and business climate. Better institutional quality—such as control of corruption and rent-seeking, fair application of the rule of law, protection of property rights, and political stability—is associated with more innovation, increased financial access, and stronger investment growth (Berkowitz, Lin, and Ma 2015). Governance reforms can lead to sizable productivity gains, particularly in countries furthest away from best practices, many of which are in Sub-Saharan Africa (Bhattacharyya 2009; Cusolito and Maloney 2018; Acemoglu, Johnson, and Robinson 2005; Figure 1.22.D). Improving the business climate by simplifying tax and

regulatory requirements and ensuring clarity and predictability for investors is another effective way to support private investment and productivity. Better governance and business climates can also help reduce the likelihood of corruption, informality, and extreme poverty (Demenet et al. 2016; Djankov et al. 2018; Lawless 2013; Paunov 2016; Figures 1.22.E and F).

Agricultural productivity, climate risks, and poverty. The effects of climate change are becoming increasingly visible. The poor are disproportionally affected by climate risks as they tend to live in more vulnerable areas, depend on income sources such as agriculture that are often susceptible to climate shocks, and lack the savings and access to borrowing that can help them cope with natural disasters (World Bank 2019g). Many EMDEs in Sub-Saharan Africa and South Asia have large agricultural sectors that are subject to extreme weather events and other environmental stresses. Agriculture accounts for at least a third of GDP in most LICs, and climate risks are presenting severe challenges in many of them (Special Focus 2.1).

Productivity-enhancing measures in the agricultural sector—including improved irrigation, better access to markets, effective use of fertilizers and new technologies—could benefit the two-thirds of the global poor who earn their livelihood from farming (World Bank Forthcoming). Improved institutions and policy buffers can enhance resilience to climate change, as they provide the resources needed to support victims of extreme events. Investment in climate-smart infrastructure, combined with appropriate land-use planning, can help mitigate those risks. Effective social safety nets and productive inclusion programs also have an important role to play in protecting the most vulnerable, acting as a countercyclical buffer during economic downturns, and facilitating transitions to productive employment.

TABLE 1.2 Emerging market and developing economies[1]

Commodity exporters[2]		Commodity importers[3]	
Albania*	Madagascar	Afghanistan	Panama
Algeria*	Malawi	Antigua and Barbuda	Philippines
Angola*	Malaysia*	Bahamas, The	Poland
Argentina	Mali	Bangladesh	Romania
Armenia	Mauritania	Barbados	Samoa
Azerbaijan*	Mongolia	Belarus	Serbia
Bahrain*	Morocco	Bhutan	Seychelles
Belize	Mozambique	Bosnia and Herzegovina	Solomon Islands
Benin	Myanmar*	Bulgaria	Sri Lanka
Bolivia*	Namibia	Cabo Verde	St. Kitts and Nevis
Botswana	Nicaragua	Cambodia	St. Lucia
Brazil	Niger	China	St. Vincent and the Grenadines
Burkina Faso	Nigeria*	Comoros	Thailand
Burundi	Oman*	Croatia	Tonga
Cameroon*	Papua New Guinea	Djibouti	Tunisia
Chad*	Paraguay	Dominica	Turkey
Chile	Peru	Dominican Republic	Tuvalu
Colombia*	Qatar*	Egypt	Vanuatu
Congo, Dem. Rep.	Russia*	El Salvador	Vietnam
Congo, Rep.*	Rwanda	Eritrea	
Costa Rica	Saudi Arabia*	Eswatini	
Côte d'Ivoire	Senegal	Fiji	
Ecuador*	Sierra Leone	Georgia	
Equatorial Guinea*	South Africa	Grenada	
Ethiopia	Sudan*	Haiti	
Gabon*	Suriname	Hungary	
Gambia, The	Tajikistan	India	
Ghana*	Tanzania	Jamaica	
Guatemala	Timor-Leste*	Jordan	
Guinea	Togo	Kiribati	
Guinea-Bissau	Trinidad and Tobago*	Lebanon	
Guyana	Turkmenistan*	Lesotho	
Honduras	Uganda	Maldives	
Indonesia*	Ukraine	Marshall Islands	
Iran*	United Arab Emirates*	Mauritius	
Iraq*	Uruguay	Mexico	
Kazakhstan*	Uzbekistan	Micronesia, Fed. Sts.	
Kenya	West Bank and Gaza	Moldova, Rep.	
Kosovo	Zambia	Montenegro	
Kuwait*	Zimbabwe	Nepal	
Kyrgyz Republic		North Macedonia	
Lao PDR		Pakistan	
Liberia		Palau	

* Energy exporters.

1. Emerging market and developing economies (EMDEs) include all those that are not classified as advanced economies and for which a forecast is published for this report. Dependent territories are excluded. Advanced economies include Australia; Austria; Belgium; Canada; Cyprus; the Czech Republic; Denmark; Estonia; Finland; France; Germany; Greece; Hong Kong SAR, China; Iceland; Ireland; Israel; Italy; Japan; the Republic of Korea; Latvia; Lithuania; Luxembourg; Malta; Netherlands; New Zealand; Norway; Portugal; Singapore; the Slovak Republic; Slovenia; Spain; Sweden; Switzerland; the United Kingdom; and the United States.

2. An economy is defined as commodity exporter when, on average in 2012-14, either (i) total commodities exports accounted for 30 percent or more of total goods exports or (ii) exports of any single commodity accounted for 20 percent or more of total goods exports. Economies for which these thresholds were met as a result of re-exports were excluded. When data were not available, judgment was used. This taxonomy results in the classification of some well-diversified economies as importers, even if they are exporters of certain commodities (e.g., Mexico).

3. Commodity importers are all EMDEs that are not classified as commodity exporters.

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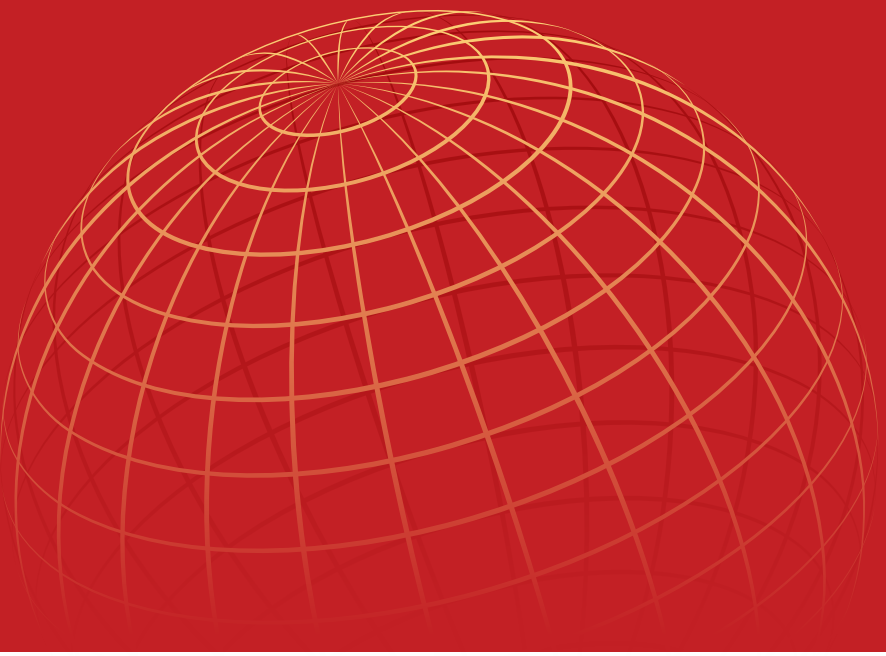


SPECIAL FOCUS 1.1

Investment: Subdued Prospects, Strong Needs

Investment: Subdued Prospects, Strong Needs

Investment growth in emerging market and developing economies (EMDEs) over the next three years is expected to be subdued and below historical averages. This continues a prolonged, broad-based slowdown after the global financial crisis, notwithstanding a modest recovery between 2016 and 2018. During the forecast period, EMDE investment growth is expected to be held back by weak global growth, limited fiscal space against the backdrop of elevated debt, and the presence of several structural constraints. Weak investment is a concern because it will further dampen potential growth, and make achieving the Sustainable Development Goals more difficult. Depending on country circumstances, the use of appropriate fiscal and structural reforms could generate upside potential for investment in the medium and long term. For EMDEs with limited fiscal space, institutional reforms to improve business conditions could help attract private investment. In light of elevated debt levels, policymakers should also ensure resources are allocated to high quality investment projects and improve the transparency and efficiency of public investment management systems where necessary.

Recent developments and prospects

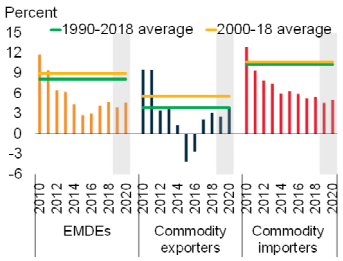
Investment growth in emerging market and developing economies (EMDEs) is below historical averages and is expected to remain weak over the forecast horizon (Figure SF1.1.1.A).[1] In absolute terms, EMDE investment amounted to $9.7 trillion (nearly one-third of GDP) in 2018. This Special Focus updates previous work analyzing the drivers and implications of post-crisis investment weakness in EMDEs (World Bank 2017; Kose et al. 2017; Vashakmadze et al. 2017).

EMDE investment growth reached a modest 4.7 percent in 2018 and is expected to slow (to 3.9 percent) in 2019, before advancing modestly in 2020 and 2021. A modest cyclical recovery in commodity exporters is expected to support the investment recovery in 2020-21. The outlook for EMDE investment has been downgraded since 2018, however, amid weaker-than-expected global activity and softening investor confidence. Moreover, EMDE investment growth is projected to remain below historical averages during the forecast period.

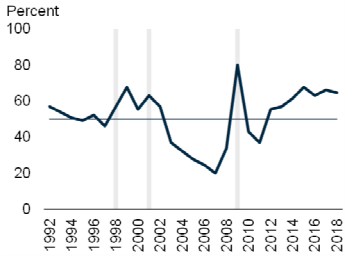
FIGURE SF1.1.1 Investment trends and prospects

Notwithstanding a modest recovery from its 2015 low, EMDE investment growth remains weak and below historical averages—in the aggregate as well as in the majority of countries. Investment growth in EMDEs is projected to advance modestly in the medium term, reflecting a pickup in commodity exporters, but to a rate still below historical averages. The sluggishness of investment is expected to persist in the long term.

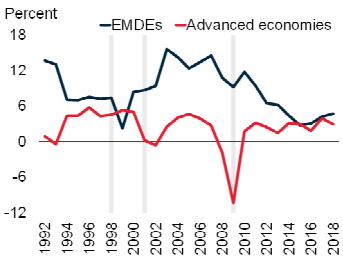
A. EMDE investment growth



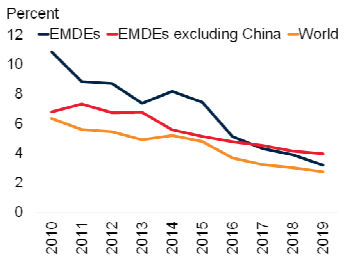
B. Share of EMDEs with investment growth below 2000-18 average



C. Investment growth



D. Long-term investment growth forecasts



Source: Consensus Economics, Haver Analytics, Oxford Economics, World Bank.
A.-C. Investment refers to real gross fixed capital formation (public and private combined). 2010 investment-weighted averages. Sample includes 65 EMDEs and 34 advanced economies (listed in Table SF1.1.1). Due to limited data availability, this special focus covers a smaller set of EMDEs than those for which the WBG projects GDP growth in *Global Economic Prospects*.
A. Shaded areas indicate forecasts.
B.C. Shaded areas indicate global recessions and slowdowns.
D. 10-year-ahead forecasts surveyed in indicated year. Constant 2010 U.S. dollar investment-weighted averages. Sample includes 23 advanced economies and 20 EMDEs (indicated by † in Table SF1.1.1). For 2010-18, the average of four projections during the year is shown; for 2019, the average of two projections during the first half of the year is shown.
Click here to download data and charts.

Note: This Special Focus was prepared by Dana Vorisek, Naotaka Sugawara, and Lei Sandy Ye. Research assistance was provided by Liu Cui and Mengyi Li.

[1] Investment is defined as real gross fixed capital formation. Table SF1.1.1 lists the countries in the investment sample. Together, the 65 EMDEs and 34 advanced economies represent 96 percent of global GDP in 2018. The 65 EMDEs represent 92 percent of total EMDE GDP in 2018.

The recent modest recovery in EMDE investment growth follows a prolonged, broad-based slowdown following the global financial crisis. Investment growth in these economies fell from 11.8 percent in 2010 to a low of 2.8 percent in 2015. In well over half of EMDEs, investment growth has been below country-specific long-term averages since 2012 (Figure SF1.1.1.B). This differs from the experience in advanced economies, where investment growth recovered rapidly after the global financial crisis and has since been around its long-term average of 2.3 percent (Figure SF1.1.1.C). For the world, investment growth is expected to decelerate to 2.7 percent in 2019, from 3.7 percent in 2018, and to remain subdued through 2021, held back by persistent sluggishness in investment growth in advanced economies.

The long-term investment outlook is subdued. The private sector's 10-year-ahead outlook for investment has steadily weakened over the past decade, for both EMDEs and the world (Figure SF1.1.1.D; Kose, Ohnsorge, and Sugawara, forthcoming).[2] In early 2019, the 10-year-ahead outlook for EMDE investment growth was 3.2 percent, nearly 8 percentage points below the most recent high in 2010, and more than half a percentage point lower than projected in 2018. The long-term outlook for EMDEs excluding China has also been downgraded relative to 2018.

Against this backdrop, this Special Focus examines the following questions.

- What were the main drivers of weak post-crisis investment growth in EMDEs?
- What are the implications of weak investment growth in EMDEs and what policy responses are available?

This Special Focus extends previous analysis of investment in EMDEs in several dimensions (World Bank 2017; Kose et al. 2017). First, it updates the investment data and provides revised projections of investment growth. Second, the study examines how the drivers of investment growth have changed during the past decade—comparing the drivers in the immediate post-crisis years to the most recent years, when investment growth began to recover. Third, it discusses the medium- and long-term consequences of weak investment growth.

The Special Focus presents the following main findings. First, investment growth in EMDEs has risen modestly since bottoming out in 2015, reflecting a cyclical recovery among commodity-exporting EMDEs and a fading of country-specific factors holding back investment in some large economies. In the medium term, investment growth is expected to continue to gain ground, although only modestly, and at a pace still below long-term historical averages. Second, empirical estimates suggest that during 2015-18, the main driver of the acceleration in EMDE investment growth was the terms of trade improvement in commodity-exporting economies. This contrasts with the multiple cyclical drivers depressing investment growth in a large number of EMDEs during 2011-15. Third, weak investment growth has contributed to weaker potential growth and will make meeting the Sustainable Development Goals (SDGs) more challenging. A sustained improvement in investment growth in EMDEs requires the use of fiscal, monetary, and structural policy tools, with specific priorities depending on country circumstances.

Drivers of investment growth

Post-crisis slowdown

The slowdown in EMDE investment growth from 2010 to 2015 reflected external and domestic factors.[3] For commodity exporters, a steep drop in oil and metals prices between mid-2014 and early 2016 and associated adverse terms-of-trade shocks

[2] The world sample includes 23 advanced economies and 20 EMDEs that together represent 87 percent of global GDP in 2018. The 20 EMDEs represent 78 percent of total EMDE GDP in 2018.

[3] Studying the trends in investment growth is relevant for short-term analysis. Trends in investment ratios (i.e., investment relative to GDP) are an important complement to trends in investment growth, and are more relevant for long-term analysis on investment and savings. For the sample of 65 EMDEs used in this note, the investment ratio has moderated somewhat, from a post-2000 high of 34.8 percent in 2013 to 33.4 percent in 2018. Excluding China, the investment ratio in EMDEs is substantially lower, but it has also fallen, from a high of 25.4 percent in 2012 to 23.8 percent in 2018.

were key factors behind their investment slowdown (Islamaj et al. 2019; Kose et al. 2017; World Bank 2017; Stocker et al. 2018; Vashakmadze et al. 2017). Policy uncertainty, weak activity in advanced economies, and high corporate leverage also dampened investment in EMDEs during this period.

Slowing investment growth in EMDEs reflected decelerations in both public and private investment growth during the post-crisis period (Figure SF1.1.2.A).[4] The two largest commodity-exporting economies, Brazil and Russia, suffered double-digit investment contractions in 2015 amid deep economic recessions. Investment growth in commodity-importing economies has been less volatile, but also moderated after 2010. An economic policy shift in China toward more sustainable and balanced growth (i.e., more reliance on consumption and less reliance on investment) contributed significantly to the EMDE investment growth slowdown (Figure SF1.1.2.B). Slowing investment growth in China may also have dampened investment growth in other EMDEs (World Bank 2017). Yet even excluding China, investment growth in EMDEs has slowed since 2010 (Figure SF1.1.2.C).

Moderate recovery since 2016

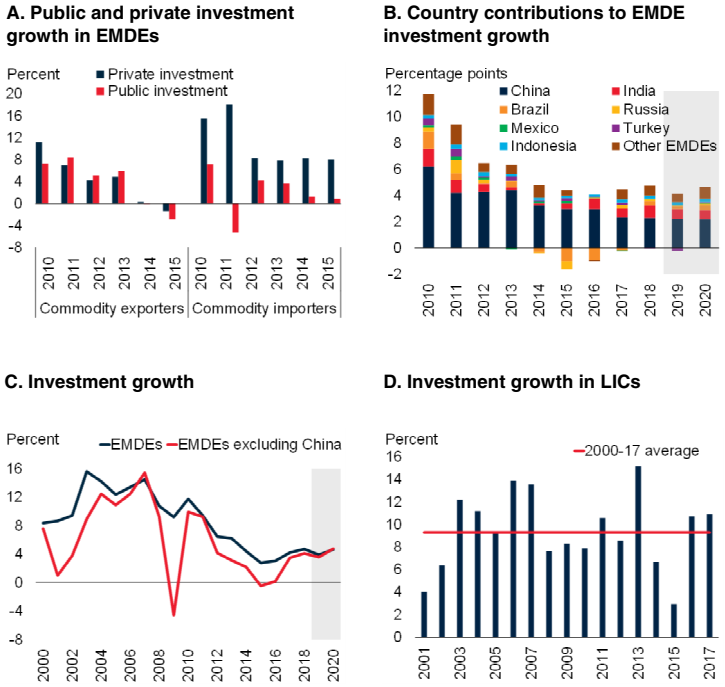
The moderate recovery in investment growth since 2016 reflects in part a pickup in global manufacturing and trade that began in mid-2016 and peaked in late 2017. The recovery has been further supported by a rebound in oil and metals prices in 2017-18, which encouraged capital expenditures in the commodity-dependent regions of Latin America and Sub-Saharan Africa.

Commodity exporters. Investment growth in EMDE commodity exporters accelerated to 2.2 percent in 2017 and 3.2 percent in 2018, after two years of contraction. In Russia, investment growth rebounded in 2016 and 2017 from a low associated with sharply declining oil prices and international sanctions in 2015. In Brazil, investment growth accelerated in 2018 as the economy slowly recovered from a multiyear recession. Large infrastructure projects are supporting solid investment in Indonesia. Improvements in these countries more than offset deteriorating investment growth in 2018 in other large economies, such as Argentina, where investment contracted due to financial turmoil, policy uncertainty, and a severe drought—and the Islamic Republic of Iran, where U.S. economic sanctions are inhibiting investment.

[4] Among the 11 EMDEs that disaggregate private and public investment in their national accounts, private investment growth outpaced public investment growth in 2016-18 in some (Bahrain, Malaysia, Mexico, South Africa, Thailand), while public investment growth has been faster in others (Bangladesh, Peru). In still other countries, the trend is less clear. Private investment has accounted for about three-quarters of total investment, on average, since 2010, in the EMDEs that disaggregate the two components.

FIGURE SF1.1.2 Decomposition of EMDE investment trends

Slowing investment growth in EMDEs after 2010 reflected decelerations in both public and private investment growth. By country composition, China accounts for a large portion of the investment slowdown in EMDEs after 2010, but commodity-exporting economies also contributed. LICs for which data is available showed above-trend investment growth in 2016 and 2017, after a slowdown in 2014-15.



Source: Haver Analytics, International Monetary Fund, World Bank.
A. 2010 investment-weighted averages. Investment refers to real gross fixed capital formation. EMDE sample includes 63 economies (listed in Table SF1.1.1, except Jamaica and West Bank and Gaza).
B. C. 2010 investment-weighted averages. Investment refers to real gross fixed capital formation. Shaded areas indicate forecasts. EMDE sample includes 65 economies (listed in Table SF1.1.1).
D. 2010 investment-weighted averages. Sample includes eight LICs: Benin, Burkina Faso, Mali, Mozambique, Nepal, Senegal, Tanzania, and Uganda.
Click here to download data and charts.

Commodity importers. Investment growth in commodity-importing EMDEs also picked up in 2018, to 5.5 percent. In China, private investment improved in response to policies, which offset weakness in public investment. In India, investment firmed as temporary disruptions, such as those related to the implementation of a goods and services tax in 2017, faded and credit growth picked up. Investment in Mexico recovered modestly in 2018 as trade uncertainty receded with the announcement of the United States-Mexico-Canada Agreement. In Turkey, however, investment slumped last year, as the country experienced high market volatility and economic stress.

Low-income countries. Low-income countries (LICs) with available data initially (during 2010-13) did not share the investment slowdown of the broader group of EMDEs (Figure SF1.1.2.D). However, investment appears to have fallen sharply, in line with other EMDEs, during the global financial crisis and the most recent commodity price bust starting in 2014. The 2014-15 slowdown was followed by two years of above-trend growth. In Nepal and Tanzania, two of the largest LIC economies, investment expanded rapidly in 2016-17, on post-earthquake reconstruction and robust construction sector activity, respectively. All LICs with available data reported solid investment growth in 2017.

Modest medium-term acceleration

Investment growth in EMDEs is expected to dip slightly in 2019, to 3.9 percent, reflecting the resumption of a trend slowdown in investment growth in China as it rebalances its economy, as well as temporary factors in several other large commodity importers. These factors include policy uncertainty in Mexico (including for the domestic oil and gas sector) and a challenging post-crisis investment environment in Argentina and Turkey.

In 2020 and 2021, investment growth is projected to accelerate moderately, supported by faster growth in commodity exporters, but still fall short of trend rates. In Brazil, for instance, investment growth is expected to recover as confidence improves and credit conditions become gradually less tight. In Russia, investment is expected to accelerate moderately as public spending on infrastructure picks up. The acceleration will not be universal among the largest economies, however. Through 2021, investment growth in China is expected to continue its gradual moderation, to rates well below those of recent decades. In India, it is expected to grow a slower pace than in 2018, although investment growth is expected to remain robust as benefits of recent policy reforms further materialize.

In addition to country-specific drivers of the EMDE investment outlook, several broad factors are expected to influence EMDE investment growth in the short and medium term.

Easier financing conditions. In the context of an increasingly dovish stance by the U.S. Federal Reserve and the European Central Bank, external financing conditions for EMDEs have improved since late 2018.[5] Sovereign bond spreads have fallen, bond issuance has picked up, and recent data indicate that capital inflows to EMDEs are recovering. The easier financing environment may provide a boost to still sluggish investment, at least in the short term. However, additional financing must be channeled toward productive uses, so that it does not simply add to already high government and corporate leverage in many EMDEs.

Limited fiscal space and rising debt. Elevated and rising debt levels in EMDEs, including corporate debt, will weigh on investment growth, especially if global financing conditions tighten unexpectedly. Government finances in many EMDEs are in a fragile position, with deteriorating debt dynamics and limited fiscal space (Figure SF1.1.3.A). In some cases, reforms to improve fiscal space have stalled, while funding of new or increasing liabilities, such as public sector wage bills, has put further strain on domestic revenues

[5] Many studies have found strong linkages between the U.S. monetary policy stance and credit cycles in EMDEs. A recent study finds that the spillovers between accommodative U.S. monetary policy and foreign bank lending to emerging markets is strongest for the most risky countries, and within countries, strongest for the most risky firms (Bräuning and Ivashina 2018).

(Brazil, South Africa). Oil exporters continue to face fiscal sustainability challenges. In metals and agricultural producers, weaker-than-envisaged commodity prices could put further pressure on already fragile public finances (South Africa, Zambia). The relationship between limited fiscal space and sluggish investment may be particularly strong for countries, including many LICs, where debt levels have increased in recent years and interest payments are absorbing a rising share of government revenues (World Bank 2019a). Inefficient management of public finances may also constrain investment growth in EMDEs.

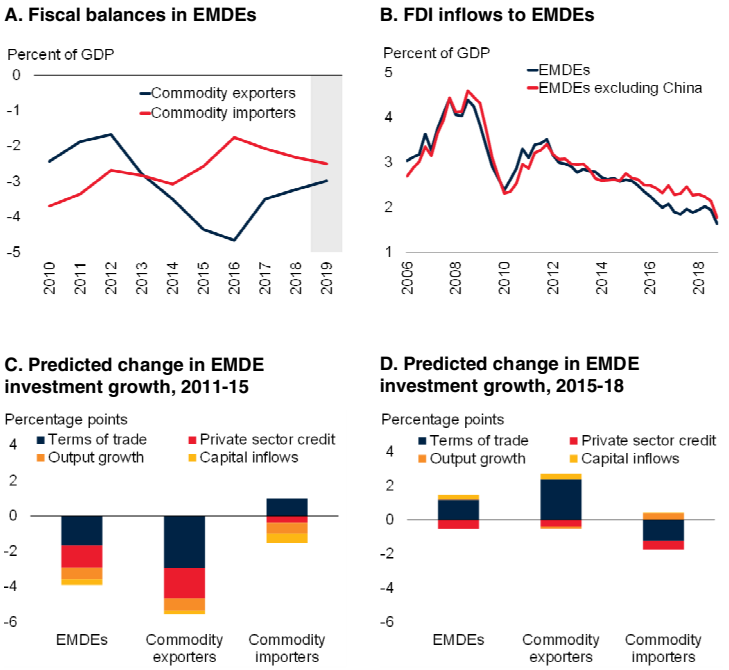
Unfavorable external economic outlook. External conditions for EMDE investment are expected to become less favorable in the medium term (World Bank 2019a). Growth is projected to ease in major economies (China, the Euro Area, the United States) in 2019-21, which may slow investment and exports in closely-linked EMDEs. Commodity prices—both energy and non-energy—are projected to weaken somewhat in 2019 (World Bank 2019b). In addition, global policy uncertainty, including trade policy uncertainty, remains elevated. Persistent investor concerns about possible further protectionist trade actions could reduce the attractiveness of new investment projects. Generalized market-related uncertainty could also reduce capital flows to EMDEs, potentially hindering investment (Figure SF1.1.3.B).[6]

Structural factors. In addition to macroeconomic factors, institutional and structural factors play a role in determining investment growth and investment ratios in EMDEs. These factors include financial sector development and oversight, trade policy, demographic change, and economic diversification, among others (World Bank 2017).

The economic landscape described above suggests that drivers of investment growth in EMDEs are diverse. An econometric exercise using panel data for 57 EMDEs suggests that over the past two decades, higher EMDE investment growth was associated with macroeconomic factors including higher output growth, stronger capital inflows, high political stability, stronger terms of trade growth, and lower private sector debt burdens (Annex SF1.1.1, Annex Table SF1.1.1.1). The regression results suggest that the pronounced investment growth slowdown in 2011-15 was, in almost equal measure, a reflection of weakening domestic output growth, a sharp deterioration in terms of trade for commodity exporters, and elevated private debt burdens (Figure SF1.1.3.C).

FIGURE SF1.1.3 Drivers of investment growth in EMDEs

Unfavorable external conditions and weak fiscal positions are expected to continue weighing on investment growth. Econometric estimates suggest that the pronounced investment growth slowdown in 2011-15 was, in almost equal measure, a reflection of weakening domestic output growth, a sharp deterioration in terms of trade for commodity exporters, and elevated private debt burdens. The subsequent moderate recovery largely reflected improving terms of trade for commodity exporters.



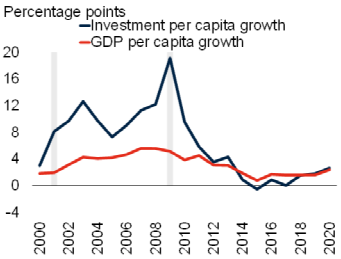
Source: Haver Analytics, International Monetary Fund, International Country Risk Guide, World Bank.
A. Medians within groups. Shaded area indicates forecast. Sample includes 151 EMDEs.
B. Four-quarter (from t-3 to t) moving sum of FDI inflows, divided by annual GDP. Sample includes 54 EMDEs. Last observation is 2018Q4.
C.D. Unweighted averages for 56 EMDEs. Charts show change in contribution of each explanatory variable to predicted investment growth (defined as coefficient estimate times the realization of the variable), based on the regression specification in first column of Annex Table SF1.1.1.1. For presentational clarity, the charts show only the four explanatory variables with the largest contributions to the predicted change in investment growth.
Click here to download data and charts.

[6] FDI is a key channel through which fixed investment is financed in EMDEs. For the EMDEs included in this Special Focus, FDI inflows dropped from about 3.3 percent of GDP in 2011 to 1.7 percent of GDP in 2017. The trend is similar when China is excluded. FDI inflows to EMDEs are estimated to have picked up moderately in 2018, although to a level below historical averages.

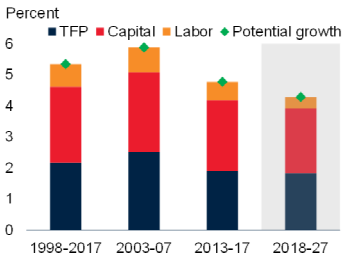
FIGURE SF1.1.4 Implications of weak investment growth in EMDEs

Decelerating investment growth during the post-crisis period has dampened the pace of convergence in per capita GDP between EMDEs and advanced economies and has slowed capital accumulation. Slowing capital accumulation, together with decelerating productivity and changing demographic conditions, has contributed to weaker potential growth in EMDEs. Continued weak investment growth will make filling large investment gaps in EMDEs more challenging.

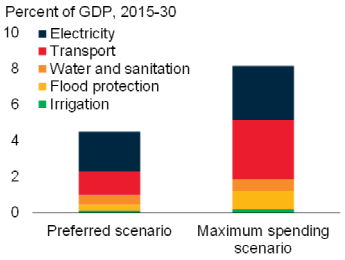
A. Difference, EMDE and advanced-economy per capita growth



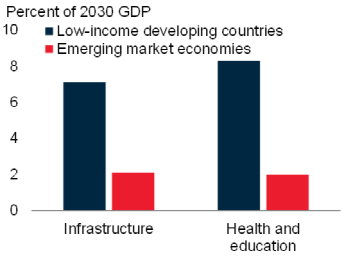
B. Contribution to potential growth, EMDEs



C. Spending needs in infrastructure sectors related to SDGs, World Bank estimates



D. Additional spending needs in sectors related to SDGs, IMF estimates



Source: Gaspar et al. (2019), Penn World Tables, Rozenberg and Fay (2019), UN Population Prospects, World Bank.
A. 2010 investment-weighted averages. Investment refers to real gross fixed capital formation (public and private combined). Shaded areas indicate global recessions and slowdowns. Sample includes 65 EMDEs and 34 advanced economies (listed in Table SF.1.1.1).
B. GDP-weighted averages. TFP = total factor productivity. Shaded area indicates forecasts. Sample includes 50 EMDEs.
C. D. SDGs = Sustainable Development Goals.
C. Bars show average annual spending needs during 2015-30. "Preferred scenario" is constructed using ambitious goals and high spending efficiency, and "maximum spending scenario" using ambitious goals and low spending efficiency. Country sample includes low- and middle-income countries. Country sample includes low- and middle-income countries, as defined by the World Bank. The technical appendix of Rozenberg and Fay (2019) provides information on the lcountry sample.
D. For health and education, estimates are the difference between the share of GDP in spending consistent with high performance and the current level of spending as a share of GDP. For infrastructure, estimates show spending needed to close the infrastructure gap (roads, electricity, and water and sanitation) between 2019 and 2030. Gaspar et al. (2019) and IMF (2018) provide more information on the low-income developing country sample.
Click here to download data and charts.

Although commodity importers benefited from the decline in commodity prices, slowing capital inflows weighed on investment growth. The subsequent moderate recovery of investment growth in 2016-18 largely reflected improving terms of trade for commodity exporters (Figure SF1.1.3.D).

Implications and policy responses

Weak investment to weigh on potential growth

The prospect that weak investment growth will remain weak over the longer-term, on the heels of the sharp slowdown in the first half of this decade, raises fundamental concerns about the economic health of EMDEs. The earlier period of weak investment growth in EMDEs dampened the pace of convergence in per capita GDP with advanced economies (Figure SF1.1.4.A). Slowing capital accumulation also contributed to a deceleration in potential growth in EMDEs during the past five years, and capital is expected to continue detracting from potential growth during the next decade (Figure SF1.1.4.B; World Bank 2018). In addition, sluggish investment may have slowed potential growth indirectly, by eroding productivity gains embedded in new equipment and technologies, or in research and development.

Sustained investment pickup needed to meet the SDGs

Despite weak investment prospects, EMDEs have large investment needs. Recent analysis by the World Bank finds that achieving the SDGs related to infrastructure (electricity, transport, water supply and sanitation) and infrastructure-related climate change costs (flood protection, irrigation) in low- and middle-income countries will require an average of investment of $1.5–$2.7 trillion per year during 2015–30, or 4.5 to 8.2 percent of these countries' combined GDP, depending on policy choices and the quality and quantity of infrastructure services (Figure SF1.1.4.C; Rozenberg and Fay 2019). The results highlight the importance of spending efficiency (i.e., the quality of spending) in achieving the infrastructure-related SDGs. An IMF study of additional annual spending needed in sectors related to the SDGs (i.e., health, education, roads, electricity, and water and sanitation) arrives at estimate of approximately $2.5 trillion per year. This figure represents about 4 percent of emerging market economies' 2030 GDP and more than 15 percent of low-income developing countries' 2030 GDP

TABLE SF.1.1.1 Economies in sample

Emerging market and developing economies (65)			Advanced economies (34)
East Asia and Pacific	**Latin America and the Caribbean**	**Middle East and North Africa**	Australia †
Cambodia *	Argentina †	Algeria	Austria
China *†	Belize	Bahrain	Belgium
Indonesia †	Bolivia	Iran	Canada †
Malaysia †	Brazil †	Kuwait	Cyprus
Mongolia	Chile †	Lebanon *	Czech Republic †
Philippines *†	Colombia †	Morocco	Denmark
Thailand *†	Costa Rica	Oman	Estonia †
Vietnam *	Dominican Republic *	Saudi Arabia	Finland
	Ecuador	United Arab Emirates	France †
Europe and Central Asia	El Salvador *	West Bank and Gaza	Germany †
Albania	Guatemala		Greece
Armenia	Honduras	**South Asia**	Hong Kong SAR, China †
Belarus *	Jamaica	India *†	Iceland
Bosnia and Herzegovina	Mexico *†	Sri Lanka *	Ireland
Bulgaria *†	Nicaragua		Israel
Croatia *†	Paraguay	**Sub-Saharan Africa**	Italy †
Hungary *†	Peru †	Benin	Japan †
Poland *†	Uruguay	Botswana	Korea, Rep. †
Romania *†		Burkina Faso	Latvia †
Russia †		Cameroon	Lithuania †
Turkey *†		Côte d'Ivoire	Malta
Ukraine †		Ghana	Netherlands †
		Kenya	New Zealand †
		Mali	Norway †
		Mauritius *	Portugal
		Mozambique	Singapore †
		Namibia	Slovak Republic †
		Nigeria	Slovenia †
		Senegal	Spain †
		South Africa	Sweden †
		Uganda	Switzerland †
			United Kingdom †
			United States †

* Commodity importers. Each EMDE is classified as a commodity importer or commodity exporter. An economy is classified as a commodity exporter when, on average in 2012-14, either (i) total commodities exports accounted for 30 percent or more of total goods exports or (ii) exports of any single commodity accounted for 20 percent or more of total goods exports. Economies for which these thresholds were met as a result of re-exports were excluded. When data were not available, judgment was used. This taxonomy results in the classification of some well-diversified economies as importers, even if they are exporters of certain commodities (e.g., Mexico).
† Countries in Consensus Economics' long-term forecast sample in Figure SF1.1.1.D.

(Figure SF1.1.4.D; Gaspar et al. 2019).[8] Mobilization of sufficient financing to close investment gaps in EMDEs has been challenging (United Nations Inter-Agency Task Force on Financing for Development 2019).

Policy responses

The use of a range of policies—counter-cyclical stimulus measures as well as structural reforms—could generate upside potential for investment growth. A multi-pronged approach could simultaneously boost both public and private investment.

Fiscal policy measures could help by directly expanding public investment, where fiscal space is available, by reallocating resources from relatively unproductive areas, and by increasing spending efficiency. Addressing shortcomings in fiscal processes, such as inefficient public investment

[8] In addition, UNCTAD (2014) estimates that additional spending of $1.5–2.7 trillion per year between 2015 and 2030 is needed to achieve the infrastructure-related goals in developing countries, plus about $400 billion for infrastructure investment related to the health and education goals. The cost estimates provided by the World Bank, IMF, and UN studies are not comparable, however. They reflect differences in country samples, subsectors (e.g., the World Bank study focuses on low-carbon transportation systems—rail and bus rapid transit—while the IMF study looks at roads), and inclusion of operation and maintenance costs, among other factors.

management systems and weak fiscal transparency, could also boost public investment.

Institutional reforms play a key role in creating conditions conducive to attracting investment (Vashakmadze et al. 2017). Relevant reforms could address country-specific impediments such as business environment constraints, high business startup costs, labor and product market inefficiencies, and weak corporate governance. In countries where financial development is weak, financial deepening could boost investment, although risk indicators must be monitored to avoid financial instability (Kiyotaki and Moore 2005; Sahay et al. 2015). For policymakers, providing clarity about the direction of policy and refraining from adopting policies with highly uncertain outcomes could help support private investment. Membership in trade and integration agreements could help improve the business and investment climate and boost investment growth in some EMDEs, perhaps particularly so if such agreements boost integration in global value chains and help lower the cost of tradable investment goods (i.e., machinery and equipment), for which EMDEs still face significantly higher costs than advanced economies (IMF 2019; UNCTAD 2013).

In the long term, many commodity-exporting EMDEs need to diversify their economies in order to reduce the vulnerability of private investment to natural resource price volatility. EMDEs will also need to develop policies to offset the long-term investment dampening effects of population aging (Aksoy et al. 2019).

Annex SF1.1.1 Empirical analysis

Framework

A fixed effects panel regression that includes an array of explanatory variables as proxies for the cost and returns to capital is used to estimate the correlates of investment growth in EMDEs. The framework is consistent with an investment model such that the marginal return on capital equals the cost of capital (e.g., Hall and Jorgenson 1967). Higher costs of capital—whether due to higher risk premia or higher risk-free real interest rates—would reduce investment, whereas higher productivity would raise it. The returns to capital are proxied by output growth and terms of trade growth. The risk premium is proxied by measures of political uncertainty. The cost of financing investment is proxied by capital inflows, private credit, and the business climate.

The weakness in investment growth has coincided with weakness in output growth and a deteriorating growth outlook for EMDEs (Didier et al. 2015). Weak growth prospects signal reduced opportunities for firms selling their goods and services and thus lead to lower investment. This is captured in the "accelerator model," which assumes that firms aim to maintain a constant capital-to-output ratio, in line with their expectations of future output growth (Jorgenson 1963). Recent work on advanced economies has shown that output growth captures broad trends in investment, but actual investment often falls short of the model predictions (Leboeuf and Fay 2016). In the regression framework used in this special focus, weak growth prospects are proxied by lagged output growth to reduce concerns about endogeneity.

Sharp decreases in commodity prices may have caused large post-crisis swings in terms of trade (Baffes et al. 2015). Terms of trade developments shape growth prospects for both commodity exporters and importers, and help control for the effects of commodity prices. In commodity-exporting economies, terms of trade movements are dominated by commodity price fluctuations. Weaker terms of trade decreases return to investment, especially in commodity-related projects. It also reduces firms' net worth, tightening their financial constraints.

Elevated private debt may have an adverse impact on firms' investment for two reasons. First, since the benefits from investment are shared between the owners and creditors of leveraged firms, high debt can discourage investment. Second, high debt may reflect misallocation of capital to less innovative firms. This is particularly pronounced for investment in an environment of weak growth prospects and investment in long-lived assets, including real estate.[1] The regression includes the

lagged private sector credit-to-GDP ratio to proxy for household and firm debt burdens and the adverse effects of debt overhang. Although the flow of debt may be used to finance investment, the level of debt is a measure of leverage and is expected to be negatively correlated with investment. For EMDEs, Borensztein and Ye (2018), Magud and Sosa (2015), and Das and Tulin (2017) show that lower debt service capacity or higher leverage are associated with weaker investment.

Capital inflows, including foreign direct investment, can lift growth both by financing investment and by acting as a catalyst for additional domestically financed investment. FDI may also have indirect, productivity-enhancing collateral benefits (Kose et al. 2009). These include pressures for better institutions, financial development, and more stabilizing macroeconomic policies. The absorption by domestic firms of the new technology or managerial practices introduced by FDI can stimulate domestic investment, provided financing is available. Forays into new export markets by domestic firms, encouraged by FDI, may require up-front investment. Foreign portfolio inflows may be associated with higher physical investment by way of risk diversification and lower cost of capital (Henry 2007). Although capital flows often funds purposes other than investment, the regression includes the change in capital inflows into the reporting economy (in percentage points of GDP) as a proxy for external financing sources, among several other financing sources, of investment.

A number of studies have highlighted the importance of the institutional environment for investment (e.g., Lim 2014; Qureshi, Diaz-Sanchez, and Varoudakis 2015). Post-crisis, private investment recovered faster in countries with more developed financial market infrastructure, and higher institutional quality (e.g., governance quality) has been associated with higher investment. To capture the business climate, a dummy variable is included for large reforms (two standard deviation improvements) captured by one of four governance indicators (regulatory quality, government effectiveness, rule of law, and control of corruption).

When firms are uncertain about future demand and future policies, their expected risk-adjusted returns may not exceed the costs of capital or the returns on liquid financial assets, holding back investment (Bloom, Bond, and Van Reenen 2007). In macroeconomic studies, the uncertainty generated by political risk has been shown to weigh on investment (Julio and Yook 2012). The regression includes, as a proxy for political stability, Political Risk Services' International Country Risk Guide (ICRG) political stability rating. A higher index indicates greater political stability. The ICRG political risk index is a weighted average of ratings of government stability, socioeconomic conditions, investment profile, corruption, the role of military in politics, law and order, external and internal conflict, religious and ethnic tensions, democratic accountability, and bureaucratic quality. Lastly, the regressions control for sudden stops in capital inflows and for country-fixed effects. Since several sudden stops occurred during global recessions and slowdowns, they also capture the impact of these episodes.

Data

Investment data are drawn from Haver Analytics and the World Bank. Investment growth denotes the annual growth rate of real gross fixed capital formation. Data on political risk ratings come from the ICRG. Data on governance come from the World Bank's Worldwide Governance Indicators. Other macroeconomic data used in the econometric analysis are drawn from the World Bank and the International Monetary Fund.

Methodology

A fixed effects panel regression is used to estimate the correlates of investment growth in 57 EMDEs for the period 1998-2018. The econometric framework is similar to that of Nabar and Joyce (2009). However, the emphasis in this Special Focus is on investment growth, as a critical component of overall output growth (ultimately,

[1] For related studies, see Hennessy (2004) and Borio et al. (2015).

ANNEX TABLE SF.1.1.1.1 Correlates of investment growth

Dependent variable: investment growth	(1) EMDEs	(2) EMDEs: including political risk events	(3) GMM	(4) Advanced economies	(5) Private investment
Lagged real GDP growth (percent)	0.453***	0.466***	0.792***	1.074***	0.440**
	[0.128]	[0.126]	[0.179]	[0.232]	[0.198]
Change in capital inflows (percentage points of GDP)	0.122***	0.115**	0.116**	0.041	0.192***
	[0.043]	[0.044]	[0.044]	[0.031]	[0.046]
Political stability	0.279**	0.218**	0.294*	-0.118	0.402**
	[0.107]	[0.100]	[0.138]	[0.099]	[0.190]
Lagged credit-to-GDP ratio (percent of GDP)	-0.284***	-0.288***	-0.049	-0.051***	-0.358***
	[0.038]	[0.037]	[0.037]	[0.015]	[0.055]
Terms of trade growth (percent)	0.233***	0.229***	0.255***	0.188	0.336***
	[0.065]	[0.066]	[0.036]	[0.113]	[0.080]
Large reform spurt	6.493**	6.276**	5.847**	-1.191	5.148**
	[2.447]	[2.468]	[1.757]	[1.176]	[2.244]
Large deterioration in political stability		-3.819***			
		[1.348]			
Sudden stop dummy	-3.553**	-3.662***	-3.266**	-3.922**	-3.165*
	[1.383]	[1.351]	[1.075]	[1.564]	[1.728]
Constant	-2.575	1.837	-14.381	15.443*	-7.254
	[7.216]	[6.857]	[9.339]	[8.233]	[11.901]
Number of observations	1,057	1,057	1,057	548	878
R-squared	0.187	0.195		0.197	0.132
Number of economies	57	57	57	34	56

Note: Results of a panel regression with country fixed effects for 57 EMDEs during 1998-2018. Dependent variable is real investment growth. Lagged output growth, capital inflows, political stability, and terms of trade growth are expected to be positively associated with investment growth, and conversely the case for lagged credit to GDP and sudden stops. Column (1) denotes the baseline regression. Column (2) controls for episodes of large deterioration in political stability, as defined by standard deviation below the historical mean. Column (3) shows results using a generalized methods of moments (GMM) regression method. The Wald chi square statistic is 103.4. Column (4) runs the same baseline regression for advanced economies. Column (5) replaces dependent variable with private investment growth. All regressions control for sudden stops in capital inflows and country fixed effects. The regressions exclude 8 EMDEs in this Special Focus due to data availability. Capital inflows are defined as the sum of FDI, portfolio flows, and other investment (including banking) flows. Reforms in governance are based on the Worldwide Governance Indicators (WGI). Political stability denotes the International Country Risk Guide's (ICRG) political risk rating. 2018 data for capital inflows where not available, terms of trade, and governance are assumed to be same as previous year due to data availability. Robust standard errors in brackets. *** p<0.01, ** p<0.05, * p<0.1

the source of rising living standards), rather than changes in the investment-to-GDP ratio, which would only capture changes in investment growth relative to output growth. This is in line with recent studies on advanced economies (Banerjee, Kearns, and Lombardi 2015; Barkbu et al. 2015; Kothari, Lewellen, and Warner 2015) or for individual EMDEs (Anand and Tulin 2014). The results are robust to adding dummies for periods of high political risk events, using the generalized-method-of-moments estimator, and using private investment growth as a dependent variable. The results for advanced economies are shown as well.

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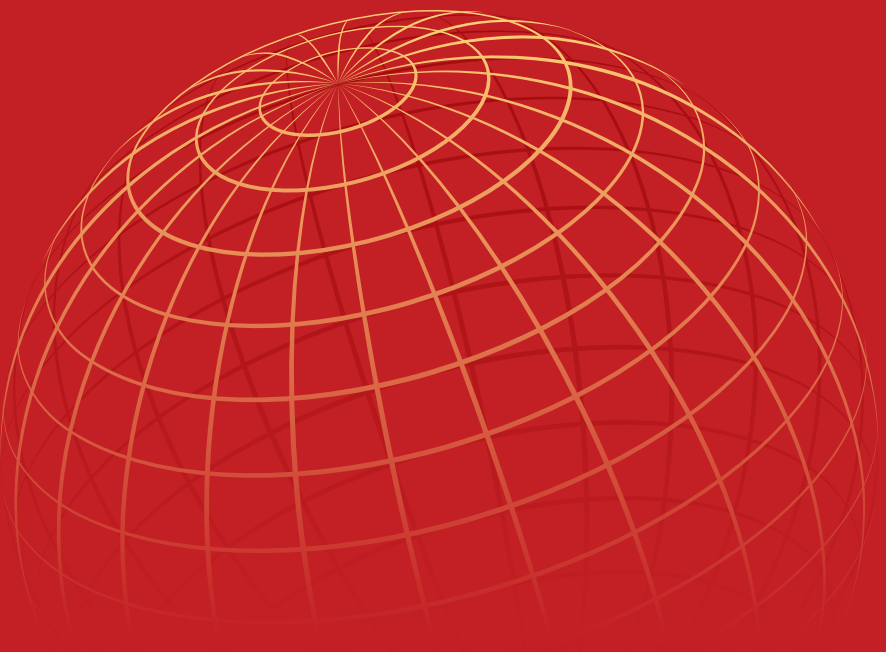


SPECIAL FOCUS 1.2

Currency Depreciations, Inflation, and Central Bank Independence

Currency Depreciations, Inflation, and Central Bank Independence

Financial market turbulence in 2018 illustrated, once again, that emerging market and developing economies (EMDEs) continue to face the risk of destabilizing exchange rate movements. These stress episodes often compel central banks to tighten policy to lessen currency pressures and fend off inflationary pressures despite slowing growth. To design appropriate policies, it is important to quantify the exchange rate pass-through to inflation associated with different domestic and global shocks and with different country characteristics. The pass-through to inflation tends to be largest when currency movements are triggered or amplified by monetary policy action. In contrast, the pass-through is significantly smaller when central banks pursue a credible inflation target, operate in a flexible exchange rate regime, and are independent from fiscal authorities. This highlights a self-reinforcing feedback loop between central bank credibility, exchange rate and price stability. Increased participation in global value chains and a lower share of imports invoiced in foreign currencies can also be associated with lower exchange rate pass-through, underscoring the need for complementary policies.

Introduction

Many emerging market and developing economies (EMDEs) confronted significant currency depreciations last year, reflecting a rise in advanced-economy yields, a strengthening in the U.S. dollar, and an increase in investor risk aversion amid financial stress in some countries. Currency pressures were most pronounced in Turkey and Argentina, due to acute concerns about monetary policy frameworks and debt sustainability. However, other EMDEs also suffered from sharp exchange rate depreciations, particularly countries with large external financing needs and those unable to maintain misaligned currency pegs or other forms of currency arrangements. In response, central banks were compelled to tighten monetary policy in order to restore market confidence: in the last quarter of 2018, the number of EMDEs hiking policy interest rates was four times larger than the number of EMDEs cutting them (Figure SF1.2.1.A). Currency pressures were accompanied by accelerating inflation, with a higher pass-through to consumer prices in countries with the largest depreciations and rising concerns about an erosion of central bank credibility (Figure SF1.2.1.B).

Despite easing global financing conditions since the start of 2019, the possibility of new episodes of financial market stress, broad-based capital outflows, and sharp exchange rate depreciations remain among the most prominent risks to EMDE prospects (Chapter 1). While flexible exchange rates can serve as a shock absorber and keep growth on a balanced and sustainable path over the medium term, sudden sharp currency depreciations can jeopardize price stability, especially when inflation expectations are poorly anchored as they tend to be in many EMDEs (Kose et al. 2019). In the presence of foreign-currency-denominated debt, currency depreciations can also raise debt burdens and financial stability concerns. These considerations help explain the greater propensity of central banks to respond to currency movements in EMDEs than in advanced economies, sometimes to a greater extent than is strictly needed to stabilize output growth and maintain low inflation (Calvo and Reinhart 2002; Ball and Reyes 2008).

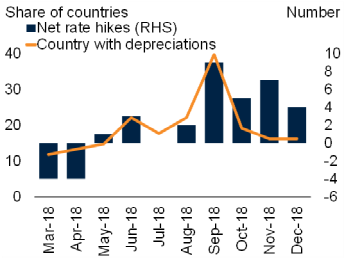
Since large exchange rate movements are more frequent in EMDEs than in advanced economies, a rigorous assessment of the exchange rate pass-through to inflation in EMDEs is a critical input into policymaking in those countries. This Special Focus provides an empirical analysis of the exchange rate pass-through ratio (ERPTR) to inflation, defined here as the percentage increase in consumer prices associated with a 1-percent depreciation of the effective exchange rate one

Note: This Special Focus was prepared by Marc Stocker, Jongrim Ha, and Hakan Yilmazkuday. Research assistance was provided by Julia Norfleet and Heqing Zhao.

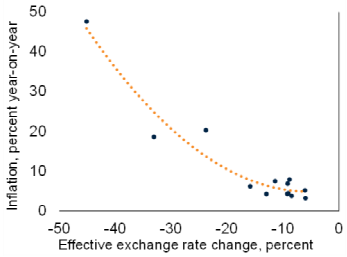
FIGURE SF1.2.1 EMDE exchange rates, monetary policy rates, and inflation in 2018

Central banks have responded to episodes of currency depreciations in 2018 by hiking policy interest rates. Inflation rose sharply in countries where currency pressures were most pronounced.

A. Frequency of currency depreciations and policy interest rate changes in EMDEs



B. Currency depreciations and inflation in EMDEs in 2018



Source: Haver Analytics, World Bank.

Note: EMDEs = emerging market and developing economies.

A. Depreciations are monthly declines in the nominal effective exchange rate of more than 5 percent on an annualized basis. Net interest rate hikes are the number of policy interest rate hikes minus the number of interest rate cuts in each month. Sample includes 68 EMDEs.

B. The horizontal axis shows cumulative change in the nominal effective exchange rate (NEER) of more than 5 percent over the period January to December 2018. Vertical axis shows consumer price inflation in December 2018. Dotted line shows second order polynomial trend. Sample includes 28 EMDEs.

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year earlier. This pass-through ratio is expected to be positive, on average, as a depreciation would tend to be accompanied by rising inflation. Specifically, this Special Focus examines the following questions:

- How does the exchange rate pass-through vary across countries and over time?
- Does the exchange rate pass-through depend on the nature of the shock?
- What country characteristics are associated with smaller pass-throughs?

The main conclusions are as follows. First, large depreciation episodes—defined as nominal effective depreciations of more than 10 percent in a quarter—continue to be associated, on average, with more significant increases in consumer price inflation in EMDEs than in advanced economies. In both country groups, larger depreciations tend to be followed by larger pass-through ratios. Second, the relationship between inflation and currency movements depends on the nature of the initial shock. Monetary policy shocks, such as an unexpectedly loose policy stance contributing to currency depreciation and accelerating inflation and activity, are more closely associated with larger exchange rate pass-throughs than any other shocks. Third, pass-throughs are generally smaller in countries with greater global value chain integration and lower share of foreign-currency invoicing. They are also smaller in countries with more flexible exchange rate regimes and a credible commitment to an inflation target. This, in turn, facilitates the central bank's task of maintaining low inflation and makes exchange rate movements a more effective buffer against external shocks.

This Special Focus complements the existing literature by documenting nonlinearities in exchange rate pass-through depending on the magnitude and direction of the exchange rate movement. It also extends, on the basis of a larger and more EMDE-oriented sample than used in previous studies, a recent literature that emphasizes the importance of the nature of the initial shock and of structural country features for the transmission of exchange rate movements to inflation.

The Special Focus highlights that central banks need to consider not only the source of exchange rate movements but also the crucial role that their subsequent policy responses play in anchoring inflation expectations and lowering the eventual pass-through to domestic prices. There is a risk that a central bank that underestimates the exchange rate channel in the transmission of its policy actions might maintain an excessively tight (or loose) monetary policy stance relative to what is needed to maintain low inflation and stabilize output growth. This could lead to excessive fluctuations in activity and make the anchoring of inflation expectations more difficult.

Pass-through across countries and over time

Channels of transmission from exchange rate to inflation. The pass-through of currency depreciations to inflation is typically incomplete, with the effect dissipating through the supply chain. The pass-through to consumer prices goes through various channels, from direct effects through commodity and other import prices, to

indirect effects through wage formation and profit markups (Bacchetta and van Wincoop 2003; Burstein and Gopinath 2014; Ito and Sato 2008; McCarthy 2007). Distribution costs, firms' internal pricing, and inventory management can also drive a wedge between producer and consumer prices and impact the size and speed of the exchange rate pass-through (Alessandria, Kaboski, and Midrigan 2010; Berger et al. 2012; Copeland and Kahn 2012).

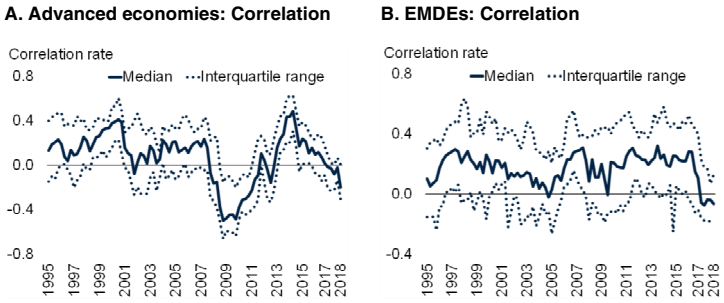
The size and speed of the impact of exchange rate movements on domestic inflation depend on several factors. These include competition among importing and exporting firms (Amiti, Itskhoki, and Konings 2016), the frequency of price adjustments (Devereux and Yetman 2003; Corsetti, Dedola, and Leduc 2008; Gopinath and Itskhoki 2010), wage bargaining structures (Aron, Macdonald, and Muellbauer 2014), the composition of trade (Campa and Goldberg 2010), and the share of trade invoiced in foreign currencies (Casas et al. 2017; Gopinath 2015).

Credible monetary policy frameworks that support well-anchored inflation expectations have also been associated with less pass-through to consumer prices (Carrière-Swallow et al. 2016; Gagnon and Ihrig 2004; Reyes 2004; Schmidt-Hebbel and Tapia 2002; Taylor 2000). A recent strand of the literature has emphasized the importance of identifying the underlying cause of currency movements when assessing pass-through ratios (Comunale and Kunovac 2017; Forbes, Hjortsoe, and Nenova 2017, 2018; Shambaugh 2008).

Correlation between exchange rate movements and inflation over time. Co-movement between exchange rate and consumer price developments has varied considerably over time. For advanced economies, the median correlation became positive during the late 1990s (+0.4 in 2000), during the mid-2000s (+0.2 in 2007), and again during the mid-2010s (+0.5 in 2014)—periods marked by unusually large monetary policy shocks or heightened uncertainty over policy actions (Figure SF1.2.2.A). In contrast, correlation rates were close to zero during the recovery in the early 2000s and 2017-18, and significantly negative during the global financial crisis (-0.5 in 2008-09)

FIGURE SF1.2.2 Correlation between inflation and effective exchange rate changes

Correlations between inflation and exchange rate movements vary considerably over time.



Source: World Bank.
Note: EMDEs = emerging market and developing economies.
A.B. Correlation over a three-year rolling window between inflation and nominal effective exchange rate depreciations in the same quarter. The sample includes 51 economies. The median and interquartile range are for three-year window correlation during 1998-2018.
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—periods marked by shifts in domestic or global demand conditions.

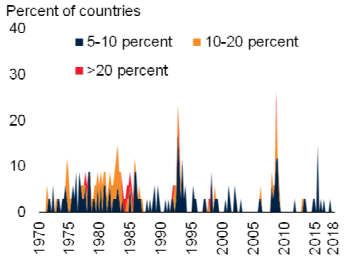
Among EMDEs, the median correlation also moved close to zero during the economic recovery in the early 2000s and during the global financial crisis, but it became increasingly positive after 2010 amid deteriorating supply-side conditions in many countries, including commodity exporters facing the end of the commodity supercycle (Baffes et al. 2015; Figure SF1.2.2.B). Shifts in the correlation between exchange rate and consumer price movements is consistent with the notion that different shocks as well as country-specific characteristics can modify the response of inflation to currency movements.

Events of large exchange rate movements. The event study presented in this section explores episodes of large exchange rate fluctuations, defined as quarterly movements in (trade-weighted) nominal effective exchange rates in excess of 5 percent across 34 advanced economies and 138 EMDEs during 1970-2018. By focusing on large exchange rate swings, the study is more likely to be successful in detecting related changes in prices throughout the entire production chain and in identifying potential nonlinearities that would cause larger ERPTRs in the event of sudden marked depreciations. By allowing for both

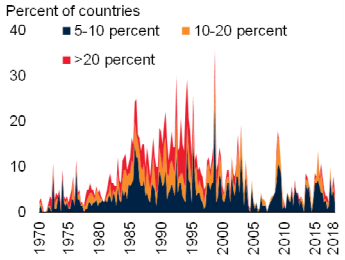
FIGURE SF1.2.3 Pass-through during significant currency depreciations

The frequency and severity of depreciation episodes have declined over recent decades. The median pass-through associated with large currency depreciations has dropped as well in EMDEs but remains higher than in advanced economies.

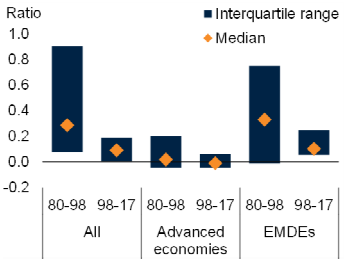
A. Frequency of significant exchange rate depreciations: Advanced economies



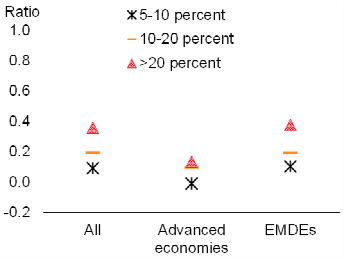
B. Frequency of significant exchange rate depreciations: EMDEs



C. Pass-through from depreciations of 5 to 10 percent



D. Pass-through from different depreciation episodes, 1998-2017



Source: World Bank.
Note: Depreciations are defined as negative quarterly changes in the nominal effective exchange rate. The sample comprises 34 advanced economies and 138 EMDEs. C.D. Pass-throughs are defined as the change in consumer prices after one quarter divided by the depreciation of the nominal effective exchange rate. The markers refer to the median pass-through.
C. The bars show the interquartile range of pass-throughs.
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depreciations and appreciation events, pass-throughs can be estimated conditional on the size and direction of the exchange rate movement.

This study identifies 2,323 depreciation events and 5,514 appreciation events in EMDEs and 242 depreciation events and 706 appreciation events in advanced economies (Figure SF1.2.3.A). The median depreciation across all events amounted to -10 percent in EMDEs and -8 percent for advanced economies, while the median appreciation amounted to 6 percent across the two groups.

The frequency and severity of large currency depreciations have declined over the past two decades, particularly in EMDEs (Figure SF1.2.3.B). Prior to 1998, such episodes clustered around periods of broad-based U.S. dollar appreciation, often associated with a tightening of U.S. monetary policy. In some cases, these led to full-blown currency or debt crises, particularly in Latin America during the 1980s and the early to mid-1990s, and in Asia and Eastern Europe during the second half of the 1990s. The incidence of currency crises has diminished since the early 2000s, with depreciations in excess of 20 percent affecting less than 1 percent of EMDEs, on average.

ERPTRs during large depreciations. The event study suggests a broad-based decline in pass-through among EMDEs over the past two decades (Figure SF1.2.3.C). Median estimates of the same-quarter pass-through of currency depreciations of 5-10 percent per quarter dropped from +0.4 in the period 1980-98 to around +0.1 since 1998 (meaning that a 10 percent depreciation in the median EMDE triggered a 1 percent increase in consumer prices in the same quarter). In advanced economies, the median pass-through for similar depreciations is close to zero for both periods. Depreciations of 10-20 percent in a given quarter continue to be accompanied by a larger pass-throughs, with median values of +0.1 for advanced economies and +0.2 for EMDEs since 1998 (Figure SF1.2.3.D). Depreciations in excess of 20 percent were associated with pass-throughs of around +0.4 in both groups of countries.

The reduced frequency of large depreciations and smaller pass-throughs over the past two decades may have common causes: enhanced monetary and fiscal policy frameworks, more flexible exchange rate regimes, accumulations of foreign exchange reserves, and better external debt management (Frankel, Parsley, and Wei 2005). Pass-throughs remained larger among EMDEs with less flexible exchange rate regimes (those devaluing from currency pegs or other forms of currency arrangements) and those without inflation-targeting central banks.

ERPTRs during large appreciations. Appreciation episodes were generally associated with positive, but smaller, pass-throughs compared to

depreciations of the same magnitude, with median values of +0.02 for advanced economies and EMDEs for appreciations of 5-10 percent, and only slightly larger for appreciations of 10-20 percent. These results may indicate that currency appreciations induce a weaker response from import and consumer prices than similarly sized depreciations (Brun-Aguerre, Fuertes, and Greenwood-Nimmo 2017). However, large currency appreciations are also rare events, making rigorous conclusions about such asymmetric effects difficult to establish in this context. Overall, the results appear to point to the presence of possible nonlinearities in the relationship between exchange rate movements and inflation, including in EMDEs (Caselli and Roitman 2016).

Pass-through to inflation and underlying shocks

The event study documents wide cross-country and time variation in the relationship between exchange rate movements and inflation. This section explores this variation further by estimating ERPTRs conditional on the underlying shocks as well as country-specific characteristics.

Empirical approach. Exchange rate pass-through ratios are estimated for 29 advanced economies and 26 EMDEs over the periods 1971Q1 to 1997Q4 and 1998Q1 to 2017Q4 in country-specific Bayesian factor-augmented vector autoregression (FAVAR) models (see Annex 1 for details).[1] The models include a global block (featuring global inflation, global output growth, and oil price changes) and a domestic block (featuring inflation, output growth, changes in nominal effective exchange rates, and monetary policy rates or equivalent short-term nominal interest rates). The identification strategy is based on the following sign and timing assumptions:

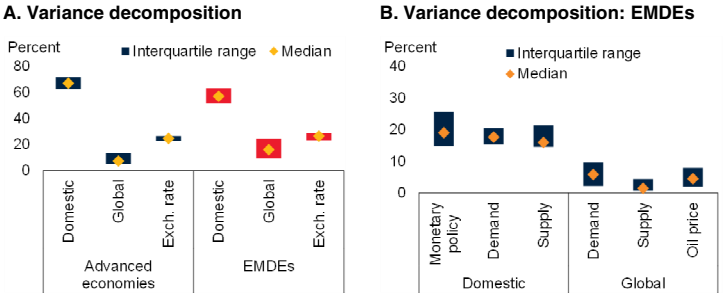
- A positive *monetary policy* shock (corresponding to an unexpected tightening of monetary policy) initially increases the domestic interest rate and appreciates the domestic currency, while it decreases domestic output growth and inflation.
- A positive country-specific *supply* or *demand* shock increases country-specific output growth. A country-specific supply shock reduces domestic inflation, whereas a country-specific demand shock increases it.
- A positive *exchange rate* shock (corresponding to an appreciation) only assumes a change in the exchange rate, while its impact on other domestic variables is left unrestricted.
- A positive *global demand* shock triggers a simultaneous increase in global output growth, global inflation, and oil prices.
- A positive *global supply* shock leads to higher global output growth and oil prices but lower global inflation.
- A positive *oil price* shock induces an increase in oil prices and global inflation but a drop in global output growth.
- Global shocks can have contemporaneous effects on domestic variables, but domestic shocks can only influence global variables with a lag.

A two-step procedure is applied to measure shock-specific exchange rate and inflation responses to these shocks, and are mapped separately from impulse response functions. Second, the pass-through is defined as the cumulative impulse response of consumer price inflation relative to the impulse response of the effective exchange rate over one year. A positive pass-through ratio indicates that a shock triggering a currency depreciation is followed by an increase in consumer prices, as is generally expected. A negative value means that a shock triggering a currency depreciation is followed by a decline in consumer prices.

[1] The model framework used here—a FAVAR with sign restrictions to identify structural shocks—accounts for the endogenous nature of exchange rate movements by identifying truly structural shocks that are, by construction, orthogonal to each other. This reduces potential estimation bias due to simultaneous interactions between variables.

FIGURE SF1.2.4 Variance decompositions of exchange rate movements, 1998-2017

Domestic shocks account for about two-thirds of the variation in exchange rates in the median advanced economy and more than half in the median EMDE after one year. Monetary policy shocks have contributed most to exchange rate variations.



Source: World Bank.
Note: Median share of country-specific exchange rate variance accounted for by global, domestic, and exchange rate shocks based on country-specific factor-augmented vector autoregression models estimated for 29 advanced economies and 26 EMDEs over 1998-2017. Bars show the interquartile range and markers represent the median across economies. EMDEs = emerging market and developing economies.
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Estimated exchange rate responses to shocks. Empirical studies have shown that certain macroeconomic fundamentals have some, albeit limited, predictive power over exchange rate movements. These fundamentals include changes in relative business cycle positions, monetary policy stances, risk premiums, and terms of trade (Ca'Zorzi and Rubaszek 2018; Cheung et al. 2017). Periods of domestic output or investment contraction are often associated with currency depreciations (Cordella and Gupta 2015; Landon and Smith 2009; Campa and Goldberg 1999). Monetary policy easing tends to lead to currency depreciations, with a change in interest rate differentials unfavorable to the domestic currency putting downward pressure on its value (Chinn and Meredith 2005; Engel 2016). Rising risk premiums and heightened sovereign default risks tend to trigger depreciation pressures (Foroni, Ravazzolo, and Sadaba 2018). Finally, nominal exchange rates can respond to terms of trade shocks, particularly in commodity-exporting countries with flexible currency regimes (Aizenman, Edwards, Riera-Crichton 2012; Schmitt-Grohé and Uribe 2018).

Focusing on the period 1998-2017, the response of nominal effective exchange rates one year after different shocks are as follows:

- **Domestic shocks**. Monetary policy tightening is followed by currency appreciations in all advanced economies and, to an even greater extent, in EMDEs, particularly those with inflation-targeting central banks and some commodity exporters (Brazil, Colombia, and South Africa). Stronger domestic demand is accompanied by currency appreciations as well, but the impact is statistically insignificant after one year in most cases. Changes in domestic supply conditions have mixed effects, consistent with the literature on productivity shocks (Alfaro et al. 2018; Corsetti, Dedola, and Leduc 2008).

- **Global shocks.**[2] In EMDEs, domestic currency appreciations are more likely in the wake of a positive global demand shock, possibly reflecting the U.S. dollar depreciation that typically accompanies global upturns and capital inflows to EMDEs, particularly those with current account deficits (Avdjiev et al. 2018). A positive global supply shock has mixed effects, with currency depreciations observed among some EMDEs that run current account surpluses (for example, China) and appreciations among some commodity exporters (for example, Brazil, Colombia, Malaysia, and South Africa). Rising oil prices also tend to be associated with currency appreciations in oil-exporting economies and with depreciations in some oil importers.

Relative contributions of global and domestic shocks to exchange rate movements. Domestic factors are the main drivers of exchange rate movements, accounting for about two-thirds of currency movements in advanced economies and more than one-half in EMDEs over the past two decades (Figure SF1.2.4.A). Changes in monetary policy play a particularly prominent role (Figure SF1.2.4.B). Although the direction and magnitude of the impact of global shocks vary substantially across countries, global shocks explain around 7 percent of the variance of currency movements in

[2] The median impact of global shocks on exchange rates is close to zero across countries, since one country's currency depreciation is, by definition, another's appreciation.

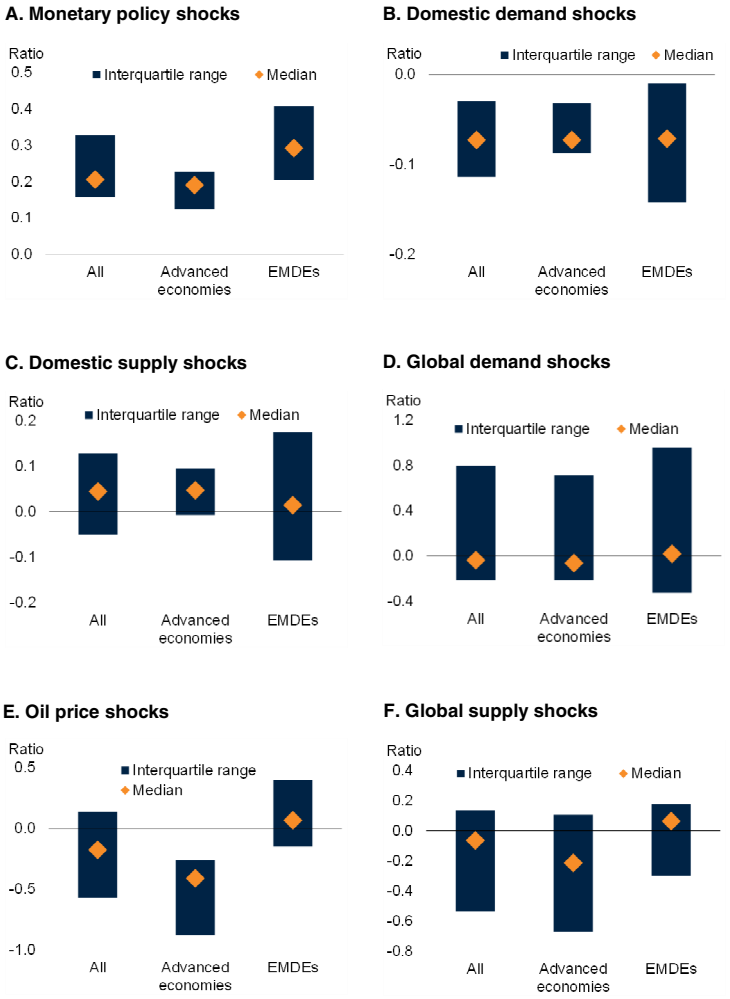
the median advanced economy and up to 16 percent in the median EMDE. About one-quarter of currency movements are accounted for by changes in other (unmeasured) factors, such as sovereign and private sector risk premiums. This is consistent with a significant impact of expectations about sovereign default risks on exchange rate dynamics (Alvarez, Atkeson, and Kehoe 2009; Foroni, Ravazzolo, and Sadaba 2018).

Estimated ERPTRs. Empirically, the following pattern of shock-specific one-year exchange rate pass-through ratios emerge:

- **Domestic shocks**. Domestic shocks account for over half the variance of inflation and exchange rates in most countries but are associated with different ERPTRs depending on their source. *Monetary policy* shocks are generally associated with large, positive ERPTRs that are statistically significant in nearly all advanced economies and EMDEs. This means that currency appreciations triggered by monetary policy tightening tend to be followed by significantly slower inflation after one year, as the dampening impact of declining import prices is compounded by the effect of decelerating demand and activity. Median values since 1998 are estimated to be +0.2 for advanced economies and +0.3 for EMDEs (Figure SF1.2.5.A). *Domestic demand* shocks are associated with small, negative ERPTRs that are statistically insignificant for most advanced economies and EMDEs (Figure SF1.2.5.B). In other words, the buildup of domestic inflationary pressures when domestic demand strengthens unexpectedly could more than offset the disinflationary impact of the accompanying currency appreciation. Median values of the ERPTRs are at around -0.07 for both advanced economies and EMDEs. *Domestic supply* shocks are associated with positive ERPTRs with lower median values than monetary policy shocks (less than +0.1 for advanced economies and EMDEs; Figure SF1.2.5.C). However, most of these estimates are insignificant, with wide variations across country groups, largely reflecting the heterogenous exchange rate response to these types of shocks.
- **Global shocks**. Global shocks account for a smaller proportion of the variance of exchange rate movements and are associated with significant variations in estimated ERPTRs,

FIGURE SF1.2.5 Shock-specific pass-throughs, 1998-2017

The exchange rate pass-through is large and positive when currency movements result from monetary policy shocks. It is smaller when currency movements are associated with changes in domestic supply conditions and negative when they are associated with changes in domestic demand conditions. Exchange rate pass-throughs vary widely when driven by global shocks.



Source: World Bank.
Note: Pass-throughs are defined as the ratio of the one-year cumulative impulse response of consumer price inflation to the one-year cumulative impulse response of the exchange rate change estimated from factor-augmented vector autoregression models for 29 advanced economies and 26 EMDEs over 1998-2017. A positive pass-through means that a currency depreciation is associated with higher inflation. Bars show the interquartile range and markers represent the median across countries.
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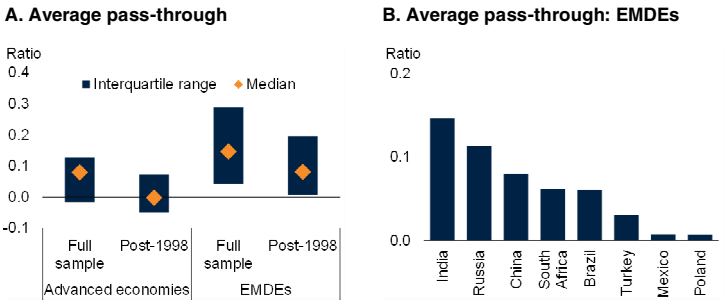
FIGURE SF1.2.6 Average pass-through

Over the past two decades, the average pass-through dropped close to zero in advanced economies and somewhat below +0.1 in EMDEs, albeit with considerable differences across countries.



Source: World Bank.

Note: Pass-throughs are defined as the ratio of the one-year cumulative impulse response of consumer price inflation to the one-year cumulative impulse response of the exchange rate change estimated from factor-augmented vector autoregression models for 29 advanced economies and 26 EMDEs over 1998-2017. A positive pass-through means that a currency depreciation is associated with higher inflation. Bars show the interquartile range and markers represent the median across countries. Shock-specific pass-throughs are aggregated using shares of currency movements accounted for by each type of shock as weights. EMDEs = emerging market and developing economies.

A. Full sample estimations are over 1971 to 2017 but can vary at the country level depending on data availability.

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reflecting the fact that these shocks have, by definition, diverging effects on individual country exchange rates (i.e., one country's currency depreciation is another's appreciation). Estimated ERPTRs associated with *global demand* shocks are statistically insignificant in over one-fifth of advanced economies and one-third of EMDEs, but are mostly positive across both groups (Figure SF1.2.5.D). *Oil price* shocks tend to be associated with positive ERPTR for the median energy exporters and a negative one for the median advanced economy, though not for the United States (partly due to the negative correlation between the U.S. dollar and oil prices; Figure SF1.2.5.E). However, estimates are insignificant in over one-half of advanced economies and almost two-thirds of EMDEs. *Global supply* shocks tend to be associated with largely insignificant ERPTRs (for nearly three-quarters of advanced economies and about two-thirds of EMDEs; Figure SF1.2.5.F).

- **Heterogenous consequences**. Collectively, these results suggest that the estimated exchange rate pass-through is highly heterogeneous across underlying shocks that trigger exchange rate fluctuations. This heterogeneity in part reflects the endogenous nature of exchange rates (Rincón-Castro and Rodríguez-Niño 2018). In general, nominal shocks (such as commodity price shocks) are more likely to change relative prices, whereas real shocks (such as supply shocks) are more likely to be associated with lower pass-throughs but a higher impact on real exchange rates that facilitates expenditure switching.

Average ERPTRs. The average ERPTR has declined in both advanced economies and EMDEs since the late 1990s (Figure SF1.2.6.A). The average ERPTR is defined here as the weighted-average of shock-specific pass-through ratios, where weights are the estimated shares of currency movements accounted for by each type of shock. The median estimate over the period 1998-2017 was close to zero for advanced economies and +0.08 in EMDEs, significantly down from the prior two decades, but with wide country variations (Figure SF1.2.6.B).[3]

Pass-through and country characteristics

The previous section illustrates the fact that ERPTRs can vary considerably depending on the nature of the shock driving exchange rate movements. However, country characteristics matter as well. In particular, previous empirical studies have emphasized that differences in monetary policy frameworks and in the degree of international integration can account for some of

[3] Among larger EMDEs, the average ERPTR in China is estimated at +0.08 since 1998, somewhat below previously reported estimates (Jiang and Kim 2013; Shu and Su 2009; Wang and Li 2010). For India, the average ERPTR is estimated at +0.14, broadly in line with previous studies (Bhattacharya, Patnaik, and Shah 2008; Forbes, Hjortsoe, and Nenova 2017; Kapur and Behera 2012). For the Russian Federation, it is measured at +0.11, consistent with findings of the Central Bank of the Russia (2014). For Brazil, the average ERPTR is estimated at +0.06 since 1998, toward the lower end of other studies (Forbes, Hjortsoe, and Nenova 2017; Ghosh 2013; Nogueira and Leon-Ledesmab 2009). For South Africa, the ERPTR is estimated at +0.07, broadly in line with the evidence presented in Kabundi and Mbelu (2018). For Turkey, the average ERPTR is somewhat lower than found in earlier studies, partly reflecting the shorter sample focusing on a period marked by significant de-dollarization and disinflation.

the heterogeneity in estimated ERPTRs (Campa and Goldberg 2010; Carrière-Swallow et al. 2016; Caselli and Roitman 2016; Coulibaly and Kempf 2010; Gagnon and Ihrig 2004; Mishkin and Schmidt-Hebbel 2007). These country characteristics are further investigated by comparing shock-specific ERPTRs for different subset of countries.

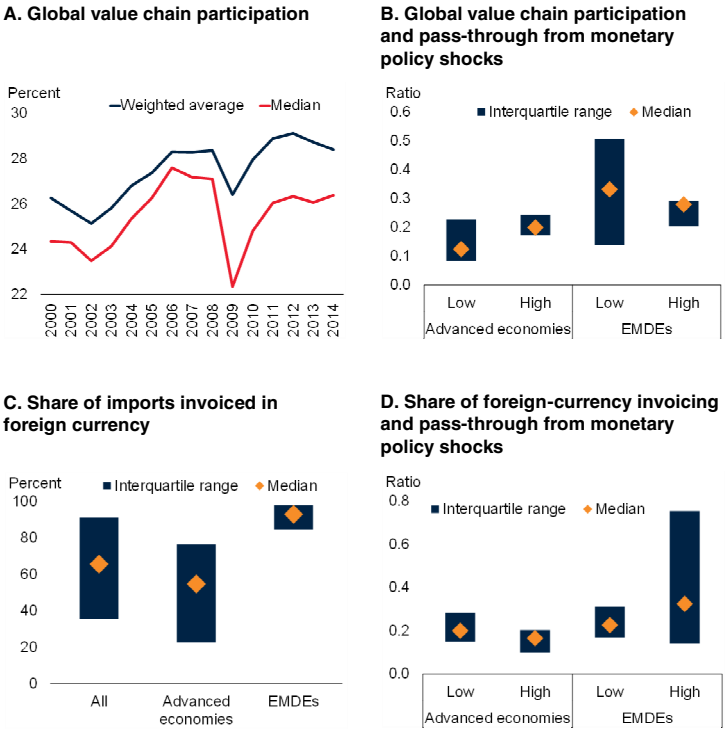
Global value chain integration. A priori, the impact of greater trade openness and international economic integration on estimated ERPTRs is difficult to ascertain. On the one hand, a larger share of imported products implies a potentially larger role for exchange rate movements in driving domestic inflation (Benigno and Faia 2016; Soto and Selaive 2003). On the other hand, increased foreign competition in domestic markets and greater integration in global value chains (GVCs) may reduce the ERPTR (Auer 2015; Berman, Martin, and Mayer 2012; Gust, Leduc, and Vigfusson 2010; Amiti, Itskhoki, and Konings 2016; de Soyres et al. 2018; Georgiadis, Gräb, and Khalil 2017; Figure SF1.2.7.A). Consistent with the literature, some economies in East Asia and the Pacific and in Eastern Europe and Central Asia are highly integrated into GVCs and also have low average pass-throughs (Chinn 2014). However, for other EMDEs, the association between GVC participation and ERPTRs is not as clear cut (Figure SF1.2.7.B).

Foreign currency invoicing. Having a large share of imports invoiced in a foreign currency could amplify the sensitivity of import and export prices to exchange rate movements (Devereux, Tomlin, and Dong 2015; Gopinath 2015). The ERPTR to import and export prices tend to be particularly elevated for countries with a high share of imports priced in U.S. dollars (Casas et al. 2017; Korhonen and Wachtel 2006). Domestic prices in highly dollarized economies also tend to react more to currency movements relative to other countries, since tradable and nontradable goods are priced in a foreign currency (Carranza, Galdon-Sanchez, and Gomez-Biscarri 2009; Reinhart, Rogoff, and Savastano 2014; Sadeghi et al. 2015). The selection of the pricing currency could itself depend on the exchange rate pass-through (Gopinath, Itskhoki, and Rigobon 2010). Among EMDEs, a higher share of imports invoiced in foreign currencies tends to be associated with higher pass-through ratios, but with significant heterogeneity across countries (Figures SF1.2.7.C and SF1.2.7.D).

Monetary policy framework and credibility. The increased adoption of credible monetary policy frameworks that support well-anchored inflation expectations has helped reduce the exchange rate pass-through to consumer prices in EMDEs by

FIGURE SF1.2.7 Global economic integration and pass-through

Higher global value chain participation is associated with lower pass-throughs in some EMDEs. A higher share of foreign-currency invoicing is associated with higher pass-throughs in some EMDEs, but does not seem to account for cross-country variations in EMDEs.



Source: Organisation for Economic Co-operation and Development, World Bank, World Trade Organization.

Note: Global value chain data are from the OECD-WTO TiVA (Trade in Value Added) database. The selected indicator is foreign value added as a percent of gross exports. Pass-throughs are defined as the ratio between the one-year cumulative impulse response of consumer price inflation and the one-year cumulative impulse response of the exchange rate change estimated from factor-augmented vector autoregression models for 29 advanced economies and 26 EMDEs over 1998-2017. A positive pass-through means that a currency depreciation is associated with higher inflation. Bars show the interquartile range and markers represent the median across countries.

B. Low and high value chain participation are defined as below or above the sample average.

C. Share of imports invoiced in foreign currency based on data for 50 countries calculated by Gopinath (2015).

D. Low and high share of foreign-currency invoicing are defined as below or above the sample average.

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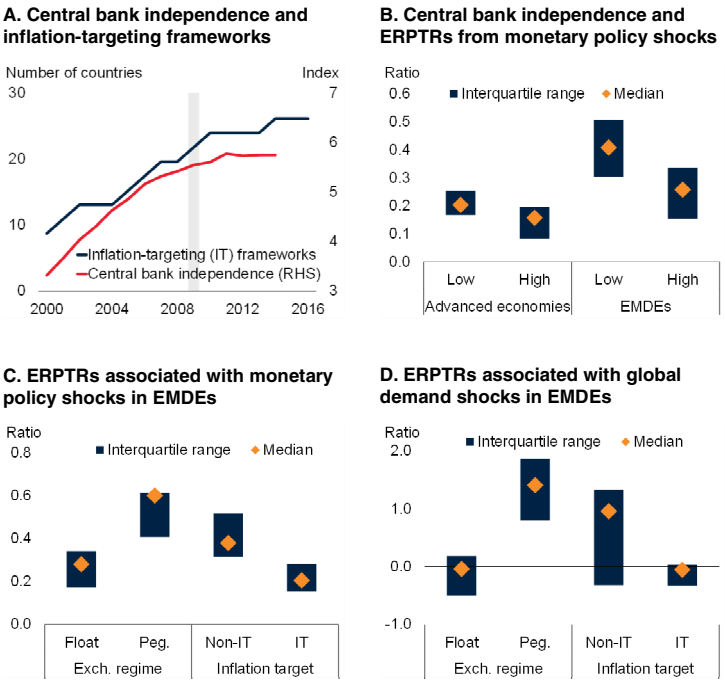
FIGURE SF1.2.8 Monetary policy frameworks and pass-through

A growing number of countries have adopted explicit inflation targets, and central bank independence has increased since 2000. Greater central bank independence has tended to dampen the pass-through to inflation of exchange rate movements stemming from monetary policy shocks and is also associated with lower average ERPTRs. Among EMDEs, the pass-through is generally lower among countries with more flexible exchange rate regimes and inflation-targeting central banks.



Source: World Bank.

Note: The central bank independence index is computed by Dincer and Eichengreen (2014). An increase in the index means greater central bank independence. Pass-throughs are defined as the ratio between the one-year cumulative impulse response of consumer price inflation and the one-year cumulative impulse response of the exchange rate change estimated from factor-augmented vector autoregression models for 29 advanced economies and 26 EMDEs over 1998-2017. A positive pass-through means that a currency depreciation is associated with higher inflation. Bars show the interquartile range and markers represent the median across countries. ERPTR = exchange rate pass-through ratio; IT = inflation-targeting.

B. Low and high central bank independence are defined as below or above the sample average.

C.D. Exchange rate and IT regimes are based on IMF classifications.

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minimizing domestic wage and mark-up adjustments (Figure SF1.2.8.A). In fact, ERPTRs associated with *domestic monetary policy* shocks are estimated to be significantly smaller in EMDEs with more independent central banks and higher in EMDEs that do not have inflation-targeting central banks and have less flexible exchange rate regimes (for example, Azerbaijan, Botswana, Jordan, and North Macedonia; Figures SF1.2.8.B and SF1.2.8.C).[4] The growing number of EMDEs adopting explicit inflation targets and reinforcing central bank transparency and independence has helped to dampen estimated ERPTRs over the last two decades. Thus an improvement of the central bank independence index from one standard deviation below the sample mean to one standard deviation above it is estimated to reduce the pass-through ratio associated with monetary policy shocks by half.

In countries with more independent central banks, inflation targets, and more flexible exchange rate regimes, inflation also responds less to exchange rate movements triggered by *global demand* and *oil price* shocks (Figure SF1.2.8.D). This implies that countries with such characteristics can better absorb external shocks through currency adjustments without threatening price stability. In countries with less flexible or pegged exchange rate regimes, global shocks could generate higher pass-through, making adjustments to devaluations more disruptive.

Conclusion

As recent financial market turbulences illustrate, large depreciations remain a threat to both price and financial stability in more vulnerable EMDEs. To formulate the appropriate monetary policy response to exchange rate pressures, central banks need to be able to anticipate the direction and magnitude of their impact on domestic inflation. But pass-through ratios—the percentage increase in consumer prices associated with a 1-percent depreciation of the nominal effective exchange rate—vary considerably across countries and over time, making inference from average values unreliable and potentially misleading for policy evaluation and forecasting purposes. Two fundamental factors help to account for the wide range of pass-through estimates: the nature of the shock triggering the currency movement and country characteristics.

An event study of past depreciation episodes suggests that the pass-through can more than

[4] This is in line with the empirical literature that has generally found ERPTRs to be smaller among advanced economies and in EMDEs with inflation targeting or more credible central banks (Carrière-Swallow et al. 2016; Gagnon and Ihrig 2004; Reyes 2004; Schmidt-Hebbel and Tapia 2002). Over the past two decades, an increasing number of central banks have adopted inflation targets and enhanced their credibility, which has helped reduce ERPTRs (Mishkin and Schmidt-Hebbel 2007; Coulibaly and Kempf 2010).

double when the effective exchange rate drops by more than 20 percent in a given quarter, illustrating the presence of non-linear effects. The exchange rate pass-through also depends on the nature of the shock. The pass-through associated with domestic monetary policy shocks, such as an unexpectedly loose policy stance contributing to currency depreciation and accelerating inflation and activity, is generally the strongest, especially in EMDEs without inflation-targeting central banks. In contrast, domestic demand shocks are typically accompanied by mostly insignificant pass-throughs, reflecting the offsetting effects of growth and exchange rate channels—that is, weakening domestic demand giving rise to currency depreciation but only a small effect on inflation. Greater central bank independence, increased global value chain integration, and a lower share of imports invoiced in foreign currencies are also associated with smaller pass-through ratios. A downward trend in average exchange rate pass-through ratios over the past two decades is consistent with improving central bank policies and increasing participation in global value chains in some countries.

These findings have important policy implications. First, structural policies can reduce the exchange rate pass-through to inflation. Policies that reinforce market competition, value chain integration, and local-currency invoicing can accelerate relative price adjustments in the event of shocks and hence help effective expenditure switching. Second, central bank credibility and transparency have significant impacts on macroeconomic stability. A credible commitment to maintaining low and stable inflation remains the most powerful way for central banks to limit the pass-through. A number of central banks have been able to achieve such outcome under inflation-targeting regimes. For countries with pegged or managed exchange rate regimes, allowing for a greater role of currency market discovery and avoiding sharp devaluations from prolonged periods of currency overvaluation is an important step toward lowering the pass-through. In any case, a clear delineation between monetary and fiscal policies helps reinforce the credibility of the central bank and keep pass-through to a minimum.

ANNEX SF1.2.1 Methodology

FAVAR model

The analysis of factors affecting the exchange rate pass-through to inflation rests on country-specific factor-augmented vector autoregression (FAVAR) models, consisting of global and domestic variables (Ha, Stocker, and Yilmazkuday 2019). The global block includes three variables: global inflation, global output growth, and oil price growth. The domestic block includes four country-specific variables: inflation, output growth, changes in nominal effective exchange rates, and monetary policy (or equivalent short-term) nominal interest rates.

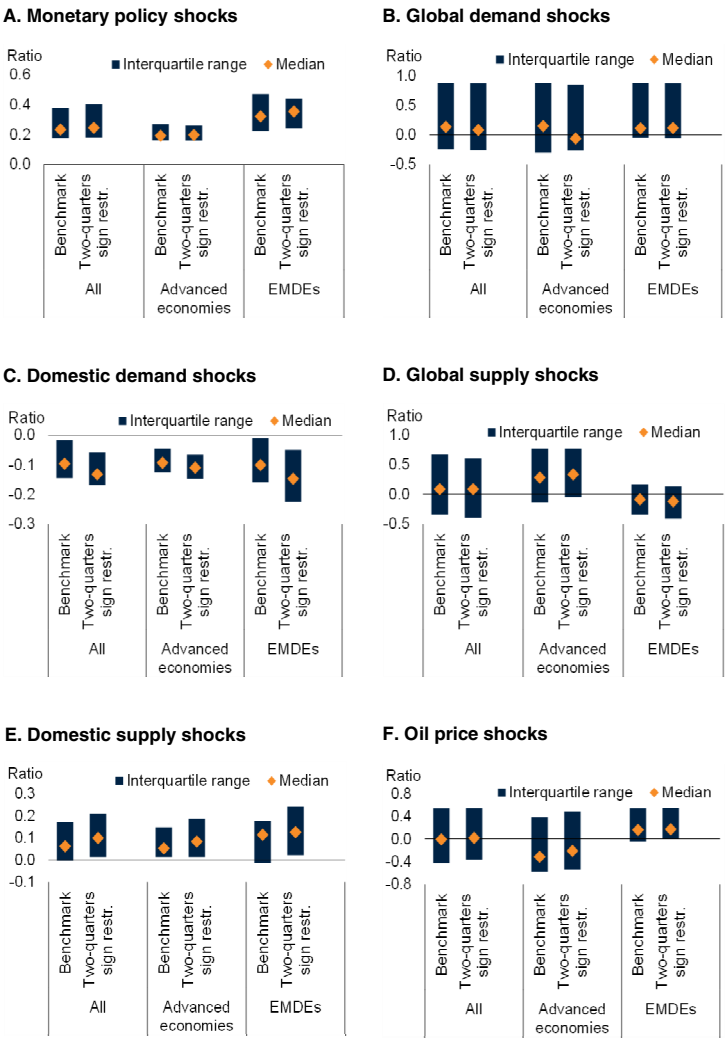
In its structural form, the FAVAR model is represented by

$$B_0 Y_t = \alpha + \sum_{j=1}^{L} B_j Y_{t-j} + \varepsilon_t$$

where $_t$ is a vector of orthogonal structural innovations; Y_t consists of global inflation ($f_t^{\pi,\text{global}}$), global output growth ($f_t^{\,,\text{global}}$), oil price growth (OP_t), country-specific inflation (π_t), country-specific output growth (Y_t), country-specific changes in nominal effective exchange rates (ER_t), and country-specific monetary policy (or equivalent short-term) nominal interest rates (I_t). The vector $_t$ consists of seven global and domestic structural shocks (to be defined below). Postulating that B_0^{-1} in the econometric model has a recursive structure such that the reduced-form errors (u_t) can be decomposed according to $u_t = B_0^{-1}{}_t$, similar to Charnavoki and Dolado (2014) and Forbes, Hjortsoe, and Nenova (2017, 2018), the imposed sign and short-term restrictions can be written as follows:

$$\begin{bmatrix} u_t^{Y,\text{global}} \\ u_t^{OP} \\ u_t^{\pi,\text{global}} \\ u_t^{Y,\text{domestic}} \\ u_t^{\pi,\text{domestic}} \\ u_t^{I,\text{domestic}} \\ u_t^{ER} \end{bmatrix} = \begin{bmatrix} + & - & + & 0 & 0 & 0 & 0 \\ + & + & + & 0 & 0 & 0 & 0 \\ + & + & - & 0 & 0 & 0 & 0 \\ * & * & * & + & + & - & * \\ * & * & * & + & - & - & * \\ * & * & * & * & * & + & * \\ * & * & * & * & * & + & + \end{bmatrix} \begin{bmatrix} \varepsilon_t^{GlobalDemand} \\ \varepsilon_t^{OilPrice} \\ \varepsilon_t^{GlobalSupply} \\ \varepsilon_t^{DomesticDemand} \\ \varepsilon_t^{DomesticSupply} \\ \varepsilon_t^{MonetaryPolicy} \\ \varepsilon_t^{ExchangeRate} \end{bmatrix}$$

ANNEX FIGURE SF1.2.1.1 Robustness of pass-through estimates: One- versus two-quarter sign restrictions



Source: World Bank.

Note: Pass-throughs are defined as the ratio of the one-year cumulative impulse response of consumer price inflation to the one-year cumulative impulse response of the exchange rate change to shocks from country-specific factor-augmented vector autoregression models estimated for 51 economies (29 advanced economies and 22 EMDEs) over 1998-2017. A positive pass-through means that a currency depreciation is associated with higher inflation. Bars show the interquartile range and markers represent the median across countries. In the alternative specification, sign restrictions are applied to the current quarter and next quarter.

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where * stands for an unrestricted initial response. Although country-specific shocks do not affect global variables in the first four quarters, global shocks can affect country-specific variables (without any sign or zero restrictions).

The identification strategy is based on the following assumptions, combining sign and short-term restrictions as shown above:

- A positive global demand shock triggers a simultaneous increase in global output growth, global inflation, and oil prices.[1] A positive global supply shock leads to higher global output growth and oil prices but lower global inflation. A positive oil price shock induces an increase in oil prices and global inflation but a drop in global output growth. Finally, global shocks can have contemporaneous effects on domestic variables, but domestic shocks can only influence global variables with a lag.

- A positive country-specific supply or demand shock increases country-specific output growth. However, a country-specific supply shock reduces domestic inflation, whereas a country-specific demand shock increases it. A positive interest rate shock (corresponding to a contractionary monetary policy) initially increases the domestic interest rate and results in an appreciation of the domestic currency, while it decreases domestic output growth and inflation. Finally, a positive exchange rate shock (corresponding to an appreciation of the domestic currency) only assumes an increase in the exchange rate, while its impact on other domestic variables is left unrestricted. All country-specific shocks are assumed to affect country-specific variables on impact through the corresponding sign restrictions, although the robustness checks also consider such restrictions lasting for an alternative number of periods (Annex Figure SF1.2.1.1). An alternative specification assumes that positive domestic demand shocks lead to a contemporaneous increase in domestic interest rates (Annex Figure SF1.2.1.2).

The structural FAVAR model framework has several advantages over the reduced-form approach in estimating the exchange rate pass-through (Rincón-Castro and Rodríguez-Niño 2018, Forbes, Hjortsoe, and Nenova 2017, Shambaugh

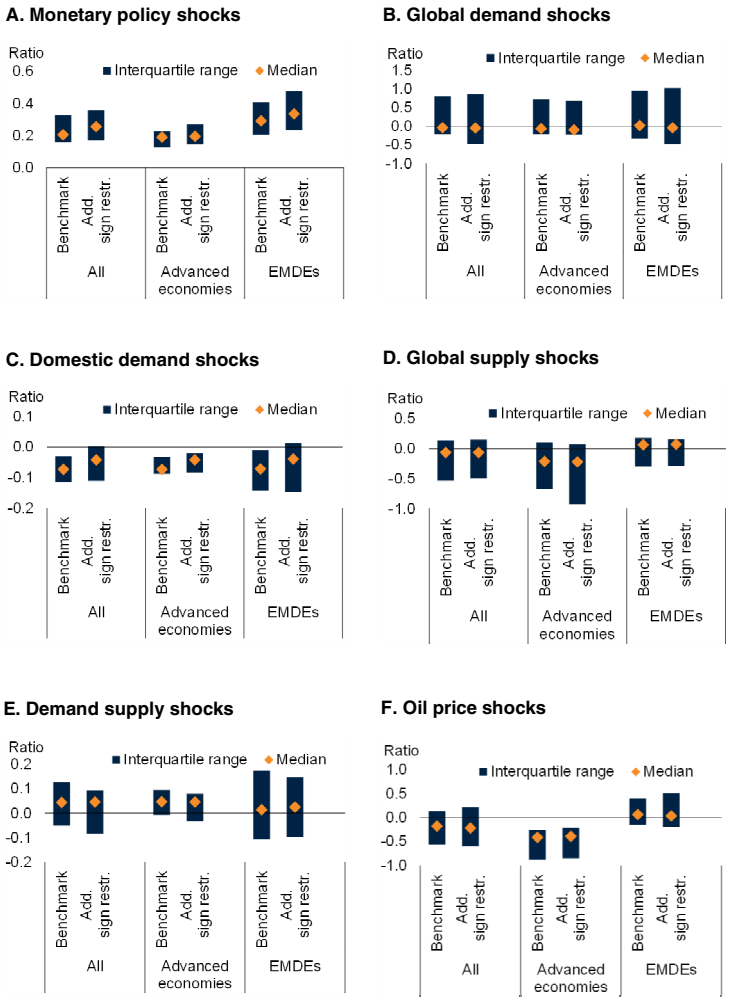
[1] Global shocks are derived from a separate tri-dimensional vector autoregression model that incorporates global output growth, global inflation, and oil price changes, following the approach of Charnavoki and Dolado (2014) and Uhlig (2005).

2008). First, it seeks to account for the endogenous nature of exchange rate movements, whereas reduced-form models assume that exchange rates are exogenously determined. In practice, exchange rates are often a function of macroeconomic fundamentals and thus the pass-through will depend on the type of shock the economy is facing. Second, the FAVAR model allows for the estimation of exchange rate pass-throughs are conditional on a variety of global and domestic shocks in a unified framework. Finally, the identification using sign and zero restrictions employed in this Special Focus seeks to identify truly structural shocks, orthogonal to each other, and reduce potential estimation bias due to simultaneous interactions between the variables.

The system is estimated on a country-by-country basis using quarterly data with two lags, as in Charnavoki and Dolado (2014). The Bayesian estimation used searches for 1,000 successful draws of at least 2,000 iterations with 1,000 burn-ins. The results shown in this Special Focus are based on the median of these 1,000 successful draws and 68 percent confidence sets at the country level, although alternative presentation methodologies (for example, the median target, as in Fry and Pagan 2011) are considered as a robustness check. In the Bayesian estimation, Minnesota priors proposed by Litterman (1986) are used; since the Minnesota prior assumes that the variance-covariance matrix of residuals is known, we use the entire variance-covariance matrix of the vector autoregression estimated by ordinary least squares. For the actual estimation, the identification strategy through the algorithm introduced by Arias, Rubio-Ramirez, and Waggoner (2014) is used, where the standard Cholesky decomposition is employed together with an additional orthogonalization step that is necessary to produce a posterior draw from the correct distribution for structural vector autoregression coefficients.

The results for the role of global and domestic shocks in domestic inflation are presented as median point estimates across countries. Interquartile ranges indicate the range from the 25th to the 75th quartile of country-specific estimates (for example, Forbes, Hjortsoe, and Nenova 2017).

ANNEX FIGURE SF1.2.1.2 Robustness of pass-through estimates: Additional sign restriction to identify domestic demand shocks



Source: World Bank.

Note: Pass-throughs are defined as the ratio of the one-year cumulative impulse response of consumer price inflation to the one-year cumulative impulse response of the exchange rate change to shocks from country-specific factor-augmented vector autoregression models estimated for 51 economies (29 advanced economies and 22 EMDEs) over 1998-2017. A positive pass-through means that a currency depreciation is associated with higher inflation. Bars show the interquartile range and markers represent the median across countries. In the alternative specification, an additional sign restriction was imposed, assuming that a positive domestic demand shock leads to a contemporaneous increase in domestic interest rates.

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Exchange rate pass-through definition

Following Shambaugh (2008) and Forbes, Hjortsoe, and Nenova (2017), for each country, the exchange rate pass-through ratio (ERPTR) is defined as the ratio of the response of country-specific inflation to the response of the nominal exchange rate changes following a given shock. Since the exchange rate is defined such that an increase denotes appreciation, the sign of the ratio

is inverted, so that a positive ERPTR denotes a situation in which a currency depreciation is accompanied by rising inflation.

As in Forbes, Hjortsoe, and Nenova (2017) and others, the ERPTR is calculated based on one-year cumulative impulse response functions of the endogenous variables. Since the Bayesian estimation results are based on 1,000 successful draws satisfying the sign restrictions, the country-specific ERPTRs are represented as the median (and 68 percent confidence sets) of successful draw-specific ERPTRs (ERPTRs are calculated for each successful draw individually before being used for a country-specific statistic).

Data

The sample includes 29 advanced economies and 26 EMDEs with at least 10 years (40 quarters) of continuous data for the variables in the domestic block, but the sample period differs across countries (Table SF1.2.1). Long-term trends of the variables are eliminated using the local mean method, as in Stock and Watson (2012). The following variable definitions are used as inputs into the FAVAR estimation:

- Global output growth is the global common factor of quarter-on-quarter, seasonally adjusted real GDP growth in a sample of 29 countries for 1971:1-2017:4.[2]
- Global inflation is the global common factor of quarter-on-quarter headline CPI inflation (seasonally adjusted) in a sample of 47 advanced economies and EMDEs.[3]
- Oil price growth is the quarter-on-quarter growth rate of nominal oil prices (average of Dubai, West Texas Intermediate, and Brent).
- Country-specific inflation is quarter-on-quarter, seasonally adjusted headline CPI inflation.
- Country-specific output growth is quarter-on-quarter, seasonally adjusted real GDP growth.
- Domestic interest rates are annualized three-month Treasury bill rates or monetary policy rates.
- Nominal effective exchange rate changes are the quarter-on-quarter changes in the trade-weighted nominal exchange rates against 52 currencies, as provided by the Bank for International Settlements.

Global output growth and global inflation are estimated using the following two single-factor dynamic factor models:

$$Y_t^i = \beta_{\text{global}}^{Y,i} f_t^{Y,\text{global}} + e_t^{Y,i}$$

$$\pi_t^i = \beta_{\text{global}}^{\pi,i} f_t^{\pi,\text{global}} + e_t^{\pi,i}$$

where $\pi^i{}_t$ and $y^i{}_t$ are inflation and output growth in country in quarter t, respectively, while $(f_t^{\pi,\text{global}})$ and $(f_t^{Y,\text{global}})$ are the global common factors for inflation and output growth in quarter t, respectively. $^{Y,i}_{t}$ and $^{\pi,}_{t}$ are residual terms in output growth and inflation in country in quarter t, respectively.

[2] The dynamic factor estimation of the global GDP factor requires a balanced panel throughout the full sample period. Thus, only a subset of countries is employed for this estimation.

[3] The number of countries in the estimation of the global output and inflation factors is based on data availability. Estimates of global inflation and output factors are not found to change much when the same group of countries is employed.

TABLE SF1.2.1 Countries and sample periods

Country	Sample period	Country	Sample period
Australia	1970:2 - 2017:4	India	1993:3 - 2017:4
Austria	1990:1 - 2017:4	Israel	1985:3 - 2017:4
Azerbaijan	2005:3 - 2017:4	Italy	1979:2 - 2017:4
Belgium	1970:2 - 2017:4	Jordan	1999:3 - 2017:4
Bulgaria	1994:4 - 2017:4	Japan	1989:3 - 2017:4
Brazil	1998:3 - 2017:4	Korea, Republic of	1991:3 - 2017:4
Botswana	1994:4 - 2017:4	Luxembourg	1999:3 - 2017:4
Canada	1970:2 - 2017:4	Mexico	1989:1 - 2017:4
Switzerland	1970:3 - 2017:4	Malta	1999:3 - 2017:4
Chile	1986:3 - 2017:4	Malaysia	2004:4 - 2017:4
China	1984:4 - 2017:4	Morocco	1995:4 - 2017:4
Colombia	1994:4 - 2017:4	Netherlands	1982:3 - 2017:4
Costa Rica	1997:3 - 2017:4	North Macedonia	2008:1 - 2017:4
Czech Republic	1992:4 - 2017:4	Norway	1979:2 - 2017:4
Germany	1970:2 - 2017:4	New Zealand	1974:3 - 2017:4
Denmark	1970:2 - 2017:4	Philippines	1987:3 - 2017:3
Dominican Republic	2004:3 - 2017:3	Poland	1992:1 - 2017:4
Egypt	2002:4 - 2017:2	Portugal	1986:2 - 2017:4
Spain	1977:3 - 2017:4	Russia	2000:1 - 2017:4
Finland	1987:3 - 2017:4	Slovak Republic	1996:1 - 2017:4
France	1970:2 - 2017:4	Slovenia	2002:3 - 2017:4
United Kingdom	1970:2 - 2017:4	South Africa	1981:3 - 2017:4
Greece	1994:4 - 2017:4	Sweden	1983:3 - 2017:4
Honduras	2005:4 - 2017:4	Thailand	2000:4 - 2017:4
Hungary	1995:4 - 2017:4	Tunisia	2000:4 - 2017:4
Indonesia	1990:3 - 2017:4	Turkey	2007:1 - 2017:4
Ireland	1984:3 - 2017:4	United States	1970:2 - 2017:4
Iceland	1988:3 - 2017:4		

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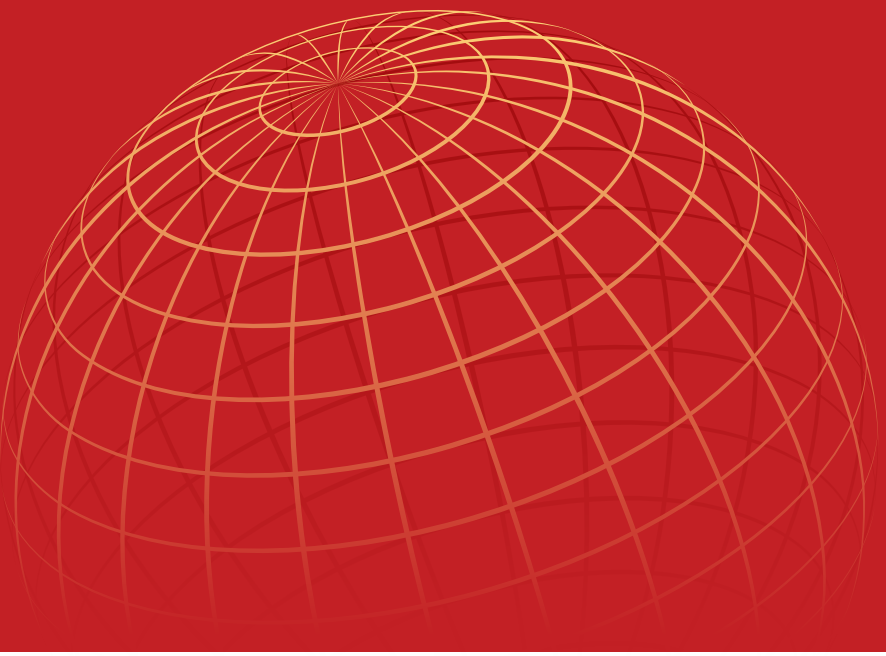


CHAPTER 2

REGIONAL OUTLOOKS

EAST ASIA and PACIFIC

Growth in the East Asia and Pacific region is projected to slow from 6.3 percent in 2018 to 5.9 percent in 2019-20, and to ease further to 5.8 percent in 2021. This will mark the first time since the 1997-98 Asian financial crisis that EAP growth dropped below 6 percent. In China, growth is expected to decelerate from 6.6 percent in 2018 to 6.2 percent in 2019, and gradually decline to 6.0 percent by 2021, reflecting softening manufacturing activity and trade amid domestic and external headwinds. In the rest of the region growth is also expected to moderate to 5.1 percent in 2019, before rebounding modestly to 5.2 percent in 2020-21, as global trade stabilizes. Risks to regional growth remain tilted to the downside and have intensified with the re-escalation of trade tensions. They include a sharper-than-expected slowdown in major economies, including China; an intensification of global trade tensions; and an abrupt change in global financing conditions and investor sentiment.

Recent developments

Growth in the East Asia and Pacific (EAP) region is slowing, largely reflecting a deceleration in China. Growth in the rest of the region is also moderating, but less sharply, albeit with notable heterogeneity (Table 2.1.1; Figure 2.1.1.A). Regional trade, especially exports, has plummeted amid weakening global investment and elevated trade policy uncertainty related to ongoing U.S.-China trade tensions. Export growth has declined sharply, in line with the slowdown in global growth of manufacturing, investment, and trade. Import growth has also decelerated, but is still solid, aided by robust domestic demand growth (Figure 2.1.1.B). Inflation is generally below targets across the region, but has been trending up recently, reflecting higher food prices (Figure 2.1.1.C). External financing conditions have been generally supportive, with narrowing bond spreads and improved net capital inflows (Figure 2.1.1.D). Regional currencies and equity markets, however, are under renewed pressure, most recently following the re-escalation of trade tensions (World Bank 2019a; Figures 2.1.1.E-F).

In China, the economy continues to slow and rebalance. Decelerating industrial production growth has been partly offset by more resilient activity in the services sector (Figure 2.1.2.A). Fiscal policies have eased and monetary policies have been generally supportive, helping to balance the impact of external and domestic headwinds (Chapter 1).

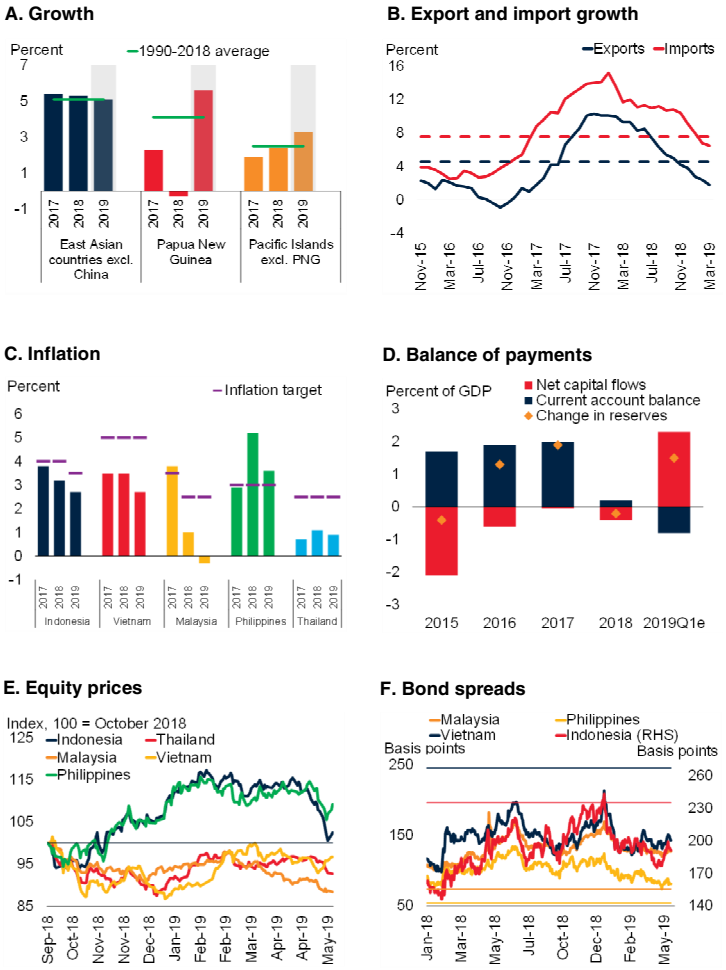
China's consumer price inflation has been trending up, but remains below the 3 percent target, while producer price inflation has bottomed out, partly reflecting some stabilization in the industrial sector. The current account surplus widened in 2019Q1 (Figure 2.1.2.B). Both export and import growth slowed sharply in late 2018, and despite some signs of stabilization, recent high-frequency indicators point to continuing broad-based weakness in trade (Figure 2.1.2.C).

Asset prices came under renewed pressure most recently, following a re-escalation of trade tensions in early May (Figures 2.1.2.D-E). Sovereign bond spreads remain above their long-term averages, reflecting slowing growth prospects amid lingering domestic vulnerabilities and ongoing trade disputes with the United States.

Note: This section was prepared by Ekaterine Vashakmadze. Research assistance was provided by Liu Cui.

FIGURE 2.1.1 EAP region excluding China: Recent developments

Growth in the EAP region is slowing, albeit with notable heterogeneity. Regional export growth has declined sharply, while domestic demand remains robust. Inflation has been trending downward across the region and is generally below targets. Net capital flows improved in 2019Q1. Regional equity markets, however, are under renewed pressure, most recently following the re-escalation of trade tensions. Financial conditions remain supportive with bond spreads generally narrowing or below their long-term averages.



Source: Haver Analytics, International Monetary Fund, World Bank.
A. East Asian countries excl. China includes Cambodia, Indonesia, Lao PDR, Malaysia, Mongolia, Myanmar, Palau, Philippines, Thailand, and Vietnam. Pacific Island excl. PNG includes Fiji, Kiribati, Marshall Islands, Micronesia, Palau, Samoa, Solomon Islands, Timor-Leste, Tonga, Tuvalu, and Vanuatu. 1990-2018 average for East Asian countries excl. China excludes Myanmar and 1990-2018 average for Pacific Island excl. PNG excludes Marshall Islands, Micronesia, Palau, Timor-Leste, and Tuvalu due to data limitations. Aggregate growth rates are calculated using 2010 U.S. dollar GDP weights. Data in shaded areas are forecasts.
B. Export and import volumes. Data include only goods. 12-month moving average. Regional aggregate excludes Cambodia, Fiji, Lao PDR, Mongolia, Myanmar, Solomon Islands, Papua New Guinea, Timor-Leste, Vanuatu, and Vietnam due to data limitations. Dotted lines indicate January 2000-March 2019 averages. Last observation is March 2019.
C. Average year-on-year consumer price inflation. Mid-point of inflation for Indonesia, Philippines, and Thailand. Inflation target for China and Vietnam. For Malaysia, the low point of Bank Negara's official forecast range of 2.5-3.5 percent in the 2019 budget is used. Last observation is April 2019.
D. e=estimate. The aggregate includes Indonesia, Malaysia, Philippines, and Thailand. Net capital flows and change in reserves are staff estimates. Net capital inflows include net capital and financial account balance, errors and omissions. 2019Q1 data is not available for Philippines and Thailand.
E. Equity index stands for the respective country composite index. Last observation is May 21, 2019.
F. The spread of a country's sovereign debt as measured by J.P. Morgan's Emerging Markets Bond Index over their equivalent maturity U.S. Treasury bond. Horizontal lines denote January 2000-May 2019 average rates. Last observation is May 21, 2019.
Click here to download data and charts.

Regulatory tightening has helped reduce leverage in some segments of the non-bank sector; however, bank credit growth remains robust and bond issuance has accelerated (Figure 2.1.2.F). Total leverage of the economy—measured as the ratio of total credit (general government and non-financial private sector) to gross domestic product—is estimated to have increased by about 2 percentage points of GDP in the year to 2018Q4. Total debt has surpassed 250 percent of GDP.

Growth in commodity importers remains robust but continues to moderate, reflecting weakening exports amid resilient domestic demand. Inflation is subdued or declining in most countries (Cambodia, the Philippines, Thailand, Vietnam), allowing monetary authorities to keep policy rates steady, generally at accommodative levels. In Thailand, domestic demand is supported by more accommodative fiscal policy. However, weakening export growth is weighing on activity. In the Philippines, private consumption is rebounding amid slowing inflation and improving employment conditions. In addition, election-related spending in the first half of 2019 is giving the economy an additional boost and is partly mitigating the impact of weakening exports.

In commodity exporters, the cyclical recovery is maturing, and the pace and composition of growth increasingly reflect country-specific factors. In larger and more diversified economies, where past terms-of-trade shocks were less acute and macroeconomic fundamentals are strong, steady growth has continued at rates of around 4.5-5 percent per year (Indonesia, Malaysia). In Indonesia, growth has been supported by robust private consumption and investment. In Malaysia, investment is rebounding, reflecting improved financing conditions and business confidence, offsetting the impact of moderating but still robust consumption growth. In smaller commodity exporters, the subdued recovery from the 2015-16 downturn is resuming at a stronger-than-expected pace, helped by investments in new mining projects (Mongolia) and a rebound in the extractive sector following a devastating earthquake in 2018 (Papua New Guinea).

Outlook

After moderating from 6.3 percent in 2018 to 5.9 percent a year in 2019-20, regional growth is projected to ease further to 5.8 percent in 2021 (Tables 2.1.1 and 2.1.2; Figure 2.1.3.A). Growth in China is projected to slow to 6.2 percent in 2019 amid continued domestic and external headwinds. The recent increase in tariffs on trade with the United States is projected to weigh on growth in 2020, which has been revised down to 6.1 percent.

This outlook is predicated on a deceleration in global trade, no further escalation of trade tensions between China and the United States, broadly stable commodity prices, and supportive global financing conditions, especially in the near term. The baseline also assumes that authorities in China continue to calibrate supportive monetary and fiscal policies to address the challenging external environment and any other headwinds to activity (SCPRC 2019).

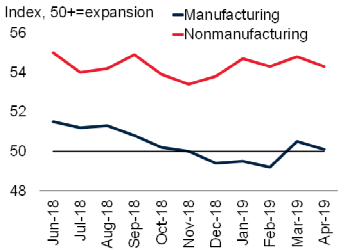
Regional growth excluding China is projected to decline to 5.1 percent in 2019 before inching up to 5.2 percent in 2020-21 as global trade rebounds. Growth among commodity importers is expected to moderate in 2020-21, reflecting capacity constraints and subdued external demand. Domestic demand will continue benefiting from favorable financing conditions amid low inflation and rising capital flows (Cambodia, the Philippines, Thailand, Vietnam). Regional economies will continue to benefit from pan-Asian infrastructure investments and expanding intra-regional trade, despite weaker-than-expected global growth and investment. The investment outlook is favorable in commodity-importing economies. Some countries will benefit from large public infrastructure projects coming onstream in 2020-21 (Thailand, the Philippines).

Growth in commodity exporters is expected to remain stable at about 5.1 percent a year in 2019-21, in line with potential, but with significant cross-country differences. In particular, growth is projected to diverge slightly between the two largest commodity exporters in the region. In Indonesia, which is less open to trade, growth is

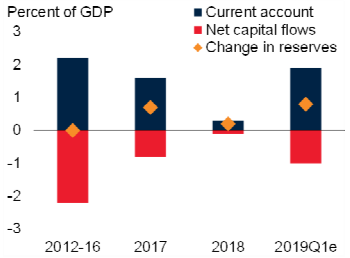
FIGURE 2.1.2 China: Recent developments

China's growth continues to slow, reflecting a deceleration in manufacturing activity and trade. The current account surplus widened in 2019Q1. Recent high-frequency indicators point to a continuing broad-based weakness in trade. Equities and the renminbi have largely recovered from losses incurred in 2018, but have come under renewed pressure recently. Growth of bank lending has remained strong, bond issuance has accelerated, but growth of other debt instruments has slowed.

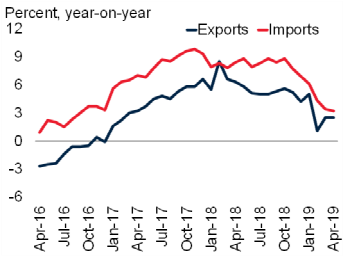
A. Manufacturing and nonmanufacturing PMI



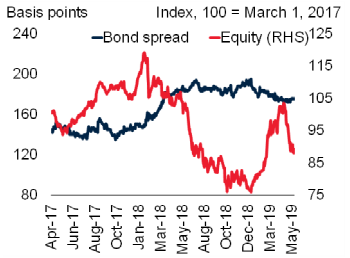
B. Balance of payments



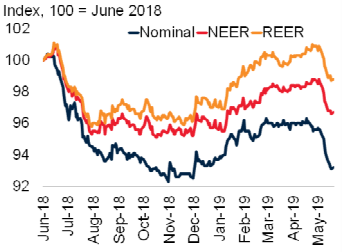
C. Export and import volumes



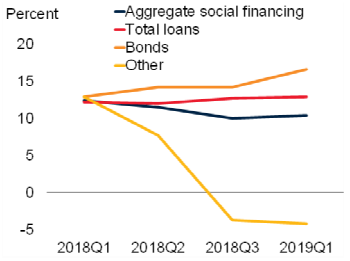
D. Bond spreads and equity prices



E. Exchange rate



F. Aggregate financing

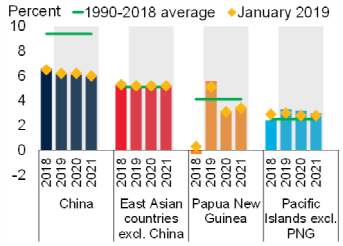


Source: Haver Analytics, National Bureau of Statistics of China, World Bank.
A. Manufacturing and nonmanufacturing are measured by Purchasing Managers' Index (PMI). PMI readings above 50 indicate expansion in economic activity; readings below 50 indicate contraction. Horizontal line indicates expansionary threshold. Last observation is April 2019.
B. e=estimate. Net capital flows and change in reserves are estimates. Net capital inflows include net capital and financial account balance, errors and omissions.
C. Data include only goods. 12-month moving average. Export and import volumes are calculated as export and import values deflated by export and import price deflators. Export and import indices for some missing values and for April 2019 are estimates. Last observation is April 2019.
D. Bond spread denotes the average spread of China's sovereign debt (measured by J.P. Morgan's Emerging Markets Bond Index) over its equivalent maturity U.S. Treasury bond. Equity index is represented by the Shanghai Stock Exchange Composite. Last observation is May 21, 2019.
E. Nominal=exchange rate vis-à-vis U.S. dollar. NEER=Nominal Effective Exchange Rate. REER=Real Effective Exchange Rate. Increase denotes appreciation. Last observation is May 20, 2019.
F. Bonds include local government special bonds and net financing of corporate bonds. Other instruments include entrusted loans, trust loans and other instruments. Last observation is March 2019.
Click here to download data and charts.

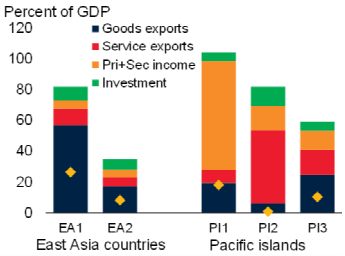
FIGURE 2.1.3 EAP region: Outlook and risks

EAP growth is projected to gradually decline, mainly reflecting the continuing structural slowdown in China. Excluding China, is also slowing, albeit with notable heterogeneity. The region is characterized by deep global integration, which makes countries vulnerable to external trade or financial shocks. Domestic and external vulnerabilities would amplify the impact of such shocks, especially where policy buffers are limited.

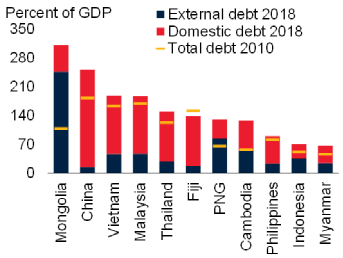
A. GDP growth



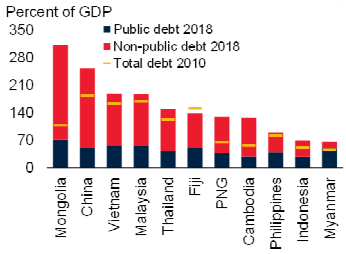
B. Exports and openness to foreign inflows, 2013-18



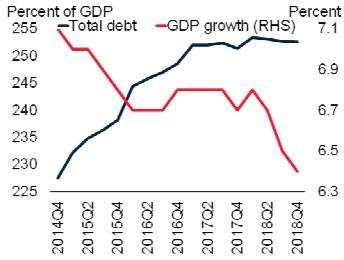
C. Total domestic and external debt



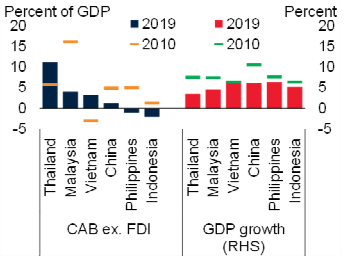
D. Total public and non-public debt



E. GDP growth and total debt in China



F. Current account balance net of FDI and GDP growth



Source: Bank for International Settlements, Haver Analytics, International Monetary Fund, The Institute of International Finance, World Bank.

A. East Asian countries excl. China includes Cambodia, Indonesia, Lao PDR, Malaysia, Mongolia, Myanmar, Palau, Philippines, Thailand, and Vietnam. Pacific Island excl. PNG includes Fiji, Kiribati, Marshall Islands, Micronesia, Palau, Samoa, Solomon Islands, Timor-Leste, Tonga, Tuvalu, and Vanuatu. 1990-2018 average for East Asian countries excl. China excludes Myanmar and 1990-2018 average for Pacific Island excl. PNG excludes Marshall Islands, Micronesia, Palau, Timor-Leste, and Tuvalu due to data limitations. Yellow diamonds denote forecasts published in the January 2019 edition of the *Global Economic Prospects* report. Aggregate growth rates are calculated using 2010 U.S. dollar GDP weights. Data in shaded areas are forecasts.

B. EA=East Asia. PI=Pacific Islands. EA1 comprises Brunei Darussalam, Cambodia, Malaysia, Mongolia, Thailand, and Vietnam; EA2 comprises Indonesia, Lao PDR, Myanmar and Philippines. PI1 comprises Kiribati, Marshall Islands, Micronesia, Timor-Leste, Tonga, and Tuvalu; PI2 comprises Palau and Vanuatu; PI3 comprises Fiji, Papua New Guinea, Samoa, and Solomon Islands. The linkages estimated in this chart only represent direct channels: spillovers may also propagate via indirect channels such as global and regional value chains. Diamonds denote direct cumulative exposure to China, Euro Area, and United States.

C. Total debt is defined as a sum of domestic and external debt. Data for 2018 are estimates.

D. Non-public debt includes all debt excluding public debt. The general government debt data for Mongolia is based on World Bank staff estimates. Data for 2018 are estimates.

E. Total debt is defined as a sum of domestic and external debt.

F. CAB ex. FDI=Current Account Balance excluding Foreign Direct Investment. Orange dashes denote GDP growth in 2010; green hyphen—CAB ex. FDI in 2010. Data for 2019 are estimates.

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projected to accelerate marginally in 2020-21, reflecting continued support from high infrastructure spending, robust private consumption. and solid growth of the working-age population. In Malaysia, growth is expected to moderate slightly but remain robust, with weakening export growth largely offset by strong domestic demand on the back of favorable financing conditions and low inflation. In smaller commodity exporters, growth is expected to remain strong in 2020, supported by continued investment in new mining projects (Mongolia, Papua New Guinea).

While growth in the region is projected to remain robust in the near term, underlying potential growth—which has fallen considerably over the past decade, in part reflecting slowing productivity—is likely to decline further over the long term. This largely reflects deteriorating demographic trends, especially in China, Thailand, and Vietnam, combined with a projected slowdown in capital accumulation in China as credit growth is reined in (World Bank 2018a, 2018b).

Risks

Risks to the forecast remain tilted to the downside. They include the possibility of a sharper-than-expected downturn in large economies, a further slowing of global trade, a possible intensification of trade tensions, and an abrupt change in global financing conditions and investor sentiment. Most of the region managed to weather the deterioration of external conditions in 2018. However, worsening conditions would place additional pressure on policymakers even though most countries having reasonably sound economic fundamentals and robust domestic demand (World Bank 2019a). The baseline also assumes that global trade policy uncertainty will remain elevated over the forecast horizon.

Around 80 percent of advanced economies, as well as China, are expected to register slower growth in 2019. In the baseline scenario, the impact of slower global growth and external demand on the EAP region is assumed to be offset by more supportive financing conditions and stronger

policy stimulus in China. However, a sharper-than-expected deceleration of activity in large economies—the Euro Area, China, and the United States—could have adverse repercussions across the EAP region, mainly through weaker demand for exports and disruption of global value chains, as well as through financial, commodity, and confidence channels (Chapter 1; World Bank 2016; Figure 2.1.3.B).

In particular, risks of a sharper-than-expected slowdown in China remain significant because of a difficult external environment alongside notable domestic challenges. Total non-financial-sector debt in China is above levels seen at the peak of previous credit booms in other major EMDEs and some advanced economies. High corporate indebtedness in sectors with weak profitability is of particular concern. Policymakers' continued reliance on credit expansion to support growth may exacerbate domestic risks by adding further leverage to its already highly leveraged corporate sector, while also contributing to rising debt in the household sector. In addition, a sizable portion of recent stimulus has taken the form of expanding local government special bond quotas. This form of stimulus may eventually become less effective because of diminishing returns to investment, and may further amplify domestic risks. More than half of the 2019 stimulus has taken the form of tax and fee cuts, whose impact on growth may be less predictable than that of changes in public investment.

A renewed spike in global policy uncertainty, including renewed trade tensions between major economies, could cause a further deterioration in confidence, investment, and trade. Policy uncertainty in the region remains high amid unresolved trade dispute between the United States and China, as demonstrated by the most recent escalation of trade tensions. Commitments by China to purchase U.S. goods as part of an interim agreement could lead to further global trade policy uncertainty and trade diversion for other countries. Failure to reach a long-term agreement between these two economies could lead to a further escalation in tariffs, with broad-ranging global and regional consequences. In the extreme case scenario, it could reduce global exports by up to 3 percent and global income by 1.7 percent over the medium term, with the largest decline (3.5 percent) occurring in China (Freund et al. 2018).[1] The region may also be negatively affected by a disorderly exit of the United Kingdom from the European Union. The U.K. is an important trading partner for several regional economies, especially Cambodia and Malaysia. The materialization of a combination of downside risks could trigger an even sharper slowdown in regional growth.

Notwithstanding the region's strong fundamentals—solid growth, diversified economic base, sound policy frameworks, and strong buffers—EAP economies remain vulnerable to risks related to abrupt changes in global financial conditions. Many countries have pockets of vulnerabilities, including elevated debt (China, Lao People's Democratic Republic, Malaysia, Mongolia, Vietnam), sizable fiscal deficits (Cambodia, Lao PDR, Mongolia, Vietnam), or significant reliance on potentially volatile capital flows (Cambodia, Indonesia; Figures 2.1.3.C-F). Renewed episodes of financial market stress could have pronounced and widespread effects on countries with high indebtedness (Chapter 1). Vulnerabilities among some EAP countries could amplify the impact of external shocks, such as a sudden stop in capital flows or a rise in borrowing costs.

[1] Assumes a 25 percent tariff surcharge on all products traded between China and the United States, combined with a decline in investor confidence, resulting in a 0.5 percentage point drop in global investment to GDP.

TABLE 2.1.1 East Asia and Pacific forecast summary

(Real GDP growth at market prices in percent, unless indicated otherwise)

	2016	2017	2018e	2019f	2020f	2021f	Percentage point differences from January 2019 projections: 2019f	2020f	2021f
EMDE EAP, GDP[1]	**6.3**	**6.5**	**6.3**	**5.9**	**5.9**	**5.8**	**-0.1**	**-0.1**	**0.0**
(Average including countries with full national accounts and balance of payments data only)[2]									
EMDE EAP, GDP[2]	6.3	6.5	6.3	5.9	5.9	5.8	-0.1	-0.1	0.0
GDP per capita (U.S. dollars)	5.6	5.8	5.7	5.4	5.3	5.3	0.0	-0.1	0.0
PPP GDP	6.3	6.4	6.3	5.9	5.9	5.8	0.0	0.0	0.0
Private consumption	7.1	6.5	8.1	7.0	7.0	7.0	-0.4	-0.1	-0.2
Public consumption	9.3	7.4	9.4	7.6	7.5	7.4	0.3	0.4	0.3
Fixed investment	6.6	5.3	5.3	5.1	5.1	4.9	-0.2	-0.1	-0.2
Exports, GNFS[3]	2.6	9.4	4.7	3.3	3.9	4.3	-1.4	-0.5	0.0
Imports, GNFS[3]	5.4	7.9	7.8	4.7	5.0	5.7	-1.8	-0.9	-0.1
Net exports, contribution to growth	-0.8	0.4	-0.9	-0.4	-0.4	-0.5	0.1	0.1	0.0
Memo items: GDP									
East Asia excluding China	4.9	5.4	5.2	5.1	5.2	5.2	-0.1	0.0	0.0
China	6.7	6.8	6.6	6.2	6.1	6.0	0.0	-0.1	0.0
Indonesia	5.0	5.1	5.2	5.2	5.3	5.3	0.0	0.0	0.0
Thailand	3.4	4.0	4.1	3.5	3.6	3.7	-0.3	-0.3	-0.2

Source: World Bank.
Note: e = estimate; f = forecast. EMDE = emerging market and developing economies. World Bank forecasts are frequently updated based on new information and changing (global) circumstances. Consequently, projections presented here may differ from those contained in other Bank documents, even if basic assessments of countries' prospects do not differ at any given moment in time.
1. GDP at market prices and expenditure components are measured in constant 2010 U.S. dollars. Excludes Democratic People's Republic of Korea and dependent territories.
2. Sub-region aggregate excludes Democratic People's Republic of Korea, dependent territories, Fiji, Kiribati, the Marshall Islands, the Federated States of Micronesia, Myanmar, Nauru, Palau, Papua New Guinea, Samoa, Timor-Leste, Tonga, and Tuvalu, for which data limitations prevent the forecasting of GDP components.
3. Exports and imports of goods and non-factor services (GNFS).
Click here to download data.

TABLE 2.1.2 East Asia and Pacific country forecasts[1]

(Real GDP growth at market prices in percent, unless indicated otherwise)

	2016	2017	2018e	2019f	2020f	2021f	Percentage point differences from January 2019 projections: 2019f	2020f	2021f
Cambodia	7.0	7.0	7.5	7.0	6.9	6.8	0.2	0.1	0.1
China	6.7	6.8	6.6	6.2	6.1	6.0	0.0	-0.1	0.0
Fiji	0.7	3.0	3.2	3.4	3.3	3.3	0.0	0.0	0.0
Indonesia	5.0	5.1	5.2	5.2	5.3	5.3	0.0	0.0	0.0
Lao PDR	7.0	6.9	6.5	6.6	6.7	6.6	0.0	0.0	0.0
Malaysia	4.2	5.9	4.7	4.6	4.6	4.6	-0.1	0.0	0.0
Mongolia	1.4	5.4	6.9	7.2	6.9	6.2	0.6	0.6	0.0
Myanmar	5.9	6.8	6.2	6.5	6.6	6.8	0.0	0.0	0.0
Papua New Guinea	4.1	2.3	-0.3	5.6	3.1	3.5	0.5	0.0	0.1
Philippines	6.9	6.7	6.2	6.4	6.5	6.5	-0.1	-0.1	-0.1
Solomon Islands	3.3	3.0	3.5	2.9	2.8	2.7	0.0	0.0	0.0
Thailand	3.4	4.0	4.1	3.5	3.6	3.7	-0.3	-0.3	-0.2
Timor-Leste[2]	5.1	-3.5	-0.7	3.9	4.6	5.0	0.6	-0.3	0.0
Vietnam	6.2	6.8	7.1	6.6	6.5	6.5	0.0	0.0	0.0

Source: World Bank.
Note: e = estimate; f = forecast. World Bank forecasts are frequently updated based on new information and changing (global) circumstances. Consequently, projections presented here may differ from those contained in other Bank documents, even if basic assessments of countries' prospects do not significantly differ at any given moment in time.
1. GDP at market prices and expenditure components are measured in constant 2010 U.S. dollars.
2. Non-oil GDP. Timor-Leste's total GDP, including the oil economy, is roughly four times its non-oil economy and is highly volatile as a result of sensitivity to changes in global oil prices and local production levels.
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EUROPE and CENTRAL ASIA

Growth in Europe and Central Asia is projected to fall sharply from 3.1 percent in 2018 to 1.6 percent in 2019. The slowdown partly reflects a sharp weakening of activity in Turkey, which fell into recession in the wake of acute financial market stress in 2018. Regional growth is projected to pick up in 2020-21 as Turkey recovers and the Russian Federation strengthens. Excluding these economies, the rest of the region is expected to moderate. In particular, growth in Central Europe is projected to soften as economies grapple with the slowdown in the Euro Area and binding domestic capacity constraints. Key external risks to the region include spillovers from weaker-than-expected activity in the Euro Area and from escalation of global policy uncertainty, particularly in relation to trade tensions and the United Kingdom's exit from the European Union. Renewed financial pressures in Turkey could also disrupt regional growth.

Recent developments

Growth in Europe and Central Asia (ECA) moderated in 2018 to 3.1 percent—close to its potential rate—while the start of 2019 has been slow amid weakening investment and trade growth. The slowdown followed a strong expansion in 2017, driven by both domestic demand and exports (Figure 2.2.1.A; World Bank 2019c). Regional growth in 2018 suffered from marked weakness in Turkey, where GDP contracted sharply in the second half of 2018. Activity in Central Europe also slowed toward the end of 2018, reflecting weakening domestic demand and challenging external factors amid a slowdown in the Euro Area (Poland, Romania). In contrast, growth in Russia accelerated due to several temporary factors.

Trade weakened across the region in early 2019, as goods trade volumes slowed in tandem with activity in the Euro Area, which is the region's largest export destination (Figure 2.2.1.B). The region's three largest economies—Russia, Turkey, and Poland—faced softening trade prospects amid slowing industrial production growth (Figure 2.2.1.C).

In response to deteriorating global growth prospects, central banks in major economies have provided additional monetary policy accommodation since the start of 2019, resulting in easing global financing conditions. The tightening cycle in monetary policy in 2018 has paused in ECA, with some economies cutting policy rates (Armenia, Azerbaijan, Georgia, Kazakhstan, Kyrgyz Republic, North Macedonia, Ukraine) or leaving them unchanged in 2019, but overall policy rates in some large ECA economies remain higher than in 2018 (Figure 2.2.1.D; Russia, Turkey). Fiscal policy has also loosened in 2019, resulting in widening government deficit-to-GDP ratios (Belarus, Kyrgyz Republic, Poland, Romania). Public debt has increased by over 10 percentage points of GDP since the global financial crisis, reaching 45 percent at the end of 2018. Inflation has been trending up in the region since the start of 2019 (Armenia, Azerbaijan, Bulgaria, Croatia, Georgia, Hungary, Kosovo, Moldova, Montenegro, Poland, Romania, Russia, Serbia, Tajikistan), driven in part by rising oil prices (Figure 2.2.1.E).

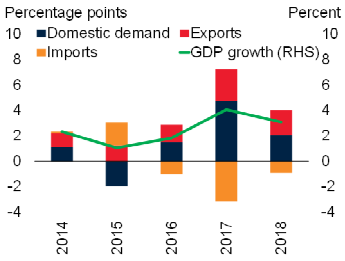
Activity strengthened somewhat in Eastern Europe, the South Caucasus, and Central Asia in 2018, with all three subregions benefiting from firming growth in Russia via close trade and financial linkages. However, the earlier boosts in Eastern Europe from improved agricultural

Note: This section was prepared by Collette M. Wheeler. Research assistance was provided by Mengyi Li and Julia R.R. Norfleet.

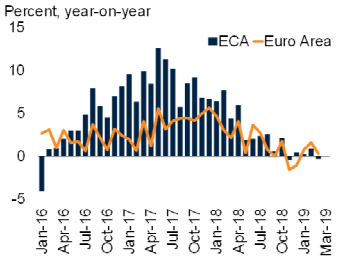
FIGURE 2.2.1 ECA: Recent developments

Growth in ECA eased in 2018 and early 2019 on weakening exports to the tightly linked Euro Area. Inflation has risen owing to a combination of oil price movements and currency depreciations, which has forced many central banks to maintain higher policy interest rates in 2019. Turkey's financial market stress was accompanied by large financial outflows, and the subsequent weakness in Turkish economic activity has weighed on regional growth.

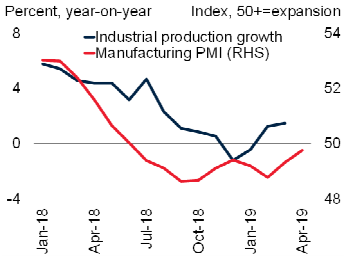
A. Contribution to regional GDP growth



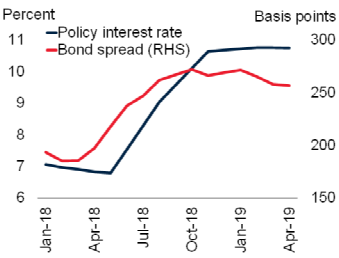
B. Growth in goods trade, volumes



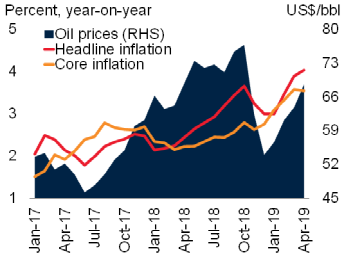
C. Industrial production growth and manufacturing PMI in Russia, Turkey, and Poland



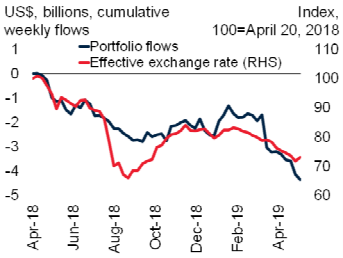
D. Bond spreads and policy interest rates



E. Inflation and global oil prices



F. Turkey portfolio flows and nominal effective exchange rate



Source: CPB Netherlands Bureau for Economic Policy Analysis, Haver Analytics, Institute of International Finance, J.P. Morgan, World Bank.

Note: For sample coverage, refer to Table 2.2.1.

A. Aggregate growth rates calculated using 2010 constant U.S. dollar GDP weights. Data for 2018 are estimates. Sample includes 18 economies, for which GDP components are available.

B. Last observation is March 2019.

C. Manufacturing PMI are 3-month moving averages. PMI is the Purchasing Managers' Index (PMI). Readings above 50 indicate expansion, readings below indicate contraction. The aggregates are calculated using constant 2010 U.S. dollar GDP weights. Last observation is April 2019 for manufacturing PMI, and March 2019 for industrial production growth.

D. Data are 3-month moving averages and calculated using 2010 U.S. dollar GDP weights. Bond spread denotes the average spread of ECA sovereign debt (measured by J.P. Morgan's Emerging Markets Bond Index) over its equivalent maturity U.S. Treasury bond. Sample includes Georgia, Hungary, Kazakhstan, Poland, Russia, Serbia, Turkey, and Ukraine, for which EMBI spreads are available. Last observation is April 2019.

E. Figure shows median inflation values. Headline inflation measured as the percent change in the consumer price index. Sample includes Belarus, Croatia, Hungary, North Macedonia, Poland, Romania, Russia, and Turkey, for which data are available. Last observation is April 2019.

F. Cumulative weekly flows since April 20, 2018. Last observation is May 17, 2019.

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harvests (Ukraine) and robust domestic demand (Moldova) have already begun to fade, as private consumption is dampened by inflationary pressures and weaker remittances in 2019. Robust services sector activity continues to underpin growth in the South Caucasus, with an additional boost coming from manufacturing in Armenia. In Central Asia, strong production in the Kashagan oil field supported the cyclical recovery in Kazakhstan in 2018, but production has flattened in 2019 due to agreed upon cuts with OPEC, as Kazakhstan is a non-OPEC partner. Strong tourist arrivals have continued in early 2019 in the Western Balkans (Albania, Montenegro), while the rebound in Serbia from earlier weather-related disruptions fades.

In Russia, growth picked up to a six-year high of 2.3 percent in 2018, despite tightening international economic sanctions and financial market pressures. The acceleration of activity was supported by the rise in oil prices, a solid contribution from net exports, as well as one-off factors such as energy-related construction projects and the hosting of the World Cup. Industrial activity slowed at the start of 2019, as compliance with agreed upon oil production cuts took effect as a non-OPEC partner. Retail sales volume growth also declined with the onset of the value-added tax hike.

Following strong growth of 7.4 percent in 2017 and solid momentum at the start of 2018, the Turkish economy slowed sharply and entered a recession in the second half of 2018. The downturn was triggered by corporate fragility stemming from rising levels of debt, often denominated in foreign currency, and exacerbated by policy uncertainty. This led to significant pressure on financial markets and the value of the lira. Growth was 2.6 percent for 2018 as a whole. The deceleration of activity was partly driven by significant financial outflows from Turkey amid market concerns about high current account deficits and policy developments, which led to sharp falls in investment and private consumption (Figure 2.2.1.F).

Growth in Poland was a robust 5.1 percent in 2018, partly reflecting European Union (EU)

fund transfers and the strongest labor market since the 1990s. Despite this, low inflation and borrowing rates enabled the authorities to undertake accommodative monetary policy and fiscal policy expansion. However, since the end of 2018, core inflation has nearly tripled, accelerating to a 6-year high in April.

Outlook

Regional growth is projected to sharply decelerate to a four-year low in 2019, to 1.6 percent, down from 3.1 percent in 2018. This is 0.7 percentage point lower than previous forecasts, reflecting weaker-than-expected activity in Turkey and Russia, as well as some smaller economies. Energy exporters in the region (Azerbaijan, Kazakhstan, Russia) should benefit from the recent rise in oil prices. Regional growth is expected to firm in 2020-21 as Turkey recovers (Figure 2.2.2.A). Excluding Turkey, regional activity is expected to stabilize, with modest growth in domestic demand and a small drag from net exports.

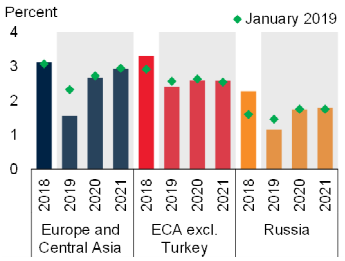
The baseline projection for regional growth is predicated on the assumption that Turkey's economy bottoms out in 2019 and that spillovers from slowing growth in the Euro Area are limited. The baseline also assumes no further escalation in trade tensions between the United States and China or other major trading partners, no disorderly exit from the European Union by the United Kingdom, and an absence of policy missteps in economies that recently suffered acute financial stress—mainly Turkey. Trade relations between the United States and China remain fragile, however, and further escalation in tariffs or retaliatory action could adversely affect economies in the region, particularly energy and metals exporters. Similarly, a deterioration in trade relations between the United States and Europe, particularly with respect to auto tariffs, could also be detrimental to the ECA region. Regional growth also depends on oil prices remaining relatively stable, moderating gradually over the forecast horizon.

The projected weakening of growth is more pronounced in Central Europe than in other ECA subregions because of closer linkages with the

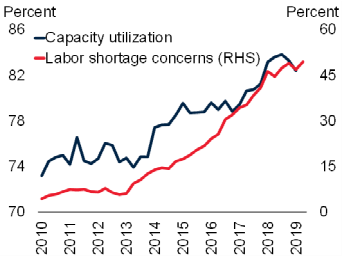
FIGURE 2.2.2 ECA: Outlook and risks

Growth in ECA is projected to fall to 1.6 percent in 2019, reflecting the effects of Turkey's financial stress and weakening activity in other large economies. Capacity constraints are expected to hinder growth in Central Europe, while a further deceleration in the Euro Area or Russia could dent activity in tightly connected subregions. Large external debt leaves regional economies susceptible to sudden shifts in investor sentiment, while the realization of contingent liabilities could pose additional fiscal costs in ECA.

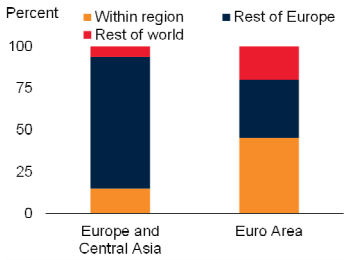
A. GDP growth



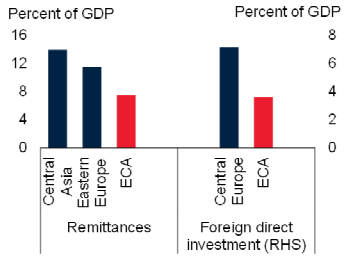
B. Capacity utilization and labor shortages in Central Europe



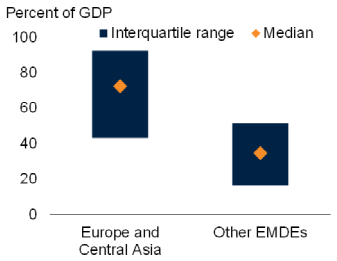
C. Share of export goods trade by destination, 2017



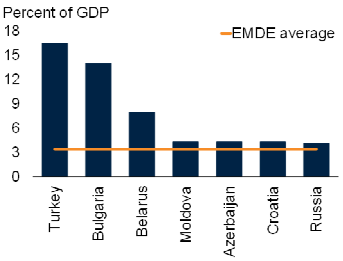
D. Remittances and foreign direct investment inflows, 2018



E. External debt, 2017



F. Average fiscal cost of realized contingent liability episodes



Source: Bova et al. (2016), European Commission, Kose et al. (2017), Organisation for Economic Co-operation and Development, United Nations Conference on Trade and Development, World Bank.

A. Aggregate growth rates calculated using constant 2010 U.S. dollar GDP weights. Shaded areas indicate forecasts. Data for 2018 are estimates. Green diamonds correspond to forecasts from the January 2019 edition of the *Global Economic Prospects* report.

B. Data are calculated using constant 2010 U.S. dollar GDP weights. Sample includes Hungary, Poland, and Romania. Labor shortage is the percentage of manufacturing firms pointing to labor shortages as a factor limiting production. Last observation is 2019Q1.

C. Shares are calculated from exports in millions of U.S. dollars.

D. Figure shows the 2018 averages for remittances, and the 2016-17 averages for foreign direct investment, based on data availability.

E. Figure shows total public and private external debt stocks as a share of GDP in 2017, as in Kose et al. (2017). "Other EMDEs" are all other EMDEs that are not in the Europe and Central Asia region.

F. Fiscal cost is measured as gross fiscal outlays and the change in the government financial position due to a contingent liability realization, as estimated by Bova et al. (2016). The data cover episodes from 1990 to 2014. Types of contingent liabilities include those that involved public sector bailouts for the financial sector, SOEs, the private non-financial sector, PPPs, and others, as defined by Bove et al. (2016).

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Euro Area and increasingly binding domestic capacity constraints (Figure 2.2.2.B). Fiscal stimulus, and the resulting boost to private consumption, will begin to fade in some of the subregion's largest economies by 2020 (Hungary, Poland, Romania). Shrinking working-age populations, partly reflecting emigration to western Europe in recent years, limits medium-term growth prospects in Central Europe. Tepid private investment growth could weaken further in the absence of sustained progress on structural reforms.

Growth is expected to moderate over the forecast horizon in both Eastern Europe and Central Asia. These regions face a more challenging external environment as growth decelerates in major trading partners, such as the Euro Area and Russia. The pace of future growth in both subregions depends on the successful implementation of structural reforms to improve the business environment, achieve debt sustainability, and restructure state-owned enterprises (Belarus, Kyrgyz Republic, Moldova, Ukraine, Uzbekistan; EBRD 2017; Funk, Isakova, and Ivanyna 2017). In Central Asia, modest growth in Russia and low productivity will weigh on activity in the region's largest economy, Kazakhstan.

Growth in the South Caucasus subregion is projected to strengthen to 4.2 percent by 2021, from 2.6 percent in 2018, assuming the continued implementation of domestic reforms and infrastructure investment. Activity in the region's largest economy, Azerbaijan, will be boosted by a new natural gas pipeline coming on stream, although this will be partly offset by the effects of weak credit growth arising from problems in the financial sector. In Armenia and Georgia, growth is expected to firm, partly on account of increased government investment.

Growth in the Western Balkans is projected to be broadly stable, dipping to 3.5 percent in 2019 but returning to 3.9 percent by 2021. This forecast is predicated on political stability and policy uncertainty remaining in check. Infrastructure investment and private consumption will help deliver robust growth in some economies (Kosovo, North Macedonia, Serbia), while a deceleration in public and private investment will slow growth in others (Albania, Montenegro; World Bank 2019d).

In Russia, the projection for 2019 has been downgraded to 1.2 percent, reflecting oil production cuts. Tighter monetary policy, combined with a value-added tax hike at the beginning of 2019, are also contributing to weaker growth momentum in the remainder of 2019. Private investment remains tepid due to policy uncertainty and prospects for slowing potential growth over the longer term due to worsening demographic pressures.

In Turkey, growth is expected to be weighed down by increased inflation and associated pressure on real incomes, banking and corporate sector deleveraging following several years of rapid credit growth, and low business and consumer confidence. Activity is expected to bottom out in 2019, with annual growth contracting 1 percent, but the recent flare up in financial market pressures highlight that downside risks remain sharply elevated. The recovery is assumed to strengthen in 2020 through gradual improvement in domestic demand and continued strength in net exports, provided that fiscal and monetary policy avert further sharp falls in the lira and corporate debt restructurings help avoid serious damage to the financial system.

In Poland, growth in 2019-20 will be buoyed by a recently announced fiscal stimulus package, amounting to roughly 2 percent of GDP. This fiscal expansion aims to boost private consumption through various social transfers and income tax reduction schemes. Nevertheless, growth is expected to slow over the forecast horizon, to 3.3 percent by 2021 from a peak of 5.1 percent in 2018, as domestic capacity constraints and slowing investment weigh on growth.

Over the long term, regional growth could be hindered by worsening demographic trends, in conjunction with tepid productivity and investment growth (World Bank 2018c; Bussolo, Koettl, and Sinnott 2015; EBRD 2018).

Structural reforms that close remaining investment gaps, encourage privatization, and promote FDI and greater participation in global value chains could help boost productivity in the region (EBRD 2015; Gould 2018; Chapter 1). Greater economic integration and regional coordination could also help spur innovation and competition, unleashing the region's growth potential (Kunzel et al. 2019).

Risks

The region's outlook remains subject to significant downside risks. Chief among these is a sharper-than-expected slowdown in ECA's most important trading partner, the Euro Area. The Euro Area purchased the majority of ECA exports in 2017, while total foreign direct investment inflows accounted for over 7 percent of GDP in Central Europe (Figure 2.2.2.C). In Central Asia and Eastern Europe, slowing activity in Russia could impact remittance inflows, which account for an important proportion of income (Kyrgyz Republic, Moldova, Tajikistan, Ukraine; Figure 2.2.2.D).

The financial stress in Turkey has had limited spillovers to the other economies in the region. However, the experience of Turkey is a stark reminder of the risk of sudden shifts in investor sentiment—in particular for countries with large current account deficits or reliance on potentially volatile capital inflows, high external debt loads, or sizable foreign-currency-denominated debt (Belarus, Croatia, Georgia, Kyrgyz Republic, Moldova, Tajikistan, Ukraine; Figure 2.2.2.E).

Increases in policy uncertainty could undermine business and investor confidence in the region. Policy disagreements between the European Union and some Central European countries could deter international investors and reduce fiscal transfers. Election outcomes in some of the region's largest economies could also elevate policy uncertainty. Further escalation of international trade restrictions could have a negative impact on the region, given its openness to trade and capital flows. A reversal of structural reforms remains a risk in many countries, especially Armenia, Azerbaijan, Belarus, Turkey, and Ukraine. Renewed conflict in the Syrian Arab Republic or Ukraine could trigger new sanctions.

Fiscal risks have increased in the ECA region despite more benign global financing conditions in 2019, as corporate debt has risen, with large shares of foreign-currency-denominated debt (Belarus, Kyrgyz Republic, Moldova, Ukraine). The rapid increase in private sector debt in ECA over the past decade has come with growing contingent liabilities for the public sector—potential bailouts of systemic private liabilities would come at a high cost. Past episodes of realized contingent liabilities have imposed large fiscal costs in the region (Figure 2.2.2.F; Bova et al. 2016).

TABLE 2.2.1 Europe and Central Asia forecast summary

(Real GDP growth at market prices in percent, unless indicated otherwise)

	2016	2017	2018e	2019f	2020f	2021f	Percentage point differences from January 2019 projections: 2019f	2020f	2021f
EMDE ECA, GDP[1]	**1.9**	**4.1**	**3.1**	**1.6**	**2.7**	**2.9**	**-0.7**	**0.0**	**0.0**
EMDE ECA, GDP excl. Turkey	1.5	3.0	3.3	2.4	2.6	2.6	-0.2	0.0	0.1
(Average including countries with full national accounts and balance of payments data only)[2]									
EMDE ECA, GDP[2]	1.8	4.1	3.1	1.5	2.6	2.9	-0.8	-0.1	0.0
GDP per capita (U.S. dollars)	1.4	3.7	2.7	1.2	2.4	2.7	-0.8	0.0	0.0
PPP GDP	1.8	3.9	3.1	1.6	2.7	2.9	-0.7	0.0	0.0
Private consumption	1.4	4.8	3.0	1.4	2.6	2.7	-1.0	-0.6	-0.2
Public consumption	3.1	3.1	1.6	1.6	1.6	1.8	-0.9	-0.6	-0.3
Fixed investment	-0.1	6.3	2.6	-0.8	3.3	3.6	-3.1	-1.3	-1.2
Exports, GNFS[3]	4.0	7.1	5.7	4.0	4.2	4.0	-1.3	-0.1	-0.5
Imports, GNFS[3]	3.5	10.7	3.2	3.2	5.4	5.8	-1.9	-0.4	0.0
Net exports, contribution to growth	0.3	-0.7	1.0	0.5	-0.2	-0.4	0.2	0.0	-0.2
Memo items: GDP									
Commodity exporters[4]	0.7	2.1	2.7	1.8	2.2	2.3	-0.2	0.0	0.0
Commodity importers[5]	3.1	6.0	3.6	1.4	3.1	3.5	-1.2	-0.1	-0.1
Central Europe[6]	3.4	5.0	4.6	3.7	3.3	3.1	0.1	0.0	0.1
Western Balkans[7]	3.2	2.6	3.9	3.5	3.8	3.9	0.0	0.0	0.1
Eastern Europe[8]	0.9	2.6	3.2	2.4	2.7	3.0	-0.5	-0.4	-0.4
South Caucasus[9]	-1.6	2.0	2.6	3.7	3.9	4.2	-0.3	0.1	0.8
Central Asia[10]	2.9	4.6	4.7	4.2	4.0	4.1	0.0	0.0	0.0
Russia	0.3	1.6	2.3	1.2	1.8	1.8	-0.3	0.0	0.0
Turkey	3.2	7.4	2.6	-1.0	3.0	4.0	-2.6	0.0	-0.2
Poland	3.1	4.8	5.1	4.0	3.6	3.3	0.0	0.0	0.0

Source: World Bank.
Note: e = estimate; f = forecast. EMDE = emerging market and developing economies. World Bank forecasts are frequently updated based on new information and changing (global) circumstances. Consequently, projections presented here may differ from those contained in other Bank documents, even if basic assessments of countries' prospects do not differ at any given moment in time.
1. GDP at market prices and expenditure components are measured in constant 2010 U.S. dollars.
2. Sub-region aggregate excludes Bosnia and Herzegovina, Kosovo, Montenegro, Serbia, Tajikistan, and Turkmenistan, for which data limitations prevent the forecasting of GDP components.
3. Exports and imports of goods and non-factor services (GNFS).
4. Includes Albania, Armenia, Azerbaijan, Kazakhstan, the Kyrgyz Republic, Kosovo, Russia, Tajikistan, Turkmenistan, Ukraine, and Uzbekistan.
5. Includes Belarus, Bosnia and Herzegovina, Bulgaria, Croatia, Georgia, Hungary, Moldova, Montenegro, North Macedonia, Poland, Romania, Serbia, and Turkey.
6. Includes Bulgaria, Croatia, Hungary, Poland, and Romania.
7. Includes Albania, Bosnia and Herzegovina, Kosovo, Montenegro, North Macedonia, and Serbia.
8. Includes Belarus, Moldova, and Ukraine.
9. Includes Armenia, Azerbaijan, and Georgia.
10. Includes Kazakhstan, the Kyrgyz Republic, Tajikistan, Turkmenistan, and Uzbekistan.
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TABLE 2.2.2 Europe and Central Asia country forecasts[1]

(Real GDP growth at market prices in percent, unless indicated otherwise)

	2016	2017	2018e	2019f	2020f	2021f	Percentage point differences from January 2019 projections: 2019f	2020f	2021f
Albania	3.3	3.8	4.1	3.7	3.7	3.8	0.1	0.2	0.3
Armenia	0.2	7.5	5.2	4.2	4.9	5.2	-0.1	0.3	0.6
Azerbaijan	-3.1	0.1	1.4	3.3	3.5	3.7	-0.3	0.2	1.0
Belarus	-2.5	2.5	3.0	1.8	1.3	1.2	-0.9	-1.2	-1.3
Bosnia and Herzegovina[2]	3.1	3.2	3.1	3.4	3.9	4.0	0.0	0.0	0.0
Bulgaria	3.9	3.8	3.1	3.0	2.8	2.8	-0.1	-0.2	0.0
Croatia	3.5	2.9	2.6	2.5	2.5	2.4	-0.3	-0.3	-0.2
Georgia	2.8	4.8	4.7	4.6	4.8	5.0	-0.4	-0.2	0.0
Hungary	2.3	4.1	4.9	3.8	2.8	2.6	0.6	0.0	0.2
Kazakhstan	1.1	4.1	4.1	3.5	3.2	3.2	0.0	0.0	0.0
Kosovo	4.1	4.2	4.2	4.4	4.5	4.5	-0.1	0.0	0.0
Kyrgyz Republic	4.3	4.7	3.5	4.3	4.0	4.1	0.9	0.1	0.1
Moldova	4.4	4.7	4.0	3.4	3.6	3.8	-0.4	0.1	0.6
Montenegro	2.9	4.7	4.9	2.9	2.4	2.3	0.1	-0.1	-0.2
North Macedonia	2.8	0.2	2.7	2.9	3.2	3.6	0.0	0.0	0.3
Poland	3.1	4.8	5.1	4.0	3.6	3.3	0.0	0.0	0.0
Romania	4.8	7.0	4.1	3.6	3.3	3.1	0.1	0.2	0.3
Russia	0.3	1.6	2.3	1.2	1.8	1.8	-0.3	0.0	0.0
Serbia	3.3	2.0	4.3	3.5	4.0	4.0	0.0	0.0	0.0
Tajikistan	6.9	7.1	7.3	6.0	6.0	6.0	0.0	0.0	0.0
Turkey	3.2	7.4	2.6	-1.0	3.0	4.0	-2.6	0.0	-0.2
Turkmenistan	6.2	6.5	6.2	5.6	5.1	4.9	0.0	0.0	0.0
Ukraine	2.4	2.5	3.3	2.7	3.4	3.8	-0.2	0.0	0.0
Uzbekistan	6.1	4.5	5.1	5.3	5.5	6.0	0.2	0.0	0.0

Source: World Bank.

Note: e = estimate; f = forecast. World Bank forecasts are frequently updated based on new information and changing (global) circumstances. Consequently, projections presented here may differ from those contained in other Bank documents, even if basic assessments of countries' prospects do not significantly differ at any given moment in time.

1. GDP at market prices and expenditure components are measured in constant 2010 U.S. dollars, unless indicated otherwise.

2. GDP growth rate at constant prices is based on production approach.

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LATIN AMERICA and THE CARIBBEAN

Growth in Latin America and the Caribbean is expected to be subdued in 2019, at 1.7 percent, reflecting challenging conditions in several of the largest economies. Gradually building momentum in Brazil and a recovery in Argentina are projected to contribute to a pickup in regional growth to 2.5 percent in 2020 and 2.7 percent in 2021. Financial conditions in the region have eased markedly since early 2019. Despite soft global trade, regional export growth has picked up, boosted by trade diversion in response to bilateral tariffs by the United States and China, and by solid growth in the United States. As these effects wane and global trade decelerates further, export growth in the region is projected to slow. Risks to the growth outlook remain tilted to the downside. Sharper-than-projected slowdowns in the United States and China could have negative spillovers on regional growth through trade, financial, and commodity market channels. Adverse market responses to weak fiscal conditions and disruptions from natural disasters are other important risks. The crisis in Venezuela also presents risks.

Recent developments

Following weak growth of 1.6 percent in 2018, activity indicators in Latin America and the Caribbean (LAC), in aggregate, have been subdued in the first half of 2019.[1] However, conditions in the largest economies are uneven. In Brazil, although labor and financing conditions have improved, activity indicators remain sluggish. Chile and Mexico are both experiencing slowdowns, and the Argentine economy continues to contract. Recent data for Colombia indicates a gradually building expansion, however.

In contrast to global trends, trade in the region continues to expand. Goods export volumes have grown steadily since early 2018, recently overtaking import growth (Figure 2.3.1.A). There is evidence that trade diversion, following the imposition of bilateral tariffs by the United States and China, has benefited some LAC countries (Brazil, Mexico). However, export orders in some large economies have moderated in recent months, consistent with weakening global trade growth.

Manufacturing activity in the region decelerated at the start of 2019, echoing a soft patch in global industrial production around the turn of the year (Figure 2.3.1.B). Mining (including oil) sector activity in LAC continues to contract. Supply disruptions in Brazil due to the Vale dam accident and in Chile due to heavy rains contributed to the contraction in early 2019, while declines in oil and gas production in Mexico persist.

Compared to the industrial sector, activity in the services sector in LAC has been much more supportive of growth (Figure 2.3.1.C). However, services growth softened in late 2018, largely due to the weak performance in Argentina; the drag should diminish as this economy recovers.

Financing conditions in the region have eased markedly in recent months, with a general fall in bond yields and credit default swap (CDS) spreads, even though in some cases bond yields remain substantially higher than in 2017 (Argentina, Mexico, Venezuela; Figure 2.3.1.D). Equity price indexes in major economies are higher than in late 2018, reflecting improved investor sentiment. Capital inflows have picked up after slowing in much of 2018.

Inflows of remittances to LAC have been robust, in part reflecting strong U.S. labor market

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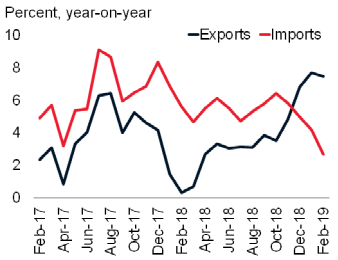
Note: This section was prepared by Dana Vorisek. Research assistance was provided by Mengyi Li.

[1] Due to lack of data, the World Bank has ceased producing a growth forecast for Venezuela and has removed Venezuela from all growth aggregates in which it was previously included.

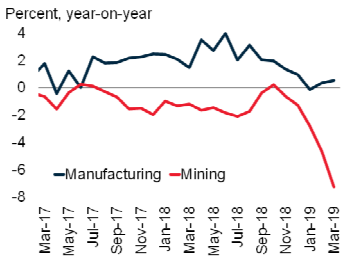
FIGURE 2.3.1 LAC: Recent developments

Export growth momentum has picked up in LAC in recent months. An expanding services sector continues to be a source of growth. Industrial production has been weak, however, especially mining production. Financing conditions in the region have eased markedly since the start of the year. The financial stress in Argentina last year and the subsequent output contraction has had an impact on neighboring countries through specific sectors, such as tourism, but has not generated widespread intraregional spillovers. The humanitarian and economic crisis in Venezuela has deepened, and oil production has further collapsed.

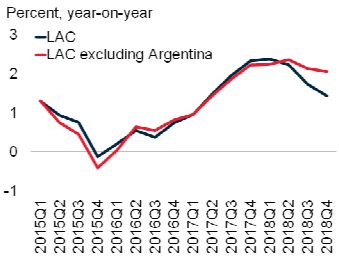
A. Trade volume growth



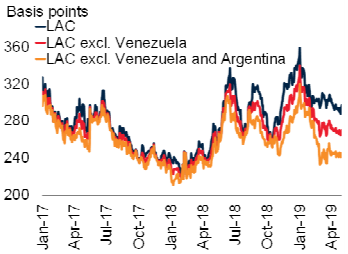
B. Manufacturing and mining production



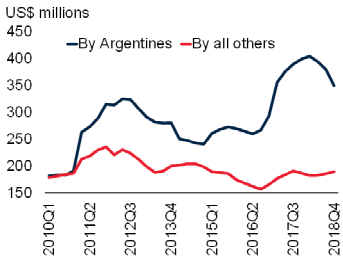
C. Services sector growth



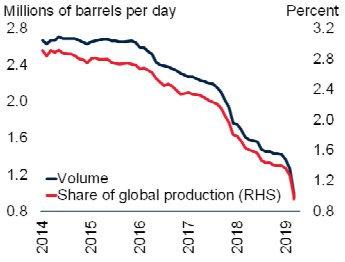
D. Bond yields



E. Tourism expenditures in Uruguay



F. Oil production in Venezuela



Source: CPB Netherlands Bureau for Economic Policy Analysis, Haver Analytics, International Energy Agency, JP Morgan, World Bank.

A. Lines show 3-month moving average growth of aggregate volumes for 13 countries representing 97 percent of regional GDP. Last observation is February 2019.

B. Lines show 3-month moving average of 2018 industrial production-weighted averages of Brazil, Chile, Colombia, Ecuador, Mexico, Peru, and Uruguay for manufacturing and Brazil, Chile, Colombia, Mexico, and Peru for mining. Last observation is March 2019.

C. LAC line shows 2018 GDP-weighted averages of Brazil, Chile, Colombia, Mexico, and Peru. Last observation is 2018Q4.

D. LAC line shows median of 16 countries; others show medians excluding the indicated countries. Last observation is May 10, 2019.

E. Lines show 4-quarter moving averages. Last observation is 2018Q4.

F. Last observation is April 2019.

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conditions. In several of the countries where remittances account for large shares of domestic GDP, remittance growth was more than 10 percent in 2018 (the Dominican Republic, Guatemala, Honduras; World Bank 2019d). Strong remittance inflows have helped offset challenging social and economic conditions in several Central American countries in 2018 (e.g., political and social unrest in Honduras and Nicaragua).

With some key exceptions (Argentina, Venezuela), inflation in LAC remains moderate, in part due to stable or strengthening exchange rates against the U.S. dollar, following significant depreciations in 2018. Headline inflation has fallen in most of the region during the past year, while core inflation has been more stable. In most countries, policy interest rates have been on hold or have been adjusted downward since the end of 2018. Among the central banks in the regions using inflation targets, inflation is in the target range in all but one (the Dominican Republic).

Although the 2018 crisis in Argentina did not have broad-ranging spillovers within the region, there have been some negative repercussions in neighboring countries. The value of Brazil's exports to Argentina fell by 15 percent in 2018. Within Brazil's industrial sector, vehicles, automobile parts, and machinery are estimated to have been most affected (Central Bank of Brazil 2019). Uruguay and Paraguay also experienced slowdowns in export growth—in particular, tourism exports—due to strong bilateral currency appreciation against the Argentine peso (Figure 2.3.1.E). Remittance inflows to Paraguay, the large majority of which come from Argentina, fell sharply in 2018, by about 19 percent.

In Venezuela, the humanitarian and economic crisis is deepening. The population is experiencing frequent electricity outages and water shortages; widespread scarcity of basic goods, including food and medicine; and sharp increases in infant and maternal mortality rates, malnutrition, and cases of preventable diseases. An estimated 3.7 million people had left the Venezuela as of early 2019—approximately 12 percent of the country's population in 2015 (UNHCR 2019). This creates challenges both in Venezuela and in host

countries. Mismanagement in the economically vital oil sector, together with insufficient maintenance and investment, have contributed to a precipitous decline in oil production—to 1 million barrels per day in April, compared to an average of 2.7 million barrels per day in 2010–15 (Figure 2.3.1.F). Large-scale electricity blackouts in the first quarter of the year resulted in a further collapse of the industrial sector.

Outlook

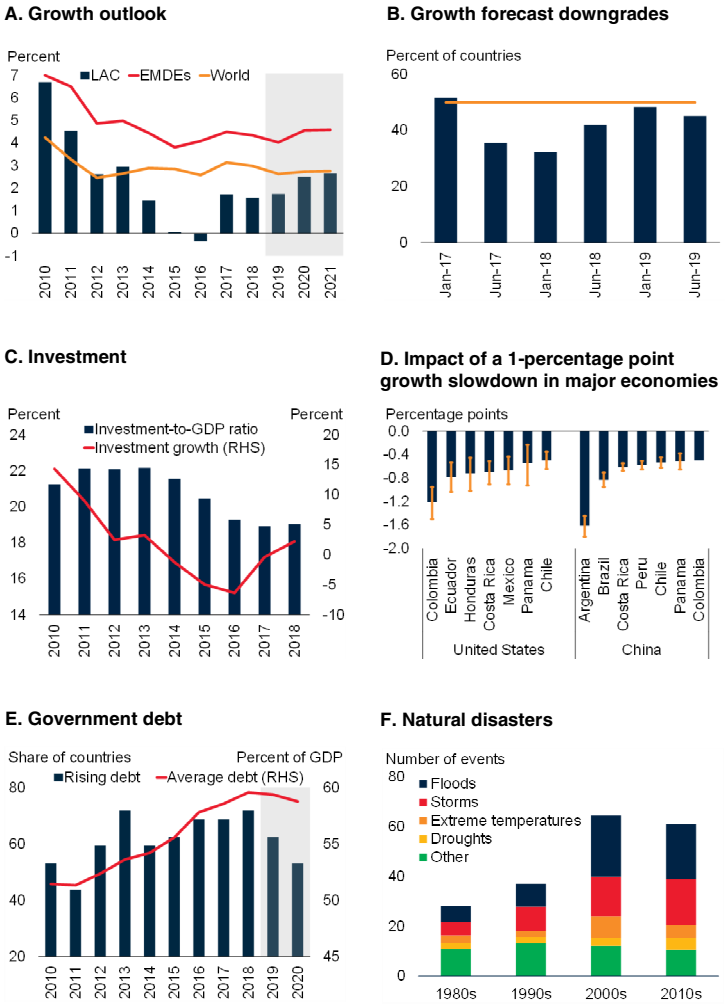
The region is projected to post subdued growth in 2019, of 1.7 percent, and to gain momentum thereafter, with growth reaching 2.5 percent in 2020 and 2.7 percent in 2021 (Figure 2.3.2.A and Table 2.3.1). However, growth prospects for 2019 and 2020 have been downgraded, reflecting weaker-than-expected activity in Brazil and Mexico, but also in smaller economies (Table 2.3.2). The growth forecast for 2019 has been downgraded for close to half of LAC economies (Figure 2.3.2.B).

The regional recovery will be driven predominantly by private consumption as inflation remains moderate and confidence returns and, in 2020-21, by a rebound in fixed investment growth. Net exports are projected to subtract slightly from growth in 2020 and 2021, as external demand weakens and import demand strengthens. The forecast recovery in investment growth is particularly welcome after weak investment performance in recent years (Figure 2.3.2.C). Falling investment-to-GDP ratios, weak productivity growth, and unfavorable demographic developments have all contributed to slowing potential output growth in recent years. With the prices of commodities projected to be relatively stable, following substantial volatility in prior years, the importance of commodity price changes for regional economic developments should diminish.

Among the largest economies in the region, growth prospects are uneven. In Brazil, a weak cyclical recovery already underway is expected to slowly gain traction, with growth rising to 1.5 percent in 2019 and 2.5 percent in 2020. Easing credit conditions, rising real wages, and, by 2020,

FIGURE 2.3.2 LAC: Outlook and risks

Growth in LAC is expected to continue to be weak in 2019, and to recover moderately during the forecast period. A rebound in fixed investment after an extended period of weakness is expected to underpin the improved regional growth forecast in 2020 and 2021. The outlook is subject to several downside risks, however. They include the possibility of sharper-than-projected slowdowns in the United States and China, which could have spillover effects, as well as adverse market responses to poor fiscal conditions and disruptions from natural disasters. The growing crisis in Venezuela also presents risks for other countries in the region.



Source: Bloomberg, Centre for Research on the Epidemiology of Disasters, Haver Analytics, International Monetary Fund, World Integrated Trade Statistics, World Bank.

B. Figure shows share of countries with growth downgrades for the current year.

C. Investment refers to real gross fixed capital formation (public and private combined). Investment-to-GDP ratio and investment growth are 2010 real GDP-weighted averages. Sample includes 17 economies representing 98 percent of regional GDP.

D. Bars represent medians and error bars 33-66 percent confidence bands. Spillover estimates are derived from cumulative impulse responses after two years from a Bayesian structural vector autoregression estimated using quarterly seasonally adjusted GDP data. The maximum data coverage is 1998Q1-2018Q2. Coverage for some countries is shorter: from 2000Q1 for Colombia, and from 2000Q2 for Honduras. The model is estimated for each spillover destination country and the variables include, in this Cholesky ordering: U.S. real GDP growth, EMBI, China's real GDP growth, Brazil's real GDP growth (for South American economies) or Mexico's real GDP growth (for Central American economies), the country's trade-weighted commodity price growth, the country's real GDP growth, and the country's real effective exchange rate appreciation.

E. Sample includes 31 economies. Venezuela is excluded.

F. Annual averages for the periods indicated. Sample includes 32 LAC economies. "Other" events are earthquakes, tsunamis, landslides, mudslides, and fires. 1980s bar shows events that occurred between 1980 and 1989, 1990s bar shows those between 1990 and 1999, 2000s shows those between 2000 and 2009, and 2010s bar shows those between 2010 and February 2019.

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reduced political uncertainty contribute to this outlook. In Argentina, the pace of contraction is expected to ease in 2019, and the economy is expected to resume expanding in 2020. The recovery will be supported by robust export growth, partly reflecting much higher agricultural production after the drought in 2018. Investment and government spending are expected to shrink at faster rates in 2019 than in 2018, however. Growth in Colombia is also forecast to continue to strengthen. Corporate tax reforms, together with the implementation of large-scale road infrastructure projects, will support a pickup in investment growth.

In other large economies, growth is projected to decelerate for at least part of the forecast period. In Mexico, growth is projected to ease for a fourth consecutive year in 2019, to 1.7 percent, as a decelerating U.S. economy slows export demand and uncertainty about key policy decisions by the new administration constrain fixed investment. As policy uncertainty fades, growth in Mexico is expected to pick up moderately, to 2 percent in 2020 and 2.4 percent in 2021. Growth in Chile is expected to be dampened by slowing export demand through 2021, together with planned fiscal tightening.

Growth in Central America is projected to accelerate moderately in the forecast period as the subregion moves past a difficult 2018. The exception is Nicaragua, where a political crisis that began in early 2018 has severely dented investor and consumer sentiment and is contributing to a very sharp contraction in investment.

In the Caribbean, growth is projected to slow to 3.4 percent in 2019, from 4.3 percent in 2018. In the Dominican Republic, growth in the industrial and services sectors is expected to moderate slightly, consistent with softer external demand as global activity decelerates. And in Haiti, the lingering effects of social unrest in 2018, together with projected fiscal tightening in the context of an IMF program, are weighing on growth. Rapid development of the offshore oil industry in Guyana will be the key driver of faster growth in the Caribbean in 2020, to about 4.1 percent.

Risks

The outlook for LAC is subject to predominantly downside risks, emanating from both external and domestic sources. Intensifying policy and political uncertainty, including a further escalation of trade restrictions between major economies, could weigh on investment and trade. Further, as the fiscal stimulus in the United States winds down and creditworthiness deteriorates in the corporate sector, slowing U.S. growth could be sharper than expected, with possible negative spillovers for LAC economies with strong trade, financial, and remittances linkages to the United States (Figure 2.3.2.D). This risk is compounded by the possibility of a larger-than-expected deceleration in economic activity in China. The United States and China have both accounted for growing shares of regional goods exports in recent years, although there are differences within LAC subregions. Roughly 80 percent of exports from Mexico and Central America go to the United States, while China has become the largest export destination of several South American economies (Brazil, Chile, Peru, Uruguay).

Government debt has risen steadily in much of the region during the past decade, to an average of 60 percent of GDP in 2018, with negative implications for regional growth if borrowing costs were to rise suddenly (Figure 2.3.2.E). Sovereign credit ratings for several countries have been downgraded since late 2018 (Argentina, Costa Rica, Nicaragua). A downgrade of Mexico's national oil company, Pemex, has raised concerns about how much more support the government can provide to the ailing company without risking a sovereign downgrade. Although slightly smaller fiscal deficits are expected to contribute to a leveling off of average government debt in the region during the forecast period, average debt stands at the highest level since 2005.

The worsening crisis in Venezuela is pressuring fiscal accounts and social programs in other LAC countries (World Bank 2018d). If economic conditions in Venezuela (e.g., oil production and prices, and remittance inflows) worsen, emigration

could rise significantly further, producing additional pressures. Within Venezuela, falling oil production or remittances would limit the availability of foreign currency and make importing basic goods, including food, more challenging (Bahar and Barrios 2018). Regional challenges related to growing outward migration from Central America may also become more acute.

Disruptions related to climate change and natural disasters are a persistent source of downside risk to the regional growth outlook. Hurricanes, floods, droughts, and earthquakes have had detrimental impacts on growth in numerous economies in the region in recent years, and the region remains highly vulnerable to such events (Figure 2.3.2.F).

TABLE 2.3.1 Latin America and the Caribbean forecast summary

(Real GDP growth at market prices in percent, unless indicated otherwise)

	2016	2017	2018e	2019f	2020f	2021f	Percentage point differences from January 2019 projections: 2019f	2020f	2021f
EMDE LAC, GDP[1]	**-0.3**	**1.7**	**1.6**	**1.7**	**2.5**	**2.7**	**-0.4**	**-0.2**	**0.0**
(Average including countries with full national accounts and balance of payments data only)[2]									
EMDE LAC, GDP[2]	-0.3	1.7	1.6	1.7	2.5	2.7	-0.4	-0.2	0.0
GDP per capita (U.S. dollars)	-1.4	0.7	0.5	0.8	1.6	1.7	-0.3	-0.1	0.0
PPP GDP	0.1	1.9	1.6	1.8	2.6	2.7	-0.3	-0.1	0.0
Private consumption	-0.3	2.4	2.0	1.8	3.2	2.9	-0.3	0.3	0.0
Public consumption	1.0	0.6	0.7	-0.2	1.2	1.2	-0.3	1.0	0.8
Fixed investment	-5.3	-0.2	2.2	1.3	3.1	4.4	-1.0	-1.8	-0.3
Exports, GNFS[3]	2.6	3.8	4.3	4.1	3.7	3.8	-0.7	-0.2	-0.1
Imports, GNFS[3]	-1.3	5.8	5.5	3.0	4.7	4.6	-1.0	-0.1	-0.3
Net exports, contribution to growth	0.8	-0.4	-0.3	0.2	-0.2	-0.2	0.0	0.0	0.0
Memo items: GDP									
South America[4]	-1.7	1.5	1.2	1.6	2.6	2.7	-0.4	-0.1	0.0
Central America[5]	3.9	3.8	2.7	3.1	3.4	3.6	-0.3	-0.1	0.0
Caribbean[6]	2.3	2.5	4.3	3.4	4.1	4.1	-0.1	0.1	0.2
Brazil	-3.3	1.1	1.1	1.5	2.5	2.3	-0.7	0.1	-0.1
Mexico	2.9	2.1	2.0	1.7	2.0	2.4	-0.3	-0.4	0.0
Argentina	-2.1	2.7	-2.5	-1.2	2.2	3.2	0.5	-0.5	0.1

Source: World Bank.
Note: e = estimate; f = forecast. EMDE = emerging market and developing economies. World Bank forecasts are frequently updated based on new information and changing (global) circumstances. Consequently, projections presented here may differ from those contained in other Bank documents, even if basic assessments of countries' prospects do not differ at any given moment in time. Due to lack of data, the World Bank has ceased producing a growth forecast for Venezuela and has removed Venezuela from all growth aggregates in which it was previously included.
1. GDP at market prices and expenditure components are measured in constant 2010 U.S. dollars.
2. Aggregate includes all countries in Table 2.3.2 except Dominica, Grenada, Guyana, St. Kitts and Nevis, St. Lucia, St. Vincent and the Grenadines, Suriname, Trinidad and Tobago, and Venezuela, for which data limitations prevent the forecasting of demand-side GDP components.
3. Exports and imports of goods and non-factor services (GNFS).
4. Includes Argentina, Bolivia, Brazil, Chile, Colombia, Ecuador, Paraguay, Peru, and Uruguay.
5. Includes Costa Rica, El Salvador, Guatemala, Honduras, Nicaragua, and Panama.
6. Includes Antigua and Barbuda, The Bahamas, Barbados, Belize, Dominica, Dominican Republic, Grenada, Guyana, Haiti, Jamaica, St. Kitts and Nevis, St. Lucia, St. Vincent and the Grenadines, Suriname, and Trinidad and Tobago.
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TABLE 2.3.2 Latin America and the Caribbean country forecasts[1]

(Real GDP growth at market prices in percent, unless indicated otherwise)

	2016	2017	2018e	2019f	2020f	2021f	Percentage point differences from January 2019 projections: 2019f	2020f	2021f
Argentina	-2.1	2.7	-2.5	-1.2	2.2	3.2	0.5	-0.5	0.1
Belize	-0.6	1.4	3.0	2.3	2.1	1.9	0.4	0.4	0.2
Bolivia	4.3	4.2	4.2	4.0	3.6	3.4	-0.3	-0.2	0.0
Brazil	-3.3	1.1	1.1	1.5	2.5	2.3	-0.7	0.1	-0.1
Chile	1.7	1.3	4.0	3.5	3.1	3.0	0.0	-0.2	-0.2
Colombia	2.1	1.4	2.6	3.5	3.7	3.7	0.2	0.0	0.1
Costa Rica	4.2	3.4	2.7	3.0	3.1	3.4	0.3	0.3	0.4
Dominican Republic	6.6	4.6	7.0	5.2	5.0	5.0	0.1	0.0	0.2
Ecuador	-1.2	2.4	1.4	0.0	0.4	0.8	-0.7	-0.3	-0.4
El Salvador	2.5	2.3	2.5	2.6	2.5	2.4	0.1	0.1	0.0
Grenada	3.7	5.1	5.2	3.9	3.7	3.7	-0.3	0.9	0.9
Guatemala	3.1	2.8	3.1	3.3	2.7	3.0	0.4	-0.3	-0.1
Guyana	3.4	2.1	4.1	4.6	33.5	22.9	0.0	3.5	-1.9
Haiti[2]	1.5	1.2	1.5	0.4	1.6	1.3	-1.9	-0.8	-1.2
Honduras	3.9	4.8	3.7	3.6	3.8	3.9	-0.2	0.0	0.2
Jamaica	1.4	1.0	1.9	1.6	1.7	1.9	-0.2	-0.3	-0.1
Mexico	2.9	2.1	2.0	1.7	2.0	2.4	-0.3	-0.4	0.0
Nicaragua	4.6	4.7	-3.8	-5.0	1.1	1.3	-4.5	-1.5	-2.3
Panama	5.0	5.3	3.7	5.0	5.4	5.2	-1.0	0.0	0.0
Paraguay	4.3	5.0	3.6	3.3	4.0	4.0	-0.6	0.0	0.0
Peru	4.0	2.5	4.0	3.8	3.9	4.0	0.0	0.1	0.3
St. Lucia	3.9	3.7	1.5	3.4	3.5	2.4	0.7	0.7	0.1
St. Vincent and the Grenadines	1.3	0.7	2.0	2.1	2.3	2.3	0.5	0.7	0.3
Suriname	-5.6	1.4	2.0	2.0	2.1	2.1	0.4	0.3	0.2
Trinidad and Tobago	-6.5	-1.9	0.7	0.9	1.5	2.1	0.0	0.3	0.9
Uruguay	1.7	2.6	1.6	1.5	2.3	2.5	-0.6	0.0	0.0

Source: World Bank.

Note: e = estimate; f = forecast. World Bank forecasts are frequently updated based on new information and changing (global) circumstances. Consequently, projections presented here may differ from those contained in other Bank documents, even if basic assessments of countries' prospects do not significantly differ at any given moment in time.

1. GDP at market prices and expenditure components are measured in constant 2010 U.S. dollars.

2. GDP is based on fiscal year, which runs from October to September of next year.

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MIDDLE EAST and NORTH AFRICA

Growth in the Middle East and North Africa is projected to remain subdued in 2019, at 1.3 percent. Activity in oil exporters has slowed due to weak oil sector output and the effects of intensified U.S. sanctions on Iran, despite an easing of fiscal stance and positive prospects in non-oil sectors in some countries. Many oil importers continue to benefit from business climate reforms and resilient tourism activity. Regional growth is projected to pick up to around 3 percent a year in 2020-21, supported by capital investment and policy reforms. Risks to the outlook are tilted to the downside, including geopolitical tensions, reform setbacks, and a further escalation of global trade tensions.

Recent developments

Growth is expected to remain subdued in the Middle East and North Africa (MENA) in 2019 (Figure 2.4.1.A).[1] Among oil exporters, oil production cuts and a contraction in economic activity in Iran due to U.S. sanctions have weighed on activity. Growth is improving modestly in oil importers as policy reforms progress, despite long-term structural challenges. While easing external financing conditions have supported regional growth, weakening external demand has softened export prospects.

Oil exporters' growth has remained subdued. Oil production cuts implemented by OPEC and some non-OPEC members (OPEC+) to rebalance global oil markets have constrained oil sector growth in the Gulf Cooperation Council (GCC) economies; however, as suggested by rising Purchasing Managers' Indexes, non-oil activity in large GCC economies is picking up amid easier fiscal stances and higher government spending (Figure 2.4.1.B). Oil exporters' growth this year is also being dragged down by a further economic contraction in Iran as the effects of U.S. sanctions intensify and private consumption weakens. While high government spending has supported activity in Algeria, hydrocarbon sector activity has been muted. Current account balances have improved among oil exporters, supported by high oil prices in most of 2018.

Growth has been steadily improving among oil importers, led by the largest economies. In Egypt, the largest country in this group, investment and natural gas output have remained strong. Tourism activity has been resilient and has supported the growth prospects of oil importers (Figure 2.4.1.C). However, export growth has softened somewhat as global demand weakened, particularly among small countries in this group (Figure 2.4.1.D). Oil importers continue to proceed with long-term adjustments, including areas that amend gaps in human capital development (Figure 2.4.1.E; World Bank 2019e).

Inflation is contained in most of the MENA region, with rates averaging less than 3 percent in the past year in the GCC countries and falling recently to about 3 percent in the smaller oil importers (Figure 2.4.1.F). Policy interest rates in these economies have mostly remained neutral. Moreover, in Egypt, inflation has subsided to

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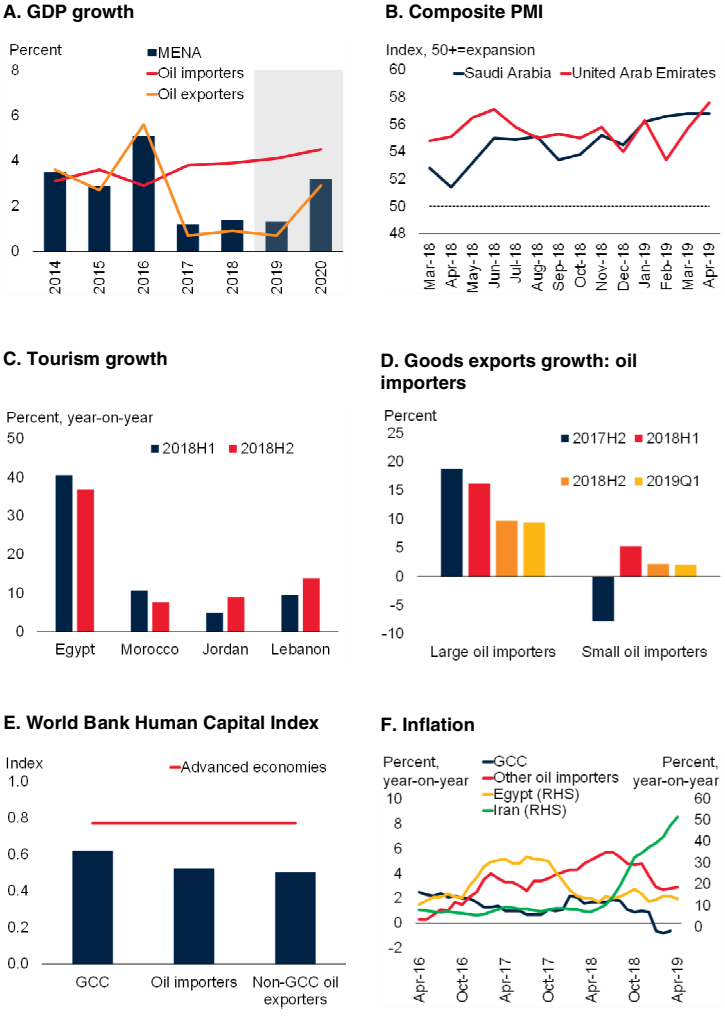
Note: This section was prepared by Lei Sandy Ye. Research assistance was provided by Liu Cui.

[1] The World Bank's Middle East and North Africa aggregate includes 16 economies and is grouped into three subregions. Bahrain, Kuwait, Oman, Qatar, Saudi Arabia, and the United Arab Emirates comprise the Gulf Cooperation Council (GCC); all are oil exporters. Other oil exporters in the region are Algeria, the Islamic Republic of Iran, and Iraq. Oil importers in the region are Djibouti, the Arab Republic of Egypt, Jordan, Lebanon, Morocco, Tunisia, and West Bank and Gaza. Syrian Arab Republic, the Republic of Yemen, and Libya are excluded from regional growth aggregates due to data limitations.

FIGURE 2.4.1 MENA: Recent developments

Growth in the MENA region is projected to remain subdued at 1.3 percent in 2019. In the large oil exporters, oil production cuts and U.S. sanctions on Iran have weighted on activity, despite positive momentum in non-oil sectors. Activity among oil importers has been supported by policy reforms and improved tourism prospects, but is constrained by weaker external demand. A number of countries continue to tackle long-term issues, such as the need for human capital investment, through structural adjustment programs. Inflation has eased in Egypt over the past year, but has risen substantially over the past year in Iran, while remaining generally low and stable elsewhere.



Sources: Haver Analytics, International Monetary Fund, World Bank.

A. Shaded area indicates forecasts. Aggregate growth rates calculated using constant 2010 GDP weights.

B. Figure shows composite Purchasing Managers' Index (PMI). PMI readings above 50 indicate expansion in economic activity; readings below 50 indicate contraction. Last observation is April 2019.

C. Figure shows average year-on-year growth of 3-month moving sum of tourism arrival for the denoted periods. Last observation is end-2018.

D. Figure shows average year-on-year growth of 3-month moving sum of goods exports values. Large oil importers are Egypt, Morocco, and Tunisia; small oil importers are Jordan and Lebanon. "2019Q1" denotes January and February.

E. The Human Capital Index ranges between 0 and 1. The index is measured in terms of productivity of the next generation of workers relative to the benchmark complete education and full health. An economy in which a child born today can expect to achieve complete education and full health will score 1 on the Index. Includes 6 GCC economies, 3 non-GCC oil exporters, and 6 oil importers.

F. CPI inflation rates. Other oil importers include Jordan, Lebanon, Morocco, and Tunisia, Last observation is April 2019.

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about 13 percent (year-on-year) recently from a peak above 30 percent in July 2017; and the central bank cut interest rates in February 2019. In contrast, Iran's inflation (year-on-year) has risen sharply from about 10 percent in mid-2018 to about 52 percent in April 2019, contributed by a depreciation of the rial in the parallel market of more than two-fold compared to levels prior to the announcement of U.S. sanctions in April 2018.

Financing conditions have eased this year as U.S. policy rate hikes pause and renewed risk appetite by international investors emerge. Bond issuance in the GCC remained robust this year, supported in part by Saudi Aramco's bond debut. Government debt in many oil importers remains high, in some instances exceeding 100 percent of GDP, and continues to challenge their access to finance internationally via high credit risk.

Outlook

Growth in the region is projected to decrease to 1.3 percent in 2019 and to pick up to about 3 percent in 2020-21. The projected pickup over the next two years is largely driven by an assumed rebound in activity in Iran as the impact of recent U.S. sanctions wanes, and by an expected ramping up of infrastructure investment in GCC economies. Growth in the rest of the region is projected to remain stable, with broadly resilient domestic demand in key economies partly offset by slowing external demand growth. Medium-term growth prospects are contingent on geopolitical tensions remaining contained and regional spillovers from conflict-ridden economies remaining limited.

For oil exporters, growth in 2019 is expected to decrease slightly to 0.7 percent, with strengthening non-oil activity only partly offsetting constraints on oil sector activity. Growth is projected to pick up to 2.9 percent in 2020 before tapering slightly in 2021. The rebound in 2020 is partly driven by rising growth in Iraq as oil production increases. Stronger infrastructure investment (including an expansion of natural gas capacity in some economies), higher oil production, and eased financing conditions associated with slowed rate hikes are expected to support higher growth in

GCC economies (World Bank 2019f; Figure 2.4.2.A).[2] An improved regulatory and business environment in the GCC will remain supportive of private sector activity. Growth in Iran is expected to resume in 2020-21, albeit at weak rates, as the impact of U.S. sanctions tapers and inflation stabilizes. Algeria's growth is expected to remain subdued as an expected return to fiscal consolidation weighs on non-oil activity.

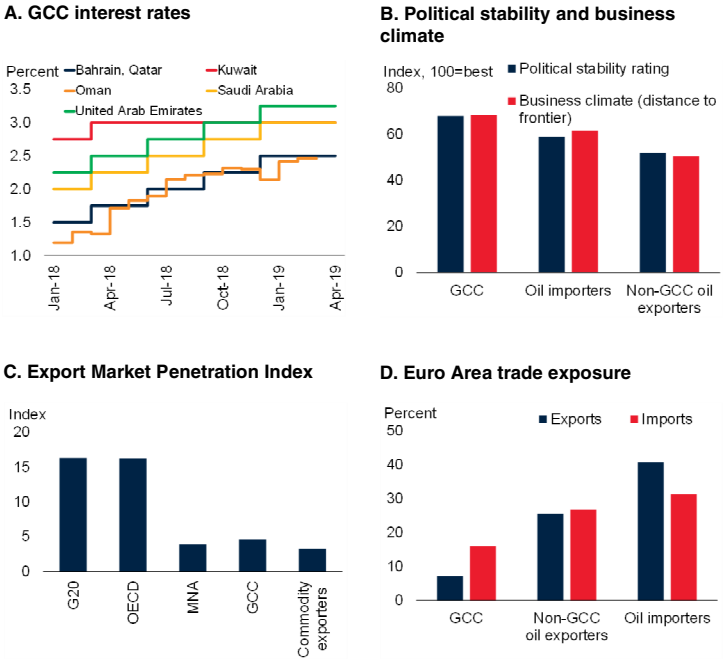
Growth in oil importers is expected to rise steadily from 3.9 percent in 2018 to 4.7 percent in 2021, led by expansions in the larger economies. These projections are predicated on business climate reforms to support investment, healthy tourism activity, and a slight easing in political risks. Growth prospects in smaller oil importers (Jordan, Lebanon, West Bank and Gaza) are highly uncertain, however, as business and consumer confidence are contingent on anticipated reforms or foreign financial assistance. Banking sector weakness and high public debt form significant constraints on growth in smaller oil importers. Nonetheless, tourism and renewed bilateral trade opportunities (for instance, between Syria and Jordan), aided by the easing of conflicts and by policy initiatives, are expected to continue supporting activity in most oil importers.

Continued IMF- and World Bank-supported policy programs in many economies (e.g., Egypt, Morocco) will promote structural adjustment, such as stronger fiscal management frameworks, more vibrant small business entrepreneurship, and electricity access; however, in other cases economic prospects are contingent upon successful policy resolution in some newly formed governments (for instance, Lebanon). New reforms, such as investment, industrial licensing and procurement laws in Egypt; small and medium enterprise financing liberalizations in the United Arab Emirates; and participation of Djibouti in the Convention on the Settlement of Investment Disputes between States and Nationals of Other States, are expected to help relieve constraints in the corporate sector and support investor confidence.

[2] The OPEC+ cuts are scheduled to expire in June and talks for renewal will commence soon thereafter. The recent decision by the U.S. to end its Iran sanctions waivers and OPEC's reaction on oil prices are expected to serve as inputs to these meetings.

FIGURE 2.4.2 MENA: Outlook and risks

Stronger momentum in the non-oil sector in the GCC, aided by a pause in rate hikes, is expected to support activity. There are several risks to the growth outlook, however. Slower-than-expected reforms could hamper not only structural adjustment, but also efforts to diversify away from commodities. Trade disputes among major economies could weigh on external demand for both oil exporters and importers. Persistently lower-than-expected growth in the Euro Area would constrain external demand for oil importers.



Sources: Haver Analytics, International Country Risk Guide, International Monetary Fund, World Bank.
A. GCC economies include Bahrain, Kuwait, Oman, Qatar, Saudi Arabia, and the United Arab Emirates. Bahrain and Qatar have the same deposit rate values during the period denoted. Last observation is April 2019.
B. Political stability rating denotes the political risk rating of the International Country Risk Guide. Business climate score denotes the overall Doing Business "distance to frontier" of the World Bank's *Doing Business* report. Figure shows unweighted averages. Latest observation in 2018.
C. Export Market Penetration index is based on the number of countries to which the reporter exports a particular product divided by the number of countries that report importing the product from global suppliers that year. Based on 2017 or latest available year of data. Includes 20 MENA economies.
D. Goods trade to Euro Area as a percent of total exports or imports for each subgroup denoted. Based on 2018 data. Includes 6 GCC economies, 3 non-GCC oil exporters, and 7 oil importers.
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Risks

Risks remain tilted to the downside for both oil exporters and importers, but for different reasons. Geopolitical risks are elevated in some oil exporters, while political challenges remain high in oil importers. Peace remains fragile in conflict-affected economies (e.g., uncertainty over the UN-coordinated truce in the Yemen war), and economic and social mobility of refugees (e.g.,

Syria) are still highly constrained (World Bank 2019g). Further amplification of U.S.-Iran tensions would pose risks for the region's economies other than Iran.

Developments in oil production in Iran, Venezuela, and the United States could add volatility to oil prices, and this could complicate or stall fiscal adjustment in both oil exporters and oil importers, including their subsidy reforms and other fiscal adjustment programs. Uncertainty about oil prices may dampen oil exporters' investment and social programs. Impact on oil exporters could also dampen capital inflows and investment to oil importers via FDI and remittance linkages. Moreover, oil price volatility may also translate to significant adjustment costs for oil importers, including in countries with still elevated energy subsidies.

Slower-than-expected reforms would weigh on regional activity, especially for oil importers. Although some political uncertainties in the region have been resolved (for example, formation of new governments), risks of reform delays or reversals remain, owing to budgetary concerns and lack of political consensus. Higher political risk, by generating uncertainty and dampening investor confidence, has been associated with weaker business climate in the region (Figure 2.4.2.B). Reconstruction in Iraq has been proceeding at a moderate pace, and materialization of its benefits in 2020 remains uncertain. Sustained implementation of reforms in oil importers is crucial for their medium-term growth, and backloaded fiscal consolidation under high debt levels in these economies may worsen the risk overhang for the private sector and generate additional uncertainty. Sustained structural reforms are also necessary to put MENA economies' current accounts on a more sustained path (Arezki et al. 2019) and to more fully untap their export potential, such as higher market penetration (Youssef and Zaki 2019; Figure 2.4.2.C).

Further escalation of trade tensions remains a key risk. Increased trade restrictions could dampen external demand from major trading partners, including the Euro Area (Figure 2.4.2.D). Relatedly, persistently weaker-than-expected activity in major trading partners, particularly the Euro Area, could weigh further on external demand from these economies and weaken remittance flows (World Bank 2019d). This risk may be partly mitigated by enhanced regional trade capacity (for instance, Djibouti export logistics hub development).

Interest rates in the GCC economies have moved broadly in tandem with U.S. rates, reflecting the general pegging of their currencies to the U.S. dollar. The recent pause of advanced-economy monetary policy normalization and renewed risk appetite for GCC assets have been supportive for GCC financial assets. Nonetheless, GCC economies have relatively open capital accounts, and a resumed tightening of external financing conditions is a downside risk to capital flows. In non-GCC economies, banking sectors are vulnerable in some cases due to exposure to sovereign risks associated with high public debt and policy uncertainty. Among oil importers, average public debt level is about 90 percent of GDP, exposing these economies to rollover risks and fluctuations in global interest rates. In GCC economies, public debt levels are lower but increased capital market access (e.g., large bond issuances) will subject them to volatility in global financial markets alongside the beneficial effects of financial market deepening.

On the upside, rising spending on infrastructure in conflict-affected countries (e.g., Iraq) may generate positive spillovers to neighboring economies. These include spending in soft infrastructure, such as broadband internet and mobile phone, that may broaden access to service delivery in areas like education, health, and financial services.

TABLE 2.4.1 Middle East and North Africa forecast summary

(Real GDP growth at market prices in percent, unless indicated otherwise)

	2016	2017	2018e	2019f	2020f	2021f	Percentage point differences from January 2019 projections 2019f	2020f	2021f
EMDE MENA, GDP[1]	**5.1**	**1.2**	**1.4**	**1.3**	**3.2**	**2.7**	**-0.6**	**0.5**	**0.0**
(Average including countries with full national accounts and balance of payments data only)[2]									
EMDE MENA, GDP[2]	4.7	1.4	1.5	1.1	2.9	2.7	-0.5	0.2	0.0
GDP per capita (U.S. dollars)	2.8	-0.3	-0.1	-0.4	1.5	1.4	-0.5	0.2	0.0
PPP GDP	5.0	1.7	1.6	1.1	3.0	2.8	-0.5	0.2	0.0
Private consumption	2.9	2.2	0.8	1.3	1.9	2.1	-0.3	-0.4	-0.2
Public consumption	-6.3	2.9	0.9	1.4	1.4	1.0	0.3	-0.5	-0.9
Fixed investment	-0.3	2.4	3.7	4.4	5.7	6.4	0.8	1.0	1.6
Exports, GNFS[3]	9.6	4.1	3.8	0.4	3.9	3.6	-1.4	0.5	0.2
Imports, GNFS[3]	-0.8	6.3	1.4	1.9	3.3	3.8	0.0	0.2	0.7
Net exports, contribution to growth	4.8	-0.2	1.4	-0.5	0.8	0.4	-0.7	0.3	-0.1
Memo items: GDP									
Oil exporters[4]	5.6	0.7	0.9	0.7	2.9	2.2	-0.7	0.6	-0.1
GCC countries[5]	2.4	-0.3	1.9	2.1	3.2	2.7	-0.5	0.5	0.0
Saudi Arabia	1.7	-0.7	2.2	1.7	3.1	2.3	-0.4	0.9	0.1
Iran	13.4	3.8	-1.9	-4.5	0.9	1.0	-0.9	-0.2	-0.1
Oil importers[6]	2.9	3.8	3.9	4.1	4.5	4.7	-0.1	-0.1	0.0
Egypt	4.3	4.8	5.4	5.7	5.9	6.0	0.0	0.0	0.0
Fiscal year basis[7]	4.3	4.2	5.3	5.5	5.8	6.0	-0.1	0.0	0.0

Source: World Bank.

Note: e = estimate; f = forecast. EMDE = emerging market and developing economies. World Bank forecasts are frequently updated based on new information and changing (global) circumstances. Consequently, projections presented here may differ from those contained in other Bank documents, even if basic assessments of countries' prospects do not differ at any given moment in time.

1. GDP at market prices and expenditure components are measured in constant 2010 U.S. dollars. Excludes Libya, Syria, and Yemen due to data limitations.
2. Aggregate includes all countries in notes 4 and 6 except Djibouti, Iraq, Qatar, and West Bank and Gaza, for which data limitations prevent the forecasting of GDP components.
3. Exports and imports of goods and non-factor services (GNFS).
4. Oil exporters include Algeria, Bahrain, Iran, Iraq, Kuwait, Oman, Qatar, Saudi Arabia, and the United Arab Emirates.
5. The Gulf Cooperation Council (GCC) includes Bahrain, Kuwait, Oman, Qatar, Saudi Arabia, and the United Arab Emirates.
6. Oil importers include Djibouti, Egypt, Jordan, Lebanon, Morocco, Tunisia, and West Bank and Gaza.
7. The fiscal year runs from July 1 to June 30 in Egypt; the column labeled 2018 reflects the fiscal year ended June 30, 2018.

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TABLE 2.4.2 Middle East and North Africa economy forecasts[1]

(Real GDP growth at market prices in percent, unless indicated otherwise)

	2016	2017	2018e	2019f	2020f	2021f	Percentage point differences from January 2019 projections: 2019f	2020f	2021f
Algeria	3.2	1.4	1.5	1.9	1.7	1.4	-0.4	-0.1	-0.4
Bahrain	3.5	3.8	1.8	2.0	2.2	2.8	-0.6	-0.6	0.0
Djibouti	9.1	4.1	6.0	7.0	7.5	8.0	-0.3	0.0	0.5
Egypt	4.3	4.8	5.4	5.7	5.9	6.0	0.0	0.0	0.0
Fiscal year basis[2]	4.3	4.2	5.3	5.5	5.8	6.0	-0.1	0.0	0.0
Iran	13.4	3.8	-1.9	-4.5	0.9	1.0	-0.9	-0.2	-0.1
Iraq	13.6	-1.7	0.6	2.8	8.1	2.3	-3.4	5.2	-0.5
Jordan	2.0	2.1	2.0	2.2	2.4	2.6	-0.1	0.0	-0.1
Kuwait	2.9	-3.5	1.2	1.6	3.0	2.9	-2.0	-0.6	-0.7
Lebanon	1.6	0.6	0.2	0.9	1.3	1.5	-0.4	-0.2	0.0
Morocco	1.1	4.1	3.0	2.9	3.5	3.6	0.0	0.0	0.1
Oman	5.0	-0.9	2.1	1.2	6.0	2.8	-2.2	3.2	0.0
Qatar	2.1	1.6	1.4	3.0	3.2	3.4	0.3	0.2	0.4
Saudi Arabia	1.7	-0.7	2.2	1.7	3.1	2.3	-0.4	0.9	0.1
Tunisia	1.1	2.0	2.5	2.7	3.2	3.5	-0.2	-0.2	-0.1
United Arab Emirates	3.0	0.8	1.7	2.6	3.0	3.2	-0.4	-0.2	0.0
West Bank and Gaza	4.7	3.1	0.9	0.5	1.0	1.6	-1.4	-0.9	-0.3

Source: World Bank.

Note: e = estimate; f = forecast. World Bank forecasts are frequently updated based on new information and changing (global) circumstances. Consequently, projections presented here may differ from those contained in other Bank documents, even if basic assessments of economies' prospects do not significantly differ at any given moment in time.

1. GDP at market prices and expenditure components are measured in constant 2010 U.S. dollars. Excludes Libya, Syria, and Yemen due to data limitations.

2. The fiscal year runs from July 1 to June 30 in Egypt; the column labeled 2018 reflects the fiscal year ended June 30, 2018.

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SOUTH ASIA

South Asia continued to enjoy solid economic activity in 2018, posting 7 percent GDP growth due to robust domestic demand. Pakistan was a notable exception, with a broad-based weakening of domestic demand over the past year against the backdrop of tightening policies aimed at addressing the country's macroeconomic imbalances. Regional growth is projected to remain close to 7 percent a year over the forecast horizon, as it continues to benefit from strong private consumption and investment. The main risks to the outlook include a re-escalation of political uncertainty and regional tensions, financial sector weakness due to nonperforming assets, fiscal challenges amid elections in several countries, and a sharper-than-expected weakening of growth in major economies.

Recent developments

South Asia's growth remains robust despite headwinds from the global economy amid weakening trade and manufacturing. Regional output is estimated to have expanded by 7 percent in 2018 (Figure 2.5.1.A). Economic activity was underpinned by strong private domestic demand. Private consumption and investment remained robust in much of the region, offsetting a slowdown in Pakistan. Government spending growth moderated in 2018, expanding closer to historical averages following rapid growth in 2017. Net exports continued to contribute negatively to regional growth, with import growth remaining stronger than export growth amid solid domestic demand (World Bank 2019h).

Regional inflation has remained moderate in most countries, partly reflecting broadly stable commodity prices (Figure 2.5.1.B). However, Pakistan has recently experienced a significant rise in inflation driven by currency depreciation, which was followed by several policy rate hikes over the course of FY2018/19.

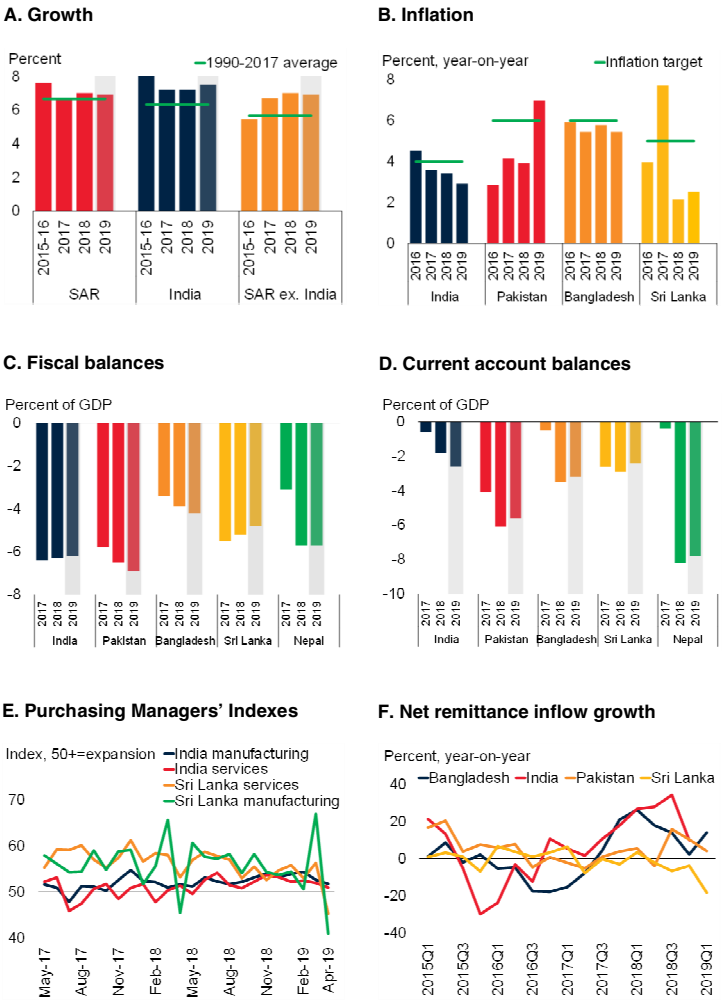
There has been limited progress in fiscal consolidation in the region (Figure 2.5.1.C). Recently announced budget plans indicate divergent developments. India has announced a package of direct benefits to farmers and some tax breaks for the middle class while others (Pakistan, Sri Lanka) are on paths of fiscal consolidation to tackle sizable deficits. Current account deficits broadly widened last year, but recent data show signs of narrowing in a context of more stable oil prices (Figure 2.5.1.D).

In India, the largest economy in the region, GDP grew by 7.2 percent in FY2018/19 (April 1, 2018 to March 31, 2019)—the same pace as shown for the previous year by upwardly revised data. A slowdown in government consumption was offset by solid investment, which benefited from both private investment and public infrastructure spending. Urban consumption was supported by a pickup in credit growth, whereas rural consumption was hindered by soft agricultural prices. On the production side, robust growth was broad-based, with a slight moderation in services and agricultural activity accompanied by an acceleration in the industrial sector. Weakening agricultural production reflected subdued harvest in major crops on the back of less rainfalls. Services activity softened mainly due to slowing trade, hotel, transport, and communication activity. The industrial sector benefited from strong manufacturing and construction with solid demand for capital goods. The slowing momentum in economic activity in late 2018 carried into the first quarter of 2019, as suggested

Note: This section was prepared by Temel Taskin. Research assistance was provided by Ishita Dugar.

FIGURE 2.5.1 SAR: Recent developments

Growth in South Asia picked up to 7 percent in from 6.7 percent in 2017. Inflation has softened in most countries, partly reflecting broadly stable commodity prices. There has been limited progress in fiscal consolidation in the region. Current account deficits mostly widened last year, but recent data show signs of narrowing amid more stable oil prices. PMIs have softened in the first half of 2019. Remittances inflows broadly picked up in 2018.



Source: Haver Analytics, World Bank.

A. SAR = South Asia Region. Shaded areas indicate forecasts. Aggregate growth rates calculated using constant 2010 U.S. dollar GDP weights. Data for 2018 are estimates.

B. Last observation is March 2019 for Bangladesh and April 2019 for India, Pakistan, and Sri Lanka. The 2019 data represent average y/y inflation year-to-date. The data refer to fiscal years of countries except for Sri Lanka, as described in Table 2.5.1.

C. D. Shaded areas indicate forecasts. Data for 2018 are estimates. The data refer to fiscal years of countries except for Sri Lanka, as described in Table 2.5.1.

E. PMI readings above 50 indicate expansion in economic activity; readings below 50 show contraction. Last observation is April 2019.

F. Data present the workers' remittances and compensation received by countries. The last available observation is 2018Q4 for India and 2019Q1 for Bangladesh, Pakistan, and Sri Lanka.

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by softening services and manufacturing Purchasing Managers' Indexes (Figure 2.5.1.E).

Elsewhere in the region, Pakistan's growth is estimated to decelerate to 3.4 percent in FY2018/19 (July 16, 2018 to July 15, 2019) from 5.8 percent in the previous fiscal year.[1] This slowdown reflects a broad-based weakening of domestic demand amid monetary and fiscal policy tightening designed to address macroeconomic imbalances, particularly large fiscal and current account deficits. These have contributed to a considerable decline in international reserves to levels that would cover less than three months of imports (World Bank 2018c). On the production side, recent high-frequency data indicate a notable weakening in both manufacturing and agricultural sectors. Inflation increased considerably during the past fiscal year, reflecting currency depreciation. Recently, financial assistance from Gulf countries and China, as well as an IMF program have helped partially rebuild confidence.

In Bangladesh, GDP is estimated to expand by 7.3 percent in FY2018/19 (July 1, 2018 to June 30, 2019), 0.3 percentage point higher than the previous projection, as a recovery in remittance inflows, stemming from improving economic activity in source countries (Figure 2.5.1.F) supported private consumption. While private investment benefited from the improved outlook for political stability, public investment was underpinned by progress in infrastructure projects. In the first half of FY2018/19, exports to the United States and China increased significantly, especially textile and apparel, in part reflecting trade diversion due to bilateral tariff increases between these two countries (World Bank 2018f).

Growth in Sri Lanka slowed marginally to 3.2 percent in 2018, on account of weaker domestic demand. Decline in international reserves and elevated political controversy contributed to depressed investor sentiment and Sri Lanka's sovereign credit rating was downgraded by one notch by some rating agencies in 2018 (World Bank 2019i). Activity remained soft in the first quarter of 2019, constrained by tight monetary policy. While last year's political turbulence has largely been resolved, recent security-related incidents are weighing on confidence and activity.

[1] Pakistani authorities have revised the growth estimate for FY2017/18 from 5.8 percent to 5.2 percent in February 2019. However, the complete revised national accounts have not yet been published, which is why the earlier figure is used in this document.

In Afghanistan, GDP growth decelerated to 1 percent in 2018, partly owing to a severe drought and increased political uncertainty. Nepal's GDP expanded by 6 percent in FY2018/19 on the back of solid services and industrial sector growth (World Bank 2018g). In Bhutan and Maldives, economic growth in 2018 continued to be underpinned by infrastructure projects and tourism. Maldives' GDP expanded 7.9 percent in 2018, reflecting solid tourism receipts and a strong construction sector growth with robust credit growth and infrastructure projects. In Bhutan, economic activity decelerated to an estimated 5.4 percent in FY2018/19 (July 1, 2018 to June 30, 2019) as investment softened with delayed hydropower projects.

Outlook

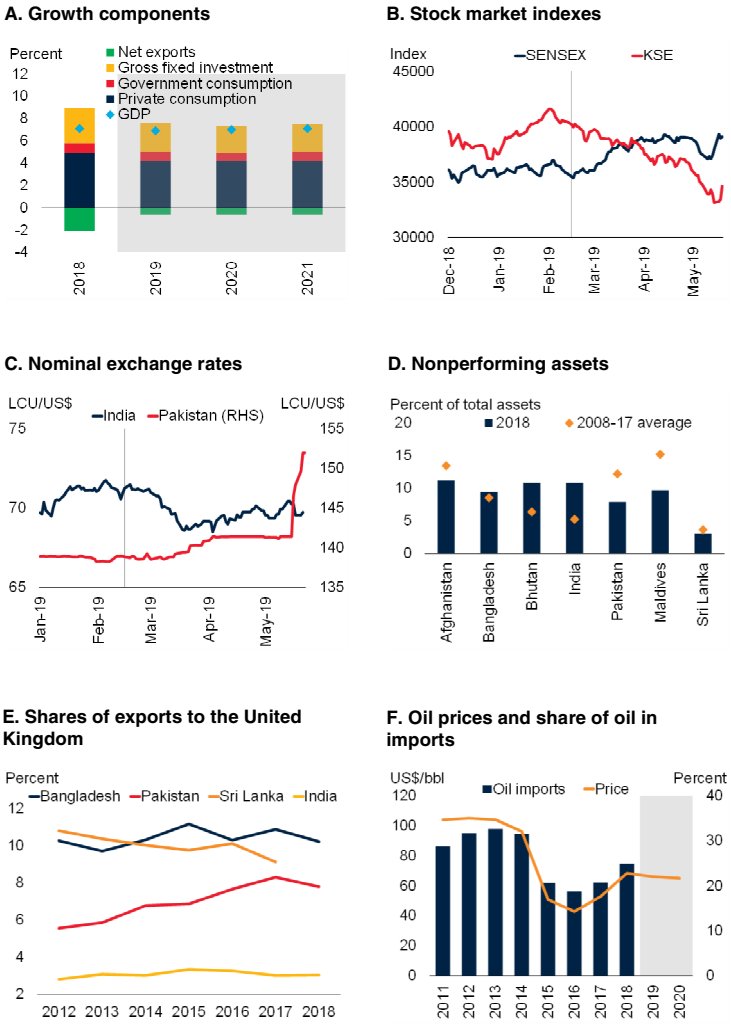
The outlook for South Asia over the forecast horizon is expected to remain solid. Regional GDP is expected to expand 6.9 percent in 2019, 0.2 percentage point down from previous projections owing to downward revisions for Pakistan, but to pick up to 7 percent in 2020 and 7.1 percent in 2021. Domestic demand growth is expected to remain solid, with support from monetary and fiscal policies in some cases (such as India). The contribution of exports to economic activity is expected to remain weak with moderate global trade growth. (World Bank 2018h; Figure 2.5.2.A).

In India, growth is projected at 7.5 percent in FY2019/20 (April 1, 2019 to March 31, 2020), unchanged from the previous forecast, and to stay at this pace through the next two fiscal years. Private consumption and investment will benefit from strengthening credit growth amid more accommodative monetary policy, with inflation having fallen below the Reserve Bank of India's target. Support from delays in planned fiscal consolidation at the central level should partially offset the effects of political uncertainty around elections in FY2018/19 (Beyer and Milivojevic 2019; World Bank, forthcoming).

Pakistan's growth is expected to slow further, to 2.7 percent, in FY2019/20 with domestic demand remaining depressed. Current account and fiscal

FIGURE 2.5.2 SAR: Outlook and risks

Domestic demand is expected to remain solid next year, with support from monetary and fiscal policies in some cases, whereas contribution of net exports will be limited with the subdued global trade outlook. The elevated tension between major South Asian economies in mid-February did not have a major immediate effect on financial markets, but a re-escalation might reduce confidence and weigh on investment. Nonperforming assets could remain elevated and weigh on credit growth unless further steps are taken to enhance effectiveness of the resolution mechanisms. Uncertainty about the Brexit process poses a risk to some South Asian economies that have preferential trade agreements with the European Union. A higher-than -expected increase in oil prices would increase current account deficits and inflation in the region.



Source: Export Promotion Bureau of Bangladesh, Haver Analytics, International Monetary Fund, World Bank.

A. Aggregate growth rates calculated using constant 2010 U.S. dollar GDP weights. Data for 2018 are estimates.

B. SENSEX and KSE are major stock market indexes of India and Pakistan, respectively. The vertical line marks February 15, 2019. Last observation is May 22, 2019.

C. The foreign exchange rates are Indian rupee and Pakistan rupee per U.S. dollar. The vertical line marks February 15, 2019. Last observation is May 21, 2019 for India and May 22, 2019 for Pakistan.

D. Last observation is 2018Q2 for Afghanistan, Bhutan, India, Pakistan, Maldives, and 2018Q1 for Sri Lanka. Bangladesh observation is 2017.

E. Last observation is 2017 for Sri Lanka and 2018 for the rest. Data show exports to the United Kingdom as a share of total exports.

F. Oil imports data cover Bangladesh, India, Pakistan, and Sri Lanka. Blue bars show oil imports as a share of total imports. Oil price data are the simple average of Dubai, Brent, and West Texas Intermediate. Shaded areas indicate forecasts.

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deficits are projected to diminish only gradually. Workers' remittances are expected to help improve both growth performance and the current account balance next year, reflecting economic recovery in source countries (Figure 2.5.2.C). This, together with a broadly stable external environment and a reduction in macroeconomic imbalances, is expected to lead to an increase in growth to 4.0 percent beginning in FY2020/21.

In Bangladesh, annual growth is projected to average 7.3 percent over the forecast horizon. Activity will be underpinned by strong infrastructure spending and solid private investment with some easing of infrastructure constraints. Slowing activity in major trade partners' economies (such as the Unites States and the Euro Area) will constrain the contribution of net exports to growth next fiscal year.

Economic activity in Sri Lanka is expected to accelerate to 3.5 percent in 2019 and to average 3.6 percent over the forecast horizon. This modest acceleration will be supported by a pickup in services sector activity and solid infrastructure investment.

Afghanistan's growth is projected to accelerate over the forecast horizon, reaching 3.6 percent by 2021, on the assumption that political stability will be restored by presidential elections in July. The business environment, and thus economic activity, is expected to benefit from an easing of the domestic armed conflict.

In Nepal, growth of 6.1 percent a year is projected over the medium term. The services sector will be supported by tourism, and manufacturing will be bolstered by the opening of the country's largest cement factory next year.

Bhutan's growth is expected to remain solid at 5.4 percent in FY2019/20 (July 1 to June 30) and to continue at around this annual rate over the forecast horizon, supported particularly by tourism and retail trade. Economic growth in the Maldives is forecast at 5.7 percent in 2019, and is projected to moderate to 5.3 percent over the medium term as investment growth in the tourism sector converges to historical averages.

Risks

The main domestic risks to the outlook include a re-escalation of political turbulence amid elections in some countries (Afghanistan, Sri Lanka); fiscal slippages with expanding public spending; and a resurgence of non-bank financial sector funding issues.

Military skirmishes between major South Asian countries in mid-February remained contained, and economic repercussions were minor. However, a re-escalation of tensions between the two countries could increase uncertainty, depress confidence, and weigh on investment in the region (Figures 2.5.2.B and 2.5.2.C). In Sri Lanka, a rise in political uncertainty in the months leading up to presidential and parliamentary elections, which will take place in 2019 and 2020, respectively, could weigh on business confidence. In addition, recent security-related incidents could dampen investor sentiment and perceptions.

In India, the new GST (goods and services tax) regime is still in the process of being fully established, creating some uncertainty about projections of government revenues. Fiscal deficits continue to exceed official targets in some countries (India, Pakistan). Supply bottlenecks such as infrastructure gaps, and relatively weak business climates continue to depress domestic and foreign investment potential in the region (Grainger and Zhang 2017; Aritua et al. 2018). Setbacks in reforms to address these issues would likely weigh on activity.

Nonperforming assets remain high in South Asia (Figure 2.5.2.D). While recent measures helped the recognition of these assets in India, the frameworks could still be improved by accelerating the resolution process. Unless further steps are taken to enhance effectiveness of the resolution mechanisms, nonperforming assets could remain elevated and pose a risk to financial stability and credit growth, weighing on activity in the region.

External risks include weakening global growth and rising policy uncertainty. A sharper-than-expected deceleration in major economies or a new escalation of trade-related tensions among

major economies would likely result in adverse trade and financial market spillovers to the region. High external debt and low international reserves could limit the policy room to address external shocks in some countries (Pakistan, Sri Lanka).

Uncertainty about the Brexit process poses a risk to some South Asian economies which have preferential trade agreements or generalized system of preferences with the European Union and significant exports to United Kingdom (Bangladesh, India, Pakistan, Sri Lanka). A no-deal Brexit could have a significant impact on exports of those countries to the UK in the absence of new trade agreements (Figure 2.5.2.E).

South Asia, as a net oil-importing region, is vulnerable to oil price spikes. A sudden increase in oil prices would tend to worsen current account balances and elevate inflation in the region (Figure 2.5.2.F). South Asia is also vulnerable to the effects of climate change, such as natural disasters, which tend both to increase inflation and weigh on activity through supply disruptions, especially in the agricultural sector.

TABLE 2.5.1 South Asia forecast summary

(Real GDP growth at market prices in percent, unless indicated otherwise)

	2016	2017	2018e	2019f	2020f	2021f	Percentage point differences from January 2019 projections: 2019f	2020f	2021f
EMDE South Asia, GDP[1,2]	**8.1**	**6.7**	**7.0**	**6.9**	**7.0**	**7.1**	**-0.2**	**-0.1**	**0.0**
(Average including countries with full national accounts and balance of payments data only)[3]									
EMDE South Asia, GDP[3]	8.2	6.7	7.1	6.9	7.0	7.1	-0.2	-0.1	0.0
GDP per capita (U.S. dollars)	6.9	5.5	5.8	5.7	5.8	5.9	-0.2	-0.1	-0.1
PPP GDP	7.6	6.2	7.6	6.9	7.0	7.1	-0.2	-0.1	0.0
Private consumption	7.6	6.2	8.3	7.0	6.9	7.0	0.0	-0.1	0.0
Public consumption	8.5	11.1	8.5	7.6	6.9	7.1	-1.5	-1.6	-1.4
Fixed investment	9.3	7.5	8.4	7.6	7.8	7.8	-0.3	0.1	0.3
Exports, GNFS[4]	1.9	6.0	7.8	5.4	5.2	5.5	-0.2	-0.7	-0.5
Imports, GNFS[4]	2.7	13.0	14.0	6.2	5.8	6.1	-0.1	-0.9	-0.7
Net exports, contribution to growth	-0.3	-2.0	-2.1	-0.6	-0.6	-0.6	0.0	0.0	0.0

Memo items: GDP[2]	16/17	17/18	18/19e	19/20f	20/21f	21/22f	19/20f	20/21f	21/22f
South Asia excluding India	5.8	6.0	5.4	4.8	5.0	5.3	-0.7	-0.6	-0.3
India	8.2	7.2	7.2	7.5	7.5	7.5	0.0	0.0	0.0
Pakistan (factor cost)	5.4	5.8	3.4	2.7	4.0	4.7	-1.5	-0.8	-0.1
Bangladesh	7.3	7.9	7.3	7.4	7.3	7.3	0.6	0.5	0.5

Source: World Bank.

Note: e = estimate; f = forecast. EMDE = emerging market and developing economies. World Bank forecasts are frequently updated based on new information and changing (global) circumstances. Consequently, projections presented here may differ from those contained in other Bank documents, even if basic assessments of countries' prospects do not differ at any given moment in time.

1. GDP at market prices and expenditure components are measured in constant 2010 U.S. dollars.
2. National income and product account data refer to fiscal years (FY) for the South Asian countries, while aggregates are presented in calendar year (CY) terms. The fiscal year runs from July 1 through June 30 in Bangladesh, Bhutan, and Pakistan, from July 16 through July 15 in Nepal, and April 1 through March 31 in India.
3. Sub-region aggregate excludes Afghanistan, Bhutan, and Maldives, for which data limitations prevent the forecasting of GDP components.
4. Exports and imports of goods and non-factor services (GNFS).

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TABLE 2.5.2 South Asia country forecasts

(Real GDP growth at market prices in percent, unless indicated otherwise)

	2016	2017	2018e	2019f	2020f	2021f	Percentage point differences from January 2019 projections: 2019	2020f	2021f
Calendar year basis [1]									
Afghanistan	2.3	2.7	1.0	2.4	3.2	3.6	-0.3	0.0	0.4
Maldives	7.3	6.9	7.9	5.7	5.2	5.3	-0.6	-0.4	-0.3
Sri Lanka	4.5	3.3	3.2	3.5	3.6	3.7	-0.5	-0.5	-0.4
Fiscal year basis[1]	**16/17**	**17/18**	**18/19e**	**19/20f**	**20/21f**	**21/22f**	**19/20f**	**20/21f**	**21/22f**
Bangladesh	7.3	7.9	7.3	7.4	7.3	7.3	0.6	0.5	0.5
Bhutan	6.3	5.8	5.4	5.4	5.2	5.2	-1.0	-1.2	-1.2
India	8.2	7.2	7.2	7.5	7.5	7.5	0.0	0.0	0.0
Nepal	8.2	6.7	7.1	6.4	6.5	6.5	0.4	0.5	0.5
Pakistan (factor cost)	5.4	5.8	3.4	2.7	4.0	4.7	-1.5	-0.8	-0.1

Source: World Bank.
Note: e = estimate; f = forecast. World Bank forecasts are frequently updated based on new information and changing (global) circumstances. Consequently, projections presented here may differ from those contained in other Bank documents, even if basic assessments of countries' prospects do not significantly differ at any given moment in time.
1. Historical data is reported on a market price basis. National income and product account data refer to fiscal years (FY) for the South Asian countries with the exception of Afghanistan, Maldives, and Sri Lanka, which report in calendar year. The fiscal year runs from July 1 through June 30 in Bangladesh, Bhutan, and Pakistan, from July 16 through July 15 in Nepal, and April 1 through March 31 in India.
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SUB-SAHARAN AFRICA

The recovery in Sub-Saharan Africa has disappointed, with weakening external demand, supply disruptions, and elevated policy uncertainty weighing on activity in major economies. Growth in the region is projected to pick up from 2.5 percent in 2018 to 2.9 percent this year and an average of 3.4 percent in 2020-21, as domestic demand gathers pace and oil production recovers in large exporting economies. However, this expected recovery is significantly slower than previously projected, reflecting persistent headwinds in major economies, and it is largely insufficient to make progress in poverty reduction. Downside risks to the outlook include weaker-than-expected external demand, lower commodity prices, renewed stress in global financial markets, fiscal slippages, political uncertainty, armed conflicts, and adverse weather conditions.

Recent developments

The economic environment in Sub-Saharan Africa (SSA) remains challenging, with external and domestic headwinds that caused the slowdown in 2018 dissipating more slowly than previously envisaged (Figure 2.6.1.A). Weakening external demand from major economies, persistent policy uncertainty, and domestic growth bottlenecks have been only partly offset by an easing of external financing conditions and recovering commodity prices.

In Angola, Nigeria, and South Africa—the three largest economies in the region—growth has remained subdued in 2019. In Nigeria, the anticipated recovery in the oil sector—the main source of government revenue—has been weaker than expected as policy uncertainty continues to constrain investment in new capacity. Weak domestic demand amid high unemployment and a challenging business environment has dampened growth in the non-oil sector. In South Africa, continued policy uncertainty and rolling power blackouts have slowed economic activity in the first half of 2019; however, it is expected to strengthen aided by somewhat easier external financing conditions and as the new administration's fast-tracking of long-delayed reforms gradually improves the business environment. Angola is expected to emerge from three years of contraction, with the recent growth momentum in the non-oil sector partly reflecting reforms to bolster the business environment. However, a faster-than-expected decline in production from decaying oil fields and lower production from marginal oil fields have led to significantly weaker-than-expected growth in 2019.

Elsewhere in the region, growth has been robust among non-resource-rich countries, supported by sustained public investment (Rwanda, Uganda; Figure 2.6.1.B). In some countries, consecutive years of good harvests have boosted agricultural exports (Benin, Côte d'Ivoire, Rwanda), and supported robust consumption growth (Burkina Faso, Kenya). In Ethiopia, however, weaker agricultural commodity prices, particularly coffee, and persistent foreign exchange shortages have weighed on activity.

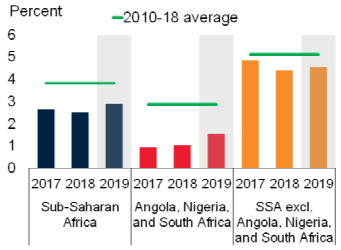
Southern and East Africa was hit by two devastating cyclones—Idai and Kenneth—in March and April 2019, which took a heavy human toll and severely affected economic activity in the Comoros, Malawi, Zimbabwe, and in particular, Mozambique. Among industrial-commodity exporters, growth has generally strengthened—despite decelerating external

Note: This section was prepared by Rudi Steinbach. Research assistance was provided by Mengyi Li.

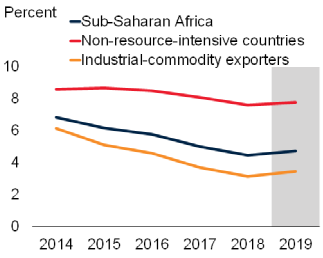
FIGURE 2.6.1. SSA: Recent developments

The recovery in Sub-Saharan Africa has lost momentum, reflecting subdued activity in Angola, Nigeria, and South Africa—the region's largest economies. More robust growth among non-resource-intensive economies has been supported by sustained public investment, although the related capital goods imports have contributed to widening current account deficits. External financing conditions have become more benign, and inflation has moderated across most of the region, but remains elevated in a number of countries. Interest burdens are exacerbating fiscal deficits.

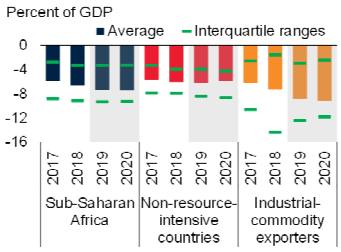
A. GDP growth



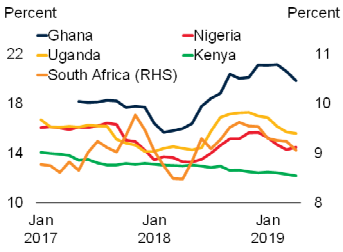
B. Public sector investment, share of GDP



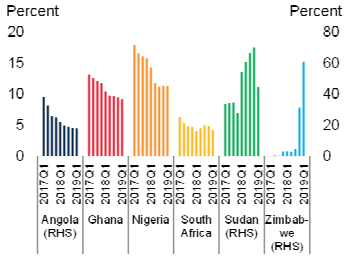
C. Current account balances



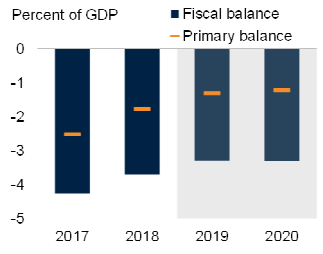
D. Financing conditions: 10-year government bond yields



E. Inflation, annual rate



F. Fiscal balances



Source: Haver Analytics; International Monetary Fund, *World Economic Outlook*; World Bank.
Note: Non-resource-intensive countries represent agricultural commodity-exporting and commodity-importing countries. Industrial commodity exporters represent oil- and metal-exporting countries.
A. Aggregate growth rates calculated using 2010 U.S. dollar GDP weights.
B. GDP-weighted averages. Sample includes 22 non-resource-intensive countries and 15 industrial-commodity exporters.
C. Simple averages of country groupings.
F. Simple averages.
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demand—as oil and mining production continued to benefit from investment in new capacity (Chad, Democratic Republic of the Congo, Mauritania). However, in Sudan—the fourth largest economy in the region—economic activity contracted in 2018 and is expected to continue doing so in this year as high inflation, chronic food and fuel shortages, and elevated political uncertainty present significant headwinds to activity. Growth is also expected to contract in Zimbabwe in 2019, as sharply higher inflation curtails real income and private consumption. In contrast, growth in the Democratic Republic of Congo continues to firm, with mining production rising sharply due to investment in new capacity.

Current account deficits have widened across the region, partly reflecting weaker exports (Guinea, The Gambia), and sizable capital goods imports related to large investment projects (Côte d'Ivoire, Mozambique, Niger; Figure 2.6.1.C). In non-resource-rich countries, sustained public investment spending is contributing to elevated deficits (Kenya, Tanzania, Uganda). International bond issuance activity has been slow to recover after weakening in the second half of last year, and FDI inflows in the region remain mixed—despite easier financing conditions and a partial recovery in commodity prices. Capital inflows are nevertheless expected to sufficiently finance current account deficits—especially in countries with large infrastructure investment programs.

Exchange rates have been broadly stable this year, or have strengthened somewhat, amid improved external financing conditions (Botswana, Kenya, South Africa; Figure 2.6.1.D). This has, in part, supported moderating inflation in many countries in early 2019 (Angola, South Africa, Tanzania, Uganda; Figure 2.6.1.E). Reduced inflationary pressures have allowed authorities to pause monetary policy tightening in some countries (Lesotho, South Africa, Uganda), and ease their stance in others (Angola, Ghana, Nigeria). In Zambia, however, monetary policy was tightened as renewed currency weakness is expected to lift inflation above the central bank's target. In Sudan, repeated devaluations as well as monetization of the fiscal deficit have fueled inflation rates in excess of 40 percent, while the removal of subsidies and foreign-currency shortages have led to comparable double-digit inflation rates in Zimbabwe. Recent oil price increases are expected to put renewed upward pressure on inflation in many countries during 2019.

Public debt vulnerabilities in the region remain a concern. While primary deficits are expected to continue gradually narrowing to 1.2 percent of GDP in 2019, overall deficits are expected to remain in excess of 3 percent, reflecting the increases in interest burdens arising from the growth in government debt (Figure 2.6.1.F). Higher interest burdens also reflect the shifting composition of debt toward more expensive non-concessional financing, which has increased to about 60 percent of total external debt—about one-third higher than in the 2000s (World Bank 2019j). These higher debt-servicing costs tend to constrain non-interest expenditures and raise concerns about debt sustainability. In non-resource-intensive economies, increased indebtedness has largely reflected continued strong public investment (Burkina Faso, Rwanda, Uganda). Among industrial-commodity exporters, rising government debt has been more acute, reflecting persistently large deficits amid expenditure overruns and revenues weighed down by softer export earnings and slower growth (Namibia, Nigeria, South Africa, Zambia; World Bank 2019k).

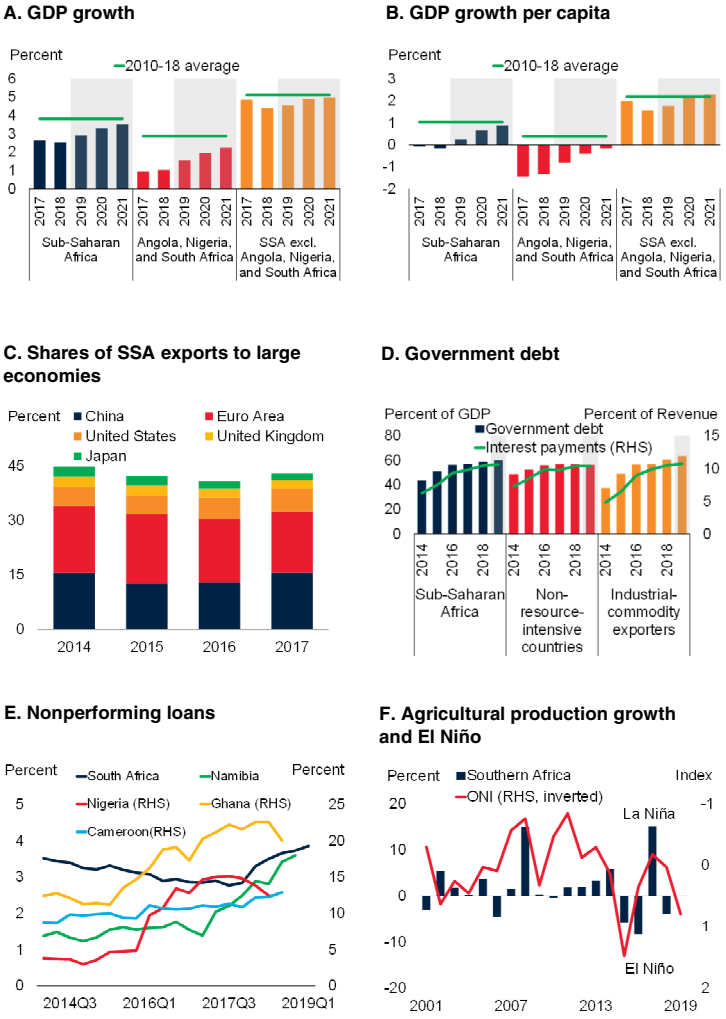
Outlook

Growth in the region is projected at 2.9 percent this year, up from 2.5 percent in 2018, but half a percentage point lower than previously forecast, reflecting more pronounced domestic headwinds and weaker-than-expected external demand. This translates into per capita growth of a mere 0.2 percent for 2019, following three consecutive years of contraction.

Growth in the region is expected to improve gradually over the forecast horizon, reaching 3.3 percent in 2020 and 3.5 percent in 2021 (Figure 2.6.2.A). This cyclical recovery is weaker than previously envisioned—despite some increase in commodity prices—reflecting in part weaker demand growth in major trading partners and, in particular, an increasingly challenging business environment in Sudan amid heightened political uncertainty. The forecast assumes that investor sentiment will improve in some of the large economies in the region, that oil production in large oil exporters will recover, and that robust growth in non-resource-intensive economies will be underpinned by continued strong agricultural production and sustained public investment.

FIGURE 2.6.2 SSA: Outlook and risks

The recovery in the region is projected to strengthen moderately, as oil production improves in Angola and Nigeria and investor confidence firms in South Africa. However, per capita growth is expected to remain low, and downside risks dominate, including the possibility of a sharper-than-expected slowdown in key partner economies. Rising public debt burdens are an increasing source of vulnerability across the region. Banking sectors have become more vulnerable in some countries. A return to El Niño conditions in 2019 could weigh on agricultural production.



Source: Haver Analytics; International Monetary Fund, *World Economic Outlook*; NOAA/National Weather Service Climate Prediction Center; World Bank.
A.-B. Aggregate growth rates calculated using 2010 U.S. dollar GDP weights. Non-resource-intensive countries represent agricultural commodity-exporting and commodity-importing countries. Industrial-commodity exporters represent oil- and metal-exporting countries.
D. Simple averages of country groupings.
E. Nonperforming loans are expressed relative to total gross loans. 2019Q1 for South Africa reflects data for January 2019.
F. ONI is the Oceanic Niño Index that measures sea surface temperature anomalies in degrees Celsius within the Niño 3.4 region of the eastern Pacific Ocean. Sustained ONI values outside of the +/- 0.5 threshold indicate El Niño or La Niña events.
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While per capita GDP growth is expected to improve somewhat, rising to 0.7 percent in 2020 and 0.9 percent in 2021, it will remain insufficient to significantly reduce poverty in the region (Figure 2.6.2.B). In countries where progress is being made in poverty reduction, increased prosperity is not always shared, as economic growth is often concentrated in urban areas with little benefit to the rural poor.

In South Africa, growth is expected to pick up from 1.1 percent in 2019, to 1.5 percent in 2020 and 1.7 percent in 2021. This forecast is predicated on fading policy uncertainty and on a gradual growth dividend from reforms to improve the business environment. Slower growth in the Euro Area—South Africa's main export destination—is expected to be counterbalanced, in part, by more benign external financing conditions and rising investment spending, reflecting the government's commitment to accelerate public investment projects in cooperation with the private sector.

Similarly, growth in Angola is expected to strengthen from 1 percent in 2019 to around 2.9 percent in both 2020 and 2021. The improved outlook, particularly for 2020, reflects an increasingly favorable business environment along with a boost from the oil sector as new capacity comes on stream.

In Nigeria, growth is expected at 2.1 percent this year—a weaker-than-expected pace reflecting the continued constraints from foreign exchange restrictions, supply disruptions in the oil sector, and a lack of much-needed reforms to spur new capacity. Growth is projected to remain broadly stable in 2020, before strengthening to 2.4 percent in 2021.

Excluding Angola, Nigeria, and South Africa, regional growth is expected to be more robust, rising from 4.6 percent in 2019 to an average of 5 percent in 2020-21. The cyclical recovery among industrial-commodity exporters will be supported over the forecast period by investment in new oil and natural gas capacity in several oil exporters (Cameroon, Ghana), and increased mining production in some metal-exporting countries, as new capacity comes on stream (Democratic Republic of the Congo, Guinea). In Sierra Leone, however, mine closures will remain a drag on metals production. Among non-resource-intensive economies, sustained strong public infrastructure spending, combined with increased private sector participation, will continue to support economic activity (Ethiopia, Rwanda, Tanzania, Uganda). In the West African Economic and Monetary Union, these factors will contribute to growth remaining above 6 percent over the next two years.

Risks

The outlook is subject to several downside risks. On the external front, a sharper-than-expected deceleration in activity in key trading partners, including China, the Euro Area, and the United States, could weigh on growth. These three economies together account for more than one-third of the region's exports and one-fifth of FDI inflows (Figure 2.6.2.C). The slowdown in the Euro Area could be aggravated by a disorderly exit of the United Kingdom from the European Union, while a further escalation of trade tensions between the United States and China could adversely impact activity in both economies. A sharper-than-projected slowdown in China would hit metal exporting countries particularly hard as it accounts for more than one-half of global metals demand (World Bank 2016, 2018i). Lower-than-expected commodity prices pose an additional risk to the outlook, as the region remains highly reliant on commodity export revenues.

Domestically, various developments could weaken fiscal positions. First, while external financing conditions have recently become more benign, they could tighten again if investor sentiment were to deteriorate. This could pose a significant risk to the outlook for countries with elevated debt burdens or where a large share of debt is denominated in foreign currency, as higher interest rates and weaker currencies would raise debt-servicing and refinancing costs, absorb revenues, and constrain poverty-reducing expenditures (Figure 2.6.2.D). Second, state-owned enterprises in some countries (Angola, Ethiopia, Ghana, Mozambique, South Africa),

particularly in the energy sector, have sizable debts that pose an additional contingent liability risk to already indebted governments (Bova et al. 2019). Third, countries holding elections during the next two-and-a-half years together account for one-quarter of the region's GDP, and the risk of fiscal slippages is particularly high, as domestic political considerations could undermine fiscal consolidation efforts (Ethiopia, Ghana, Tanzania, Zambia; Neumann and Ssozi 2015). Fourth, in countries where continued public investment is expected to support growth, the sustainability thereof could weaken if not accompanied by strong public investment management.

Regarding banking sector vulnerabilities, nonperforming loan (NPL) ratios have risen, or remain elevated, among some industrial-commodity exporters (Cameroon, Namibia, Nigeria, South Africa), as weaker growth and softer export revenues have translated into increasingly impaired private sector balance sheets (Figure 2.6.2.E). In Ghana, the large stocks of NPLs are mostly related to state-owned enterprises, and the authorities' continued measures to help clear them have been contributing to improved credit extension. Nevertheless, if slower-than-expected growth were to materialize, banking sectors could become even more vulnerable and likely amplify the growth slowdown (Mpofu and Nikolaidou 2018).

Risks that political instability, armed conflicts, or insurgencies may weigh on economic activity are particularly elevated in some economies (Cameroon, Nigeria, Sudan, Zimbabwe). Conflicts and insurgencies, in particular, could lead to forced displacements and hit agricultural production especially hard, reducing incomes and heightening food insecurity in many areas (Adelaja and George 2019). In some countries, a continuation of disappointing growth could become self-perpetuating. As slower growth stifles social progress and poverty reduction efforts, discontent and populist policies could become more widespread. This could further elevate policy uncertainty and undermine investor confidence. The extreme weather events that have afflicted agricultural sectors in Southern and East Africa during the first half of this year include the return of El Niño conditions (Figure 2.6.2.F). More severe droughts than assumed could further suppress agricultural output and exacerbate poverty.

TABLE 2.6.1 Sub-Saharan Africa forecast summary

(Real GDP growth at market prices in percent, unless indicated otherwise)

	2016	2017	2018e	2019f	2020f	2021f	Percentage point differences from January 2019 projections: 2019f	2020f	2021f
EMDE SSA, GDP[1]	**1.3**	**2.6**	**2.5**	**2.9**	**3.3**	**3.5**	**-0.5**	**-0.3**	**-0.2**
(Average including countries with full national accounts and balance of payments data only)[2]									
EMDE SSA, GDP[2,3]	1.3	2.6	2.5	2.9	3.3	3.5	-0.5	-0.3	-0.2
GDP per capita (U.S. dollars)	-1.4	-0.1	-0.2	0.2	0.7	0.9	-0.6	-0.2	-0.1
PPP GDP	1.6	2.9	2.8	3.1	3.5	3.7	-0.6	-0.3	-0.2
Private consumption	0.0	2.2	2.0	2.2	2.7	2.8	-0.6	-0.2	0.3
Public consumption	-0.4	1.1	2.6	2.6	2.5	2.7	-0.3	-0.5	-0.1
Fixed investment	-0.6	4.7	5.8	5.9	6.1	6.7	-1.0	-0.9	-0.8
Exports, GNFS[4]	2.3	6.7	2.1	2.3	3.1	3.0	-0.8	-0.3	-0.1
Imports, GNFS[4]	-3.0	2.7	4.2	3.0	3.4	3.7	-0.5	-0.2	-0.1
Net exports, contribution to growth	1.6	1.2	-0.6	-0.2	-0.1	-0.2	-0.1	0.0	0.1
Memo items: GDP									
SSA excluding Nigeria, South Africa, and Angola	4.2	4.8	4.4	4.6	4.9	5.0	-0.8	-0.5	-0.4
Oil exporters[5]	-0.7	1.5	1.4	2.1	2.5	2.6	-0.8	-0.3	-0.2
CFA countries[6]	2.9	3.4	4.3	5.0	5.0	5.1	0.1	0.3	0.5
CEMAC	-0.8	-0.2	1.7	3.1	3.1	3.3	0.1	0.5	1.0
WAEMU	6.4	6.6	6.5	6.6	6.5	6.5	0.2	0.1	0.2
SSA3	-0.8	0.9	1.0	1.6	2.0	2.2	-0.3	-0.1	0.1
Nigeria	-1.6	0.8	1.9	2.1	2.2	2.4	-0.1	-0.2	0.0
South Africa	0.6	1.4	0.8	1.1	1.5	1.7	-0.2	-0.2	-0.1
Angola	-2.6	-0.1	-1.7	1.0	2.9	2.8	-1.9	0.3	0.0

Source: World Bank.

Note: e = estimate; f = forecast. EMDE = emerging market and developing economies. World Bank forecasts are frequently updated based on new information and changing (global) circumstances. Consequently, projections presented here may differ from those contained in other Bank documents, even if basic assessments of countries' prospects do not differ at any given moment in time.

1. GDP at market prices and expenditure components are measured in constant 2010 U.S. dollars. Excludes Central African Republic, São Tomé and Príncipe, Somalia, and South Sudan.
2. Sub-region aggregate excludes Central African Republic, São Tomé and Príncipe, Somalia, and South Sudan, for which data limitations prevent the forecasting of GDP components.
3. Sub-region growth rates may differ from the most recent edition of Africa's Pulse (https://www.worldbank.org/en/region/afr/publication/africas-pulse) due to data revisions and the inclusion of the Central African Republic and São Tomé and Principe in the sub-region aggregate of that publication.
4. Exports and imports of goods and non-factor services (GNFS).
5. Includes Angola, Cameroon, Chad, Republic of Congo, Gabon, Ghana, Nigeria, and Sudan.
6. Includes Benin, Burkina Faso, Cameroon, Central African Republic, Chad, Republic of Congo, Côte d'Ivoire, Equatorial Guinea, Gabon, Mali, Niger, Senegal, and Togo.

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TABLE 2.6.2 Sub-Saharan Africa country forecasts[1]

(Real GDP growth at market prices in percent, unless indicated otherwise)

	2016	2017	2018e	2019f	2020f	2021f	Percentage point differences from January 2019 projections: 2019f	2020f	2021f
Angola	-2.6	-0.1	-1.7	1.0	2.9	2.8	-1.9	0.3	0.0
Benin	4.0	5.8	6.5	6.5	6.5	6.5	0.3	0.0	-0.1
Botswana	4.3	2.9	4.5	4.2	3.9	4.0	0.3	-0.2	-0.1
Burkina Faso	5.9	6.3	6.8	6.0	6.0	6.0	0.0	0.0	0.0
Burundi	-0.6	0.5	1.6	1.8	2.1	2.0	-0.5	-0.4	-0.8
Cabo Verde	4.7	4.0	4.5	4.4	4.6	4.7	-0.3	-0.3	-0.2
Cameroon	4.6	3.5	4.0	4.2	4.4	4.6	0.0	-0.1	0.1
Chad	-6.3	-3.0	2.6	3.4	5.6	4.8	-1.2	-0.5	-0.1
Comoros	2.2	2.7	2.8	3.1	3.2	3.2	0.0	0.1	0.1
Congo, Dem. Rep.	2.4	3.7	5.8	5.9	6.5	6.8	1.3	1.0	0.9
Congo, Rep.	-2.8	-3.1	0.8	5.4	1.5	1.9	2.2	1.6	3.4
Côte d'Ivoire	8.0	7.7	7.4	7.4	7.3	7.3	0.1	-0.1	0.5
Equatorial Guinea	-8.8	-4.7	-2.9	-2.2	-1.9	-1.8	-0.1	3.9	4.0
Eswatini	3.2	1.9	0.5	1.1	1.6	1.7	-0.6	-0.2	-0.1
Ethiopia[2]	7.6	10.2	7.9	7.9	8.2	8.2	-0.9	-0.7	-0.7
Gabon	2.1	0.5	0.8	2.8	3.7	3.9	-0.2	0.0	0.2
Gambia, The	0.4	4.6	6.6	5.4	5.2	5.0	0.0	0.0	-0.2
Ghana	3.4	8.1	6.3	7.6	7.0	5.8	0.3	1.0	-0.2
Guinea	10.5	10.6	5.8	5.9	6.0	6.0	0.0	0.0	0.0
Guinea-Bissau	6.3	5.9	3.8	4.3	4.8	5.5	0.1	0.4	1.0
Kenya	5.9	4.9	6.3	5.7	5.9	6.0	-0.1	-0.1	0.0
Lesotho	3.1	-0.4	1.7	1.5	0.4	4.1	0.3	0.2	2.3
Liberia	-1.6	2.5	1.2	0.4	1.6	1.3	-4.1	-3.2	-3.5
Madagascar	4.2	4.3	5.2	5.2	5.3	5.1	-0.2	0.0	-0.2
Malawi	2.5	4.0	3.5	4.5	4.7	5.1	0.2	-0.6	-0.4
Mali	5.8	5.3	4.9	5.0	4.9	4.8	0.0	0.0	0.0
Mauritania	2.0	3.0	3.6	6.7	5.8	6.0	1.8	-1.1	-0.9
Mauritius	3.8	3.8	3.8	3.9	3.9	3.5	-0.1	0.3	-0.1
Mozambique	3.8	3.7	3.3	2.0	3.5	4.2	-1.5	-0.6	0.1
Namibia	1.1	-0.9	-0.1	0.9	1.5	1.9	-0.9	-0.6	-0.2
Niger	4.9	4.9	5.2	6.5	6.0	5.6	0.0	0.0	0.0
Nigeria	-1.6	0.8	1.9	2.1	2.2	2.4	-0.1	-0.2	0.0
Rwanda	6.0	6.1	8.6	7.8	8.0	7.5	0.0	0.0	-0.5
Senegal	6.2	7.2	6.8	6.8	7.0	7.0	0.2	0.2	0.1
Seychelles	4.5	5.3	3.6	3.4	3.0	3.2	0.0	-0.3	0.3
Sierra Leone	6.4	3.8	3.7	5.4	5.4	5.2	0.3	-0.9	-1.1
South Africa	0.6	1.4	0.8	1.1	1.5	1.7	-0.2	-0.2	-0.1
Sudan	4.7	4.3	-2.3	-1.9	-1.3	-0.8	-5.5	-5.1	-4.6
Tanzania	6.9	6.8	6.0	5.4	5.7	6.1	-1.4	-1.3	-0.9
Togo	5.2	4.3	4.9	5.0	5.2	5.1	0.2	0.1	0.0
Uganda[2]	4.6	3.9	5.9	6.1	6.5	5.8	0.1	0.1	-0.7
Zambia	3.6	3.4	3.5	2.5	2.8	2.8	-1.1	-1.0	-1.0
Zimbabwe	0.8	4.7	3.5	-3.1	3.5	4.9	-6.8	-0.5	0.9

Source: World Bank.

Note: e = estimate; f = forecast. World Bank forecasts are frequently updated based on new information and changing (global) circumstances. Consequently, projections presented here may differ from those contained in other Bank documents, even if basic assessments of countries' prospects do not significantly differ at any given moment in time.

1. GDP at market prices and expenditure components are measured in constant 2010 U.S. dollars. Excludes Central African Republic, São Tomé and Príncipe, Somalia, and South Sudan.

2. Fiscal-year based numbers.

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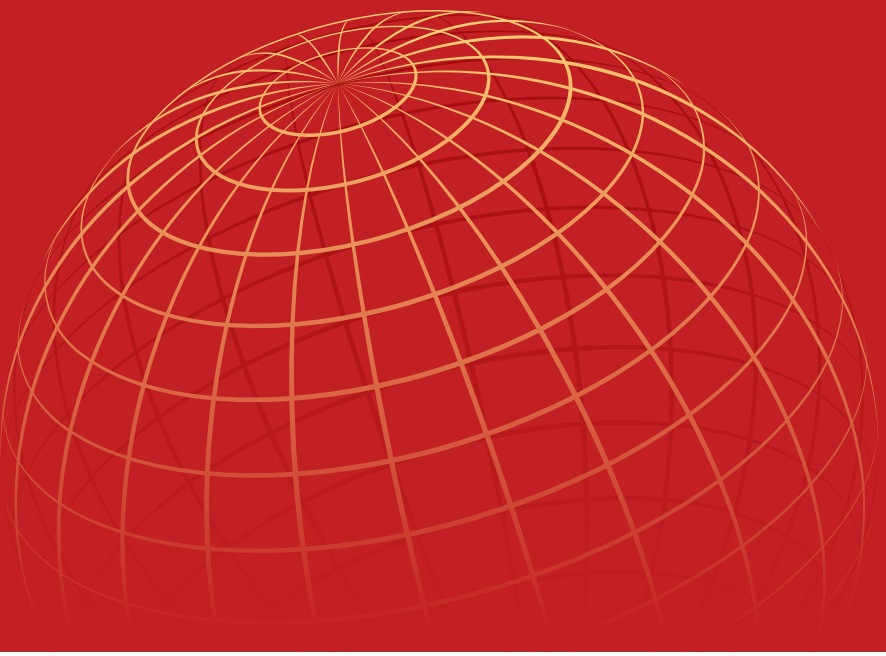

SPECIAL FOCUS 2.1

Growth in Low-Income Countries: Evolution, Prospects, and Policies

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There are currently 34 countries classified as low-income, about half the number in 2001. Rapid growth in low-income countries from 2001-18 allowed many to progress to middle-income status, supported by a pre-crisis commodity price boom, the MDRI and HIPC debt relief initiatives, increased investment in human and physical capital, improved economic policy frameworks, and recoveries from the deep recessions in transition economies during the 1990s. However, the prospects for today's LICs appear much more challenging. Compared to the LICs in 2001 that became middle-income countries, today's LICs are further below the middle-income threshold and more often fragile than were LICs in 2001. Their heavy reliance on agriculture makes them vulnerable to climate change and extreme weather events, and their scope to boost external trade is limited by geography. Coordinated and multi-pronged policy efforts are required to address these challenges.

Introduction

Since 2001, the number of low-income countries (LICs) has almost halved, to 34 in 2019 from 64 in 2001 (Figure SF2.1.1.A).[1] During this period, their number rose to a peak of 66 in 2003 before falling to a trough of 31 in 2016. Since then, however, the decline has stalled, if not reversed, with four countries—Senegal, the Syrian Arab Republic, Tajikistan, and the Republic of Yemen—relapsing into LIC status amid armed conflict and terms of trade shocks, while only one country (Cambodia) reached middle-income status. The countries classified as LICs in 2001 that have converged to middle-income (MIC) status experienced average growth of 5.8 percent a year during 2001-2018—about one-half faster than non-LIC EMDEs over the same period and one-quarter faster than those 2001 LICs that have remained in the group (4.5 percent), although with wide heterogeneity (Figure SF2.1.1.B).

Several factors have contributed to the rapid economic growth of the 2001 LICs. Twelve 2001 LICs were transition economies, of which nine rebounded sharply during the 2000s from their deep recessions in the 1990s.[2] Among non-transition 2001 LICs, rapid investment growth boosted overall economic growth, on average contributing more than one-third to output growth during 2001-18. In six of these countries (Cameroon, the Democratic Republic of Congo, Guinea, Indonesia, Mauritania, Mozambique), investment booms followed new resource discoveries. Debt relief in the early 2000s, and the fiscal space created by it, supported government spending on non-interest expenditure.[3] In addition, business climates and policy frameworks improved in most of the 2001 LICs.

Rapid economic growth in LICs has contributed to poverty reduction. The share of extreme poor in the population of 2001 LICs has fallen by 16 percentage points, on average, and this has contributed 20 percentage points—about one third—to the decline in the global poverty headcount between 2001 and 2015. This contribution, however, mostly reflects sharp declines in the poverty headcount of the 2001 LICs that reached middle-income levels, while masking broadly unchanged poverty headcounts among the countries that have remained, or became, LICs (Figure SF2.1.1.C). Today's LICs

Note: This Special Focus was prepared by Rudi Steinbach. Research assistance was provided by Mengyi Li.

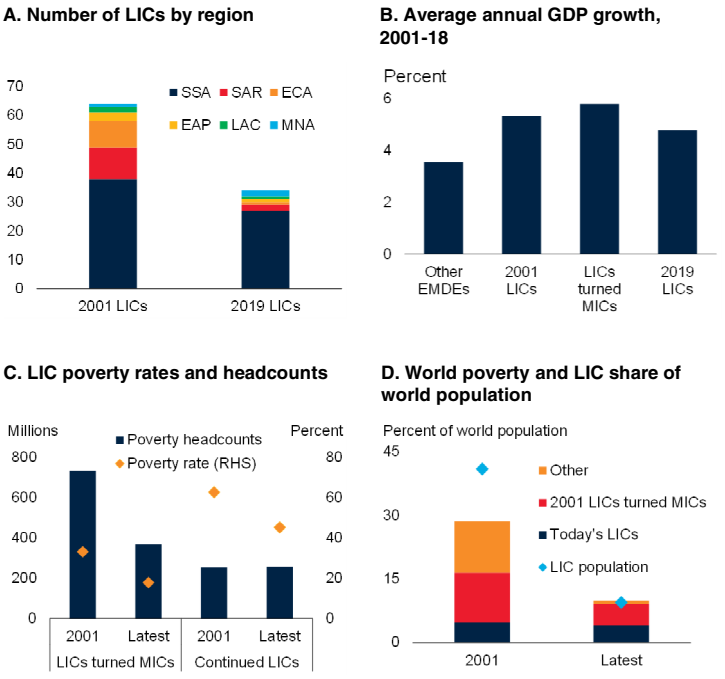
[1] LICs in 2019 reflect the country classification of the 2018/19 World Bank fiscal year and are defined as countries with GNI per capita (World Bank Atlas method) of $995 or less in 2017; 2001 LICs reflect the country classification of the 2000/01 fiscal year and had GNI per capita of $755 or less in 1999. New thresholds are determined at the start of each World Bank fiscal year. Of the 64 2001 LICs, 32 moved to middle-income country status while 32 remained classified as LICs in 2019.

[2] Transition economies are economies that changed from centrally-planned to market-oriented economic systems. Those that were LICs in 2001 include Armenia, Azerbaijan, Georgia, the Kyrgyz Republic, Cambodia, Lao People's Democratic Republic, Moldova, Tajikistan, Turkmenistan, Ukraine, Uzbekistan, and Vietnam. On average, their economies contracted by an estimated 30 percent during 1990-1996.

[3] Government non-interest expenditure rose by 2 percentage points of GDP, on average, between the year of debt relief and 2018.

FIGURE SF2.1.1 LIC growth since 2001

The number of LICs has declined from 64 in 2001 to 34 in 2019. Growth in LICs benefited from several factors and has allowed 32 countries to progress to middle-income status. Sharp declines in LIC poverty rates have contributed one-third to the decline in the global poverty headcount since 2001. However, these declines mask broadly unchanged headcounts among countries that have remained LICs. While the share of LICs in the global population has declined by three-quarters—from 41 percent in 2001 to 10 percent in 2015—they are home to more than 40 percent of the world's poor.



Source: United Nations, World Bank.

A. LICs = low-income countries. LICs in 2001 had per capita GNI (US$, current) at $755 or below, while LICs in 2019 have per capita GNI at $995 or below in 2017.

B. Other EMDEs exclude 2001 LICs.

C. Latest reflects 2015 data. Due to data limitations, poverty share for "LICs turned MICs" includes 26 of 32 countries and reflects 94.1 percent of the sample population in 2015; "Continued LICs" includes 25 of 32 countries and reflects 79.8 percent of the sample population.

D. Latest reflects 2015 data. Due to data limitations, poverty share for "LICs turned MICs" includes 26 of 32 countries and reflects 94.1 percent of the sample population in 2015; "Today's LICs" includes 34 of 34 countries.

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account for less than one-tenth of the global population (one-quarter their share in 2001). However, they are home to around 40 percent of the world's extreme poor (Figure SF2.1.1.D). This share is expected to remain elevated amid continued fragility in many of these economies, while the poverty headcount is expected to continue to decline elsewhere.

Today's LICs face severe challenges that threaten to hold back convergence of their per capita incomes with those in MICs. Today's LICs also face significantly larger spending needs than non-LIC EMDEs to meet the Sustainable Development Goals by the end of next decade, underscoring the need for sustained and robust growth (Gaspar et al. 2019).

Against this backdrop, this Special Focus examines the following questions.

- What has driven and supported growth in LICs since 2001?
- How have these factors affected LIC progression to MIC status?
- What are the prospects for future progression among today's LICs?

This Special Focus presents the following findings. First, growth in low-income countries—and, especially those that have progressed to middle-income status—has benefited from a confluence of favorable developments since 2001. Second, prospects for further progress by today's LICs toward middle-income status are challenging. Compared to the LICs of 2001 that became MICs, today's LICs have per capita incomes that are even further below the middle-income threshold, more likely to be fragile, more often landlocked and clustered with other LICs, heavily reliant on agriculture, and face weaker prospects for long-term commodity demand.[4] Third, since today's LICs account for 40 percent of the global extreme poor, challenging prospects for LIC growth will set back progress towards eliminating extreme poverty globally.

This Special Focus extends previous analysis of LIC growth (World Bank 2015a). First, a broader set of factors that have contributed to LIC growth since 2001 is considered—in particular, the roles of investment in human and physical capital, greater trade integration, and improved business climates and policy frameworks. Since three-quarters of LICs rely heavily on commodity exports and revenues, the impact of the 2014-16 commodity price plunges is examined. Second, and in contrast to the earlier work which examined the fates of the 64 LICs of 2001,

[4] Fragile LICs are those affected by fragility, conflict, and violence, according to the World Bank's Harmonized List of Fragile Situations.

the study here zooms in on the drivers of growth in the smaller group of 34 LICs of 2019, including the four countries that have become LICs in recent years amid weaker commodity prices and increased fragility. Third, this Special Focus highlights the implications for global poverty goals.

What has supported growth in LICs since 2001?

The 64 countries classified as LICs in 2001 experienced growth of 5.3 percent a year, on average, during 2001-18—considerably faster than the 3.6 percent growth in non-LIC EMDEs (Figure SF2.1.2.A). For those LICs, this was a sharp improvement from their tepid growth of 1.6 percent annually during the 1990s.

Growth in the 64 2001 LICs was supported by several cyclical and structural factors. The 2001-11 commodity price boom lifted growth in the one-third of LICs that were—or became—industrial commodity exporters. In the nine LICs transitioning into market-oriented economies, the deep recessions of the 1990s were followed by cyclical rebounds. In five countries, armed conflicts eased in the 2000s after inflicting heavy human and economic losses during the 1990s. Debt relief for about half of the 2001 LICs helped put these economies on a more sustainable financial footing. Business climates and governance, especially the rule of law, improved significantly in more than half of the 2001 LICs.

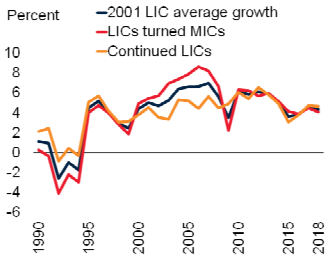
Cyclical factors

Commodity price boom. Around three-quarters of 2001 LICs benefited from the commodity price boom of 2001-11. During the commodity price boom, energy and industrial metals prices more than tripled and agricultural prices rose by around 150 percent (Figure SF2.1.2.B). The boom, along with a decline in easily accessible mineral and gas deposits in advanced economies and more cost-effective transport through advances in bulk shipping fueled unprecedented investment in commodity exploration and production in the 2001 LICs (Figure SF2.1.2.C; Lusty and Gunn 2015). In 2008, commodity prices—particularly metals and oil prices—declined sharply with the onset of the global financial crisis, but recovered to pre-crisis levels within about a year. However, by

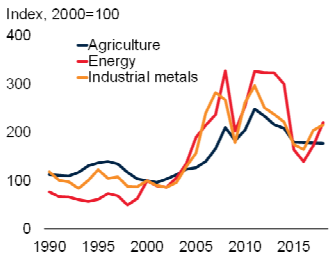
FIGURE SF2.1.2 Cyclical and structural factors supporting LIC growth

Growth in the LICs of 2001 was supported over the next decade by booming commodity prices, increased resource production amid large investments in mineral exploration, debt relief under the MDRI and HIPC initiatives, and receding conflicts, particularly in Africa. Conflict-related casualties have, however, risen sharply in the Middle East where several countries have tipped into the low-income bracket.

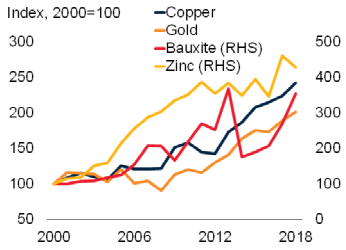
A. Annual GDP growth in LICs of 2001



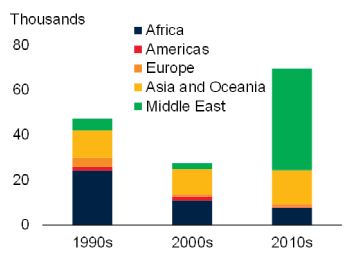
B. Agricultural, energy, and industrial metals prices



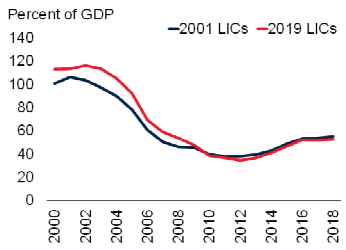
C. Resource production in LICs of 2001



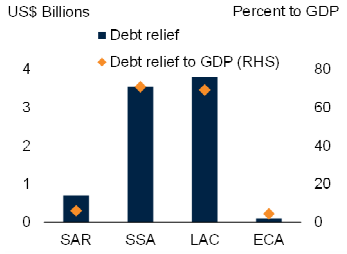
D. Annual average conflict-related deaths



E. Gross government debt in LICs of 2001 and LICs of 2019



F. MDRI and HIPC relief in LICs of 2001



Source: Haver Analytics; International Monetary Fund, *World Economic Outlook*; Peace Research Institute of Oslo (PRIO), Roser (2019); World Bank Pink Sheet; World Bank staff calculations; World Bureau of Metal Statistics.

B. Agriculture includes 23 commodities, industrial metals includes 7 metals, and Energy includes coal, crude oil, and natural gas. Index 100=2000.

D. Only conflicts in which at least one party was the government of a state and which generated more than 25 battle-related deaths are included. The data refer to direct violent deaths only and exclude outbreaks of disease or famine. Data up to 2016. Country-level data unavailable.

E. Unweighted averages. 2001 LICs includes 61 countries and the 2019 LICs includes 31 countries.

F. Committed debt relief under the assumption of full participation of creditors. Bars represent average debt relief per region in US$ billions for all HIPC and MDRI LICs. Diamonds reflect average debt relief per region relative to countries' GDP.

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2011, commodity prices began to slide again, and they fell by 30-60 percent to a low in 2016 before gradually and only partially recovering. By 2018, industrial metals and energy prices were at their 2005-06 levels in real terms while agricultural prices remained near their 2016 lows.

Two-thirds of the 2001 LICs were already heavily reliant on commodity exports and revenues in 2001—the majority of them on metals and energy exports, and the rest on agricultural commodity exports. Another one-tenth of the 2001 LICs subsequently became reliant on commodity exports, specifically metals and energy, after discoveries and exploitation of major commodity deposits. Several "giant" oil and gas fields—conventional fields with recoverable reserves of 500 million barrels or more—have been discovered offshore of East, West, and Central Africa, to the benefit of many 2001 LICs in these regions (Côte d'Ivoire, Cameroon, Ghana, Mozambique, Tanzania). During the 2000s, major new commodity deposits were also discovered in Indonesia (oil and gas), Lao PDR (copper, gold), Mauritania (copper, gold, and oil), Republic of Congo (oil), and Zambia (copper). From 2003-12, new commodity discoveries in Sub-Saharan Africa accounted for 22 percent of global discoveries and 15 percent of global exploration expenditures (Schodde 2013).

The commodity boom of 2001-11 supported above-average growth in those 2001 LICs that were, or became, commodity exporters. Exports of primary commodities in these countries rose by one-half of GDP between 2001 and 2011. Higher export earnings helped improve fiscal positions, with government revenues of commodity-exporting LICs rising by close to 4 percentage points of GDP, on average, and fiscal deficits narrowing by around 1 percentage point of GDP, between 2001 and 2011. This, as well as debt relief, allowed a doubling of social expenditures between the 2000s and 2010s. The commodity-driven growth surge was accompanied by a decline in inflation to single digits and an annual 3 percent real exchange rate appreciation between 2001 and 2011, on average, in commodity-exporting LICs (Trevino 2011; Guillaumont, Jeanneny, and Hua 2015).

Rebounds in transition economies. Nine of the 2001 LICs were, in the early 2000s, rebounding from the deep recessions into which their economies had plunged as they made the transition from centrally planned to market-based economies. By the time their economies had bottomed out in the mid- to late-1990s, their output had declined from its pre-recession levels by one fifth in Uzbekistan, by more than a third in Kazakhstan, and by at least one half in Armenia, Azerbaijan, Georgia, the Kyrgyz Republic, Moldova, Tajikistan, and Ukraine (Iradian 2007).[5] As a result, per capita incomes had fallen below the low-income threshold.

However, despite the drop in output these economies continued to have a foundation of solid human and physical capital, with near-universal literacy rates, triple the average secondary enrollment ratio of the average 2001 LIC, and power-generating capacity similar to those of advanced economies. Governments in many of these countries were implementing growth-enhancing structural reforms to accelerate the transition, including privatization of state-owned assets (for example, agricultural land reform in Azerbaijan); establishment of legal systems and property rights (the Kyrgyz Republic); the design of more efficient social safety nets (Armenia); strengthening of financial systems; greater openness to international trade, including through accession to the WTO (Georgia); and the improvement of business environments through substantive regulatory simplification (Moldova). These reforms helped boost productivity growth, including by promoting investment and exports (Loukoianova and Unigovskaya 2004). Growth since 2001 was further supported by the commodity boom, as seven of these nine transition economies were also heavily reliant on commodity exports.[6]

[5] It is likely that the real GDP declines in these transition economies were overstated in the official data of the early 1990s, as the private sectors that were emerging at that time were typically not fully included in the statistical base during the early days of the transition (Iradian 2007).

[6] The commodity-exporting transition-economy LICs of 2001 were Armenia, Azerbaijan, the Kyrgyz Republic, Tajikistan, Turkmenistan, Ukraine, and Uzbekistan.

Structural factors

Receding conflicts. Five of the LICs of 2001—all of which remain LICs today—emerged from severe conflicts in the 1990s and early 2000s (Burundi, the Democratic Republic of Congo, Liberia, Rwanda, and Sierra Leone). The conflict in the Democratic Republic of Congo is estimated to have cost 2.5 million lives when deaths related to conflict-induced disease and famine are included—equivalent to 3 percent of today's population (Lacina and Gleditsch 2004; Roberts et al. 2001). Conflicts in Burundi, Liberia, Rwanda, and Sierra Leone inflicted losses of human life equivalent to between 1 and 10 percent of their populations. While most of these economies are still considered fragile, conflict-related casualties in Africa have been on a declining trend since the 1990s (Figure SF2.1.2.D). This has provided a more favorable setting for a growth rebound.

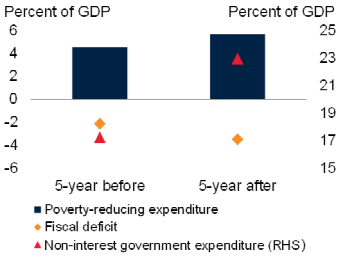
Debt relief. Thirty-five of the 2001 LICs (of which 26 remain LICs today) received debt relief during the early 2000s in the context of the Multilateral Debt Relief Initiative (MDRI) and Highly-Indebted Poor Country (HIPC) initiative. Between the year preceding debt relief and two years after it, government debt in these countries declined by 53 percentage points of GDP, on average, to 31 percent of GDP (Figures SF2.1.2.E and SF2.1.2.F). Rapid growth from 2001, more broadly, also supported the reduction of debt ratios. In the median 2001 LIC, government debt declined by 35 percentage points of GDP, from 84 percent of GDP in 2001 to 49 percent of GDP in 2018.

This reduction of debt burdens has helped put public finances on a sounder footing. While government deficits increased slightly (by about 1 percentage point of GDP), non-interest government expenditures rose by 5 percentage points of GDP, and combined health and education expenditures rose by one-fifth between the five years preceding debt relief and the five years following it (Figure SF2.1.3.A). More sustainable public finances supported macro-economic stability (Bayraktar and Fofack 2011; Marcelino and Hakobyan 2014).

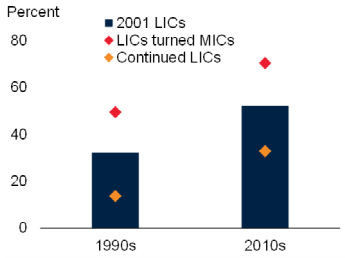
FIGURE SF2.1.3 Domestic factors supporting LIC growth

The reduction of debt burdens has helped put public finances in the LICs of 2001 on a sounder footing. Policy frameworks have also improved, and governments have become more effective. Investments in human and physical capital have contributed to higher secondary school enrollment ratios and greater access to electricity. In addition, more effective health care interventions have raised average life expectancy in these countries.

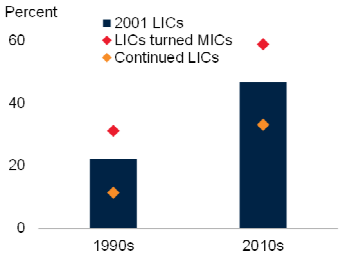
A. Public finances before and after debt relief



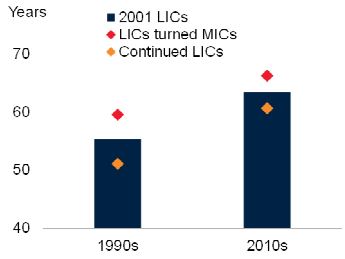
B. Share of population with access to electricity in 2001 LICs



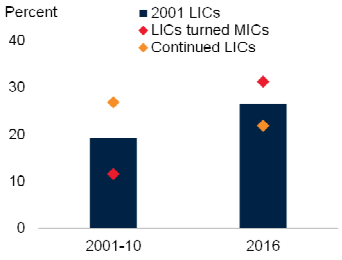
C. Average secondary school enrollment rates in 2001 LICs



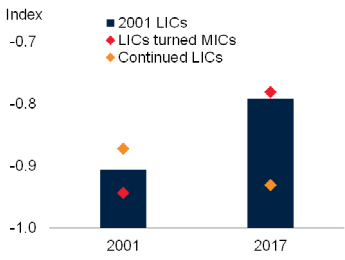
D. Average life expectancy in 2001 LICs



E. Share of 2001 LICs with flexible exchange rate arrangements



F. Government effectiveness in 2001 LICs



Source: International Monetary Fund, *World Economic Outlook;* Reinhart and Rogoff (2004); Worldwide Governance Indicators; World Development Indicators.

Note. "LICs turned MICs" are those LICs in 2001 that have achieved MIC per capita incomes by 2019; "Continued LICs" are LICs that have remained LICs since 2001.

A. Poverty-reducing expenditure represents public spending on health and education. Unweighted average for 26 LICs that received MDRI or HIPC debt relief.

B.-F. Unweighted averages.

B. 2010s includes data up to 2016. 2001 LICs, "LICs turned MICs", and "Continued LICs", include 62, 32, and 30 countries, respectively.

C. 2010s includes data up to 2017. 2001 LICs, "LICs turned MICs", and "Continued LICs", include 55, 26, and 29 countries, respectively.

D. 2010s includes data up to 2017. 2001 LICs, "LICs turned MICs", and "Continued LICs", include 64, 32, and 32 countries, respectively.

E. Following the coarse exchange rate regime classification of Reinhart and Rogoff (2004), where categories 1-2 represents fixed, and 3-6 represent more flexible arrangements. 2010s includes data up to 2016. 2001 LICs, "LICs turned MICs", and "Continued LICs", include 63, 32, and 31 countries, respectively.

F. 2001 LICs, "LICs turned MICs", and "Continued LICs", include 64, 32, and 32 countries, respectively.

Click here to download data and charts.

Since 2013, the downward trend in 2001 LICs' debt has reversed, with government debt rising in the median 2001 LIC by 14 percentage points of GDP to 49 percent of GDP in 2018. That said, only two of the 2001 LICs—Benin and Chad—have returned to debt ratios near those before debt relief. The composition of this debt has become increasingly non-concessional as countries have accessed capital markets and borrowed from non-Paris Club creditors (World Bank 2019a). In 2018, 44 percent of the external debt of the median LIC of 2001 was on non-concessional terms, compared with 30 percent in 2001.

Trade integration. Many of the 2001 LICs have reaped benefits from greater trade integration by entering into free trade agreements. Moldova's trade agreement with the European Union has supported export growth and is encouraging reforms, in particular related to governance, the financial sector, and the business environment (European Commission 2018). In Sub-Saharan Africa, membership in free trade areas has boosted intra-regional trade (Burundi, Kenya, Rwanda, Tanzania, Uganda), and supported FDI inflows, industrialization, and integration into global value chains (e.g., Lesotho; Buigut 2016, Morris and Staritz 2017). Similarly, Nicaragua reaped growth dividends and attracted stronger FDI inflows between 2005 and 2011 as a result of the Central America-Dominican Republic Free Trade Agreement (Hornbeck 2012). The India-ASEAN agreement that went into effect in 2009-10 has benefited the 2001 LICs that became members (Bhutan, Bangladesh, India; Bhattacharyya and Mandal 2016).

Investment in human and physical capital. Most 2001 LICs boosted their investment in human and physical capital during the period of rapid growth from 2001. Between 2001 and 2017, the ratio of total investment to GDP in these countries increased by 5 percentage points, of which one-third represented increased public investment.

- *Infrastructure*. Infrastructure in sectors such as electricity and communications has improved significantly among LICs (Calderón and Servén 2010; Kumar and Rauniyar 2018). From 2001 to 2016, access to electricity in the median 2001 LIC increased from 30 to 53 percent of the population and, in one-quarter of LICs, from 52 to 84 percent (Figure SF2.1.3.B).[7] Communications infrastructure has improved rapidly, helped in part by the spread of mobile phone networks (Aker and Mbiti 2010; World Bank 2016b). The use of mobile phones has reduced information inefficiencies and transaction costs, benefitting particularly businesses and small-scale farmers in rural areas where distances from markets are large (Aker 2011). Transaction costs could be lowered even further if broad-band internet network infrastructure was increased from its current low coverage of 1 percent of the population in the median LIC in 2016 (World Bank 2019b).

- *Human capital*. In the median 2001 LIC, secondary education net enrollment ratios rose from 24 to 47 percent of the school-age population between 2001 and 2016, supported by a 25 percent increase in government spending on education (Figure SF2.1.3.C). This, combined with improvements in average life expectancy in LICs—in part due to the improved prevention and more effective treatment of widely-prevalent conditions such as malaria, HIV, and AIDS—is creating the preconditions for an increasingly productive future workforce (Figure SF2.1.3.D; Asiki et al. 2016; Barofski, Anekwe, and Chase 2015).

Improved business climates and policy frameworks. The business climate has improved in the majority of the 2001 LICs between the 1990s and the 2010s. More specifically, the ease of starting a business, obtaining credit, and trading across borders has, on average, increased by 20-30 index points since 2006 (World Bank 2019c). Similarly, the Worldwide Governance Indicator scores for the rule of law have strengthened by about 20 percent, and there have been more moderate improvements in regulatory quality and political stability.

[7] That said, access to electricity in some countries still remains below 10 percent of the population (Burundi, Chad, South Sudan).

A growing number of LICs have strengthened their fiscal management through medium-term debt management strategies (World Bank 2019a). Some have strengthened their monetary policy frameworks and their buffers against shocks by adopting flexible exchange rate arrangements and using their policy instruments to target low domestic inflation; more than one-quarter of 2001 LICs had flexible exchange rate regimes in 2016, compared to fewer than one-fifth during 2001-10, on average (Figure SF2.1.3.E).[8] Improved policy frameworks and increased resilience to external shocks among the 2001 LICs have also been supported by increases in foreign exchange reserves from 8 percent of GDP in 2001 to 14 percent of GDP, on average, in 2017.

How have these factors affected LIC progression to MIC income levels?

The 2001 LICs that became MICs benefited somewhat more from the factors discussed above than those that remained (Figures SF2.1.3.B-2.1.3.F). On average, the 2001 LICs that became MICs had stronger policy frameworks, better governance and business environments, better-developed infrastructure, larger improvements in human capital, and more fiscal resources due to revenue bases being significantly larger—by at least one fifth of GDP. The 2001 LICs that became MICs also had a geographical advantage, as less than one-third were landlocked compared to almost half of today's LICs. Furthermore, the 2001 LICs that were landlocked but became MICs had, on average, neighbors with per capita incomes that were 36 percent higher than current incomes among the neighbors of today's landlocked LICs.

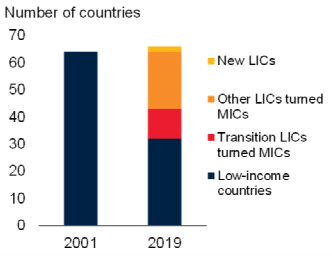
LICs that achieved MIC per capita income levels. Between 2001 and 2019, 32 LICs achieved middle-income status (Figure SF2.1.4.A). The progress made by LICs that have become MICs

[8] Exchange rate regimes are grouped according to the classification in Ilzetski, Reinhart and Rogoff (2017), with the only exception that freely falling currencies are also regarded as flexible exchange rate arrangements.

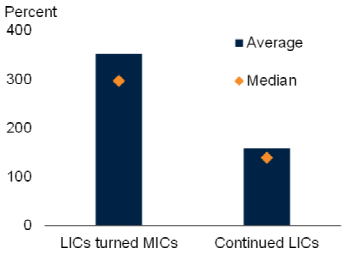
FIGURE SF2.1.4 Factors supporting LIC progression to MIC income levels

A quarter of the 2001 LICs that have become MICs were transition economies that recovered from deep recessions after the end of socialism throughout much of the world. Improvements in per capita income were more pronounced in the LICs that have reached MIC status. A few rapid-growing LICs have not been able to reach MIC status, partly due to very low starting positions in 2001. In countries that have reached MIC status, school enrollment ratios, government effectiveness, and the rule of law improved as they neared the year of moving to MIC status, as well as in the years thereafter. At the point of becoming a MIC, these measures were consistently better than the LIC median.

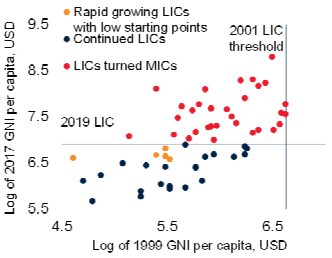
A. Low-income countries, 2001 and 2019



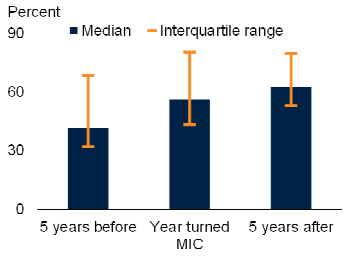
B. Growth in 2001 LIC per capita incomes between 2001 and 2019



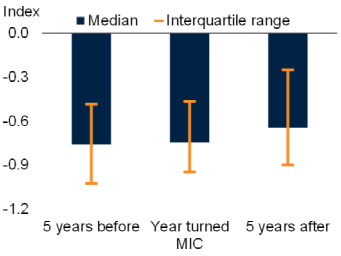
C. Progression of 2001 LIC per capita incomes



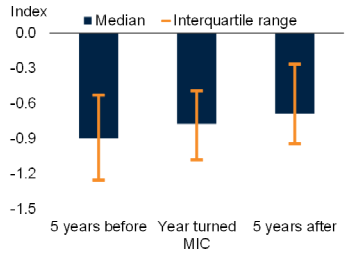
D. Secondary school enrollment in LICs turned MICs



E. Government effectiveness in LICs turned MICs



F. Rule of law in LICs turned MICs



Source: Worldwide Governance Indicators (WGI), World Bank staff calculations, World Development Indicators.

C. Sample includes 59 2001 LICs. GNI per capita according to the World Bank Atlas method. GNI per capita for 1999 was published in August 2000 and reflects the original data used for country income classification in the 2001 World Bank fiscal year, while GNI per capita for 2017 was published in October 2018 and reflects the data used for the 2019 World Bank fiscal year. Exceptions are Liberia and Myanmar, for which GNI per capita in 2002 is used as a proxy for 1999. Rapid-growing LICs with low starting points are defined as LICs that had per capita incomes below one-third of the $755 LIC threshold in 2001, and these incomes have increased to above two-thirds of the $995 LIC threshold in 2019.

D. Sample includes 13 LICs that became MICs, due to data limitations. Year turned MIC reflects the World Bank fiscal year.

E.-F. WGI index scores are standard normal units that range between -2.5 and 2.5, with zero mean. A negative score implies government effectiveness or rule-of-law below the global average. Sample includes all 32 LICs that became MICs. Year turned MIC reflects the World Bank fiscal year.

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has helped lift 20 percent of the global poor in 2001 out of poverty by 2016, more than offsetting the increasing poverty headcount among the countries that remained LICs.[9]

- *Favorable initial conditions*. The 2001 LICs that have become MICs were some of those countries closest to the middle-income threshold to begin with: their average per capita income in 2001 was about 80 percent higher than that of the LICs that have remained LICs (Table SF2.1.1). LICs that achieved MIC status also grew somewhat more rapidly during 2001-18 (Figure SF2.1.4.B; Johnson and Papageorgiou, forthcoming).[10] However, the growth differential between these two LIC groups masks substantial dispersion within each group. Despite exceptionally fast and sustained growth—more than tripling per capita incomes between 2001 and 2018—several 2001 LICs remain LICs today (Figure SF2.1.4.C; Ethiopia, Rwanda, Tanzania). This mostly reflects their low 2001 per capita incomes (70 percent below the 2001 threshold LIC income). In these countries, robust growth was supported by improving macroeconomic environments, institutional and business climate reforms, and strong public investment (Government of Rwanda and World Bank 2019; Möller and Wacker 2017).

- *Commodity discoveries and exploitation*. Of the 32 LICs that became MICs, about one half benefited from discoveries of commodity deposits or expanded exploitation of metals, oil, or gas resources. Today, many former 2001 LICs—such as Angola, the Republic of Congo, Equatorial Guinea, Ghana, Lesotho, Indonesia, Lao PDR, Mauritania, Nigeria, Sudan, Timor-Leste, Uzbekistan, and Zambia—have achieved middle-income status partly as a result of new commodity discoveries or the exploitation of commodity resources. Large investments in the resource sectors of Azerbaijan, Cameroon, and Mongolia facilitated their progression to middle-income status (World Bank 2015a). The countries that became MICs amid the commodity price boom often had stronger institutional quality and governance than those that remained LICs, and were therefore less likely to fall victim to the resource curse that erodes non-resource competitiveness (Dauvin and Guerreiro 2017).

- *Rebounding transition economies*. Another one-quarter of the LICs that have progressed to MIC status since 2001 were the remaining transition-economy LICs. All but one (Tajikistan) have returned to middle-income per capita income levels.

- *Trade integration, peace, and reforms*. Of the 27 LICs of 2001 that have subsequently signed trade agreements, 20 achieved MIC status as entry into large free trade areas catalyzed export spurts (Moldova, Nicaragua).[11] Others reached MIC status after emerging from conflict (Côte d'Ivoire, Solomon Islands), or undertaking substantial public infrastructure investment (Bhutan).[12] The 2001 LICs that reached MIC status have steadily strengthened human capital development, the effectiveness of their governments, business climates, and the quality of their institutions in the years before progression and thereafter. In fact, these countries have consistently outperformed the median LIC on measures of these factors (Figures SF2.1.4.D-2.1.4.F).

[9] Due to data limitations, poverty headcount data excludes the following 11 LICs of 2001: Afghanistan, Azerbaijan, Haiti, Cambodia, Myanmar, Democratic People's Republic of Korea, Somalia, Sudan, Turkmenistan, Uzbekistan, and Zimbabwe. In 2001, their combined population accounted for 8 percent of the total 2001 LICs population.

[10] In terms of per capita growth, the difference was more pronounced (Figure 2.1.4B).

[11] Excludes "region-region" agreements such as the Cotonou agreement between the European Union and the 78 economies in the African, Caribbean and Pacific Group of States.

[12] During the 2000s, the government of Bhutan transformed the economy's growth prospects by investing heavily in hydropower infrastructure, taking advantage of the country's mountainous terrain and high average annual rainfall. Electricity capacity in Bhutan tripled and the share of the population with access to it rose from 39 percent in 2001 to 100 percent by 2016. Surplus electricity is exported and accounts for a third of exports and almost half of government revenue, while overall power generation is estimated to contribute 1 percent of GDP annually (World Bank 2015b).

New LICs: 2016-19. Countries that have reached MIC status often face structural challenges that constrain their prospects for continued strong growth, while those MICs with incomes near the LIC threshold risk falling back into the LIC bracket (EBRD 2019). Four countries were classified as LICs between 2016 and 2019 from middle-income levels: Senegal, Syria, Tajikistan, and Yemen. While Syria was classified as a LIC for the first time, Senegal, Tajikistan, and Yemen relapsed into LIC status after some of the growth-enhancing factors discussed above had helped them move to middle-income status in earlier years.

- *Senegal* suffered a series of adverse shocks in the years leading up to its relapse, which weighed heavily on per capita incomes. The decline in commodity prices from 2011 was aggravated by two consecutive droughts that severely disrupted agricultural production between 2011 and 2014 and also led to widespread famine, while a long-lasting domestic energy crisis repeatedly disrupted economic activity until the mid-2010s.
- In *Tajikistan*, robust growth was accompanied by a halving of its currency's value stemming from the 2014-16 commodity price slump and by rapid population growth; as a result, per capita incomes declined.
- Armed conflicts in *Syria* and *Yemen* caused sharp declines in per capita incomes in both countries by severely disrupting activity, destroying physical infrastructure, and forcibly displacing more than one-half of Syria's population and almost a tenth of the population in Yemen (World Bank 2017a, 2019d). In both countries, oil production has fallen by 90 percent from pre-war levels, sharply constraining fiscal positions.

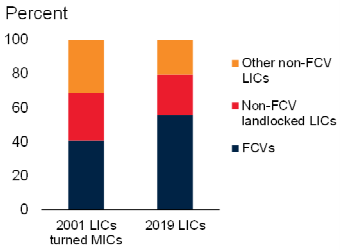
Prospects for further LIC progression

Challenges for future progression towards MIC per capita income levels. Prospects for most of today's LICs to progress to MIC levels in the near future are dim, as the factors that may hold back

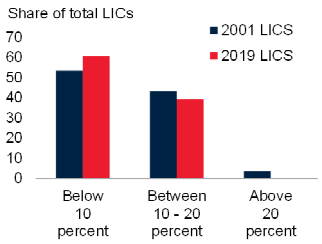
FIGURE SF2.1.5 Features of today's LICs

For today's LICs, prospects of becoming MICs are dim. More than half of them are affected by fragility, conflict, and violence, their governments are less effective than those of the 2001 LICs that became MICs, and public spending on health care is lower. Many countries are landlocked, and their neighbors are mostly low-income or lower-middle-income countries. LICs are heavily dependent on agriculture, which faces severe challenges as extreme weather events become more frequent.

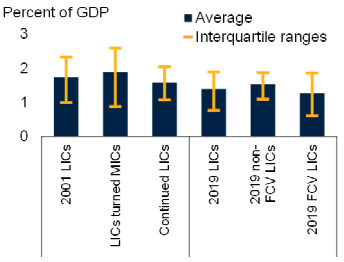
A. LICs affected by fragility, conflict, and violence



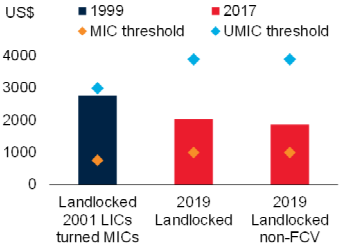
B. Distribution of LICs per capita incomes as percent of non-LIC EMDEs average



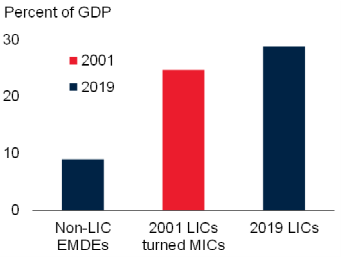
C. Average share of public healthcare spending in LIC GDP



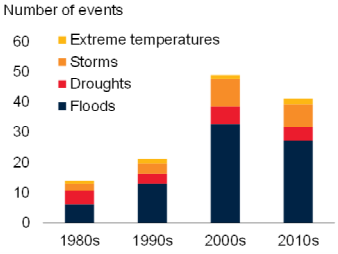
D. Per capita incomes in LICs' neighbors



E. Share of agriculture in the economy



F. Extreme weather events in LICs



Source: The Emergency Events Database—Universite Catholique de Louvain, World Bank, World Bank Doing Business, World Bank staff calculations, World Development Indicators.

Note: "LICs turned MICs" are those LICs in 2001 that have achieved MIC per capita incomes by 2019; "Continued LICs" are LICs that have remained LICs since 2001. FCV = fragility, conflict, and violence. UMIC = upper-middle-income country.

A. Bars for 2001 "LICs turned MICs" reflect shares in 2001, bars for 2019 LICs reflect latest shares. Due to data limitations, official FCV country classifications for 2001 are not available. This share is based on the World Bank FCV country classification of the 2005/06 fiscal year that has been amended to include countries that had the presence of UN peace-keeping missions between 1999 and 2001.

B. Blue bars represent share of 2001 LICs in 2001, red bars represent share of 2019 LICs in 2017. X-axis reflects ranges of LIC per capita incomes relative to that of the US, in percent. 2001 LICs includes 58 countries, 2019 LICs includes 28 countries.

C. Unweighted averages. 2001 LICs, "LICs turned MICs" and "Continued LICs" include 60, 32, and 28 countries, respectively. 2019 LICs, non-FCV and FCV LICs include 31, 14, and 17 countries, respectively.

D. Unweighted averages. Neighbors of LICs only include countries with shared land borders. Sample includes 16 landlocked 2001 "LICs turned MICs", 15 2019 landlocked LICs and 8 2019 landlocked non-FCV LICs.

E. Unweighted averages.

F. Data reflect annual averages of extreme weather events in the LICs of 2019.

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progression are more pervasive today than they were in the 2001 LICs (Figure SF2.1.5.A).

- *Weaker starting positions*. The gaps between per capita incomes in today's LICs and in middle-income countries are larger than the corresponding gaps faced by the LICs of 2001 that subsequently became MICs (Figure SF2.1.5.B). Comparing today's LICs with those that have become MICs, public spending on health care relative to GDP is lower by one-quarter, the share of their populations with access to electricity is lower by one-third, and measures of financial inclusion are lower by one-half to one- quarter (Figure SF2.1.5.C).[13]

- *Fragile or in conflict*. 56 percent of today's LICs are countries affected by fragility, conflict, and violence (FCV)—about one-third more than the share of countries in conflict among the 2001 LICs that became MICs.[14] In these FCVs, weak governments and poor institutions are endemic. Government revenues in these countries are often lower than in other LICs, leaving them heavily dependent on foreign aid to finance critical government spending (IMF 2014). Their economies are volatile and prone to collapses (World Bank 2017b). Since 1990, chronic FCVs—countries that have been FCVs for at least five years—have faced annual output contractions of 3 percent or more at least once every decade.

- *Clustered*. More than half of the LICs that are not FCVs are landlocked, and their neighbors are mostly other LICs or countries with per capita incomes just above middle-income thresholds (Figure SF2.1.5.D). This geographical disadvantage—often exacerbated by high trade costs and behind-the-border non-tariff barriers—limits LICs' ability to unleash a growth burst by encouraging trade with large trading partner economies (Arvis, Raballand, and Marteau 2010; Arvis et al. 2013; Paudel and Cooray 2018).

- *Heavily reliant on agriculture*. All but two (Yemen, Zimbabwe) of today's LICs are heavily dependent on the agricultural sectors which accounts for almost 30 percent of GDP on average compared with 9 percent of GDP in the average non-LIC EMDE (Figure SF2.1.5.E). In 70 percent of today's LICs (considerably more than the 40 percent of 2001 LICs that became MICs) agriculture accounts for more than one-quarter of the economy. Climate change is presenting many of these agricultural sectors with severe challenges as mean temperatures continue to rise and extreme weather events such as droughts, floods, and heatwaves occur more frequently and with greater intensity than in the 1980s and 1990s (Figure SF2.1.5.F; World Bank 2017b; IPCC 2014; Chaney et al. 2014; Hoeppe 2014). Recoveries from droughts appear to be taking longer, resulting in less time for livelihoods to be restored between droughts and thereby rendering countries even more vulnerable to the adverse impacts of climate change (Schwalm 2017). Climate-related destruction of crops and livelihoods could push many LIC populations further into poverty and this is aggravated by the limited capacity and resources of LICs to counter the adverse effects of climate change (Hallegatte et al. 2016).

- *Weaker prospects for commodity demand*. To transform recent resource discoveries in LICs into strong, sustained economic growth will require continued robust commodity demand growth, as well as strong governance and

[13] While mobile payment systems have improved financial inclusion in LICs, limited access to electricity, particularly in rural areas, severely constrains the charging of mobile phones (Max and Berman 2018; Riley and Kulathunga 2017, World Bank Group and China Development Bank 2017).

[14] Due to data limitations, official FCV country classifications for 2001 are not available. This share is based on the World Bank FCV country classification of the 2005/06 fiscal year that has been amended to include countries with UN peace-keeping missions between 1999 and 2001.

[15] Mozambique's deep-water gas fields are estimated to hold more oil-equivalent reserves than are held by Angola or Nigeria—Sub-Saharan Africa's two largest oil producers—and production is set to start by 2022/23 (World Bank 2015a). Oil reserves in Uganda are estimated to be the fourth-largest in Sub-Saharan Africa, and production could start within the next three years (Alkadiri and Tesfay 2014). Large off-shore gas fields were recently discovered in Tanzania.

institutions to manage the associated revenue windfalls (Addison and Roe 2018).[15] However, long-term prospects for commodity demand are weakening as growth in China—the largest source of commodity demand—slows and shifts towards less resource-intensive sectors (World Bank 2018a).

- *Debt vulnerabilities on the rise*. While government debt ratios in most of today's LICs are significantly lower than in 2001—helped largely by debt relief initiatives—their general rise since 2013 has contributed to increased vulnerabilities (World Bank 2019a). The interest burden brought about by greater indebtedness could constrain poverty-reducing expenditures, particularly on health and education.

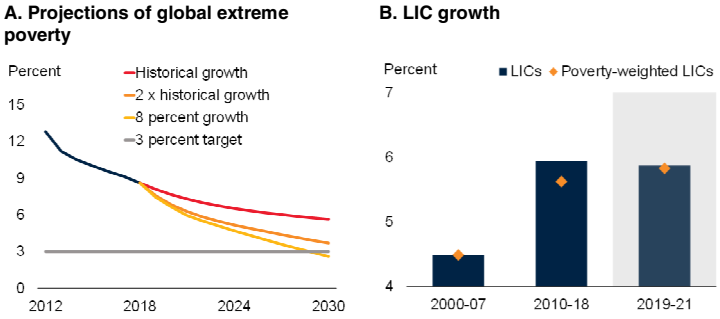
Conclusion

Growth in low-income countries has benefited from a confluence of favorable cyclical and structural developments since 2001 that have reduced the number of LICs by almost one-half. These factors have, at various points, included a commodity price boom, cyclical rebounds from the collapse of centrally-planned regimes in the early-1990s, debt relief, fewer armed conflicts (especially in Africa), trade integration, and improved business climates and policy frameworks. However, the cyclical factors that contributed to LICs reaching MIC status were either unique events (transition rebounds) or are unlikely to be repeated over the foreseeable future (commodity boom), while structural factors that could support growth present lasting policy challenges that will require various policy reform efforts. Prospects for progression of today's LICs to middle-income status are, therefore, more challenging. Compared to the LICs of 2001 that became MICs, today's LICs have per capita incomes that are further below the middle-income threshold, are more likely to be fragile, are more often landlocked and clustered with other LICs, are heavily reliant on agriculture, and face weaker prospects for long-term commodity demand.

Poverty implications. Today's LICs account for about 40 percent of the global poor and have

FIGURE SF2.1.6 Challenges LICs face in reducing poverty

For the world to reach the Sustainable Development Goal of reducing extreme poverty to 3 percent, per capita incomes will need to grow by 6 percent per year until 2030, but with the condition that incomes in the bottom 40 percent of the income distribution grow by 8 percent per year. Growth is expected to fall well short of this requirement.



Source: World Bank, World Bank (2018b).
A. Data based on global real per capita growth. 8 percent growth assumes average annual growth in per capita incomes of 6 percent for all countries, but that incomes of the bottom 40 percent of the distribution grow at 8 percent, while those in the top 60 percent grow at 4.7 percent.
B. Bars represented GDP-weighted aggregates. Diamonds represent GDP aggregates weighted according to each country's share in total poverty.
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average poverty rates in excess of 40 percent. Subdued prospects for lifting average per capita incomes in most of today's 34 LICs to middle-income levels pose a challenge for achieving the Sustainable Development Goals and reducing global extreme poverty to 3 percent by 2030. To reach this goal, per capita GDP would need to grow by 6 percent per year up to 2030 and per capita incomes of the bottom 40 percent of the income distribution would need to grow at 8 percent per year (Figure SF2.1.6.A; World Bank 2018b). Even during the global economic expansion that preceded the global financial crisis, per capita growth in LICs fell well below such rates (1.9 percent during 2001-07). Overall growth in LICs since the global financial crisis has been lower when growth is weighted according to the share of the world's extreme poor as opposed to output shares, implying that growth has been slower where it is needed most: in countries with the largest numbers of extreme poor (Figure SF2.1.6.B).

Policy implications. Coordinated and multi-pronged policy efforts are needed to boost both domestic and external drivers of LICs growth. Efforts to harness external drivers of growth include integrating LICs into global trade,

diversifying exports, and encouraging foreign direct investment (Lee and Zhang 2019). Domestically, this can help embody upgrades to skills and technologies, but needs to be supported by continued investment in human and physical capital, while maintaining sustainable government debt profiles. Further efforts to foster domestic sources of growth include developing stronger and deeper financial systems, ensuring greater financial inclusiveness, and strengthening governance and business climates to help the private sector to thrive while overcoming some of the challenges of informality (EBRD 2019; World Bank 2017c; 2018c; 2019a). Enhanced competition policies, including the liberalization of unwarranted price controls, can encourage innovation, boost productivity and improve international competitiveness (World Bank 2016c; 2017d). Growth could further be supported by measures aimed at ending conflicts and reducing social tensions, mobilizing domestic resources more effectively for sustainable government finances, and managing and adapting to growing climate risks.

TABLE SF2.1.1 Low-income countries

	GNI per capita used for 2019 income classification (2017, USD)	Latest GNI per capita (2017, USD)	GNI per capita used for 2001 income classification (1999, USD)	Share of agriculture in GDP (percent)	Share of primary commodity exports in GDP (percent)
2001 LICs turned MICs					
Turkmenistan	6,650	6,380	660	…	…
Azerbaijan	4,080	4,080	550	5.6	30.2
Armenia	4,000	3,990	490	14.9	8.3
Georgia	3,790	3,780	620	6.9	6.2
Indonesia	3,540	3,540	580	13.1	5.9
Angola	3,330	3,570	220	10.0	28.4
Mongolia	3,290	3,270	350	10.3	46.7
Bhutan	2,720	2,660	510	17.4	…
Ukraine	2,390	2,390	750	10.2	13.8
Sudan*	2,380	2,380	330	30.5	11.2
Lao PDR	2,270	2,270	280	16.2	8.0
Moldova, Rep.	2,180	2,200	370	…	3.5
Vietnam	2,170	2,160	370	15.3	5.1
Nicaragua	2,130	2,130	430	15.5	1.5
Nigeria	2,080	2,100	310	20.8	11.4
Uzbekistan	1,980	2,000	720	…	…
Solomon Islands*	1,920	1,920	750	…	27.8
India	1,820	1,800	450	15.5	1.2
São Tomé and Príncipe	1,770	1,770	270	11.5	…
Pakistan	1,580	1,580	470	22.9	0.3
Côte d'Ivoire*	1,540	1,580	710	21.6	5.7
Ghana	1,490	1,880	390	19.7	7.1
Bangladesh	1,470	1,470	370	13.4	0.1
Kenya	1,440	1,460	360	34.6	1.4
Cameroon	1,360	1,370	580	14.4	12.7
Congo, Rep.*	1,360	1,430	670	6.4	44.0
Zambia	1,300	1,290	320	6.7	25.4
Lesotho	1,280	1,210	550	6.1	…
Cambodia	1,230	1,230	260	23.4	1.1

TABLE SF2.1.1 Low-income countries *(continued)*

	GNI per capita used for 2019 income classification (2017, USD)	Latest GNI per capita (2017, USD)	GNI per capita used for 2001 income classification (1999, USD)	Share of agriculture in GDP (percent)	Share of primary commodity exports in GDP (percent)
2001 LICs turned MICs					
Myanmar*	1,190	1,210	…	23.3	…
Kyrgyz Republic	1,130	1,130	300	12.3	4.1
Mauritania	1,100	1,100	380	23.1	16.3
2001 Continued LICs					
Tajikistan	990	990	290	…	…
Senegal	950	1,240	510	16.0	2.3
Tanzania	910	910	240	…	0.7
Zimbabwe*	910	1,170	520	8.3	3.8
Benin	800	800	380	23.0	4.3
Guinea	800	790	510	16.4	6.9
Nepal	790	800	220	26.2	0.3
Mali*	770	770	240	38.3	1.1
Comoros*	760	1,280	350	29.9	0.0
Haiti*	760	760	460	17.6	…
Ethiopia	740	740	100	34.0	0.0
Rwanda	720	720	250	31.0	1.3
Guinea-Bissau*	660	660	160	49.0	0.0
Chad*	630	640	200	49.1	…
Burkina Faso	610	590	240	28.7	5.4
Togo*	610	610	320	41.8	3.9
Uganda	600	600	320	24.6	0.8
Afghanistan*	570	560	…	20.5	…
Sierra Leone	510	510	130	60.3	0.7
Congo, Dem. Rep.*	450	460	110	19.9	…
Gambia, The*	450	680	340	23.0	0.5
Mozambique*	420	420	230	21.3	31.1
Madagascar	400	400	250	20.0	6.0
Central African Republic*	390	390	290	39.6	…
Liberia*	380	620	…	37.1	…
Niger	360	360	190	39.7	4.1
Malawi	320	320	190	26.1	0.9
Burundi*	290	280	120	…	0.3
Eritrea*	…	…	200	…	…
Korea, Dem. People's Rep.	…	…	…	…	…
Somalia*	…	…	…	…	…
Yemen*	…	…	350	6.0	…
New LICs					
Syria*	…	…	970	…	…

Source: World Bank World Development Indicators, World Integrated Trade Statistics.
Notes: Asterisks indicate economies affected by fragility, conflict, and violence (FCV). Ellipses indicate data unavailability. GNI per capita according to the World Bank Atlas method. GNI per capita for 1999 was published in August 2000 and reflects the original data used for country income classification in the 2001 World Bank fiscal year, while GNI per capita for 2017 was published in October 2018 and reflects the data used for the 2019 World Bank fiscal year. Latest GNI per capita incorporates data revisions that have occurred since the release of original GNI per capita data that was used for income classifications. South Sudan is also a new LIC, but not included in the table because it only gained independence in 2011; data not available.

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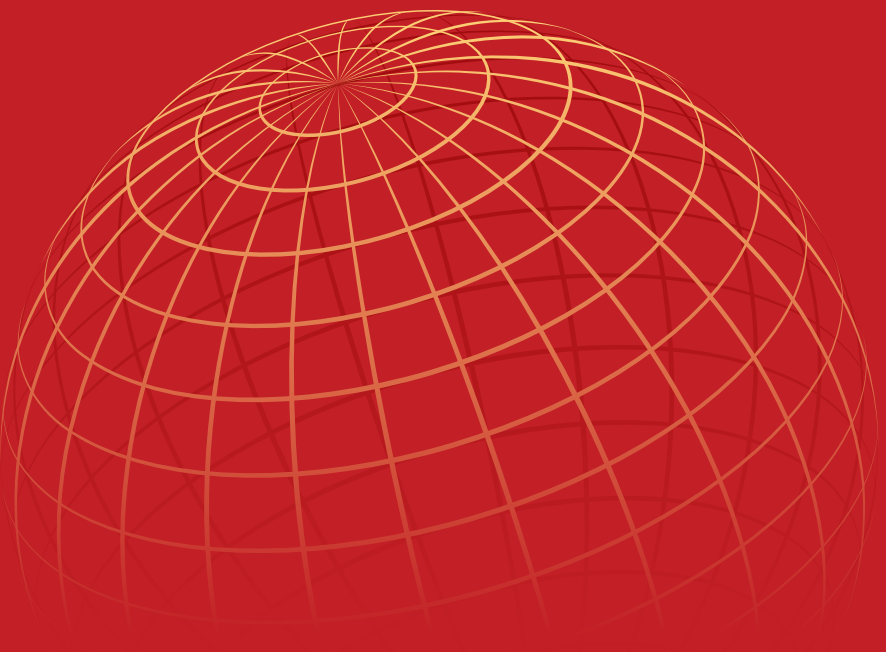

STATISTICAL APPENDIX

Real GDP growth

	Annual estimates and forecasts [1] (Percent change)						Quarterly estimates [2] (Percent change, year-on-year)					
	2016	2017	2018e	2019f	2020f	2021f	17Q4	18Q1	18Q2	18Q3	18Q4	19Q1e
World	2.6	3.1	3.0	2.6	2.7	2.8	3.4	3.2	3.2	2.9	2.7	..
Advanced economies	1.7	2.3	2.1	1.7	1.5	1.5	2.5	2.4	2.4	2.0	1.9	2.0
United States	1.6	2.2	2.9	2.5	1.7	1.6	2.5	2.6	2.9	3.0	3.0	3.2
Euro Area	2.0	2.4	1.8	1.2	1.4	1.3	2.7	2.4	2.2	1.6	1.2	1.2
Japan	0.6	1.9	0.8	0.8	0.7	0.6	2.3	1.4	1.4	0.1	0.2	0.8
Emerging market and developing economies	4.1	4.5	4.3	4.0	4.6	4.6	4.8	4.9	4.8	4.4	4.2	..
East Asia and Pacific	6.3	6.5	6.3	5.9	5.9	5.8	6.4	6.6	6.4	6.2	6.1	6.1
Cambodia	7.0	7.0	7.5	7.0	6.9	6.8	..	..	..	..	..	..
China	6.7	6.8	6.6	6.2	6.1	6.0	6.7	6.8	6.7	6.5	6.4	6.4
Fiji	0.7	3.0	3.2	3.4	3.3	3.3	..	..	..	..	..	..
Indonesia	5.0	5.1	5.2	5.2	5.3	5.3	5.2	5.1	5.3	5.2	5.2	5.1
Lao PDR	7.0	6.9	6.5	6.6	6.7	6.6	..	..	..	..	..	..
Malaysia	4.2	5.9	4.7	4.6	4.6	4.6	5.7	5.3	4.5	4.4	4.7	4.5
Mongolia	1.4	5.4	6.9	7.2	6.9	6.2	6.3	6.3	6.1	6.6	7.7	8.6
Myanmar	5.9	6.8	6.2	6.5	6.6	6.8	..	..	..	..	..	..
Papua New Guinea	4.1	2.3	-0.3	5.6	3.1	3.5	..	..	..	..	..	..
Philippines	6.9	6.7	6.2	6.4	6.5	6.5	6.6	6.5	6.2	6.0	6.3	5.6
Solomon Islands	3.3	3.0	3.5	2.9	2.8	2.7	..	..	..	..	..	..
Thailand	3.4	4.0	4.1	3.5	3.6	3.7	4.0	5.0	4.7	3.2	3.6	2.8
Timor-Leste	5.1	-3.5	-0.7	3.9	4.6	5.0	..	..	..	..	..	..
Vietnam	6.2	6.8	7.1	6.6	6.5	6.5	7.7	7.4	6.9	6.8	7.3	6.8
Europe and Central Asia	1.9	4.1	3.1	1.6	2.7	2.9	3.5	4.2	3.8	2.9	1.8	..
Albania	3.3	3.8	4.1	3.7	3.7	3.8	3.6	4.3	4.2	4.6	3.1	..
Armenia	0.2	7.5	5.2	4.2	4.9	5.2	..	..	..	..	..	..
Azerbaijan	-3.1	0.1	1.4	3.3	3.5	3.7	..	..	..	..	..	..
Belarus	-2.5	2.5	3.0	1.8	1.3	1.2	4.5	5.3	4.0	2.2	1.3	..
Bosnia and Herzegovina	3.1	3.2	3.1	3.4	3.9	4.0	2.4	3.2	3.4	2.7	3.0	..
Bulgaria	3.9	3.8	3.1	3.0	2.8	2.8	3.3	3.5	3.2	2.7	3.0	..
Croatia	3.5	2.9	2.6	2.5	2.5	2.4	2.2	2.5	2.9	2.8	2.3	..
Georgia	2.8	4.8	4.7	4.6	4.8	5.0	5.3	5.2	5.6	3.7	4.5	..
Hungary	2.3	4.1	4.9	3.8	2.8	2.6	4.5	4.6	4.9	5.1	5.1	5.3
Kazakhstan	1.1	4.1	4.1	3.5	3.2	3.2	3.1	4.1	4.3	3.9	5.2	..
Kosovo	4.1	4.2	4.2	4.4	4.5	4.5	..	..	..	..	..	..
Kyrgyz Republic	4.3	4.7	3.5	4.3	4.0	4.1	..	..	..	..	..	..
Moldova	4.4	4.7	4.0	3.4	3.6	3.8	..	..	..	..	..	..
Montenegro [5]	2.9	4.7	4.9	2.9	2.4	2.3	..	..	..	..	..	..
North Macedonia	2.8	0.2	2.7	2.9	3.2	3.6	1.6	0.9	3.0	3.0	3.7	..
Poland	3.1	4.8	5.1	4.0	3.6	3.3	4.5	5.0	5.1	5.7	4.5	..
Romania	4.8	7.0	4.1	3.6	3.3	3.1	6.8	4.0	4.1	4.2	4.1	5.0
Russia	0.3	1.6	2.3	1.2	1.8	1.8	0.3	1.9	2.2	2.2	2.7	0.5
Serbia	3.3	2.0	4.3	3.5	4.0	4.0	2.5	4.9	4.9	4.1	3.4	2.3
Tajikistan	6.9	7.1	7.3	6.0	6.0	6.0	..	..	..	..	..	..
Turkey	3.2	7.4	2.6	-1.0	3.0	4.0	7.3	7.4	5.3	1.8	-3.0	..
Turkmenistan	6.2	6.5	6.2	5.6	5.1	4.9	..	..	..	..	..	..
Ukraine	2.4	2.5	3.3	2.7	3.4	3.8	2.2	3.4	3.8	2.8	3.5	2.2
Uzbekistan	6.1	4.5	5.1	5.3	5.5	6.0	..	..	..	..	..	..

Real GDP growth *(continued)*

	Annual estimates and forecasts [1] (Percent change)						Quarterly estimates [2] (Percent change, year-on-year)					
	2016	2017	2018e	2019f	2020f	2021f	17Q4	18Q1	18Q2	18Q3	18Q4	19Q1e
Latin America and the Caribbean	-0.3	1.7	1.6	1.7	2.5	2.7	2.3	1.9	1.7	1.5	1.1	..
Argentina	-2.1	2.7	-2.5	-1.2	2.2	3.2	4.5	4.1	-3.8	-3.6	-6.2	..
Belize	-0.6	1.4	3.0	2.3	2.1	1.9	..	..	..	..	..	..
Bolivia	4.3	4.2	4.2	4.0	3.6	3.4	5.2	4.9	4.9	4.0	3.3	..
Brazil	-3.3	1.1	1.1	1.5	2.5	2.3	2.2	1.2	0.9	1.3	1.1	..
Chile	1.7	1.3	4.0	3.5	3.1	3.0	3.0	4.7	5.3	2.6	3.6	1.6
Colombia	2.1	1.4	2.6	3.5	3.7	3.7	1.3	2.0	2.9	2.6	2.7	2.8
Costa Rica	4.2	3.4	2.7	3.0	3.1	3.4	3.4	3.0	3.8	2.5	1.4	..
Dominican Republic	6.6	4.6	7.0	5.2	5.0	5.0	6.5	6.6	7.2	7.4	6.6	..
Ecuador	-1.2	2.4	1.4	0.0	0.4	0.8	2.8	1.8	1.4	1.5	0.8	..
El Salvador	2.5	2.3	2.5	2.6	2.5	2.4	2.8	2.9	2.9	2.2	2.2	..
Grenada	3.7	5.1	5.2	3.9	3.7	3.7	..	..	..	..	..	..
Guatemala	3.1	2.8	3.1	3.3	2.7	3.0	2.9	1.8	3.6	3.6	3.5	..
Guyana	3.4	2.1	4.1	4.6	33.5	22.9	..	..	..	..	..	..
Haiti [3]	1.5	1.2	1.5	0.4	1.6	1.3	..	..	..	..	..	..
Honduras	3.9	4.8	3.7	3.6	3.8	3.9	4.3	3.0	4.0	3.4	4.5	..
Jamaica	1.4	1.0	1.9	1.6	1.7	1.9	1.2	1.4	2.2	1.9	2.0	..
Mexico	2.9	2.1	2.0	1.7	2.0	2.4	1.5	1.2	2.6	2.5	1.7	1.3
Nicaragua	4.6	4.7	-3.8	-5.0	1.1	1.3	4.1	2.4	-5.2	-4.4	-7.7	..
Panama	5.0	5.3	3.7	5.0	5.4	5.2	4.4	4.0	3.1	3.6	4.0	..
Paraguay	4.3	5.0	3.6	3.3	4.0	4.0	5.0	5.4	6.6	1.4	1.2	..
Peru	4.0	2.5	4.0	3.8	3.9	4.0	2.4	3.2	5.5	2.4	4.8	2.3
St. Lucia	3.9	3.7	1.5	3.4	3.5	2.4	..	..	..	..	..	..
St. Vincent and the Grenadines	1.3	0.7	2.0	2.1	2.3	2.3	..	..	..	..	..	..
Suriname	-5.6	1.4	2.0	2.0	2.1	2.1	..	..	..	..	..	..
Trinidad and Tobago	-6.5	-1.9	0.7	0.9	1.5	2.1	..	..	..	..	..	..
Uruguay	1.7	2.6	1.6	1.5	2.3	2.5	1.6	2.0	2.2	1.8	0.6	..
Middle East and North Africa	5.1	1.2	1.4	1.3	3.2	2.7	1.1	2.3	2.4	2.8	3.2	..
Algeria	3.2	1.4	1.5	1.9	1.7	1.4	..	..	..	..	..	..
Bahrain	3.5	3.8	1.8	2.0	2.2	2.8	2.9	-1.0	2.1	1.4	4.6	..
Djibouti	9.1	4.1	6.0	7.0	7.5	8.0	..	..	..	..	..	..
Egypt [3]	4.3	4.2	5.3	5.5	5.8	6.0	5.3	5.4	5.4	5.3	5.5	5.6
Iran	13.4	3.8	-1.9	-4.5	0.9	1.0	2.4	2.9	2.5	..	..	..
Iraq	13.6	-1.7	0.6	2.8	8.1	2.3	..	..	..	..	..	..
Jordan	2.0	2.1	2.0	2.2	2.4	2.6	..	..	..	..	..	..
Kuwait	2.9	-3.5	1.2	1.6	3.0	2.9	-2.7	-0.5	0.6	2.9	2.0	..
Lebanon	1.6	0.6	0.2	0.9	1.3	1.5	..	..	..	..	..	..
Morocco	1.1	4.1	3.0	2.9	3.5	3.6	..	..	..	..	..	..
Oman	5.0	-0.9	2.1	1.2	6.0	2.8	..	..	..	..	..	..
Qatar	2.1	1.6	1.4	3.0	3.2	3.4	3.3	2.0	1.7	1.7	0.3	..
Saudi Arabia	1.7	-0.7	2.2	1.7	3.1	2.3	-1.3	1.3	1.6	2.3	3.6	..
Tunisia	1.1	2.0	2.5	2.7	3.2	3.5	..	..	..	..	..	..
United Arab Emirates	3.0	0.8	1.7	2.6	3.0	3.2	..	..	..	..	..	..
West Bank and Gaza	4.7	3.1	0.9	0.5	1.0	1.6	..	..	..	..	..	..

Real GDP growth *(continued)*

	Annual estimates and forecasts [1] (Percent change)						Quarterly estimates [2] (Percent change, year-on-year)					
	2016	2017	2018e	2019f	2020f	2021f	17Q4	18Q1	18Q2	18Q3	18Q4	19Q1e
South Asia	8.1	6.7	7.0	6.9	7.0	7.1	7.5	8.0	7.9	6.8	6.4	..
Afghanistan	2.3	2.7	1.0	2.4	3.2	3.6	..	..	..	..	..	..
Bangladesh [3,4]	7.1	7.3	7.9	7.3	7.4	7.3	..	..	..	..	..	..
Bhutan [3,4]	7.4	6.3	5.8	5.4	5.4	5.2	..	..	..	..	..	..
India [3,4]	8.2	7.2	7.2	7.5	7.5	7.5	7.7	8.1	8.0	7.0	6.6	..
Maldives	7.3	6.9	7.9	5.7	5.2	5.3	..	..	..	..	..	..
Nepal [3,4]	0.6	8.2	6.7	7.1	6.4	6.5	..	..	..	..	..	..
Pakistan [3,4]	4.6	5.4	5.8	3.4	2.7	4.0	..	..	..	..	..	..
Sri Lanka	4.5	3.3	3.2	3.5	3.6	3.7	3.7	4.0	3.9	3.5	1.8	..
Sub-Saharan Africa	1.3	2.6	2.5	2.9	3.3	3.5	2.6	2.5	2.0	2.7	2.8	..
Angola	-2.6	-0.1	-1.7	1.0	2.9	2.8	..	..	..	..	..	..
Benin	4.0	5.8	6.5	6.5	6.5	6.5	..	..	..	..	..	..
Botswana	4.3	2.9	4.5	4.2	3.9	4.0	6.4	4.5	5.2	4.0	4.1	..
Burkina Faso	5.9	6.3	6.8	6.0	6.0	6.0	..	..	..	..	..	..
Burundi	-0.6	0.5	1.6	1.8	2.1	2.0	..	..	..	..	..	..
Cabo Verde	4.7	4.0	4.5	4.4	4.6	4.7	..	..	..	..	..	..
Cameroon	4.6	3.5	4.0	4.2	4.4	4.6	..	..	..	..	..	..
Chad	-6.3	-3.0	2.6	3.4	5.6	4.8	..	..	..	..	..	..
Comoros	2.2	2.7	2.8	3.1	3.2	3.2	..	..	..	..	..	..
Congo, Dem. Rep.	2.4	3.7	5.8	5.9	6.5	6.8	..	..	..	..	..	..
Congo, Rep.	-2.8	-3.1	0.8	5.4	1.5	1.9	..	..	..	..	..	..
Côte d'Ivoire	8.0	7.7	7.4	7.4	7.3	7.3	..	..	..	..	..	..
Equatorial Guinea	-8.8	-4.7	-2.9	-2.2	-1.9	-1.8	..	..	..	..	..	..
Eswatini	3.2	1.9	0.5	1.1	1.6	1.7	..	..	..	..	..	..
Ethiopia [3]	7.6	10.2	7.9	7.9	8.2	8.2	..	..	..	..	..	..
Gabon	2.1	0.5	0.8	2.8	3.7	3.9	..	..	..	..	..	..
Gambia, The	0.4	4.6	6.6	5.4	5.2	5.0	..	..	..	..	..	..
Ghana	3.4	8.1	6.3	7.6	7.0	5.8	5.5	5.4	5.4	7.4	6.8	..
Guinea	10.5	10.6	5.8	5.9	6.0	6.0	..	..	..	..	..	..
Guinea-Bissau	6.3	5.9	3.8	4.3	4.8	5.5	..	..	..	..	..	..
Kenya	5.9	4.9	6.3	5.7	5.9	6.0	5.3	6.6	6.3	6.4	5.9	..
Lesotho	3.1	-0.4	1.7	1.5	0.4	4.1	3.2	2.7	1.9	-1.5	..	..
Liberia	-1.6	2.5	1.2	0.4	1.6	1.3	..	..	..	..	..	..
Madagascar	4.2	4.3	5.2	5.2	5.3	5.1	..	..	..	..	..	..
Malawi	2.5	4.0	3.5	4.5	4.7	5.1	..	..	..	..	..	..
Mali	5.8	5.3	4.9	5.0	4.9	4.8	..	..	..	..	..	..
Mauritania	2.0	3.0	3.6	6.7	5.8	6.0	..	..	..	..	..	..
Mauritius	3.8	3.8	3.8	3.9	3.9	3.5	..	..	..	..	..	..
Mozambique	3.8	3.7	3.3	2.0	3.5	4.2	..	..	..	..	..	..
Namibia	1.1	-0.9	-0.1	0.9	1.5	1.9	..	..	..	..	..	..
Niger	4.9	4.9	5.2	6.5	6.0	5.6	..	..	..	..	..	..
Nigeria	-1.6	0.8	1.9	2.1	2.2	2.4	2.1	2.0	1.5	1.8	2.4	2.0
Rwanda	6.0	6.1	8.6	7.8	8.0	7.5	..	..	..	..	..	..
Senegal	6.2	7.2	6.8	6.8	7.0	7.0	..	..	..	..	..	..
Seychelles	4.5	5.3	3.6	3.4	3.0	3.2	..	..	..	..	..	..
Sierra Leone	6.4	3.8	3.7	5.4	5.4	5.2	..	..	..	..	..	..

Real GDP growth *(continued)*

	Annual estimates and forecasts [1] (Percent change)						Quarterly estimates [2] (Percent change, year-on-year)					
	2016	2017	2018e	2019f	2020f	2021f	17Q4	18Q1	18Q2	18Q3	18Q4	19Q1e
Sub-Saharan Africa (continued)												
South Africa	0.6	1.4	0.8	1.1	1.5	1.7	1.4	0.7	0.1	1.3	1.1	..
Sudan	4.7	4.3	-2.3	-1.9	-1.3	-0.8	..	..	..	..	..	..
Tanzania	6.9	6.8	6.0	5.4	5.7	6.1	8.4	..	..	..	..	..
Togo	5.2	4.3	4.9	5.0	5.2	5.1	..	..	..	..	..	..
Uganda [3]	4.6	3.9	5.9	6.1	6.5	5.8	5.9	6.8	4.9	6.2	6.6	..
Zambia	3.6	3.4	3.5	2.5	2.8	2.8	3.3	2.7	3.9	5.6	2.5	..
Zimbabwe	0.8	4.7	3.5	-3.1	3.5	4.9	..	..	..	..	..	..

Source: World Bank and Haver Analytics.
Note: e = estimate; f = forecast.
1. Aggregate growth rates calculated using constant 2010 U.S. dollars GDP weights.
2. Quarterly estimates are based on non-seasonally-adjusted real GDP, except for advanced economies, as well as Ecuador. Data for Bosnia and Herzegovina are from the production approach. Quarterly data for Jamaica are gross value added.
Regional averages are calculated based on data from following countries.
East Asia and Pacific: China, Indonesia, Malaysia, Mongolia, Philippines, Thailand, and Vietnam.
Europe and Central Asia: Albania, Belarus, Bosnia and Herzegovina, Bulgaria, Croatia, Georgia, Hungary, Kazakhstan, North Macedonia, Poland, Romania, Russia, Serbia, Turkey, and Ukraine.
Latin America and the Caribbean: Argentina, Bolivia, Brazil, Chile, Colombia, Costa Rica, Dominican Republic, Ecuador, El Salvador, Guatemala, Honduras, Jamaica, Mexico, Nicaragua, Panama, Paraguay, Peru, and Uruguay.
Middle East and North Africa: Bahrain, Egypt, Iran, Kuwait, Qatar, and Saudi Arabia.
South Asia: India and Sri Lanka.
Sub-Saharan Africa: Botswana, Ghana, Kenya, Nigeria, South Africa, Tanzania, Uganda, and Zambia.
3. Annual GDP is on fiscal year basis, as per reporting practice in the country.
4. GDP data for Pakistan are based on factor cost. For Bangladesh, Bhutan, Nepal, and Pakistan, the column labeled 2019 refers to FY2018/19. For India, the column labeled 2018 refers to FY2018/19.
5. Quarterly data are preliminary.
Click here to download data.

Data and Forecast Conventions

The macroeconomic forecasts presented in this report are prepared by staff of the Prospects Group of the Development Economics Vice-Presidency, in coordination with staff from the Macroeconomics, Trade, and Investment Global Practice and from regional and country offices, and with input from regional Chief Economist offices. They are the result of an iterative process that incorporates data, macroeconometric models, and judgment.

Data. Data used to prepare country forecasts come from a variety of sources. National Income Accounts (NIA), Balance of Payments (BOP), and fiscal data are from Haver Analytics; the World Development Indicators by the World Bank; the World Economic Outlook, Balance of Payments Statistics, and International Financial Statistics by the International Monetary Fund. Population data and forecasts are from the United Nations World Population Prospects. Country- and lending-group classifications are from the World Bank. DECPG databases include commodity prices, data on previous forecast vintages, and in-house country classifications. Other internal databases include high-frequency indicators such as industrial production, consumer price indexes, house prices, exchange rates, exports, imports, and stock market indexes, based on data from Bloomberg, Haver Analytics, OECD Analytical House Prices Indicators, IMF Balance of Payments Statistics, and IMF International Financial Statistics.

Aggregations. Aggregate growth for the world and all sub-groups of countries (such as regions and income groups) is calculated as GDP-weighted average (at 2010 prices) of country-specific growth rates. Income groups are defined as in the World Bank's classification of country groups.

Forecast Process. The process starts with initial assumptions about advanced-economy growth and commodity price forecasts. These are used as conditioning assumptions for the first set of growth forecasts for EMDEs, which are produced using macroeconometric models, accounting frameworks to ensure national account identities and global consistency, estimates of spillovers from major economies, and high-frequency indicators. These forecasts are then evaluated to ensure consistency of treatment across similar EMDEs. This is followed by extensive discussions with World Bank country teams, who conduct continuous macroeconomic monitoring and dialogue with country authorities and finalize growth forecasts for EMDEs. The Prospects Group prepares advanced-economy and commodity price forecasts. Throughout the forecasting process, staff use macroeconometric models that allow the combination of judgement and consistency with model-based insights.

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	South Asia	January 2017, Box 2.5.1
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Global growth has continued to soften this year. A modest recovery in emerging market and developing economies continues to be constrained by subdued investment, which is dampening prospects and impeding progress toward achieving critical development goals. Downside risks to the outlook remain elevated, and policymakers continue to face major challenges to boost resilience and foster long-term growth.

In addition to discussing global and regional economic developments and prospects, this edition of *Global Economic Prospects* includes analytical essays on the benefits and risks of government borrowing, recent investment weakness in emerging market and developing economies, the pass-through of currency depreciations to inflation, and the evolution of growth in low-income countries.

Global Economic Prospects is a World Bank Group Flagship Report that examines global economic developments and prospects, with a special focus on emerging market and developing economies, on a semiannual basis (in January and June). The January edition includes in-depth analyses of topical policy challenges faced by these economies, while the June edition contains shorter analytical pieces.

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