

CHAPTER 1

GLOBAL OUTLOOK

Disappointments, Risks, and
Spillovers

Global growth again fell short of expectations in 2015, slowing to 2.4 percent from 2.6 percent in 2014. The disappointing performance was mainly due to a continued deceleration of economic activity in emerging and developing economies amid weakening commodity prices, global trade, and capital flows. Going forward, global growth is projected to edge up, but at a slower pace than envisioned in the June 2015 forecast, reaching 2.9 percent in 2016 and 3.1 percent in 2017-18. The forecast is subject to substantial downside risks, including a sharper-than-expected slowdown in major emerging and developing economies or financial market turmoil arising from a sudden increase in borrowing costs that could combine with deteriorating fundamentals and lingering vulnerabilities in some countries.

Summary and key messages

A further deceleration of activity in key emerging and developing economies overshadowed a modest recovery in major high-income countries in 2015. This deceleration was accompanied by further declines in commodity prices, subdued global trade, bouts of financial market volatility, and weakening capital flows. Global growth continued to disappoint, and is now estimated at a slower-than-expected 2.4 percent in 2015, 0.4 percentage point below June 2015 *Global Economic Prospects* projections.

In developing countries, growth in 2015 is estimated at a post-crisis low of 4.3 percent, down from 4.9 percent in 2014 and 0.4 percentage point lower than projected in June (Figure 1.1). In a development unprecedented since the 1980s, most of the largest emerging economies in each region have been slowing simultaneously for three consecutive years. The economic rebalancing in China is continuing and accompanied by slowing growth. Brazil and Russia have been going through severe adjustments in the face of external and domestic challenges. On average, activity in emerging and developing commodity exporters stagnated in 2015, as they continued to be hard hit by declining commodity prices. As a result, the contribution to global growth from these economies has declined substantially. More generally, 2015 growth estimates for more than half of developing countries were further downgraded. Disappointments are concentrated in Latin America and, to a lesser degree, Sub-Saharan Africa, where a number of commodity exporters are struggling to maintain growth.

Notable exceptions in an otherwise gloomy outlook for developing countries include South Asia (reflecting reduced macroeconomic vulnerabilities and domestic policy reforms in India), as well as some commodity-importing countries in East Asia. Growth in low-income countries generally remained robust in 2015, albeit slowing to 5.1 percent from 6.1 percent in 2014. Some low-income economies showed continued strength (Ethiopia, Rwanda, Tanzania), supported by large-scale infrastructure investment, ongoing mine development, and consumer spending. However, fiscal risks have increased in several countries in East Africa because of sharp increases in public debt and contingent liabilities.

These scattered bright spots aside, the widespread slowdown across emerging and developing economies is a source of concern for the global economy and poses a threat to hard-won achievements in poverty reduction: more than 40 percent of the world's poor live in the developing countries where growth slowed in 2015.

Worsening prospects for developing countries have coincided with a sharp slowdown in global trade, a rise in financial market volatility, and a substantial decrease in capital inflows (Figure 1.2). In anticipation of tighter U.S. monetary policy, currency pressures have intensified and borrowing costs have increased, particularly for a number of commodity exporters. Significant nominal currency depreciations against the U.S. dollar are straining balance sheets in countries with elevated dollar-denominated liabilities. In an environment of weak global trade, exports are likely to languish. On the domestic front, a trend deceleration in productivity growth, rising private sector leverage, depleted fiscal buffers, and heightened policy uncertainty are major headwinds.

TABLE 1.1 Global real GDP growth¹
(Percent)

	2013	2014	2015e	2016f	2017f	2018f	(Percentage point difference from June 2015 projections)		
							2015e	2016f	2017f
World	2.4	2.6	2.4	2.9	3.1	3.1	-0.4	-0.4	-0.1
High income²	1.2	1.7	1.6	2.1	2.1	2.1	-0.3	-0.2	-0.1
United States	1.5	2.4	2.5	2.7	2.4	2.2	-0.2	-0.1	0.0
Euro Area	-0.2	0.9	1.5	1.7	1.7	1.6	0.0	-0.1	0.1
Japan	1.6	-0.1	0.8	1.3	0.9	1.3	-0.3	-0.4	-0.3
United Kingdom	2.2	2.9	2.4	2.4	2.2	2.1	-0.2	-0.2	0.0
Russia	1.3	0.6	-3.8	-0.7	1.3	1.5	-1.1	-1.4	-1.2
Developing countries²	5.3	4.9	4.3	4.8	5.3	5.3	-0.4	-0.6	-0.2
East Asia and Pacific	7.1	6.8	6.4	6.3	6.2	6.2	-0.3	-0.4	-0.4
China	7.7	7.3	6.9	6.7	6.5	6.5	-0.2	-0.3	-0.4
Indonesia	5.6	5.0	4.7	5.3	5.5	5.5	0.0	-0.2	0.0
Thailand	2.8	0.9	2.5	2.0	2.4	2.7	-1.0	-2.0	-1.6
Europe and Central Asia²	3.9	2.3	2.1	3.0	3.5	3.5	0.3	-0.4	-0.2
Kazakhstan	6.0	4.4	0.9	1.1	3.3	3.4	-0.8	-1.8	-0.8
Turkey	4.2	2.9	4.2	3.5	3.5	3.4	1.2	-0.4	-0.2
Romania	3.5	2.8	3.6	3.9	4.1	4.0	0.6	0.7	0.6
Latin America and the Caribbean²	3.0	1.5	-0.7	0.1	2.3	2.5	-1.5	-2.3	-0.6
Brazil	3.0	0.1	-3.7	-2.5	1.4	1.5	-2.4	-3.6	-0.6
Mexico	1.4	2.3	2.5	2.8	3.0	3.2	-0.1	-0.4	-0.5
Colombia	4.9	4.6	3.1	3.0	3.3	3.5	-0.4	-0.9	-0.9
Middle East and North Africa	0.6	2.5	2.5	5.1	5.8	5.1	0.1	1.4	2.0
Egypt, Arab Rep. ³	2.1	2.2	4.2	3.8	4.4	4.8	0.0	-0.7	-0.4
Iran, Islamic Rep.	-1.9	4.3	1.9	5.8	6.7	6.0	0.9	3.8	4.7
Algeria	2.8	3.8	2.8	3.9	4.0	3.8	0.2	0.0	0.0
South Asia	6.2	6.8	7.0	7.3	7.5	7.5	-0.1	0.0	0.0
India ³	6.9	7.3	7.3	7.8	7.9	7.9	-0.2	-0.1	-0.1
Pakistan ^{3,4}	4.4	4.7	5.5	5.5	5.4	5.4	-0.5	1.8	0.9
Bangladesh ³	6.1	6.5	6.5	6.7	6.8	6.8	0.2	0.0	0.1
Sub-Saharan Africa²	4.9	4.6	3.4	4.2	4.7	4.7	-0.8	-0.3	-0.3
South Africa	2.2	1.5	1.3	1.4	1.6	1.6	-0.7	-0.7	-0.8
Nigeria	5.4	6.3	3.3	4.6	5.3	5.3	-1.2	-0.4	-0.2
Angola	6.8	3.9	3.0	3.3	3.8	3.8	-1.5	-0.6	-1.3
MEMORANDUM ITEMS									
Real GDP growth									
World (2010 PPP weights)	3.2	3.4	3.1	3.6	3.8	3.9	-0.3	-0.4	-0.2
BRICS	5.7	5.1	3.9	4.6	5.3	5.4	-0.6	-0.8	-0.5
Low-income countries	6.4	6.1	5.1	6.2	6.6	6.6	-0.7	-0.1	0.1
Emerging markets (EME) ⁵	4.9	4.5	3.7	4.2	4.8	4.9	-0.5	-0.7	-0.4
Frontier markets (FME) ⁶	3.7	2.2	1.1	2.3	3.4	3.8	-0.7	-0.9	-0.6
Commodity-exporting EME & FME ⁷	3.3	1.9	-0.4	0.9	2.6	2.9	-1.3	-1.7	-0.8
Other EME & FME	5.6	5.7	5.7	5.7	5.7	5.8	-0.1	-0.2	-0.3
World trade volume growth ⁸	3.3	3.6	3.6	3.8	4.3	4.5	-0.8	-1.1	-0.6
Oil price growth ⁹	-0.9	-7.5	-46.5	-8.5	7.2	7.2	-6.8	-18.1	1.6
Non-energy commodity price growth	-7.2	-4.6	-14.8	-1.8	1.9	1.9	-3.8	-3.0	0.6
International capital flows to developing countries (percent of GDP)¹⁰									
Developing countries	5.9	5.3	3.1	3.7	4.2	4.5	-2.0	-1.3	-0.6
East Asia and Pacific	6.2	5.3	2.0	3.0	3.8	4.3	-3.1	-1.9	-0.8
Europe and Central Asia	6.8	4.6	2.7	3.1	3.6	4.1	-2.3	-2.7	-2.9
Latin America and the Caribbean	6.9	6.7	5.5	5.4	5.3	5.3	0.1	-0.1	0.1
Middle East and North Africa	2.4	2.3	3.1	3.2	3.3	3.5	0.9	1.1	1.1
South Asia	4.3	4.9	5.0	5.1	5.2	5.2	-0.8	-0.5	-0.3
Sub-Saharan Africa	5.0	5.1	4.0	4.0	4.1	4.3	-0.2	0.0	0.2

Source: World Bank.

Notes: PPP = purchasing power parity; 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 differ at any given moment in time.

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

2. Since July 2015, Argentina, Hungary, Seychelles, and Venezuela, RB have been classified as high income, and have been removed from respective developing regions. Percentage differences from previous Global Economic Prospects projections are calculated after modifying previous numbers to this new classification.

3. In keeping with national practice, data for Bangladesh, Arab Republic of Egypt, India, and Pakistan are reported on a fiscal year basis in Table 1.1. Aggregates that depend on these countries are calculated using data compiled on a calendar year basis.

4. GDP data for Pakistan are based on market prices.

5. Includes Brazil, Chile, China, Colombia, Czech Republic, Egypt, Hungary, India, Indonesia, Korea, Rep., Malaysia, Mexico, Morocco, Pakistan, Peru, Philippines, Poland, Qatar, Russian Federation, Saudi Arabia, South Africa, Thailand, Turkey, and United Arab Emirates.

6. Includes Argentina, Azerbaijan, Bahrain, Bangladesh, Bolivia, Botswana, Bulgaria, Costa Rica, Côte d'Ivoire, Croatia, Ecuador, El Salvador, Gabon, Georgia, Ghana, Guatemala, Honduras, Jamaica, Jordan, Kazakhstan, Kenya, Kuwait, Lebanon, Mauritius, Mongolia, Namibia, Nigeria, Oman, Panama, Paraguay, Romania, Senegal, Serbia, Sri Lanka, Tunisia, Ukraine, Uruguay, Venezuela, RB, Vietnam, and Zambia.

7. Includes Argentina, Azerbaijan, Bahrain, Bolivia, Botswana, Brazil, Chile, Colombia, Costa Rica, Côte d'Ivoire, Ecuador, Gabon, Ghana, Guatemala, Honduras, Indonesia, Jamaica, Kazakhstan, Kenya, Kuwait, Malaysia, Mongolia, Namibia, Nigeria, Oman, Panama, Paraguay, Peru, Qatar, Russian Federation, Saudi Arabia, Senegal, South Africa, Sri Lanka, Ukraine, United Arab Emirates, Uruguay, Venezuela, RB, and Zambia.

8. World trade volume for goods and non-factor services.

9. Simple average of Dubai, Brent, and West Texas Intermediate.

10. Balance of payments data for capital inflows of foreign direct investment, portfolio investment, and other investment (BPM6).

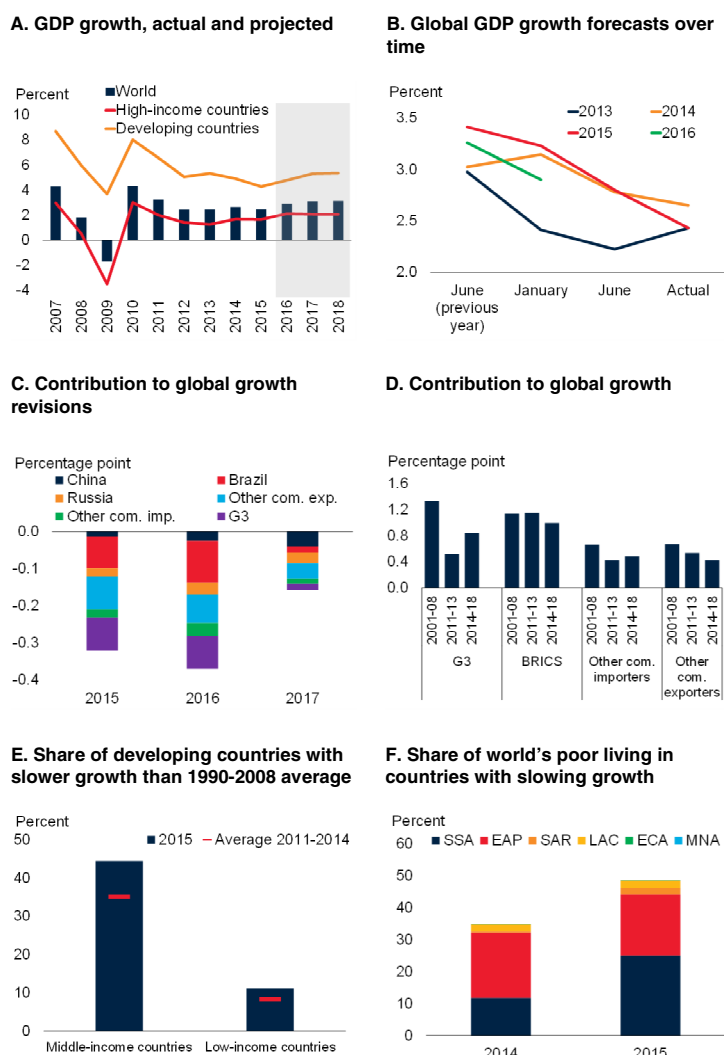
In contrast to developing countries, the recovery in major high-income countries gained traction in 2015 and has been increasingly driven by stronger domestic demand as labor markets heal and credit conditions improve. However, 2016 growth forecasts for high-income countries have been marked down in light of the effect on the United States of dollar appreciation and the impact on Japan of slowing trade in Asia. Conditions for a continued but fragile upturn in the Euro Area still appear in place, despite soft external demand and rising geopolitical concerns. Albeit gradually dissipating, legacies from the global financial crisis continue to be felt across high-income countries, limiting both aggregate demand and the underlying growth potential of these economies.

Going forward, global growth should pick up, albeit at an appreciably slower pace than previously projected, reaching 2.9 percent in 2016 and 3.1 percent in 2017-18. Global inflation is expected to increase moderately in 2016 as commodity prices level off, but will remain low by historical standards. A modest upturn in global activity in 2016 and beyond is predicated on a continued recovery in major high-income countries, a gradual slowdown and rebalancing in China, a stabilization of commodity prices, and an increase in global interest rates that is gradual and stays well contained. All of these projections, however, are subject to substantial downside risks.

Although it is still a low-probability scenario, a faster-than-expected slowdown in China combined with a more protracted deceleration in other large emerging markets is a risk. Empirical estimates suggest that a sustained 1 percentage point decline in growth in the BRICS (Brazil, the Russian Federation, India, China, and South Africa) would reduce growth in other emerging and developing economies by around 0.8 percentage point and global growth by 0.4 percentage point. This suggests a substantial risk of contagion through other emerging markets, with potential adverse effects for some advanced economies as well. Compounding this risk is the possibility of a protracted decline in potential growth throughout emerging and developing economies, persistently subdued growth in major high-income countries, and an escalation of

FIGURE 1.1 Global and developing-country growth prospects

Despite a modest recovery in high-income countries, global growth slowed in 2015, as developing-country growth dipped to a post-crisis low. The upturn in 2016 and 2017 is projected to be shallower than previously anticipated. Weakening prospects are most visible among key commodity exporters, pointing to a significantly lower contribution to global growth than in the past. China's gradual slowdown and rebalancing continued. Low-income countries continued to show some resilience, but a rising share of the world's extreme poor live in countries with slowing growth.



Sources: Haver Analytics; CPB Netherlands Bureau for Economic Policy Analysis; World Bank.
 A. Shaded areas indicate forecasts.
 B. Global GDP growth forecasts for a given year over subsequent Global Economic Prospects projection exercises.
 C. Contribution to global growth revisions measured in constant 2010 U.S. dollars. "Other Com. Exp." stands for other commodity exporters, and excludes Russia and Brazil; "Other Com. Imp." stands for other commodity importers, and excludes China and G3 (Euro Area, Japan, and United States). Cumulative contributions from individual country growth revisions can differ from global growth revisions reported in Table 1.1 due to decimal rounding.
 D. Contributions to global growth measured in constant 2010 U.S. dollars. "Other Com. Exp." stands for other commodity exporters, and excludes Russia, Brazil and South Africa; "Other Com. Imp." stands for other commodity importers, and excludes China, India and G3 (Euro Area, Japan, and United States).
 E. For each year, the fraction of middle- and low-income countries in which growth is slower than its historical average for 1990-2008.
 F. Share of extreme poor (\$1.90/day) living in developing countries that grew more slowly in the current year than in the previous year. 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.

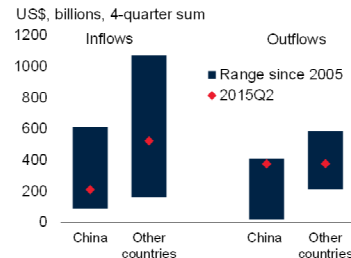
FIGURE 1.2 Global trade, finance, and risks

Deteriorating growth prospects for developing countries have been accompanied by weakening global trade, capital flows, and commodity prices. Currency pressures have increased, particularly for some commodity exporters. Domestic challenges have intensified as well, with elevated private sector debt, slowing credit, and weaker productivity growth. Prospects of rising borrowing costs combined with lingering vulnerabilities in some countries could heighten the risk of financial market turbulence. Further growth disappointments in major emerging economies could disproportionately affect other developing countries.

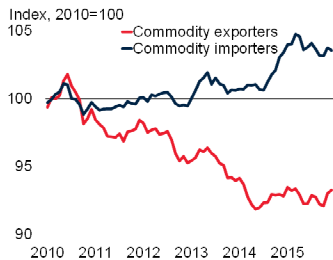
A. Global merchandise trade growth



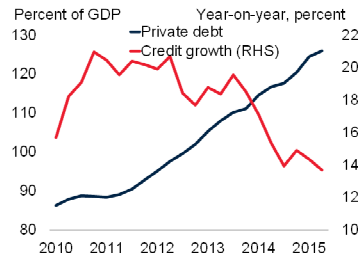
B. Capital flows in emerging and developing countries



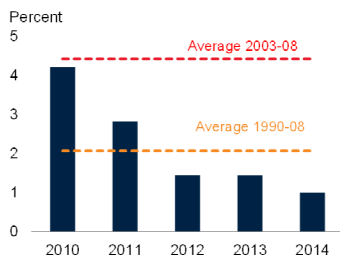
C. Exchange rates



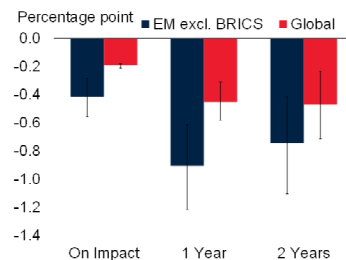
D. Credit growth and private debt



E. Productivity growth in BRICS



F. Impact of a 1 percentage point decline in BRICS on growth



Sources: Haver Analytics; World Bank; CPB Netherlands Bureau for Economic Policy Analysis; Bank for International Settlements.

A. Global merchandise trade is the average of global imports and exports. Volumes are computed by deflating nominal trade flows by unit value indexes. Latest observation is October, 2015.

B. Based on quarterly balance of payment data for the largest 23 emerging and developing economies. Includes foreign direct investment, portfolio, short-term debt, and other investment flows. Countries are classified as either emerging or frontier markets when they have either full or partial access to international financial markets.

C. Median effective exchange rate of developing countries classified as either commodity exporters or commodity importers. An increase denotes appreciation. Latest observation is November 2015.

D. GDP-weighted average of credit growth to and debt-to-GDP ratios of households and non-financial corporations in BRICS and MIMT (BRICS are Brazil, Russia, India, China, and South Africa; MIMTs are Mexico, Indonesia, Malaysia, and Turkey). Latest observation is 2015 Q2.

E. Unweighted average of total factor productivity growth in BRICS using 2010 USD GDP weights.
F. Weighted average of the responses of other emerging market and global GDP to a 1 percentage point decline in growth of BRICS countries' GDP, according to a vector-autoregression models presented in Chapter 3. Confidence bands span the 16th-84th percentiles. EM (excluding BRICS) comprises Chile, Colombia, Czech Republic, Egypt, Hungary, Indonesia, Korea, Morocco, Mexico, Malaysia, Pakistan, Peru, Philippines, Poland, Qatar, Saudi Arabia, Thailand, Turkey, United Arab Emirates.

geopolitical tensions. In addition, baseline forecasts of a smooth monetary policy tightening cycle in the United States are subject to considerable uncertainty. A sudden readjustment of expectations about the future trajectory of U.S. interest rates could combine with domestic fragilities and policy uncertainties in some developing countries to generate financial stress. Given the weak outlook and lingering vulnerabilities in many developing countries, these risks have the potential to be a source of damaging sudden stops in capital flows in the most fragile economies.

Policies can play an important role in mitigating risks and supporting growth. A combination of cyclical and structural policies could be mutually reinforcing. In the near term, policy actions need to be focused on building the ability to withstand financial market turbulence. Cyclical policies need to be supplemented with structural reform measures that boost investors' confidence in the short term and enhance growth prospects in the long term.

Major economies

The recovery in major high-income countries gained traction last year. This has been increasingly driven by stronger domestic demand, particularly in the United States, where employment conditions are robust. In the Euro Area, credit growth is picking up and unemployment is declining. The recovery remains fragile in Japan despite substantial policy stimulus. With external demand negatively affected by a slowdown in large emerging market economies, growth forecasts across major high-income economies in 2016 have been shaded down, but growth should still show some improvement from 2015. The tightening cycle of the U.S. Federal Reserve is projected to be very gradual, while policy accommodation will likely continue in the Euro Area and Japan. China's gradual slowdown and rebalancing continued in 2015, as further deceleration in sectors with excess capacity was partially offset by robust growth in services.

United States

Domestic demand in 2015 was supported by robust consumption and dynamic investment outside the oil sector. In contrast, net exports remained a drag on growth and industrial activity continued to be subdued in the second half of 2015 (Figure 1.3). For 2015 as a whole, growth is estimated at 2.5 percent—the highest annual rate in the post-crisis period. Solid labor market conditions continued to support a consumption-led recovery, with job creation averaging more than 200,000 per month in 2015 and the unemployment rate falling to 5 percent in the final quarter of 2015. However, labor participation has continued to trend down, and is unlikely to recover much as the number of baby-boomers approaching retirement age increases. Labor productivity has moved downward in recent years, constraining potential output growth (Gordon 2014, Hall 2014, Fernald and Wang 2015). Household real disposable income has been boosted by employment gains, declining oil prices and moderate wage growth. This led to rising personal consumption growth in 2015, despite an increase in the savings ratio. A recovery in housing markets and prospects of strengthening wage growth amid tight labor market conditions support a positive outlook in 2016.

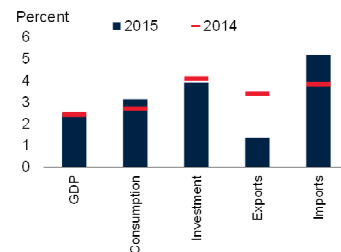
The decline in net exports is a principal factor dampening growth at present. This is the result of the strength of the dollar and the softness in external demand, particularly from large emerging markets. Reflecting in part asynchronous monetary policy stances among major central banks, the dollar has appreciated more than 20 percent in nominal effective terms—and 18 percent in real effective terms—since mid-2014. Empirical studies suggest that an appreciation around this size may reduce GDP growth by one percentage point after two years (Laporte and Roberts 2014; Brayton, Laubach, and Reifschneider 2014).

Headline inflation continued to hover around zero in the second half of 2015, with the renewed fall in oil prices during the summer of 2015 and the strengthening dollar exerting downward pressures. Excluding food and energy, inflation stayed below 2 percent and is projected to rise only gradually in

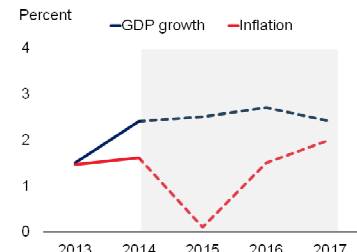
FIGURE 1.3 United States

Robust consumer spending and investment in the non-oil private sector supported above-trend growth in 2015, and should continue to be the main drivers of growth in 2016. The unemployment rate has dropped to lows seen during previous recoveries, but labor participation and growth in productivity have been declining, constraining potential output. A strengthening U.S. dollar and weakening external demand are weighing on exports and manufacturing activity. This points to a very gradual tightening cycle by the U.S. Federal Reserve.

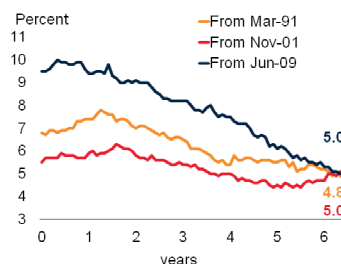
A. GDP and demand components



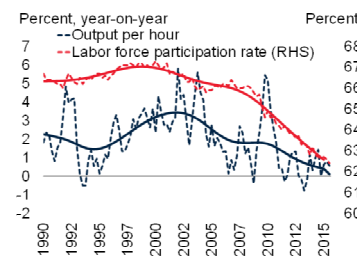
B. Growth and inflation



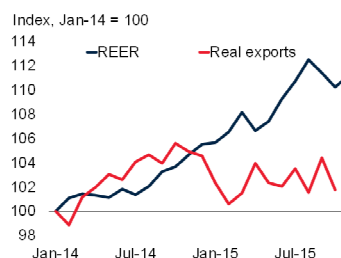
C. Unemployment rate from cyclical troughs



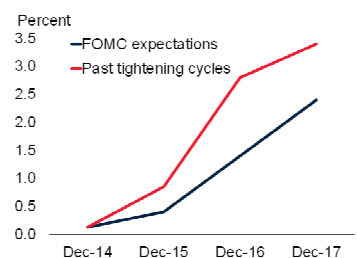
D. Labor participation and productivity growth



E. U.S. dollar exchange rate and real exports



F. U.S. policy interest rate expectations

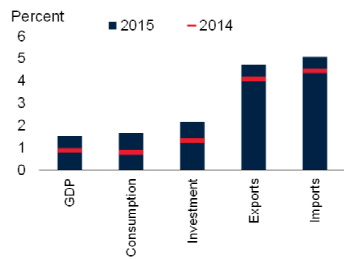


Sources: Haver Analytics; World Bank; Federal Reserve Economic Data (FRED).
 B. Inflation is the year-on-year percent change of the overall Consumer Price Index.
 C. Based on the last three cyclical troughs identified by the NBER's Business Cycle Dating Committee: March 1991, November 2001, and June 2009.
 D. Productivity growth is measured as annual change in real output per hour worked of all persons in the non-farm business sector. The civilian labor force participation rate is the ratio of people either employed or actively looking for work to the active age population. The thick lines show the trend measured by a Hodrick-Prescott filter. Latest observation is 2015 Q3.
 E. REER: real effective exchange rate based on relative CPI inflation. An increase denotes appreciation. Latest observation is October 2015 for real exports and November, 2015 for exchange rates.
 F. Past tightening cycles refer to average of Fed fund rate hikes during previous tightening cycles (December 1986, March 1988, February 1994, March 1997, June 1999, and June 2004).

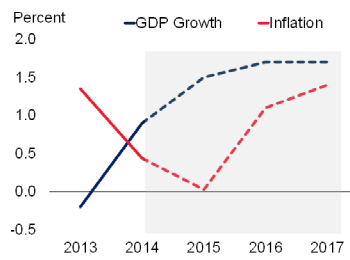
FIGURE 1.4 Euro Area

The recovery in the Euro Area in 2015 has been supported by both strengthening domestic demand and exports. Pickups in credit and intra-European trade growth point to a broadening recovery. Deflation concerns have receded, but core inflation and wage growth remain subdued among economies with high long-term unemployment rates.

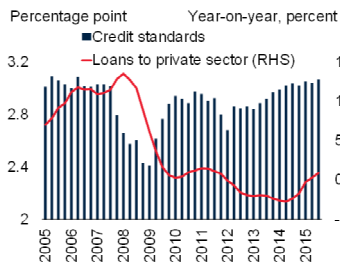
A. GDP and demand components



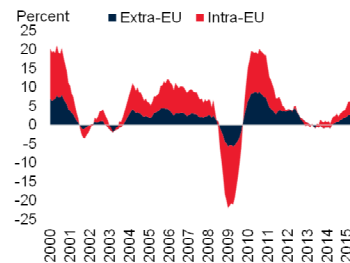
B. Growth and inflation



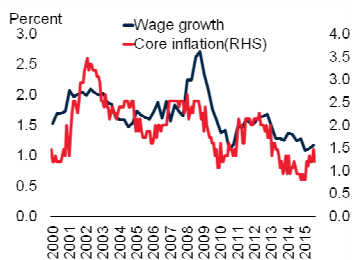
C. Private loan growth and credit standards



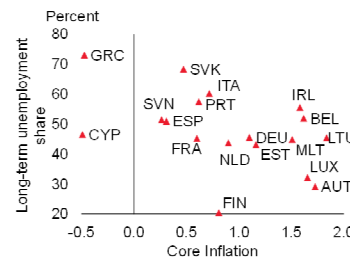
D. Extra and intra-EU export growth (nominal)



E. Wage growth and core inflation



F. Long-term unemployment and core inflation, 2015



Sources: Haver Analytics; World Bank; Eurostat; European Central Bank, Bank Lending Survey.
 B. Inflation is the year-on-year percent change of the Harmonized Index of Consumer Prices.
 C. Credit standard is calculated as the difference (net percentage) between the share of banks reporting that credit standards have been easing and the share of banks reporting that they have been tightened. A positive net percentage indicates that a larger proportion of banks have eased credit standards. Latest observation is 2015 Q3.
 D. Six month moving average. Latest observation is September, 2015.
 E. Wage growth is measured as percentage change, year-over-year, in negotiated wage rates. Latest observation is 2015 Q3 for wage growth and November, 2015 for core inflation.
 F. Standard ISO country codes. Long-term unemployment rate refers to people who are actively seeking for employment for at least a year in percent of total unemployment. Long-term unemployment is 2015 Q3 for most countries. Core inflation is the average of January to November 2015. Core Inflation is Harmonized Consumer Price Index excluding energy, foods, and tobacco.

further to 2.8 percent of GDP in 2015, the result of stronger growth and consolidation efforts. Fiscal policy has eased to a broadly growth-neutral stance in 2014-15, having weighed on activity in previous years.

Robust employment growth, still-accommodative financing conditions, and low oil prices should continue to support domestic demand in the period ahead. Growth is projected to average 2.7 percent in 2016, above potential but somewhat lower than predicted in June, reflecting a larger drag from net exports. Growth is expected to stabilize around 2.3 percent in 2017-18, with the output gap closing in 2017. Monetary policy tightening is likely to be very gradual throughout the forecast period.

Euro Area

Growth picked up in 2015, as domestic demand strengthened and exports accelerated, partly due to the lagged effect of a euro depreciation (Figure 1.4). For the year as a whole, Euro Area growth is estimated at 1.5 percent, in line with previous expectations, with activity firming in Spain, somewhat disappointing in Germany, and still lagging (albeit gradually recovering) in France and Italy. Low oil prices and favorable financing conditions are supporting consumer spending and investment. In the absence of further escalation, security concerns following the terrorist attacks in Paris are not expected to have lasting effects on confidence and activity.

Diminishing fiscal consolidation and healing labor markets are underpinning domestic demand, although conditions vary across countries. Since the start of the European Central Bank's (ECB) quantitative easing program, credit conditions have improved and credit growth has resumed following several years of contraction. However, credit remains tight in some countries because of elevated non-performing loans and impaired bank balance sheets. Despite the monetary policy easing, the euro appreciated about 7 percent in trade-weighted terms since reaching a low in April 2015, mainly reflecting the broad-based depreciation of emerging-market currencies. This may reduce somewhat the momentum of export growth and delay a pick-up in inflation. Although

2016. Market-based inflation expectations remained somewhat below the Federal Reserve's 2 percent inflation target in the second half of 2015, pointing towards a gradual normalization of policy rates. The fiscal deficit is estimated to have fallen

the impact may vary depending on the underlying factors driving currency movements, results from a number of macroeconomic models indicate that a 7 percent euro appreciation reduces Euro Area GDP growth by between 0.2-0.4 percentage point, and inflation by 0.1-0.5 percentage point (ECB 2015a, European Commission 2015a).

Peripheral economies have been little affected by contagion from the Greece crisis. A third bailout program was agreed to with European partners in August 2015, amounting to €86 billion (\$95 billion), in exchange for pension, tax, and other reforms. The weakening of the Greek economy following the implementation of capital controls in June 2015 will make program implementation challenging, but the disbursement of bailout funds and the agreed bank recapitalization plan have reduced immediate funding pressures.

Deflation concerns have receded since the start of 2015 but have not disappeared, with core inflation and wage growth remaining subdued, particularly among economies with high long-term unemployment rates. Headline inflation remained close to zero in 2015. Market-based inflation expectations have bottomed out but remain below the 2 percent target. This situation led the ECB to ease monetary policy further in December 2015.

Conditions should continue to improve in 2016, with growth reaching 1.7 percent, a bit slower than expected in June, reflecting a weakening external environment. Growth should average 1.6 percent in 2017-18, slightly above potential. However, concerns persist about low potential growth, high unemployment, and large public debt. While population ageing limits growth potential (Jimeno 2015), labor mobility and migration can help alleviate some of these constraints (World Bank 2015b) and help adjustments to country-specific shocks in monetary union (Beyer and Smets 2015).

The recent acceleration in the number of asylum seekers is creating important absorption and policy challenges that could strain public services and government finances in exposed countries, but is expected to provide some marginal support to Euro Area-wide growth in the short-term through rising public expenditure and private

consumption.¹ Over the medium term, the influx may also help to meet labor shortages in the face of an ageing population. However, the ultimate effect on growth and public finances remains highly uncertain, depending on the performance of migrants in the labor market (Münz et al. 2006, OECD 2014) as well as the coherence of national and EU policy responses.

Japan

Japan experienced a soft growth patch in mid-2015, confirming a weak underlying trend despite rising corporate profits and continued policy stimulus. Private consumption contracted in 2015 and investment was stagnant, which was only partially offset by positive but relatively subdued export growth (Figure 1.5). Overall, GDP growth is estimated at 0.8 percent for 2015, 0.3 percentage point lower than projected in June.

Despite the low value of the yen since 2013, the export response has been modest. This disappointment partly owes to past offshoring of production to the rest of Asia, which helped develop regional value chains and shifted sales to overseas subsidiaries. The transition to foreign plants was led by the more productive enterprises (Wakasugi et al. 2014). This offshoring trend appears to have lowered Japan's gross export elasticity. Weakening external demand from the rest of Asia also played a dampening role on exports, as value-added trade between Japan and other Asian countries intensified during the 2000s (Ito and Wakasugi 2015).

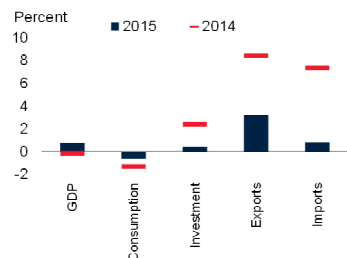
The Bank of Japan maintained its commitment to quantitative easing, and a further expansion of asset purchases is likely as inflation is not expected to reach the central bank's target before 2017. Tax revenues have increased following the rise in the consumption tax in April 2014 and the growth in corporate profits, but achieving primary balance by 2020-21 will be challenging, as spending pressures on social security and defense remain significant. Skill shortages in key services sectors

¹The European Commission predicts that the influx of 3 million migrants over the next three years would provide a net gain of up to ¼ of percentage point to EU growth by 2017 (European Commission 2015b).

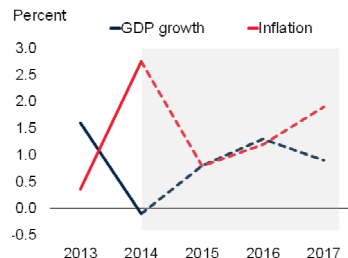
FIGURE 1.5 Japan

Growth in Japan remains fragile, with private consumption and investment failing to pick up in 2015. Growth is expected to recover moderately to 1.3 percent in 2016, from 0.8 percent in 2015. Past offshore investments have helped raise sales and profit by overseas subsidiaries, but restrained exports. Skill shortages continued to increase, raising prospects of a gradual acceleration in wage growth. Rising female participation has boosted employment rates and is helping to offset demographic pressures. Long-term inflation expectations remain below the 2 percent inflation target, despite further policy easing by the Bank of Japan.

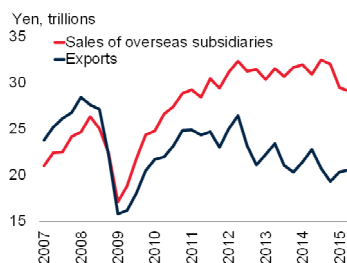
A. GDP and demand components



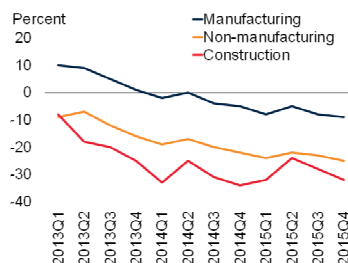
B. Growth and inflation



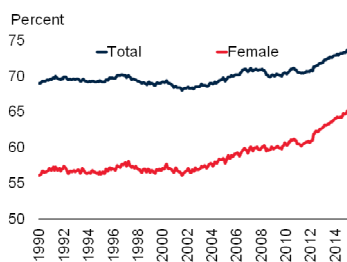
C. Exports and sales of overseas subsidiaries



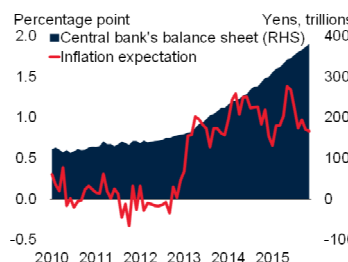
D. Employment shortages by industry



E. Female and overall employment rate



F. Inflation expectations and central bank balance sheet



Sources: Haver Analytics; World Bank; Bank of Japan.

B. Inflation is the year-on-year percent change of the Consumer Price Index.

C. Latest observation is 2015 Q2.

D. Percent of reporting companies based on the Bank of Japan's Tankan survey data on labor market shortages is a diffusion index taking a negative value when companies report perceived labor shortages (as factor hampering production). Latest observation is 2015 Q3.

E. Percent of the active age population. Latest observation is October, 2015.

F. Inflation expectations extracted from 5-year swap rates. Central Bank's balance sheet is total assets held. Latest observation is November, 2015.

continued to increase, as reforms that have encouraged female labor force participation have only partially offset demographic pressures on labor supply. The tight labor market in the services sector raises the prospect of a gradual acceleration in wage growth.

Sustained policy accommodation, and the prospect of higher earnings and record low unemployment, are positives for the outlook. Going forward, growth is expected to recover to 1.3 percent in 2016, less than expected in June due to a downward revision to both domestic demand and exports. The recovery remains fragile and dominated by downside risks.

China

Sectoral rebalancing in China became more pronounced in 2015. It was accompanied by bouts of volatility in financial markets and additional government stimulus measures. Growth in 2015 is estimated at 6.9 percent, down from 7.3 percent the previous year. The deceleration reflects an ongoing correction in the property sector, weakness in industrial activity, and slower growth in non-traditional credit. The robust expansion of consumer spending and services has helped boost the economy, and is in line with the rebalancing sought by policymakers. Even so, forecasts for 2016-17 have been downgraded, with growth expected to reach 6.5 percent by 2017.

In line with rebalancing efforts, the deceleration in activity during 2015 has been most visible in industry and real estate—sectors with considerable overcapacity and, in the case of industry, a high presence of state-owned enterprises (Figure 1.6). These sectors saw the sharpest increase in investment and leverage in 2009-13, resulting in a significant concentration of debt among a small number of large firms (Chivakul and Lam 2015). Balance sheets and credit quality have deteriorated in sectors with excess capacity. Policy efforts to reduce supply mismatches in the real estate sector, and to tighten nonbank credit flows, continued to weigh on non-traditional credit growth, which slowed notably during 2015. Weaker activity in manufacturing and construction have significantly impacted import demand, which contracted in the first half of 2015.

The service sector has seen its share of employment increasing in recent years, and accounted for the majority of new urban jobs created in 2015 (World Bank 2015a). This helped offset stagnant hiring in shrinking industrial sectors, and kept urban labor markets tight. Wages

and real incomes have continued to increase, albeit at lower rates, contributing to sustained growth of private consumption. A continued rebalancing from industry to services should support the shift from investment to consumption, whose share in GDP is gradually recovering from a post-crisis dip.

Policies became more supportive throughout the course of 2015, in order to counter slowing activity. The People’s Bank of China (PBOC) continued to lower benchmark interest rates and required reserve ratios, while implementing new collateral policies to facilitate refinancing for commercial banks. The central bank also continued to inject liquidity into the financial system, especially during the June stock market correction. The fiscal deficit widened to a six-year high of 2.3 percent of GDP in 2015, reflecting accelerated infrastructure investment by the central government in the second half of the year. The increase in central government spending more than offset cutbacks at the local government level resulting from lower revenues due to falling land sales, restrictions imposed on borrowing through Local Government Financing Vehicles (LGFV), and other off-budget transactions.

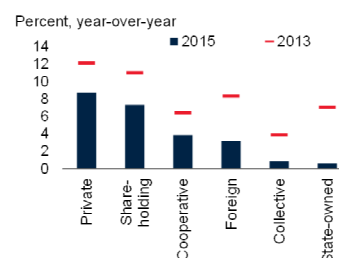
To foster greater exchange rate flexibility, the PBOC introduced a change in the calculation of the renminbi reference rate on August 10. This led to an almost 3 percent depreciation against the U.S. dollar, the largest three-day drop since the mid-1990s. The change was implemented against a backdrop of accelerated capital outflows and slowing growth. While it sparked some market volatility in the short term, the decision was fully aligned with the objective of allowing market forces to play a greater role in the economy. With this exception, the renminbi has been stable throughout 2015, and has continued to appreciate in real effective terms despite strong capital outflows.

Private capital outflows have increased as capital controls have been loosened. The net outflow reflects corporate efforts to reduce net foreign currency exposures and foreign short-term debt. Currency interventions to reduce the resulting downward pressure on the renminbi contributed to an estimated US\$443 billion decline in foreign currency reserves since September 2014 (11.5

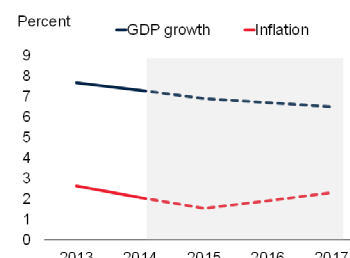
FIGURE 1.6 China

The growth slowdown in China has been most noticeable among enterprises operating in the manufacturing and real estate sectors. Growth forecasts have been revised down to 6.9 percent in 2015 and 6.7 percent in 2016. In evidence of the rebalancing of China’s economy, the share of services employment has increased, supporting real incomes and contributing to robust private consumption. A drop in equity prices and a change in exchange rate policy led to market turbulence, but foreign reserves remain plentiful and the current account is in surplus, reducing risks associated with capital outflows.

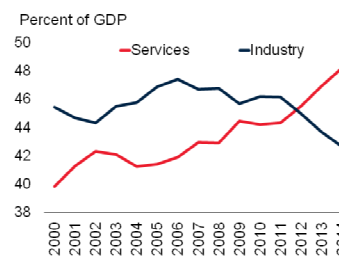
A. Value-added by type of companies



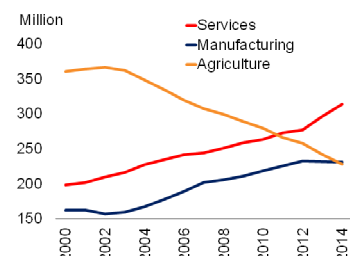
B. Growth and inflation



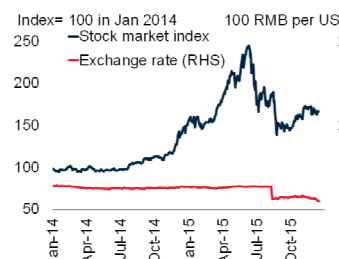
C. GDP share of services and industry



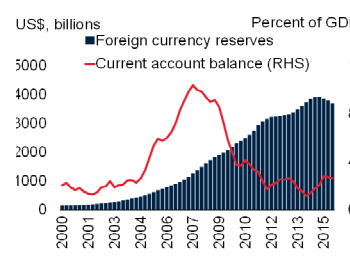
D. Employment by sector



E. Stock market index and exchange rate



F. Current account balance and reserves

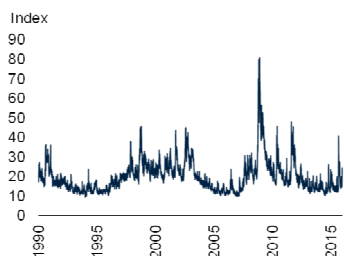
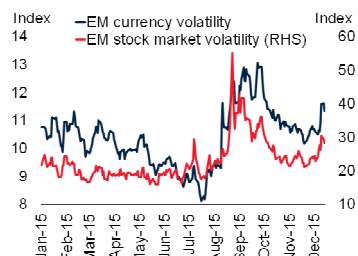
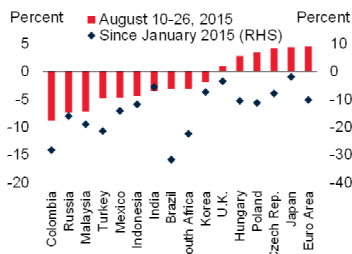
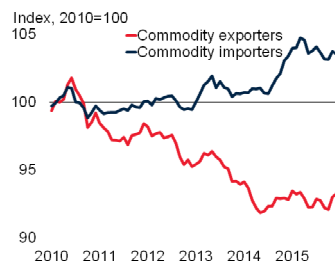
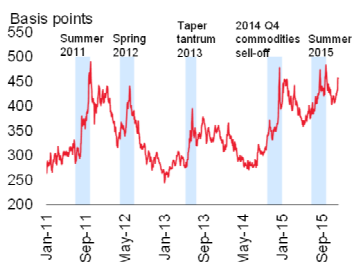
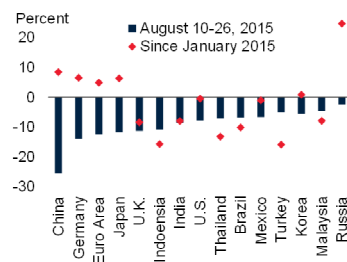


Sources: Haver Analytics; World Bank.
 A. 2015 is the average of January to October.
 B. Inflation is the year-on-year percent change of the Consumer Price Index.
 E. Stock market index is the Shanghai Stock Exchange Composite Index (SHCOMP). Latest observation is December 16, 2015.
 F. Foreign currency reserves is the foreign exchange holdings of the People’s Bank of China. Latest observation is 2015Q3.

percent off their peak level). The drop in reserves in August 2015, US\$94 billion, was the sharpest drop on record, and partly reflected valuation effects, as well as an effort to diversify foreign

FIGURE 1.7 Financial volatility and asset valuations

Concerns about prospects in emerging markets, combined with China's stock-market correction in the summer of 2015 and uncertainty about the impact of a normalization in U.S. monetary policy, contributed to greater financial market volatility. Equity and currency markets were particularly affected, with the most significant currency depreciations among key commodity exporters and in countries with lingering vulnerabilities. Borrowing costs also rose in line with heightened risk-aversion.

A. Global volatility index**B. Emerging market volatility indexes****C. Currency changes against the U.S. dollar****D. Nominal effective exchange rate****E. Emerging market bond spreads****F. Equity price indexes**

Sources: World Bank; Haver Analytics; Bloomberg.

A. Implied stock-market volatility derived from option pricing on the U.S. S&P 500 Index (VIX index). Latest observation is December 15, 2015.

B. EM currency and stock market volatility computed by Bloomberg. Latest observation is December 15, 2015.

C. An increase denotes appreciation. Latest observation is December 15, 2015.

D. Median effective exchange range of developing countries classified as either commodity exporters or commodity importers. A decline denotes depreciation. Latest observation is November 2015.

E. EMBI Global bond spreads measured from emerging market U.S.dollar-denominated Brady bonds, loans, and Eurobonds with an outstanding face value of at least \$500 million. Latest observation is December 15, 2015.

F. Latest observation is December, 2015.

assets through the purchase of gold. Notwithstanding this decline, China's foreign exchange reserves remain substantial, at about US\$3.5 trillion (or 32.8 percent of GDP).

Global trends and spillovers

Concerns about the growth outlook and prospects of rising U.S. interest rates led to a tightening in financing conditions for many developing countries and contributed to a significant slowdown in capital inflows in 2015. Commodity exporters, and countries with heightened domestic challenges, are especially affected. The widespread slowdown in emerging market economies contributed to a contraction in global trade in the first half of the year, adding headwinds to the global recovery. The broad weakness in commodity prices in 2015 is expected to persist in 2016, maintaining pressure on commodity exporters while supporting real income gains among importers.

Increasingly difficult financial conditions

Global financial market volatility rose noticeably in 2015 against the backdrop of slowing activity in large emerging economies, diverging monetary policies of major central banks, continued declines in commodity prices, and fragile liquidity conditions. In this context, market adjustments to adverse or unexpected news have been abrupt. Following a correction from overvalued equity prices in China and an unforeseen change in its exchange rate regime during the summer of 2015, the VIX index of stock-market volatility, often considered a proxy of global risk aversion, briefly surged to levels last seen during the 2011-12 Euro Area crisis (Figure 1.7)². While there was no unusual stress in short-term funding markets, nor a credit crunch in any large emerging markets, the summer market turmoil led to a sharp sell-off in developing country assets and a drop in capital inflows to those economies.

Half of the 20 largest developing-country stock markets saw plunges of 20 percent or more from their 2015 peaks. Currencies of key commodity exporters (including Brazil, Indonesia, Malaysia, the Russian Federation, and South Africa), and developing countries subject to heightened political risk (including Brazil and Turkey) fell to multi-year lows both against the U.S. dollar as

²In contrast, currencies in high-income Eastern European countries appreciated in nominal effective terms, alongside the euro, which strengthened during the turmoil on safe-haven flows.

well as in trade-weighted terms (Figure 1.7). Since July 2015, sovereign debt spreads have widened by 45 basis points and emerging market corporate debt spreads by 80 basis points, with the largest increases occurring among commodity exporters in Africa, Latin America, and East Asia. Since October, equity markets have rebounded, and sovereign bond spreads have narrowed, although remaining elevated in many countries. Several emerging market currencies also retraced some of their losses against the U.S. dollar, led by the Malaysian ringgit and the Indonesian rupiah.

Global investors pulled about \$52 billion from emerging market equity and bond funds in the third quarter of 2015, the largest quarterly outflow on record (Figure 1.8). This was mostly driven by institutional investors reducing their exposure in a sign of deteriorating confidence about long-term prospects. Net short-term debt and bank outflows from China, combined with a broad-based retrenchment in the Russian Federation, accounted for the bulk of the outflow from emerging markets, but portfolio and short-term capital inflows also dried up elsewhere in the third quarter of 2015. Meanwhile, FDI inflows remained generally steady, although they decelerated in some economies.

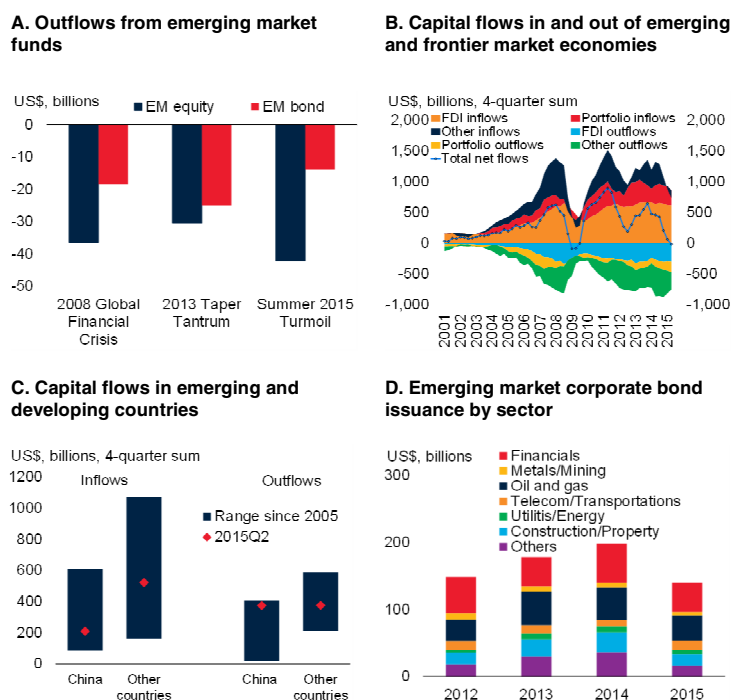
International bond issuance by emerging market corporates slowed significantly, particularly in the oil and gas sector. This has partially reversed the post-crisis doubling of bond issuance by developing country corporates, especially in commodities-related sectors. Since 2010, bonds have been issued more often to refinance debt than for investment purposes (Rodrigues Bastos, Kamil, and Sutton 2015). In consequence, some commodity firms have become highly leveraged, and are now vulnerable to a combination of rising borrowing costs and declining commodity prices.

Looking ahead, the diverging monetary policy stances of major economies will continue to be a key determinant of financial conditions in developing countries.

- *United States.* Following a first hike in December 2015, the pace of interest rate increases in the United States is expected to be

FIGURE 1.8 Capital flows

Capital flows decelerated to their weakest level since the global financial crisis, particularly in China. Foreign direct investment has shown greater resilience, while short-term debt and portfolio inflows have decelerated significantly. Weakening capital flows have exacerbated currency and equity market pressures in many countries, particularly among commodity exporters. Borrowing costs also rose in line with heightened risk-aversion, and corporate bond issuance slowed significantly, particularly from construction, oil and financial companies.



Sources: World Bank; EPFR Global; Bloomberg; Dealogic; JP Morgan; U.S. Federal Open Market Committee.
 A. Figure shows cumulative EPFR weekly flows. "Global Financial Crisis" refers to June 11, 2008 to October 28, 2009. "Taper Tantrum" refers to May 29 to September 4, 2013. "Summer 2015 Turmoil" refers to July 17 to September 16, 2015.
 B. C. Based on quarterly balance of payment data for the largest 23 emerging and developing economies. Includes foreign direct investment, portfolio, short-term debt, and other investment flows. Last observation is 2015Q2. Four-quarter moving sum.
 D. Last observation is December, 2015.

gradual and notably slower than in previous tightening cycles, reflecting in part low inflation expectations and U.S. dollar appreciation. Legacies from the crisis, such as elevated household debt and weak productivity growth, also point towards a protracted period of low interest rates. Since the tightening cycle has been widely anticipated, baseline projections assume a benign impact on capital inflows to emerging and developing economies. However, as financial market expectations are susceptible to scares, risks of volatility during the Fed tightening cycle remain significant (Arteta et al. 2015).

- *Euro Area and Japan.* Continued quantitative easing by the ECB and the Bank of Japan should help shore up global liquidity. Negative interest rates in Europe and increasing yield differentials with the United States could contribute to a further appreciation of the U.S. dollar and have mixed effects for developing countries. On the one hand, the increase in cross-border lending from European banks and Eurobond issuance during 2015 is likely to continue as the Euro Area recovery becomes more firmly entrenched and as bank balance sheets improve. On the other hand, continued strengthening of the dollar could contribute to refinancing pressures in countries with significant dollar-denominated liabilities.

Capital inflows to developing countries dipped to a post-crisis low relative to GDP in 2015 (Table 1.1). They are expected to recover slowly in 2016-17 as developing-country growth stabilizes. A gradual shift from portfolio to cross-border bank lending flows is likely to continue, supported in particular by a healing European banking sector and ongoing policy accommodation by the ECB. A gradual rise in global interest rates and continued weakness in commodity prices could affect FDI decisions, particularly in mining and exploration, while the cost of infrastructure financing is expected to rise. Renewed bouts of volatility, or heightened concerns about developing country growth prospects, represent downside risks to this benign scenario.

Renewed decline in commodity prices

Commodity prices fell further in the second half of 2015. By November, the three industrial commodity price indexes—energy, metals, and agricultural raw materials—were down, on average, 45 percent from their 2011 peaks (Figure 1.9). Abundant supplies, due in part to investment during the decade-long price boom, and softening demand are the main factors behind the continued weakness. The appreciation of the U.S. dollar, the currency in which most commodities are traded, has also contributed to the price weakness.

- *Oil.* The price of oil (simple average of Brent, Dubai, and West Texas Intermediate)

dropped below \$40 per barrel towards the end of 2015. Prices have been driven lower by high stocks in OECD economies, ample global supplies, and expectations of slower global demand (particularly from large emerging markets). U.S. crude oil production has begun to decline due to lower investment and drilling but was resilient for most of 2015. OPEC production increased further, reaching a three year high, with much of the increase coming from Saudi Arabia and Iraq. A removal of sanctions following the implementation of the Iran nuclear agreement could increase Iranian oil exports by 0.5-0.7 million barrels per day by 2016, nearing the pre-sanctions level of 4 percent of global consumption. Since other energy prices are at least partially linked to oil prices, prices for other energy products, including natural gas, have also fallen.

- *Metals.* The slump in metal prices, which reached their lowest levels in more than 6 years in November, reflects well-supplied markets as well as weaker growth in major emerging markets. New mining capacity came into operation in several countries, especially Australia, adding to already abundant supplies.
- *Agricultural commodities.* Grain and oilseed prices dipped in 2015, mostly in response to well-supplied markets, with the agricultural price index standing 33 percent below its early -2011 high as of November. The stocks-to-use ratio (a measure of how well supplied markets are) for key grains remains well above its 5- and 10-year average levels. Ample supplies and the weak influence of global food prices on most local prices, suggest that the El Niño weather pattern, which some forecasts say may be the strongest since 1997-98, is unlikely to raise global food commodity prices in a significant way (World Bank 2015c).

Conditions remain in place for a protracted period of low commodity prices in coming years. Oil prices are projected to average \$49 per barrel in 2016, and then rise only gradually. Metal and agricultural prices are likely to edge up in the range of 1-2 percent. While geopolitical risks and

adverse weather conditions could lead to a more rapid recovery in prices, risks are on the downside. In the case of oil, prices may come under renewed downward pressure if weakness in emerging and developing economies persists or if the Islamic Republic of Iran receives substantial foreign investment to expand capacity quickly (Iran has the world's largest proven natural gas reserves, and fourth largest oil reserves). These developments suggest continued significant headwinds for the outlook for growth, fiscal positions, and trade of commodity-exporting countries, emphasizing the need to accelerate the diversification of their economies.

Global trade weakness

Global merchandise trade contracted in the first half of 2015, for the first time since 2009 (Figure 1.10). This was largely driven by a drop in import demand from emerging and developing economies, including in East Asia and the Pacific, Europe and Central Asia, and Latin America and the Caribbean. Growing import demand from the United States and the Euro Area did not offset the drop in developing countries' import demand, which now accounts for half of global trade.

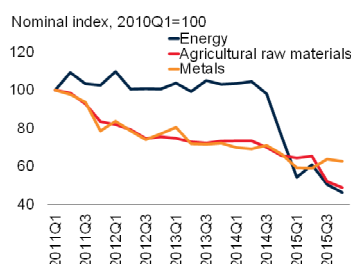
The contraction in import demand from emerging and developing economies reflected four trends:

- *GDP contractions in Brazil and the Russian Federation.* Recessions in these two countries sharply reduced import demand. Sanctions against the Russian Federation further restricted trade. More generally, sharp declines in commodity prices reduced export revenues and demand across commodity exporters, leading to a significant slowdown in imports from these countries.
- *Rebalancing in China.* As a result of an increasingly pronounced shift in sources of growth from trade-intensive investment and exports toward less trade-intensive consumption and services, import growth has slowed.
- *Currency depreciations.* Real effective exchange rate depreciations have been accompanied by a decline in imports in several countries, but

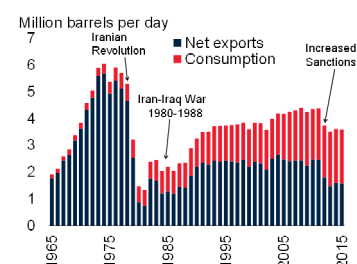
FIGURE 1.9 Commodity markets

By end-2015, the three World Bank industrial commodity price indexes—energy, metals, and agricultural raw materials—were down, on average, 45 percent from their 2011 peaks. Oil prices declined further in the second half of 2015, despite large reductions in investment and drilling in U.S. shale oil. The agreement with the Islamic Republic of Iran over its nuclear program could provide a boost to its oil exports. Metal prices continued to reflect well-supplied markets and weaker demand from major emerging markets. The strong El Niño weather pattern may affect numerous local markets but it is unlikely to have major effects on global food prices given well-supplied markets.

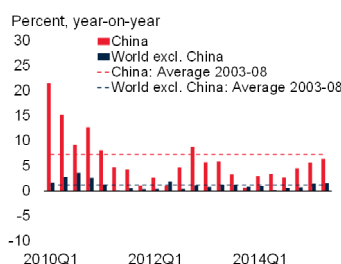
A. Commodity prices



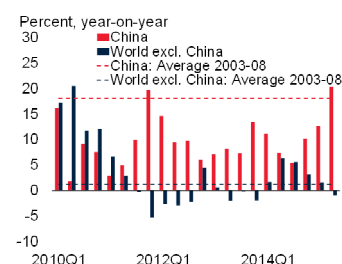
B. Islamic Republic of Iran's oil production



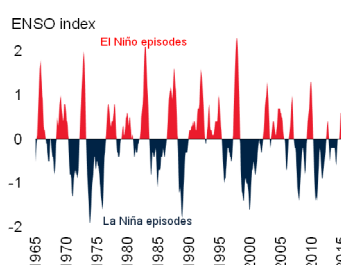
C. Oil consumption growth



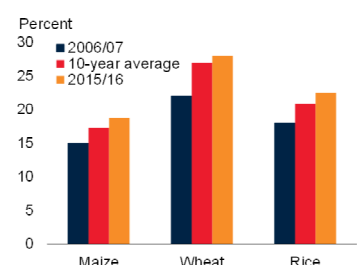
D. Refined metal consumption growth



E. El Niño index



F. Stock-to-use ratios



Sources: Baker Hughes; BP Statistical Review of World Energy; World Bank; World Bureau of Metal Statistics.
 A. Last observation is 2015Q4.
 B. Last observation is 2015.
 C. D. Last observation is 2015Q2.
 E. The ENSO (El Niño Southern Oscillation) index represents a centered three-month mean SST (Sea Surface Temperature) anomaly for the Niño 3.4 region. Latest historical observation is October 2015. November 2015 through June 2016 are forecasts.
 F. The stocks-to-use ratio indicates the level of stocks for any given commodity as a percentage of consumption. Latest observation is November 2015.

have thus far shown limited benefits for exports. This may partly reflect changes in global value chains that may be reducing the elasticity of exports to real effective appreciation (Ahmed, Appendino, and Ruta 2015).

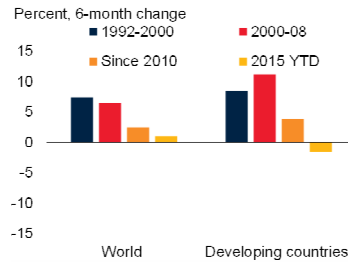
FIGURE 1.10 Global trade slowdown

Global merchandise trade slowed considerably in 2015, driven by a deceleration in import demand from large emerging markets. China's rebalancing away from import- and commodity-intensive sectors and economic contraction in Brazil and Russia appear to have played a particularly significant role. Given the rising importance of "south-south" trade flows, developing-country exports have been negatively affected. Currency depreciations have thus far shown limited benefits for exports, which could partly reflect a reduced exchange rate elasticity. Slower value chain integration could also be factor capping trade opportunities for developing countries.

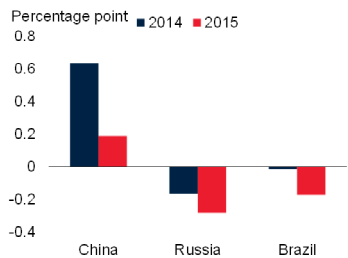
A. Global merchandise trade growth



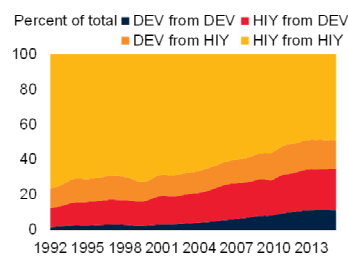
B. Merchandise import growth



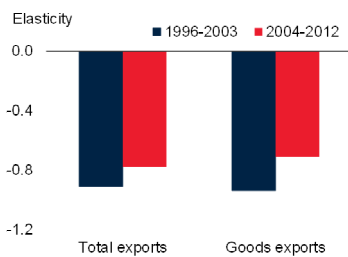
C. Contribution to global import growth



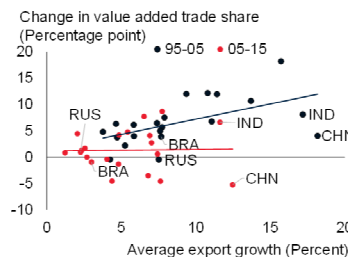
D. Composition of global import demand



E. Elasticity of exports to change in real effective exchange rate



F. Export growth and value chain integration



Sources: World Bank, IMF Direction of Trade Statistics (DOTS); CPB Netherlands Bureau for Economic Policy Analysis; Organization for Economic Co-operation and Development, TIVA; Ahmed, Appendino, and Ruta (2015).
 A. Global merchandise trade measured in real term (deflated by unit value indexes); average of global imports and exports. Grey areas indicate period of global trade contraction. Last observation is October, 2015.
 B. Merchandise import volumes. Recently-graduated high-income countries (Argentina, Chile, Hungary, and the Russian Federation) are included in the developing country aggregate. Last observation is October, 2015.
 C. Import volumes for goods and non-factor services. 2015 are estimates.
 D. HIY are high-income countries, DEV are developing countries. Based on bilateral trade flows between G20 economies. Recently-graduated high-income countries (Argentina, Chile, Hungary, the Russian Federation and República Bolivariana de Venezuela) are included in the developing-country aggregate.
 E. Elasticities derived from a panel model regressing annual real export growth over annual real exchange rate growth across 46 countries and over the period 1996-2012 as in Ahmed, Appendino, and Ruta (2015).
 F. Value chain integration measured as share of foreign value added in gross exports. Change in value added trade share is computed from 2005 to 2011 (latest available data).

However, conventional trade, which still represents roughly half of global trade flows, shows greater responsiveness to exchange rate developments (IMF 2015a).

- *Stabilization of value chains.* During 1990-2008, countries that were integrating faster into global value chains also saw more rapid export growth than others (Esaicth and Miroudot 2015). Since then, value chains appear to have stabilized such that manufacturing sub-sectors with a higher degree of vertical specialization witnessed the largest deceleration in trade growth (Constantinescu, Mattoo, and Ruta 2015, World Bank 2015d).

Estimates for trade flows in 2015 and forecasts for 2016-17 have been revised down, in line with the weakened post-crisis relationship between trade and activity.³ Persistent weakness in global trade diminishes export opportunities but also the scope for productivity gains through increasing specialization and diffusion of technologies. This could continue to put a cap on growth prospects, particularly among smaller and more open developing economies. Renewed liberalization efforts could help reinvigorate trade.⁴ The Trans-Pacific Partnership (TPP), agreed at the technical level between Australia, Brunei, Canada, Chile, Japan, Malaysia, Mexico, New Zealand, Peru, Singapore, the United States, and Vietnam, could provide a new impetus to trade, and lift activity, by helping to reduce tariffs and other trade barriers (Chapter 4). By 2030, the TPP could lift member country GDP by an average of 1.1 percent, with much larger benefits in countries with currently high trade barriers like Vietnam and Malaysia. The spillover effects for non-members remain uncertain. Losses due to preference erosion and trade diversion could be partially offset by positive spillovers from regulatory convergence.

³The post-crisis slowdown in global trade has been attributed to a number of factors including (i) anemic growth in advanced economies, (ii) the changing composition of global demand and persistent weakness in investment, (iii) the maturation of global value chains, (iv) weak trade finance and (v) slow trade liberalization momentum (World Bank 2015a).

⁴According to some estimates, removing all tariffs, state aid, export subsidies and other trade restrictions affecting LDCs could boost their exports by up to 30 percent (Evenett and Fritz 2015).

Developing countries

Growth in developing countries slowed to 4.3 percent in 2015, reflecting domestic and external challenges. Domestic difficulties included slowing productivity growth, policy uncertainty, and eroding policy buffers that have led to contractionary monetary and fiscal policies in some countries. External headwinds include persistently low commodity prices, subdued global trade, spillovers from weakness in major emerging markets, decelerating capital flows and rising borrowing costs. The slowdown reflects both cyclical and structural components. Commodity exporters have continued to adjust to steep declines in oil and other commodity prices. In low-income countries, however, growth has remained robust, as solid infrastructure investment and consumer spending has partly offset weakening external demand. The modest pickup in activity in developing countries expected in 2016 and 2017 is predicated on continued growth momentum in high-income countries, stabilization of commodity prices, still-accommodative monetary policy in major economies, and a steady process of rebalancing in China.

Recent developments

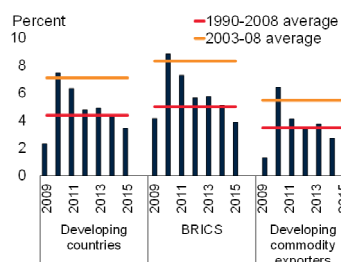
Developing-country growth slowed in 2015 to 4.3 percent, its weakest showing since 2009, and a pace well below its pre-crisis average (Figure 1.11). China's economy continued to slow in an orderly fashion, and its rebalancing away from import and commodity-intensive activities has had repercussions for global trade and commodity prices. Brazil and the Russian Federation have taken a turn for the worse as a result of global and domestic headwinds, with both countries experiencing deepening contractions, above-target inflation, and deteriorating public finances. In South Africa, chronic power supply bottlenecks are a major factor behind weak growth. In contrast to other major developing countries, growth in India remained robust, buoyed by strong investor sentiment and the positive effect on real incomes of the recent fall in oil prices.

The fact that four of the five BRICS are experiencing slowing or contracting activity, as are a substantial fraction of other developing countries, highlights the synchronous nature of

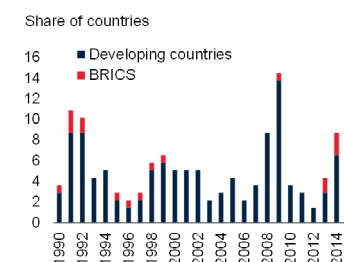
FIGURE 1.11 Growth in emerging and developing economies

Growth in emerging and developing economies slowed to post-crisis low in 2015. The deceleration was driven by external and domestic factors and was highly synchronous. Investor confidence and credit ratings have been adversely affected by deteriorating growth prospects, particularly among commodity-exporting countries. The recent slowdown partly results from the unwinding of cyclically strong post-crisis growth but also has a structural component across many developing regions.

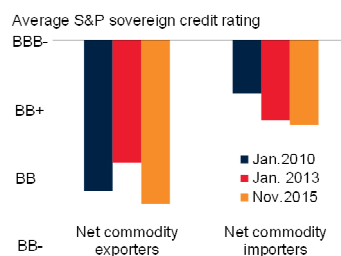
A. GDP Growth



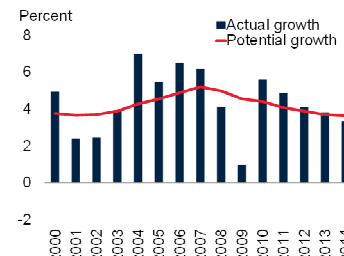
B. Share of countries experiencing three consecutive years of declining growth



C. Sovereign credit ratings



D. Cyclical and structural growth slowdown in developing countries



Sources: World Bank; Standard & Poor's; Haver Analytics; Didier et al. (2015).
 A. B. Recently-graduated high-income countries (Argentina, Chile, Hungary, the Russian Federation, and República Bolivariana de Venezuela) are included in the developing country aggregate.
 B. Figure shows share of emerging and developing countries slowing for three consecutive years out of a sample of 138 countries.
 C. Latest observation is November, 2015.
 D. Unweighted average of emerging market economies. Potential growth defined as in Didier et al. (2015).

the ongoing deceleration in developing countries—more so than in any episode over the past 25 years, with the exception of the Great Recession of 2009.⁵

In about half of developing countries, growth in 2015 is likely to fall short of expectations, with the largest disappointments among energy exporters (Angola, Colombia, Ecuador, Kazakhstan, Nigeria, the Russian Federation, the República Bolivariana de Venezuela) and countries experiencing conflicts (Ukraine) or policy

⁵The impact of the BRICS on other emerging and developing economies is discussed in more detail in Chapter 3.

uncertainty (Brazil). In contrast, the continued recovery in the Euro Area has lifted growth more than expected in some of its developing country trading partners, including those in Europe and Central Asia and North Africa.

Both external factors—including weak global trade, financial market volatility, and persistently low commodity prices—and domestic factors have contributed to the slowdown. Adverse external developments have continued to hit commodity-exporting developing economies particularly hard. Growth in several of the largest ones (Brazil, Colombia, Nigeria, Peru, South Africa) weakened considerably in 2015, as the impact of deteriorating terms of trade on exports was compounded by tightening macroeconomic policy and softening investor confidence. Governments responded to falling fiscal revenues from the resource sector with spending cuts. Central banks raised interest rates to help moderate pressures on exchange or inflation rates. Investor confidence weakened on deteriorating growth prospects and credit ratings, resulting in declining capital inflows and currency depreciations.

The recent slowdown in developing-country growth partly reflects an unwinding of cyclically strong, policy-supported, post-crisis growth, especially in East Asia and Pacific and in Latin America and the Caribbean. However, it also has a considerable structural component, which is most pronounced in Europe and Central Asia and the Middle East and North Africa. On average, among the 24 largest emerging and developing economies, about one-third of the slowdown between 2010 and 2014 was structural in nature (Didier et al. 2015). In particular, demographic trends have passed a turning point since the global crisis—with potentially profound implications for growth (World Bank 2015b). Since 2010, working-age population growth has slowed, particularly in Europe and Central Asia and the Middle East and North Africa. As a result, the share of the working-age population has risen only marginally or fallen in most regions other than Sub-Saharan Africa, where many countries are still in a phase of pre- or early demographic dividends. Other domestic sources of the slowdown include

slowing productivity growth, continued domestic policy uncertainty, and—as discussed in detail later—eroding policy buffers that narrowed policy options.

- *Slowing productivity growth.* Total factor productivity (TFP) growth in emerging markets has declined steadily since 2010. By 2014, TFP growth had returned to its long-term average of around 0.5 percent, well below the 2.3 percent gain recorded in 2010 (Didier et al. 2015). The TFP slowdown was pronounced in the Middle East and North Africa, where TFP has been contracting since 2007. In Latin America and the Caribbean, and Eastern Europe and Central Asia TFP growth has ground to a virtual halt.
- *Policy uncertainty.* Domestic policy uncertainty increased in 2015 (including in Latin America, East Asia and the Pacific, and Europe and Central Asia), as a result of elections, or political unrest. Among low-income countries, a flare-up of violence (Afghanistan), political tensions (Burkina Faso, Burundi, Guinea Bissau, Nepal), and uncertainty surrounding elections and labor disputes (Benin, Democratic Republic of Congo) drove up political risk in 2015. Concerns about policy direction can hold back domestic and foreign investors, reduce capital flows and dampen investment and consumption growth (Gourio, Siemer, and Verdelhan 2014; Julio and Yook 2013).

Policy uncertainty and the removal of policy stimulus have weighed on investment and consumption growth rates, which have fallen well below pre-crisis levels. Growth of credit to the private sector has slowed sharply in several countries (Figure 1.12). In some places, credit retrenchment reflects monetary policy tightening to mitigate inflation concerns (Brazil, South Africa) and slowing capital inflows, weighing further on domestic liquidity and credit conditions. Other reasons behind the slowdown in credit growth include weak domestic demand, heightened uncertainty, and the government's decision to reduce the use of public credit as a

counter-cyclical tool. In several countries, consumption growth has been further dampened by rising unemployment rates (including Brazil and South Africa), and moderating employment growth.

Partly reflecting uncertainty about the outlook, consumption growth remains below its pre-crisis and long-term averages, despite increased real incomes due to declines in food inflation and oil prices. In several countries, these developments have sharply reduced headline inflation, especially in countries with a large share of food in their consumption baskets (India, Pakistan, the Philippines). In some regions and countries (Europe and Central Asia, Thailand), falling food and oil prices have coincided with persistent economic slack and played a role in lowering inflation below target rates.

Low-income countries have generally remained resilient, growing by 5.1 percent in 2015. Large-scale infrastructure investment and sustained consumer spending helped offset weakening external demand and low commodity prices. Even so, commodity-exporting low-income countries faced currency pressures, which contributed to a sharp increase in interest rates in Uganda and a decline in reserves in many countries (Burundi, Democratic Republic of Congo, Mozambique, Tanzania, Zimbabwe).

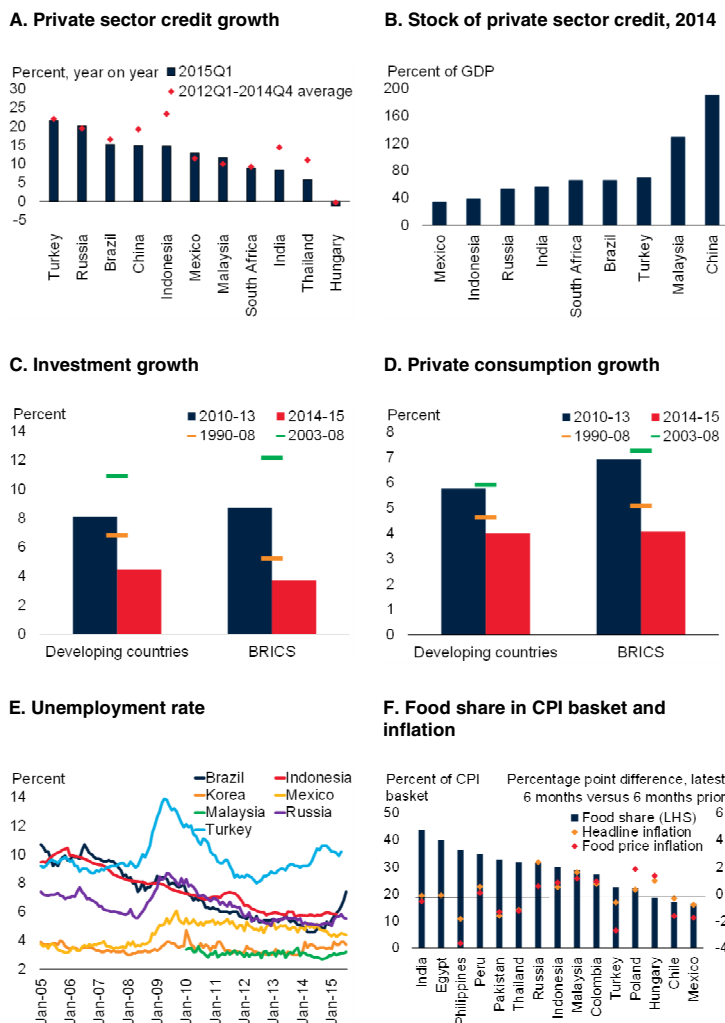
Eroding buffers and lingering vulnerabilities

Weakening activity in developing countries has been accompanied by eroding policy space and lingering vulnerabilities (Figure 1.13). Slowing growth, rising debt, and, for commodity exporters, weakening export and fiscal revenues, have eroded credit ratings. Some large emerging and developing economies lost, or risked losing, investment grade status in 2015 (Brazil, the Russian Federation), and some others appeared to be struggling to maintain it.

Eroding policy space. As growth has slowed and as authorities have supported economic activity with fiscal stimulus and monetary policy loosening, policy buffers have eroded. Fiscal

FIGURE 1.12 Domestic demand conditions in developing countries

Credit growth has slowed, but private sector debt remains high in many countries. Investment and private consumption growth in emerging and developing economies has been below pre-crisis rates. Rising unemployment has weighed on consumer confidence and spending in some countries, despite the increase in real incomes resulting from falling food and energy inflation.

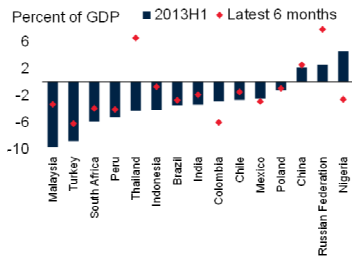
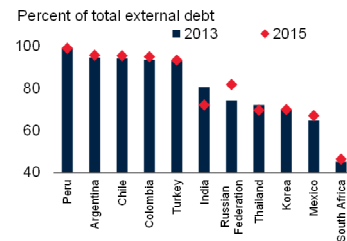
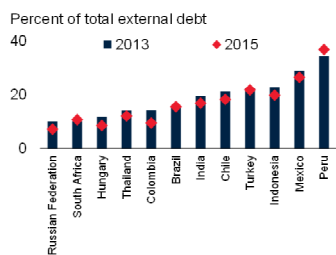
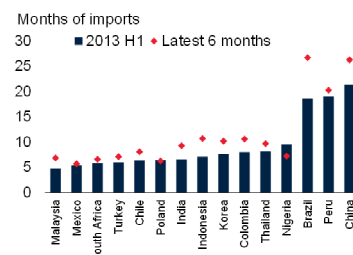
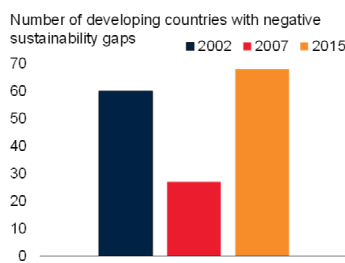
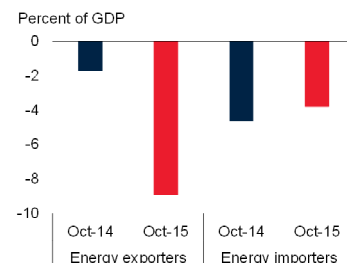


Sources: World Bank; Bank for International Settlements; International Labor Organization; Haver Analytics.
 C. D. Recently-graduated high-income countries (Argentina, Chile, Hungary, the Russian Federation, and República Bolivariana de Venezuela) are included in the developing country aggregate.
 E. Unemployment rate data is seasonally adjusted. Latest observation November, 2015.
 F. Right vertical axis shows percentage point difference in average year-over-year inflation from April to October 2015 versus October 2014 to April 2015.

deficits have widened from pre-crisis levels in commodity exporters and importers alike (World Bank 2015d,e). Inflation, especially in commodity exporters, has risen outside target bands and external and foreign currency debt has increased. With shrinking policy room, domestic policy stimulus has been gradually withdrawn.

FIGURE 1.13 Macro-financial vulnerabilities

Current account balances have improved modestly among oil importers, but deteriorated among exporters. Countries with elevated external debt or with a high share of short-term external debt have made only limited progress in reducing these exposures. More countries have seen government debt and the sustainability gap deteriorate from pre-crisis levels. Fiscal balances have worsened rapidly among oil and other commodity exporters in 2015.

A. Current account balance**B. External debt denominated in foreign currency****C. Short-term share of external debt****D. Foreign reserve coverage****E. General government sustainability gaps****F. Projected fiscal balances, 2015**

Source: World Bank, World Bank QEDS database; IMF World Economic Outlook October 2014 and October 2015.

A. Latest observation is 2015 Q3 for most countries.

D. Latest observation is October, 2015 for most countries.

E. Sustainability gap is defined as the difference between the actual primary balance and the debt-stabilizing primary balance at current interest rates and growth rates. A negative sustainability gap indicates an unsustainable stock of debt and deficit. Figure reflects data for the 123 developing countries with available data for all three years shown.

F. Structural fiscal balance projections from October 2014 and October 2015 IMF World Economic Outlook reports.

Weakening corporate balance sheets. Corporate leverage has grown significantly since 2009. It has become increasingly concentrated in sectors more exposed to business cycle swings, such as

construction and mining, and among firms with weakening balance sheets (IMF 2015b). Corporate debt has been increasingly financed through international bond issuance rather than bank lending. In some cases this has meant rising currency exposures, with debt service costs more sensitive to changing global financing conditions. Past experience suggests that rising corporate leverage increases the probability of capital flow reversals (Mendoza 2010; Mendoza and Terrones 2008; Elekdag and Wu 2011). Finally, many developing-country banking sectors with high non-performing loan ratios have not seen much improvement in asset quality.

Large external debt. Some developing countries with elevated total external debt, or with a high share of short-term external debt, have made little progress in reducing such burdens (the Czech Republic, Malaysia, Mongolia, South Africa, Turkey). India, Mexico, and South Africa have reduced the share of their external debt denominated in foreign currency but still carry sizable stocks. As monetary policy tightens in the United States, some of these countries may be vulnerable to rollover, exchange rate, and interest rate risks (Borio 2014, IMF 2015b). Foreign reserves have come under pressure in many commodity exporters (Indonesia, Malaysia), and in countries which are prone to capital flow reversals (Turkey). Current account balances have improved among a number of oil-importing economies, although deficits remain elevated for several of them.

Deteriorating public sector balance sheets. General government debt has increased in many developing countries. Fiscal deficits have deteriorated considerably more than expected in commodity exporters, while remaining broadly steady in other developing countries. As a result, the number of countries in which debt is rising has surged from pre-crisis levels. In a number of developing countries (Indonesia, Peru, Poland, South Africa, Turkey), foreign participation in government debt markets remains elevated, making them potentially vulnerable to global shifts in investor sentiment (Arslanalp and Tsuda 2014).

These vulnerabilities are further constraining policy room to support weakening activity (see Section on developing country policies). Large fiscal deficits and high government debt dampen the effectiveness of fiscal stimulus (World Bank 2015d, Figure 1.14). Rising foreign currency-denominated debts, or rollover requirements generate risks from sharp depreciations or from spikes in interest rates (Chow et al. 2015). This requires central banks to take financial stability into greater account than otherwise when considering monetary stimulus to support activity, even when inflation expectations are anchored.

Outlook

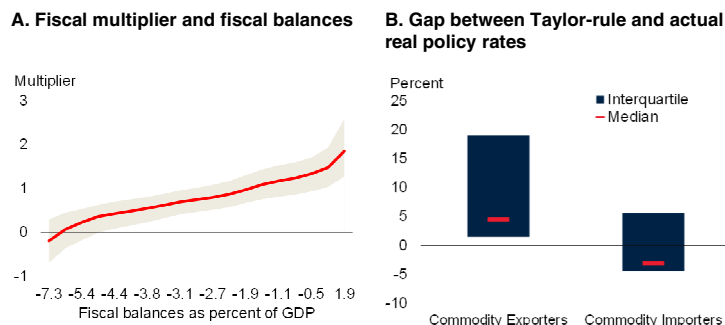
Baseline projections assume that 2015 marked a low point for developing country growth (Figure 1.15). Growth is expected to rise to 4.8 percent in 2016, similar to the pace in 2014, and to 5.3 percent in 2017 and 2018. This modest improvement is predicated on continued momentum in high-income countries, a stabilization of commodity prices, still-accommodative monetary policy in major economies with no bouts of financial market turbulence, and a continued gradual slowdown in China. With stabilizing commodity prices, growth in commodity exporters is expected to resume.

Among low-income countries, growth is mostly steady or rising. However, forecasts for 2016 have been downgraded for some countries from previous projections, reflecting lower commodity prices and rising security and political tensions in some countries.

The persistent growth slowdown in emerging and developing economies has led to repeated forecast downgrades. The largest emerging markets are among the countries subject to significant downward revisions to their long-term forecasts in recent years. Many of the factors underpinning the slowdowns – low commodity prices, weak global trade, and slow productivity growth – are expected to persist (World Bank 2015e, World Trade Organization 2015). Also, developing countries will likely face rising borrowing costs. In particular, countries with large borrowing needs and high levels of dollar-denominated debt could be adversely impacted by rising U.S. interest rates.

FIGURE 1.14 Monetary and fiscal policy space

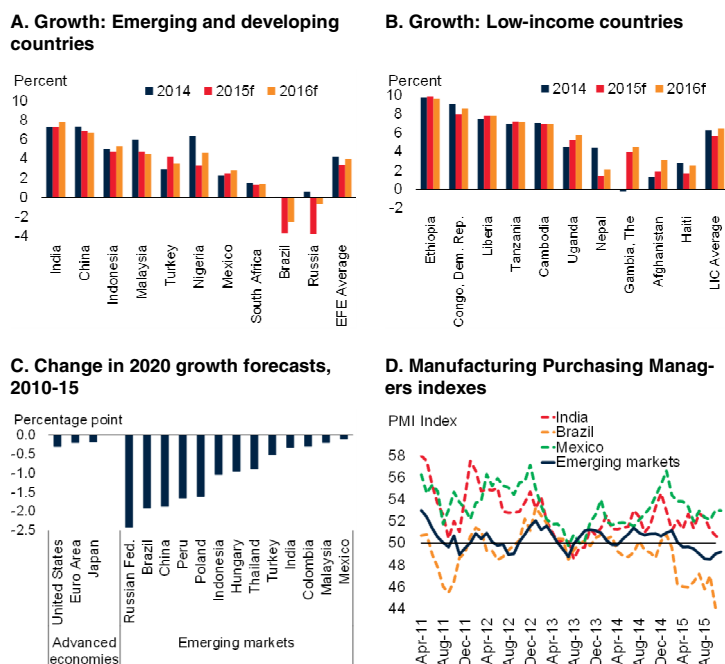
Fiscal stimulus becomes less effective as fiscal deficits widen. Real policy rates in many commodity exporting countries may still be below levels implied by Taylor rules. This constrains central banks' ability to respond to weakening growth with policy accommodation.



Source: World Bank.
 A. Fiscal multipliers for different levels of fiscal balance (in percent of GDP) after two years, estimated from an IPVAR model using a sample of 15 emerging and frontier markets. Values on the x-axis correspond to percentiles of the fiscal balance; shaded area is the 16-84 percent confidence band. Fiscal multipliers are larger (fiscal stimulus is more effective), when fiscal deficits are lower.
 B. Real policy rate and inflation target data are for October 2015, expected inflation as of September 2015. Taylor rules stipulate how much central banks should change interest rates in response to deviations from policy objectives (inflation target or others). The real Taylor rule interest rate is calculated as $1.353 \times (\text{expected inflation} - \text{inflation target}) + 2.233$ (Ostry, Ghosh, and Chamon 2012). A positive gap denotes current policy rates below those implied by the Taylor rule.

FIGURE 1.15 Developing-country outlook

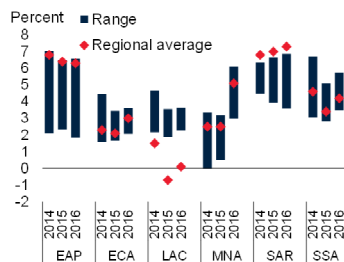
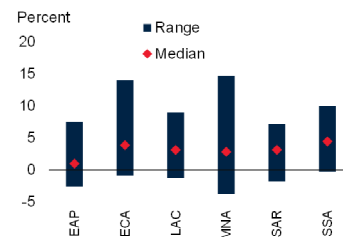
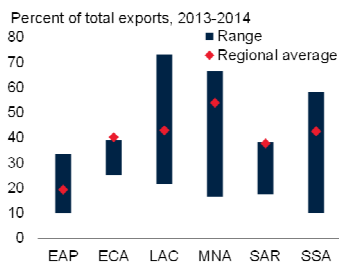
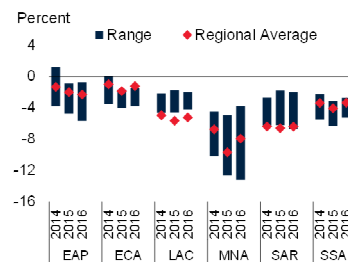
Developing-country and emerging-market growth is expected to recover somewhat in 2016. However, Brazil and Russia are expected to see further contractions, which will exert a drag on trading partners' activity. Among low-income countries, the pace of growth is expected to be steady or increasing. Persistent slowdown in emerging and developing economies have resulted in a significant downgrade of their underlying growth potential in recent years.



Sources: World Bank; Haver Analytics; Consensus Economics.
 C. Figure shows percentage-point revision to 2020 forecast between October 2010 and October 2015.
 D. Latest data as of November 2015.

FIGURE 1.16 Regional outlook

There is considerable heterogeneity in regional developments and outlooks. In the East Asia and Pacific region, growth remains sustained and inflation generally subdued. In Europe and Central Asia, the eastern part is negatively affected by developments in Russia while the western part is benefits from the recovery in the Euro Area. Low commodity prices and domestic challenges will continue to weigh on growth in Latin America and the Caribbean, the Middle East and North Africa, and Sub-Saharan Africa. Currency and fiscal pressures are building in 2015 in commodity-exporting regions.

A. Developing regions: Growth**B. Developing regions: Inflation in 2015****C. Developing regions: Commodity exports****D. Developing regions: Fiscal deficits**

Sources: World Bank; Haver Analytics; IMF World Economic Outlook October 2015.

A.D. "Range" denotes range from lowest quartile to highest quartile among countries in each region. Regional averages are GDP-weighted.

Underneath these broad trends, there is considerable heterogeneity in regional growth outlooks (Figure 1.16). In the East Asia and Pacific region, a gradual slowdown is underway. In Europe and Central Asia, weakness in the eastern part, mainly due to developments in Ukraine and spillovers from Russia, is offsetting improvements in the western part resulting from recovery in the Euro Area. In Latin America and the Caribbean, persistently weak commodity prices and domestic challenges will continue to weigh on regional growth. In the Middle East and North Africa, an international agreement expected to lift international sanctions on the Islamic Republic of Iran is pushing up regional growth. South Asia

will be a bright spot, reflecting improved conditions in India. And growth in Sub-Saharan Africa will continue to be negatively impacted by low commodity prices and infrastructure constraints, although low-income countries are expected to remain resilient.

- *East Asia and Pacific.* Growth is estimated to have slowed to 6.4 percent in 2015, and is expected to decelerate to 6.3 on average in 2016-18, reflecting the gradual slowdown in China and a sluggish recovery in the rest of the region. Growth is expected to rise modestly in Indonesia and Malaysia in 2016-18, as political tensions subside in Malaysia, and reforms are implemented to spur investment growth in Indonesia. In Thailand, growth is expected to remain weak, at 2-2.7 percent in 2016-18, as political uncertainty continues to weigh on private investment, and high household debt constrains private consumption. Among the large developing ASEAN economies, growth in the Philippines and Vietnam will benefit from rising household incomes caused by low commodity prices, a diversified and competitive export base (Vietnam), and investment driven by robust FDI flows. Risks to the outlook remain tilted to the downside, stemming from a larger-than-expected slowdown in China and tightening global financing conditions.

- *Europe and Central Asia.* Growth is estimated to have dipped to 2.1 percent in 2015—the slowest rate since 2009. This reflects the combination of an unexpectedly sharp output contraction in Ukraine, slowdown in all major energy-exporting economies of the region, and negative regional spillovers from Russia. Growth in Ukraine may start rebounding, helped by easing tensions and the IMF-supported stabilization program. Economic activity in Turkey will benefit from low fuel prices, but will face headwinds from tepid export demand (including negative effects from Russian sanctions) and tighter external financing conditions. Regional growth is projected to strengthen to an average of 3.0 percent in 2016 and 3.5 percent in 2017-18, helped in part by the ongoing Euro Area

recovery, though there are several downside risks to the outlook, including possible escalation of geopolitical tensions and continued recession in Russia and Ukraine.

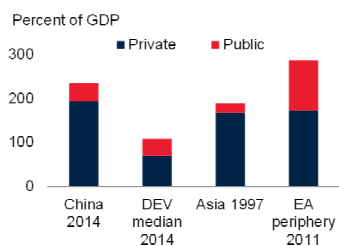
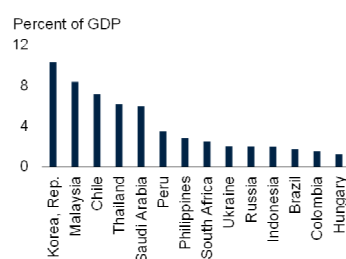
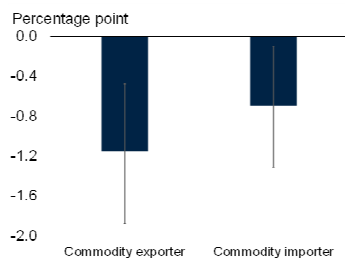
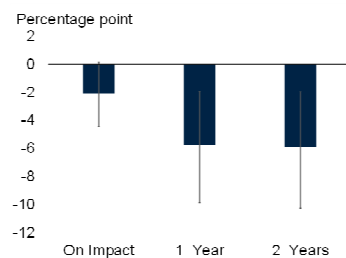
- Latin America and the Caribbean.* After three years of slowing growth, activity in the broader region is estimated to have contracted by 0.9 percent in 2015, as it grappled with the protracted decline of commodity prices and domestic challenges weighing on the region's largest economies. Declining demand and wage rigidities have led to deteriorating labor market conditions and rising unemployment (World Bank 2015f). However, there are substantial differences among the sub-regions. Bearing the brunt of the slump in commodity prices, along with domestic headwinds, developing South America's output is estimated to have declined 2.1 percent in 2015, including a contraction of 3.7 percent in Brazil. In contrast, estimated growth rates for developing Central and North America and the Caribbean were significantly more favorable, at 2.7 and 3.3 percent, respectively. For the region as a whole, stagnation is still predicted in 2016, followed by a modest recovery of about 2.2 percent in 2017-18, as commodity prices stabilize and some of the policy challenges in large economies subside. The current recession in Brazil is expected to extend into 2016 reflecting tight macroeconomic policy and, particularly, a loss of consumer and investor confidence partly due to political uncertainty. Although weighed down by low oil prices and associated fiscal pressures, growth is expected to pick up in Colombia and Mexico thanks to robust demand from the U.S. market, dividends from implementation of structural reforms (Mexico), and a peace agreement with insurgents (Colombia).
- Middle East and North Africa.* Growth is estimated at 2.5 percent in 2015, unchanged from 2014. Among oil exporters, growth mostly slowed or was negative in 2015. The one exception was Iraq, where oil production has risen despite security problems. Oil

exporters are grappling with the economic consequences of low oil prices; most oil importers are seeing benefits. Despite low oil prices, growth in the region will accelerate to above 5 percent in 2016-18. The improvement is predicated on a strong recovery in the Islamic Republic of Iran, the region's largest developing economy. The international agreement to suspend or remove sanctions on international trade and financial transactions, beginning in 2016, is an important supporting factor for the Iranian economy (Devarajan and Mottaghi 2015). The agreement stands to have positive spillover effects for oil-importing neighboring countries, but might have negative effects on developing oil exporters in the region if additional oil production and exports put downward pressure on international oil prices (Ianchovichina, Devarajan, and Lakatos forthcoming). Risks to the regional outlook are tilted to the downside and arise from both low oil prices and protracted domestic security challenges.

- South Asia.* Growth is projected to accelerate to 7.5 percent in 2016-18, from 7.0 percent in 2015—the fastest pace among all developing regions. Falling oil prices have improved investor and consumer confidence, and domestic policy reforms in India and Pakistan have reduced vulnerabilities. Domestic risks include a stalling of the reform process and political tensions in some countries. High levels of problem loans on bank balance sheets remain a challenge to financial stability and to the supply of credit for productive investment (World Bank 2015g). External risks stem from potential volatility amid tightening global financial conditions and weak remittances from Gulf Cooperation Council (GCC) countries.
- Sub-Saharan Africa.* Growth slowed to an estimated 3.4 percent in 2015, the lowest rate since 2009, due to low commodity prices and infrastructure constraints. A rebound is expected in 2016-18, as these headwinds wane, providing some support for government spending and private investment. A modest

FIGURE 1.17 Slowdown in China

Downside risks to Chinese growth have risen, debt levels are elevated and continued to increase despite decelerating credit growth. Total debt as a percent of GDP is now significantly larger than in most other emerging and developing economies. However, ample policy buffers, large international reserves and current account surpluses limit the risk of sharp adjustment. Should the slowdown be more abrupt than currently predicted, other emerging and developing economies and, in particular, commodity exporters would be most affected.

A. Private and public debt**B. Exports to China****C. Impact of a 1 percentage point decline in China's growth on growth in other emerging economies****D. Impact of a 1 percentage point decline in China's growth on commodity prices**

Sources: Haver Analytics; IMF Direction of Trade Statistics (DOTS); Bank for International Settlements; World Bank.

A. "DEV median" refers to the median value across developing countries in 2014. EA is Euro Area. C. D. Cumulated impulse responses for different horizons due to a one-off (but persistent) unexpected 1 percentage-point decline in Chinese growth. Commodity exporters are defined as those countries for which commodity exports exceed 30 percent of total exports during the estimation period, 1998-2014. Confidence bands span the 16th-84th percentiles.

D. Cumulated impulse responses of trade-weighted commodity prices at different horizons due to a 1 percentage point decline in China growth. Confidence bands span the 16th-84th percentiles.

recovery is projected in Nigeria and South Africa, the region's two largest economies. For Nigeria, the forecast assumes that uncertainty around government policy is lessened; that fuel and power shortages become less severe; that fiscal consolidation tapers off; and that import costs decline. In South Africa, labor and social tensions, high unemployment, and constraints associated with electricity supply will continue to weigh on activity. However, low-income countries may register relatively high growth, supported by large-scale infrastructure investment and resilient consumer spending. Overall, growth in the region is projected to accelerate to 4.2 percent in 2016, strengthening further to 4.7 percent

in 2017-18. Overvalued currencies and larger fiscal and current account deficits over the period 2011-14 have eroded policy buffers, thus limiting policy options should shocks arise (World Bank 2015h).

Risks to the outlook

Downside risks dominate and have become increasingly centered on emerging and developing countries, as a gradual recovery in major high-income countries takes hold. A slowdown in China, and widespread weakness across other BRICS, could have substantial spillovers on other emerging and developing economies. Financial market turbulence—triggered, for instance, by spikes in borrowing costs during the U.S. tightening cycle or by rising risk aversion—could significantly impact capital flows to the more vulnerable emerging and developing economies and intensify balance-sheet vulnerabilities. Commodity exporters and countries with large imbalances and policy uncertainty are particularly exposed to these risks. While past experience suggests that isolated terrorism-related events amid heightened global geopolitical risks do not appear to have lasting economic consequences, escalation could have uncertain regional and global repercussions. As yet, unrealized gains from declining oil prices for importers pose an upside risk.

Global growth prospects have become more uncertain, and risks are more skewed to the downside, than in the June 2015 forecasts. Rising uncertainty is evidenced by heightened volatility in global financial markets and a greater dispersion of private sector forecasts for global growth, interest rates, and inflation. While the balance of risks to global growth remains tilted to the downside, the likelihood of a global recession in 2016 appears to be low, as world GDP per capita (measured in 2010 US\$) was still growing by an estimated 1.5 percent in 2015.⁶ The downside

⁶A global recession corresponds to a contraction in world real output per capita accompanied by a broad, simultaneous decline in various other measures of global economic activity, including industrial production, trade, capital flows, employment, and energy consumption. This has happened four times over the past half century: in 1975, 1982, 1991, and 2009. The world economy also experienced two periods—in 1998 and 2001—when growth slowed significantly without tipping into an outright recession (Kose and Terroses 2015).

risks do though have the potential to exert a significant drag on global growth.

Slowdown in China

Although the growth slowdown in China continues to be gradual, downside risks to growth may have increased. Baseline growth forecasts are predicated on the assumption that reforms will continue, and that the authorities will maintain sufficient buffers to ensure an orderly rebalancing.

Domestically, the main short-term risk is the unwinding of high leverage in sectors with excess capacity. This may cause a sharper-than-expected slowdown in investment, especially in residential estate, and hence in aggregate demand (Figure 1.17). Debt levels are high and continue to rise despite decelerating credit growth. Total (public and private) debt relative to GDP is larger than in most other developing countries, and is also above levels observed in economies affected by the Asian crisis in 1997. However, public debt is estimated at less than 40 percent of GDP—or 60 percent if off-budget liabilities are included—and is predominantly held domestically. This provides the government with the fiscal space to deploy stimulus in the event of a sharper-than-expected slowdown (IMF 2015c).

Capital controls on portfolio investment and bank lending, as well as a largely state-owned financial system, limit the risk of financial instability and disorderly capital outflows. If reduced confidence in the financial system leads to attempts to convert local currency deposits into foreign currency, the resulting spike in demand for foreign currency could be met, for instance, with the ample central bank international reserves, estimated at over \$3 trillion.

Over the last decade, China has become a major driver of demand for developing-country exports and a key source of investment and, most recently, finance (Eichengreen, Park, and Shin 2012). Trade linkages with China are significant for the East Asia region, and for commodity exporters globally; hence, the transmission of any growth fluctuation through trade should be larger for those countries. This effect would be amplified

through the impact on international commodity prices. Countries with impaired macroeconomic policy buffers could be particularly affected. Financial stress in one or several commodity exporters could outweigh potential real income gains for importers in the short term, hence adding downward pressure on global growth.

Widespread weakness across the BRICS

A growth slowdown in BRICS could have global repercussions, dampening growth across emerging and developing economies. A 1 percentage point growth slowdown in the BRICS as a whole could result in a 0.8 percentage point decline in growth in other emerging market countries over a span of two years (Figure 1.18, Chapter 3). Growth shocks in Russia would reverberate across the ECA region, reducing ECA growth almost one-for-one. In contrast, the international spillovers from growth shocks in Brazil, India, and South Africa are not likely to be widespread. In the event of acute stress in any of the BRICS, confidence in emerging market assets more broadly could suffer from contagion effects, in which case spillovers could be considerably larger.

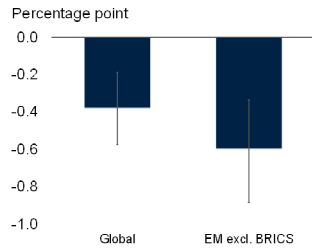
Such spillovers would transmit through a number of channels (Chapters 2 and 3). China is deeply integrated into supply chains in East Asia and the Pacific, and constitutes a large export market for commodity-exporting countries in Sub-Saharan Africa and Latin America. Brazil trades significantly with neighboring Latin American countries, partly as a result of regional free trade agreements. Remittances from Russia account for more than 10 percent of GDP in several countries in the Caucasus and Central Asia (Armenia, Kyrgyz Republic, Tajikistan). India is an important source of foreign direct investment and official development assistance for neighboring countries (Bhutan, Nepal).⁷

⁷Spillover risks also emanate from large advanced and emerging markets other than BRICS. For example, commodity-exporting countries are an important export market for several commodity-importing countries, accounting for 25 percent or more of exports from the latter group (Hungary, Korea, Poland, Thailand, Turkey).

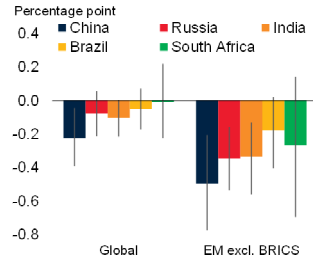
FIGURE 1.18 Spillovers from slowing growth in BRICS

Spillovers from the slowdown in BRICS are primarily impacting other emerging and developing economies. This reflects strengthening trade, financial, and commodity market linkages. China constitutes a significant export destination for commodity-exporting countries, which in turn are important export markets for many commodity importers. The Russian Federation has particularly tight interconnections with neighboring economies through trade and remittance flows.

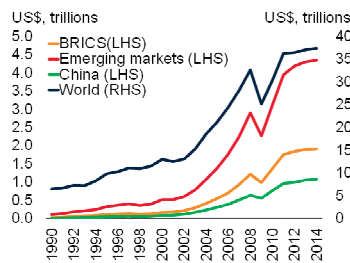
A. Impact of a 1 percentage point decline in BRICS growth on global and EM growth



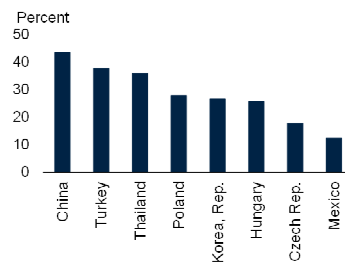
B. Impact of a 1 percentage point decline in each of the BRICS on global and EM growth



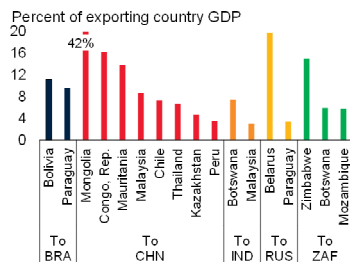
C. Value of exports from emerging markets



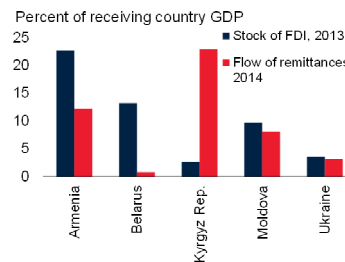
D. Share of goods exports from commodity-importing EMs to commodity exporters, 2014



E. Countries with largest share of exports to BRICS, 2014



F. FDI and remittances from Russia to neighboring developing countries



Sources: World Bank; United Nations Comtrade; IMF Direction of Trade Statistics (DOTS), IMF Coordinated Direct Investment Survey (CDIS).

A. B. Cumulated impulse responses at the two year horizon due to a 1 percentage point decline in growth in each of the BRICS economies. "EM" is emerging markets excluding BRICS. "Global" is GDP weighted average of BRICS, EM, and G7. Confidence bands span the 16th-84th percentiles. E. BRA, CHN, IND, RUS and ZAF are respectively Brazil, China, India, Russia and South Africa.

Financial market turbulence

Amid lingering developing-country vulnerabilities, the risk of financial turbulence in some emerging and developing economies has increased. This risk is exacerbated by an expected tightening in global borrowing costs and financial conditions, the potential for further U.S. dollar appreciation, the possibility of heightened risk aversion, and worsening creditworthiness in emerging and developing economies.

U.S. monetary policy tightening. Tighter U.S. monetary policy may affect the outlook for global borrowing costs. The adjustment may be smooth, as rising U.S. policy rates have long been anticipated by markets in the context of a robust recovery in the United States. At the same time, other major central banks will continue their very accommodative policies, likely dampening the global impact of higher U.S. interest rates. However, this baseline of a modest and smooth U.S. tightening is subject to substantial risks (Figure 1.19). First, the U.S. term premium is unusually low and well below its historical average, and could rebound abruptly. Second, market expectations of future policy rates remain well below those of Fed policymakers following a first hike in December, 2015. A sudden closing in this gap could be disruptive. Third, fragile market liquidity conditions, even in deep sovereign bond markets, could amplify the impact of the initial shock and facilitate its propagation to other market segments. This context increases the risks of spikes in U.S. long-term yields and of financial market and exchange rate volatility.

U.S. dollar strength, currency exposures, and corporate debt. A further appreciation of the U.S. dollar could add pressure on emerging and developing country currencies. This could contribute to a rising cost of debt refinancing and expose vulnerabilities in domestic corporate and banking sectors. Considering the negative correlation between commodity prices and the dollar, this effect could be reinforced by a negative income effect for some exporters (Druck, Magud, and Mariscal 2015). In the past, periods of rapid dollar appreciations were sometimes associated with a greater incidence of financial crisis in

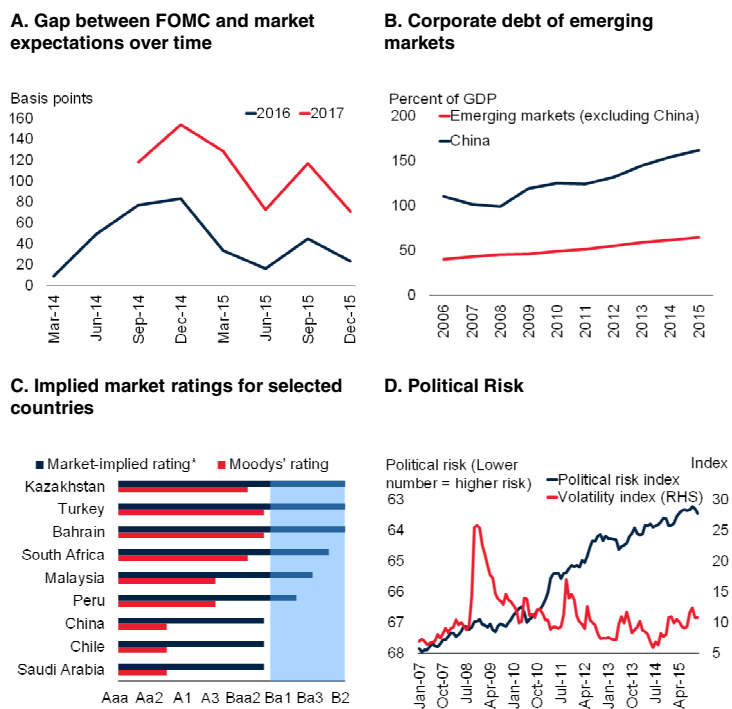
emerging markets, such as during the first half of 1980s in Latin America and second half of the 1990s in Asia. In the latter episode, countries with currencies tightly connected to the dollar experienced a greater proportion of sudden stops and sharper economic downturns (IMF 2015b). High and rising levels of private indebtedness increase the risk of corporate defaults. Banking sectors generally remain well capitalized, but corporate debt represents a significant share of their assets, despite rising intermediation through bond markets in recent years. Widespread corporate distress could impair capital and reduce collateral values, constraining the supply of bank finance for the rest of the economy.

Risk aversion and contagion effects. An abrupt increase in risk aversion—triggered, for instance, by a sudden increase in global interest rates, by heightened concerns about debt in key developing countries, by a credit event in a major emerging market, or by rising geopolitical tensions—could lead to contagion affecting other economies, even if they have limited vulnerabilities. In particular, further credit downgrades in large emerging market economies could cause a general reappraisal of risk. Market-implied ratings, based on credit default swap prices, indicate heightened investor concerns about exposures to weak commodity prices, soft growth, and political risks. In a financial stress situation, pro-cyclical behavior of asset managers could amplify asset price movements and contagion effects.

Capital flow reversals and the cost of sudden stops. The materialization of the aforementioned risks could have significant effects on borrowing conditions and have a sizable adverse impact on developing-country capital flows (Arteta et al. 2015). A 50 basis point (two standard deviations) jump in global long-term interest rates could temporarily reduce aggregate capital flows to developing countries by 0.9 percentage points of their combined GDP, with the effect peaking after one year (Figure 1.20). Analogously, a 10 point (two standard deviations) shock in the VIX index of implied stock-market volatility (a proxy for risk aversion) could reduce aggregate developing-country capital flows on impact by up to 2.2 percent of GDP, with the effect dissipating

FIGURE 1.19 Rising borrowing costs and balance sheet pressures

The U.S. tightening cycle is expected to have a benign impact, but there are risks of sudden adjustments in long-term yields and a further strengthening of the U.S. dollar. High levels of private indebtedness could increase the risk of corporate defaults, while further credit downgrades and rising political uncertainty could lead to a broad-based repricing of risk.



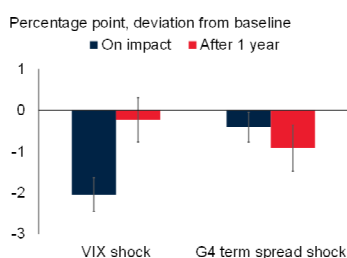
Source: World Bank; U.S. Federal Open Market Committee; Bloomberg; International Country Risk Guide (ICRG); World Bank; Escolano, Kolerus, and Nguouana (2014).
 B. GDP-weighted average. List of emerging markets includes China, Czech Republic, Hungary, India, Indonesia, Mexico, Poland, South Africa, Thailand, and Turkey.
 C. Latest observation December, 2015.
 D. Unweighted averages of Political Risk Rating for emerging markets according to the International Country Risk Guide. A higher Political Risk Rating indicates lower political risk. Political Risk Ratings are a weighted average of ratings of government stability, socioeconomic conditions, investment profile, corruption, the role of the military in politics, law and order, external and internal conflict, religious and ethnic tensions, democratic accountability, and bureaucratic quality. Volatility index is calculated by JPMorgan and tracks implied volatility from 13 emerging-market currencies against the U.S. dollar. Latest observation is November, 2015.

rapidly. Financial stress associated with these events could combine with domestic fragilities and increase the risks of multiple sudden stops across more vulnerable developing countries. The short-run costs of these events could be substantial. In the two years following a sudden stop, developing countries could experience an average decline in GDP of almost 7 percentage points, a drop in investment of more than 21 percentage points, and currency depreciation vis-à-vis the U.S. dollar of about 14 percentage points more than before the event.

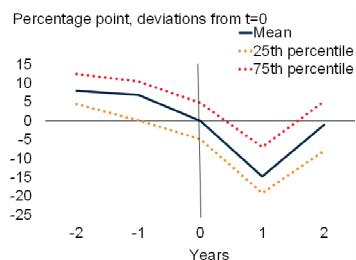
FIGURE 1.20 Deteriorating capital flows and sudden stops

Rising borrowing costs and risk aversion could lead to an abrupt decline in developing-country capital flows. Financial stress could combine with domestic fragilities, increasing the risks of damaging sudden stops in more vulnerable developing countries. The short-run costs of sudden stops in terms of lost activity and investment can be substantial.

A. Impact of U.S. interest rate and volatility shock on capital flows to developing and emerging markets



C. Sudden stops and investment growth in developing and emerging markets



Sources: World Bank; Arteta et al. (2015).

A. VIX and G4 (Euro Area, Japan, the United Kingdom, and the United States) term spread shocks are two-standard deviation shocks, amounting respectively to a 10 index-point increase in VIX and 45 basis-point increase G4 term spreads. Impulse response are derived from VAR model linking capital inflows to emerging and frontier markets to quarterly real GDP growth in emerging and frontier markets as well as G4 countries, real G4 short-term interest rates (three-month money market rates minus annual inflation measured as changes in GDP deflator), G4 term spread (10-year government bond yields minus three month money market rates), and the VIX index of implied volatility of S&P 500 options. Confidence bands span the 16th-84th percentiles.

B. Blue line denotes averages for EFEs that experienced systemic sudden stops. Grey shades denote 75th and 25th percentiles. A systemic sudden stop is a period when capital flows fall one standard deviation below their historical mean and, at the same time, the VIX index surpasses by one standard deviation its historical mean. The calculations include 21 nonconsecutive systemic sudden stop episodes for 58 EFEs in 1995-2014.

Combined risk of BRICS weakness and financial stress

The spillover effects from a synchronous BRICS slowdown could be much more pronounced if it is combined with a tightening of risk spreads that could result from developing-country financial stress. The BRICS slowdown scenario discussed earlier, when combined with tightening financial conditions—for instance, the EMBI spread increasing by 100 basis points from the current level in 2015—could cut growth in emerging and frontier markets by about 1.3-1.5 percentage points in 2015 (Figure 1.21). The effects of such a financial market turbulence would be more muted on the advanced economies. Global growth would decline about 0.9-1.2 percentage point in 2015 from the baseline forecast. Financial tightening would reduce growth particularly sharply in frontier markets, with their less liquid, more volatile, and fragile financial markets.

Weak commodity prices and other risks for low-income countries

Although all commodity prices have declined sharply from their 2011 peaks, they are still higher in real terms than their 1985 to 2004 average. While geopolitical risks and adverse weather conditions could lead to a more rapid recovery in commodity prices than currently predicted, most of the risks are on the downside. Since nearly two-thirds of current LICs are commodity exporters, the fall in commodity prices in recent years has dealt a major terms of trade shock and led to a substantial widening of fiscal and current account deficits. Further weakness in global commodity prices could result in even sharper fiscal and currency adjustments. It could also lead to delays in investments in energy and mining, particularly in East African countries. Fiscal risks are elevated in several countries in East Africa, relating to sharp increases in public debt due to large infrastructure projects, public-private partnerships, contingent liabilities, and devolution processes (Mauro et al. 2015). Other risks involve political tensions and security issues (Afghanistan, Burkina Faso, Burundi, Chad, Nepal, Niger), upcoming elections (Benin), and labor disputes (Niger, Sierra Leone).

Slower potential output growth

Slowing actual and potential growth amid lingering vulnerabilities has left developing countries more susceptible to external and domestic shocks. Potential growth in developing countries has declined steadily since the global financial crisis, mainly reflecting the trend slowdown in total factor productivity growth (Figure 1.22). The slowdown in potential output and productivity growth reflects slowing efficiency gains as well as demographic trends, which have passed a turning point since the global crisis with potentially profound implications (World Bank 2015b). Looking ahead, falling fertility rates and rising life expectancy will intensify these trends in countries with ageing populations, which may put additional pressures on productivity growth and, more broadly, on GDP growth. In particular, by 2025, outright declines in working age populations are expected in Europe and Central

Asia—partly as a result of emigration—and in East Asia and the Pacific. South Asia and Sub-Saharan Africa are exceptions, since still-high population growth will lead to an increase in the share of the working-age population. Although these trends should support stronger growth in pre- and early-dividend regions, these also face the highest poverty rates. Without improvements in poverty headcount rates, these regions could experience even greater concentrations of global poverty in the future.

Terrorism and geopolitical tensions

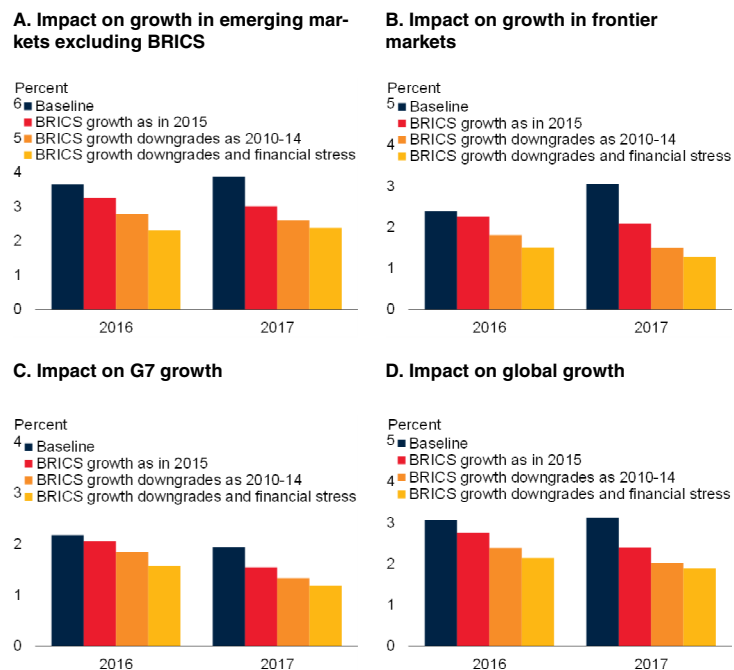
Recent terrorism-related violence in France and elsewhere has raised security concerns and highlighted rising geopolitical risks. Experience from past terrorist attacks in major economies suggests that isolated events are unlikely to have lasting economic consequences. Direct costs and the fiscal impact of security and emergency measures were generally limited, while effects on confidence and activity were generally short-lived. Even in the case of the September 11, 2001 attacks in the United States, financial markets and business confidence recovered within a few months (Figure 1.23).⁸ Other terrorist attacks in Europe, such as the Madrid and London bombings in 2004 and 2005, had similarly small effects on their respective economies and no perceptible global impacts (Kollias et al. 2011). The negative effect of terrorism on economic activity is generally estimated to be considerably smaller and less persistent than that related to external wars or internal conflict (Blomberg, Hess, and Orphanides 2004). It is also viewed as less pronounced in high income countries, with negative short-term effects offset by rising government spending.

However, repeated threats or escalating geopolitical risks could potentially have more significant adverse effects. These include a more protracted impact on consumer and investor confidence, disruption to travel and tourism, heightened risk aversion, and higher transaction and insurance costs (IMF 2001, Johnston and

⁸The overall cost of the September 11 attacks for the U.S. economy has been estimated at less than ½ percentage point of GDP (Roberts 2009).

FIGURE 1.21 Growth slowdown in BRICS combined with financial stress

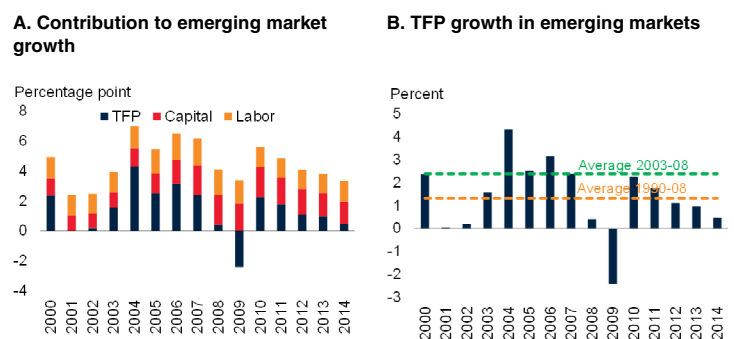
A combination of continued weak BRICS growth and rising emerging market bond spreads could considerably reduce growth in other emerging and developing countries.



Source: World Bank staff estimates. Note: EMBI = Emerging Markets Bond Index. Conditional forecasts of emerging markets excluding BRICS, frontier markets, G7, and global growth, with conditions imposed on future BRICS growth and EMBI. The conditions are: (i) BRICS growing at the current rate in 2015; BRICS continue to grow at its current 2015 level (annualized rate of 3.2 percent) during the forecast horizon; (ii) BRICS growth with forecast downgrades as during 2010-14: BRICS continue to grow during the forecast horizon at its current 2015 level minus the average forecast downgrades it saw during 2010-14. The forecast downgrades are based on the World Bank forecasts. In these two scenarios, EMBI is restricted to equal the unconditional forecasts from the aggregate VAR model during the forecast horizon; (iii) BRICS growth with forecast downgrades and financial stress: The second scenario is combined with EMBI rising by 100bp during the forecast horizon. Global growth is the GDP-weighted average of BRICS, emerging markets excl. BRICS, frontier markets, and G7 growth. The baseline forecasts are constructed from the forecasts presented in Chapter 1 by aggregating across countries in a given group. Conditional forecasts are based on the aggregate VAR model.

FIGURE 1.22 Weakening potential growth

Potential growth in emerging and developing countries has declined steadily since the global financial crisis, mainly because of the trend slowdown in total factor productivity (TFP) growth.

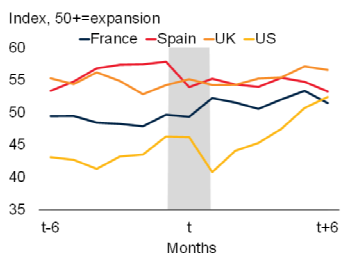


Source: World Bank. A. Unweighted averages of key emerging and developing countries. GDP is decomposed into total factor productivity (TFP) and factors of production using a Cobb-Douglas production function. Labor is proxied by employment, and the capital stock derived using the perpetual inventory method (assuming a labor share of national income of 0.7). Total factor productivity is derived as the residual.

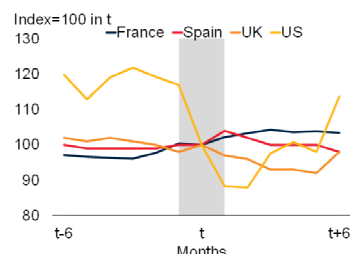
FIGURE 1.23 Terrorism and geopolitical tensions

Terrorist attacks in the United States in 2001, Spain in 2004, the United Kingdom in 2005 and France in January 2015 did not lead to lasting effects on confidence and activity. Recurring terrorist-induced violence has been highly concentrated in a small number of developing countries, with significant regional implications.

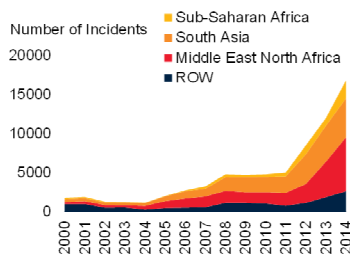
A. Purchasing Managers Index around significant terrorist attacks in major high-income countries



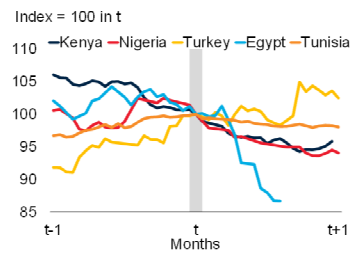
B. Consumer confidence around significant terrorist attacks in major high-income countries



C. Number of terrorist attacks across regions



D. Stock markets around major terrorist attacks in developing countries in 2015



Source: World Bank; Global Terrorism Database; Haver Analytics.

A. Date of significant attacks incorporated are: France (1/7/2015), UK (7/7/2005), Spain (3/11/2004) and United States (9/11/2001). Confidence measures are composite PMI indexes for France, Spain and the United Kingdom, and manufacturing ISM for the United States.

B. Data was originally collected by Pinkerton Global Intelligence Service (PGIS), Center for Terrorism and Intelligence Studies (CETIS), and Institute for the Study of Violent Groups (ISVG). Original GTD1 (1970-1997) employed the definition of terrorism utilized by PGIS, and based on the original GTD1 definition, each incident included in the GTD2 (1998-2007) had to be an intentional act of violence or threat of violence by a non-state actor. In addition, two of the following three criteria also had to be met for inclusion in GTD2:

1. The violent act was aimed at attaining a political, economic, religious, or social goal;
2. The violent act included evidence of an intention to coerce, intimidate, or convey some other message to a larger audience (or audiences) other than the immediate victims; and
3. The violent act was outside the precepts of International Humanitarian Law.

C. Date of significant attacks incorporated are: Kenya (4/1/2015), Nigeria (1/3/2015, 7/1/2015, 9/20/2015), Turkey (10/10/2015) and Egypt (10/31/2015).

Nedelescu 2005). In developing countries, the rising number of terrorist incidents and related conflict have already inflicted significant economic, social and humanitarian costs for the affected countries. In 2014 alone, roughly 80 percent of the people killed in terrorist activities were in just five countries (Afghanistan, Iraq, Nigeria, Pakistan, and Syria), with significant cross-border repercussions.⁹ The global cost of

⁹Since 1989, 88 percent of all terrorist attacks occurred in countries experiencing or involved in violent conflict (START 2015).

terrorist attacks in 2014 was estimated at US\$ 52 billion, a 10-fold increase from 2000 (Institute for Economics and Peace 2015).

A flaring up of geopolitical risks in the Middle East remains a significant risk, as tensions have increased and non-conflict countries have been affected by terrorist activity in 2015 (including Egypt, Tunisia and Turkey).¹⁰ Security concerns also remain prominent in some Sub-Saharan countries (Cameroon, Chad, Kenya, Mali, Niger, Nigeria) as well as in South Asia, with Afghanistan beset by domestic security and insurgency challenges. Taken together, a significant rise in geopolitical risks could potentially affect regional prospects and might, in a scenario of escalating tensions, disrupt an already fragile global recovery.

Upside risk: Unrealized gains from the oil supply shock

The expected positive effect of falling oil prices on large oil importers and hence on global activity has been surprisingly muted. The increase in retail trade and private consumption across major high-income countries has fallen short of the real income gains conferred by lower energy prices since mid-2014 (Figure 1.24). There are several reasons for the muted response. First, the speed of the decline in oil prices has put severe strains on both private and public sector balance sheets among major oil exporters, with significant cross-border spillovers for regional trading partners. Second, oil importers are reacting with caution. High indebtedness, limited room for additional monetary policy accommodation, and slowing long-term growth prospects have encouraged debt reduction and precautionary savings, rather than consumption and investment. Empirically, there is evidence that increased oil price volatility may have a depressing effect, particularly on consumer durables and investment outlays (Kilian 2011; Plante and Traum 2012; Guo and Kliesen 2005; Elder and Serletis 2010; Kilian 2014). Should this uncertainty decline, the positive effects in

¹⁰Global repercussions could include a further intensification of migration flows and rising volatility on international oil markets. In the medium and long term, the negative economic impacts in the region, along with already weak indicators of living conditions, may contribute to further violence.

importing economies represent an upside risk to baseline forecasts. Stable lower oil prices could eventually release pent-up demand. Such delayed reaction to lower oil prices was observed in the 1980s and 1990s, especially in the United States, where consumption initially slowed as consumers were unsure whether lower prices would persist (IMF 2015d). As prices stabilized at lower levels, savings dropped and spending accelerated.

Policy challenges

Challenges in major economies

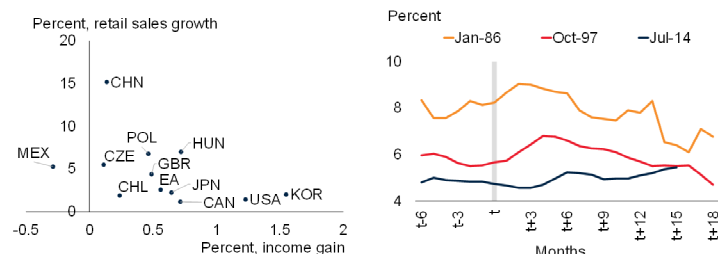
In major high-income countries, monetary policy is expected to tighten very gradually in the United States, and to remain highly accommodative elsewhere. Fiscal consolidation is also expected to ease, but most major economies have yet to put in place plans for medium-term fiscal sustainability. China faces the policy challenge of supporting a gradual slowdown and rebalancing while limiting financial vulnerabilities. However, the authorities retain significant policy buffers, and the government is proceeding with its comprehensive reform agenda.

United States. U.S. labor market conditions have made significant headway over the last year, but there is still considerable uncertainty about the underlying strength of the economy, and the amount of remaining slack. This has led to a debate about where policy interest rates are heading over the medium term. According to U.S. Fed policy makers, short-term interest rates should stabilize around 3 percent over the long-run, reflecting a gradual increase in the natural rate of interest from current low levels (Figure 1.25). However, uncertainty around estimates of this natural rate could imply a more gradual increase in policy rates than suggested by simple policy rules (Hamilton et al. 2015). Conditions at present therefore warrant a very gradual normalization of policy rates, balancing the risk of raising too quickly and potentially derailing the recovery, against that of raising too slowly and seeing accelerated inflation. Very low interest rates carry the additional risk of potentially excessive risk taking amid a search for yield (IMF 2015d). Signs of rising credit risks are already present, with weakening underwriting standards and an

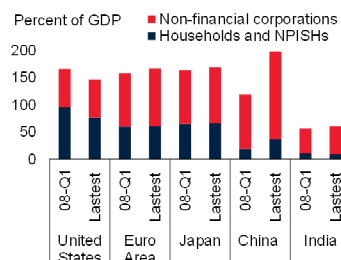
FIGURE 1.24 Unrealized gains due to low oil prices

Given the income boost from lower energy prices, the observed pickup in private consumption generally fell short of expectations across oil importing countries. Stronger domestic demand might yet emerge, representing an upside risks to projections. For instance, following the 1985-86 and 1997-98 oil price declines, the household saving rate in the United States initially increased but subsequently decline. Debt deleveraging pressures and policy uncertainty could limit the potential for lower household savings this time.

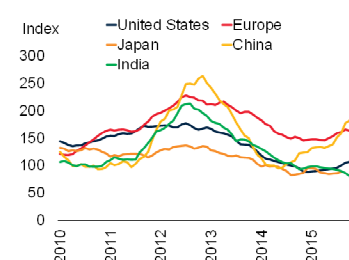
A. Income gain from lower energy prices and retail sales volume since June 2014 **B. U.S. personal savings rate around previous oil price declines**



C. Debt



D. Policy uncertainty



Sources: World Bank; Baker, Bloom and Davis (2015).
 A. Standard ISO country codes. Income gain measured as changes in the energy component of consumer prices times the weight of energy consumption in the CPI basket.
 B. Latest observation 2015 Q3.
 D. The Economic Policy Uncertainty Index is derived from the weighted average of newspaper coverage of policy-related economic uncertainty and, depending on the country, disagreement among forecasters. A higher value indicates more uncertainty about economic policy. Latest observation November, 2015.

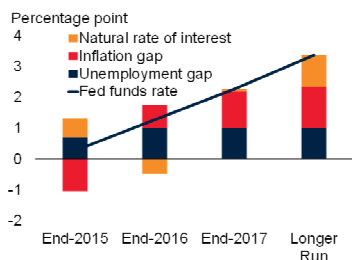
increasing volume of funds flowing to lower-rated U.S. companies (OCC 2015). The U.S. banking sector has strengthened its capital base since the crisis, but some risks have migrated to non-bank intermediaries which are subject to fewer regulatory and supervisory rules (FSOC 2015).

Fiscal deficits have been declining thanks to spending restrictions and stronger growth, but there is still a need for a comprehensive plan for long-term fiscal sustainability. This will require tax reform, and improved quality of public spending, including infrastructure investment (CBO 2015). Brinkmanship around budget negotiations,

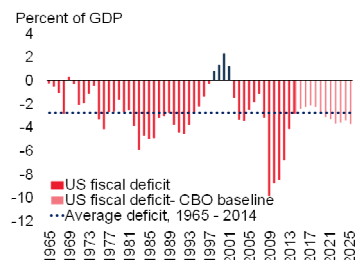
FIGURE 1.25 Policy challenges in the United States

According to U.S. Federal Reserve policy makers, short-term interest rates should stabilize slightly above 3 percent over the long-run, reflecting a gradual increase in the natural rate of interest from current low levels. U.S. fiscal deficits have been declining thanks to stronger growth, but there is still a need for a comprehensive plan to ensure fiscal sustainability over the medium-term.

A. United States: Contribution to policy interest rate projections



B. United States: Government deficit projections



Sources: World Bank; International Monetary Fund; U.S. Congressional Budget Office.

A. Using the Taylor rule described in Yellen (2015) and the central tendency of FOMC forecasts for unemployment and inflation, FOMC projections for the federal funds rate path can be decomposed into the expected contribution from future labor market improvements, rising inflation, and the natural rate of interest. More specifically, the Taylor Rule is defined as $R = RR^* + p + 0.5(p - 2) - (U - U^*)$, where R denotes the Taylor Rule federal funds rate, RR^* is the estimated value of the natural rate of interest, p is the current inflation rate (measured as PCE inflation), U is the unemployment rate, and U^* is the natural rate of unemployment (considered to be the long-run FOMC forecast for the unemployment rate).

B. Baseline assumes current laws do not change.

spending, and debt caps remain an important source of uncertainty, sporadically affecting investor confidence and global financial markets. Structural reforms to facilitate re-entry into the labor market and boost labor productivity are needed. Longer-term challenges include stagnating wages for lower-income families, and deteriorating public infrastructure (OECD 2015).

Euro Area. The ECB's asset purchase program has helped ease financial conditions in the Euro Area. It has reduced bond yields, weakened the euro, and improved the supply of credit (Georgiadis and Grab 2015). It has also mitigated the possible fallout from the Greek debt crisis (European Commission 2015b). Ongoing bank balance sheet repair, and high levels of non-performing loans, may nevertheless continue to constrain the supply of credit in parts of the Euro Area (Figure 1.26). Speeding up the resolution of distressed assets is needed to support bank lending. Further efforts to accelerate capital markets integration could help improve the allocation of credit and support private sector investment.

Reflecting a pickup in growth and low borrowing costs, the aggregate Euro Area fiscal deficit is expected to narrow to 2.0 percent of GDP in 2015. Fiscal policy appears to have been broadly neutral to growth in 2015, a trend that may continue in 2016, although several countries require additional consolidation measures (European Commission 2015b). Countries with available fiscal space could use it flexibly to support the recovery, generating positive cross-border spillovers, especially when cyclical conditions are weak (Auerbach and Gorodnichenko 2013), especially as monetary policy is constrained by the zero lower bound (Goujard 2013 and in't Veld 2013). Effective implementation of the European Investment Plan (catalyzing up to €315 billion in private investment through public funds and guarantees) could also help support growth in countries with limited fiscal space and more fragile banking sectors.

Efforts to implement structural reforms are moving forward, but greater emphasis is needed to address rigidities and fragmentations of labor, product, and services markets, which are hampering productivity, innovation, and growth. Reforms in core countries could generate significant cross-border spillovers, particularly in the area of innovation policies (Coe, Helpman, and Hoffmaister 2009). Peripheral economies have urgent needs for reform to deal with domestic structural issues (Varga, Roeger, and in't Veld 2014). In response to the unprecedented flow of refugees and migrants along the Eastern Mediterranean-Western Balkans, European policymakers have agreed on a series of short-term actions to rescue and support refugees, while coordinating border policies. Establishing equitable sharing of responsibility for resettlement of refugees and associated financial costs is key, along with upholding EU's law regarding the free movement of people, and addressing the root causes of displacement through development efforts.

Japan. Amid record-low interest rates, continued vigilance regarding financial stability risks is warranted, in particular through monitoring of balance sheets and the use of stress tests to assess

banks' resilience to lower market liquidity and higher volatility of asset prices, exchange rates, and interest rates.

Fiscal consolidation has been delayed, and public debt is expected to continue edging up (Figure 1.26). The structural reform agenda is making progress, with important new legislation passed or under consideration by parliament, including in the areas of energy, agriculture, and tax policies. Removing tax-induced disincentives to work, broadening the availability of child-care facilities, increasing the participation of older workers and relaxing immigration restrictions in sectors with labor shortages would help counteract demographic pressures (IMF 2015e). Further reforms to reduce labor market duality, improve corporate governance, deregulate agriculture and domestic services, and eliminate barriers to investment in Japan remain key policy priorities.

China. Progress continues to be made in several of the reform areas announced in late 2013.¹¹ According to the preliminary information following the fifth plenum, the 13th Five-Year Plan (FYP) indicative target for GDP growth is likely to be lowered to 6.5 percent (vs. 7 percent in the 12th FYP). By lowering growth targets, Chinese authorities are in a better position to address key short-term risks while promoting the reforms needed for sustained medium-term growth.¹² A key policy challenge is to achieve an orderly shift to a more sustainable economic path. The transition will encompass an expanding role for the market and a shift from excessive investment in real estate and manufacturing towards greater domestic consumption and services (Figure 1.27). Achieving this will require policies that facilitate the reallocation of resources

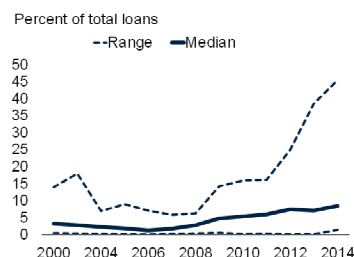
¹¹In particular, there has been progress in financial reforms (e.g., interest rate liberalization, deposit insurance), external sector reforms (e.g., steps toward capital account liberalization and exchange-rate flexibility), fiscal reforms (i.e., changes in fiscal framework of local government debt), and pension reform (e.g., unification of civil servants' pensions with the urban pension system).

¹²The new Five-Year Plan covers a broad range of reform areas to be implemented by 2020. It pledges to accelerate reforms to: (i) reduce government intervention in the pricing of goods and services; (ii) relax restrictions on foreign investment; (iii) adjust fiscal responsibilities between central and local governments; and (iv) reform state-owned enterprises as mixed ownership. It also relaxed the one-child policy.

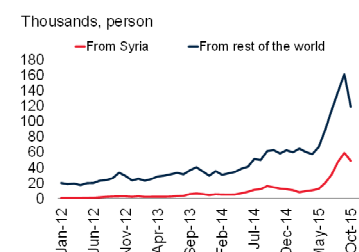
FIGURE 1.26 Policy challenges in Euro Area and Japan

Elevated levels of non-performing loans in the Euro Area continue to constrain the supply of credit. Faster resolution of distressed assets would help support bank lending. The recent acceleration of migrant flows to Europe creates absorption challenges in the short term, but could have benefits over time. In Japan, fiscal consolidation has been delayed and public debt is expected to edge further up. Relaxing immigration restrictions in sectors with labor shortages could help counteract demographic pressures.

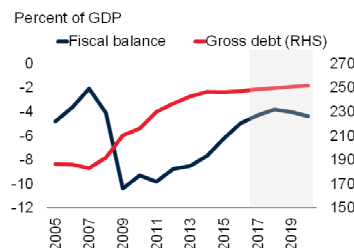
A. Euro Area: Non-performing loans across member states



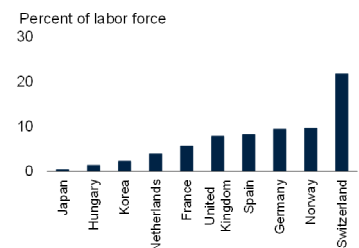
B. Euro Area: Migrant flows



C. Japan: Public deficit and debt projections



D. Share of migrants in the labor force

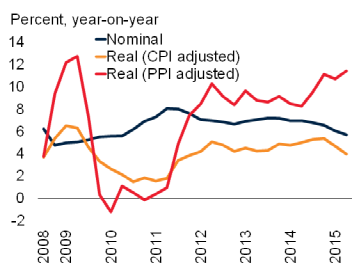
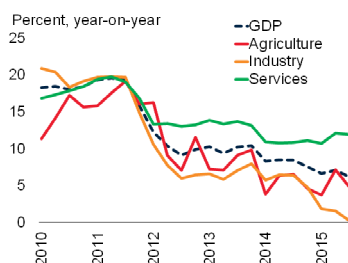


Sources: World Bank; European Central Bank; International Monetary Fund; Organization for Economic Co-operation and Development.
 A. Bank nonperforming loans to total gross loans are the value of nonperforming loans divided by the total value of the loan portfolio (including nonperforming loans before the deduction of specific loan-loss provisions). The loan amount recorded as nonperforming should be the gross value of the loan as recorded on the balance sheet, not just the amount that is overdue.
 B. Last observation is October, 2015.

from sectors that have accumulated excess capacity to those with higher growth potential. Examples of such policy steps include a gradual removal of implicit state guarantees for loans (e.g. through implementing an integrated budget law and unified fiscal accounting), and allowing the orderly exit of inefficient firms, including state-owned enterprises. In the short term, market discipline in the financial sector should be strengthened to mitigate risks associated with a concentration of leverage among slowing sectors (IMF 2015c). At the same time, ad hoc administrative measures should be gradually replaced by market-based mechanisms so that

FIGURE 1.27 Policy challenges in China

China's key policy priorities include calibrating stimulus measures, providing a greater role to market forces, and ensuring a smooth transition from manufacturing and real estate to services and consumption.

A. China: Lending rates**B. China: Nominal GDP growth by sector**

Sources: World Bank; International Monetary Fund; U.S. Congressional Budget Office.
A. Lending rates are the interest rates applied to private sector companies and households. Latest observation is September 2015.
B. Latest observation is 2015Q3.

credit is more efficiently allocated (World Bank 2015i). The recent inclusion of the renminbi in the Special Drawing Right (SDR) basket of the International Monetary Fund is an important milestone in the integration of the Chinese economy into the global financial system.

Structural reforms will help support growth. For instance, removing entry barriers and reducing regulatory and administrative burdens will enhance incentives for private investment. Likewise, implementation of fiscal reforms, such as consolidating the business tax with the VAT, will lower the tax burden and promote investment, particularly in the transportation and financial services sectors. Making more land available for commercial activities will also improve the prospects for service-sector investment and growth. Furthermore, efforts to gradually increase the retirement age could contribute to an increase in labor force participation. Reform efforts to accelerate unification of the urban-rural hukou system would also support more efficient labor markets. Removing barriers to a structural shift towards services could help moderate the trend decline in productivity growth, while an increase in the labor share of GDP is critical to rebalance growth on the demand side from investment to consumption.

Challenges in developing economies

In the short term, policy actions need to focus on building resilience against downside risks to growth. As noted above, these risks include a slowdown in major emerging and developing economies, financial sector turmoil amid tighter global borrowing conditions, and persistently low commodity prices. Where cyclical slowdowns are underway, and where there is sufficient policy space, countercyclical fiscal and monetary stimulus can be employed to support activity. Cyclical policies need to be reinforced with longer-term structural measures. These should focus on easing supply side constraints, and offsetting demographic headwinds in the relatively higher-income developing regions, where the working-age share of the population is shrinking. Global poverty will increasingly be concentrated in regions with the highest working-age population growth rates. Policy makers in such regions will face pronounced challenges to ensure productive employment for their expanding labor force.

Monetary and exchange rate policies

Monetary policies continue to diverge between oil-exporting and oil-importing countries. The deceleration of inflation in oil-importing countries has allowed some easing in monetary policy. In oil-exporting countries, depreciation pressures have increased inflation and financial stability risks. Several central banks have responded with foreign exchange market intervention (Azerbaijan, Kazakhstan, Mexico, Nigeria), and policy interest rate increases (Angola, Colombia, Kazakhstan) in the second half of 2015. Nevertheless, in several countries, policy rates may still be lower than required to meet inflation targets, particularly among commodity-exporting countries (Figure 1.28).¹³ In the event of a further slowdown in these countries, central banks may not be able to lower rates further without raising risks to financial stability or inflation.

¹³Such a relationship between monetary policy rates, cyclical conditions, and inflation targets is estimated in a Taylor rule (e.g., as estimated in Ostry, Ghosh, and Chamon 2012) for a sample of emerging markets. The calculation assumes that monetary policy is in practice geared towards meeting the announced inflation target, that the monetary policy rate is the main policy instrument, and that the coefficient estimates from a cross-country regression is an adequate representation of the country-specific relationships.

Greater exchange rate flexibility may help absorb shocks, while conserving foreign exchange reserves. However, this benefit has to be balanced against domestic financial stability and inflation risks, which may be significant in some countries. In Kazakhstan, the shift to a floating exchange rate regime over the past year has raised concerns about the balance sheet risks associated with large foreign currency exposures. In contrast, in Qatar, Saudi Arabia, and the United Arab Emirates, large fiscal and reserve buffers have allowed fiscal policy to be loosened and currency pegs to remain supported (IMF 2015a).

Financial globalization, and the rising influence of global interest rates in determining domestic financing conditions, will likely make domestic monetary policy objectives more difficult to achieve (Obstfeld 2015; Sobrun and Turner 2015). This places a premium on credible monetary policy that maintains price stability over the medium term, and institutional reforms that limit the risk of pro-cyclical policies associated with capital flows.

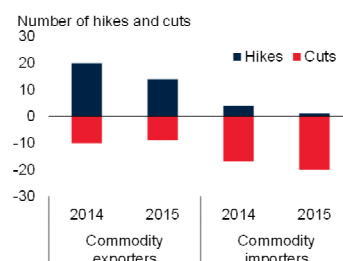
Policies concerning the joint choice of exchange-rate regimes and the use of capital controls are of key importance for emerging and developing economies. Developing countries with fixed exchange rates may choose to use capital controls to give monetary policy a degree of autonomy to achieve domestic macroeconomic objectives. Developing countries appear to be more likely to have controls on capital flows if they also have fixed exchange rates, and that the presence of this effect depends upon the level of income per capita (Chapter 4). In particular, lower-income countries appear to set their policy with respect to capital account measures with less independence relative to their exchange rate policies.¹⁴

¹⁴In principle, countries that choose to control both the exchange rate and the capital account may still exercise monetary policy autonomy to stabilize economic conditions (Cordella and Gupta 2015). This is only possible, however, if they have the necessary monetary policy space—which has generally been narrowing recently, amid inflation and foreign reserve pressures.

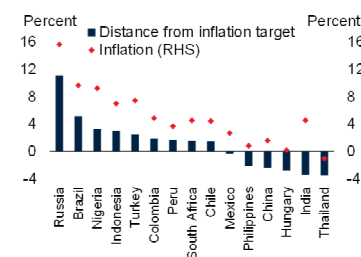
FIGURE 1.28 Monetary policy challenges in developing countries

Commodity-exporting countries have tightened monetary policy to ease currency depreciation pressures and contain inflation and financial stability risks. Inflation was still above targets in several commodity-exporting countries in the second half of 2015.

A. Central bank policy rates



B. Inflation versus inflation target, October 2015



Sources: World Bank; International Monetary Fund; Haver Analytics; Federal Reserve Board. A. Data includes 11 commodity exporters and 13 commodity importers. Hikes and cuts refer to central bank rate decisions, including base rate, policy rate, repo rate, Selic rate, discount rate, reference rate, lending rate, refinancing rate, and benchmark rate. Latest data as of December, 2015.

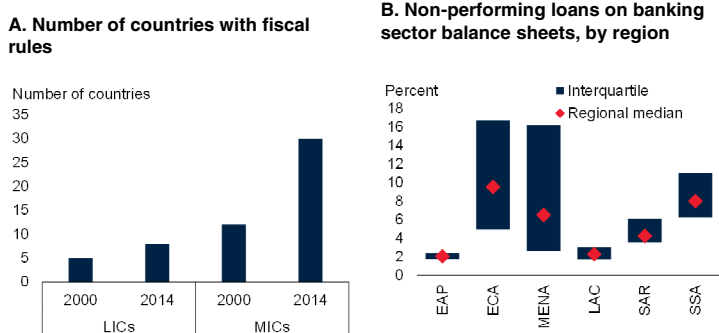
Financial sector policies

The pro-cyclicality of capital flows has been reflected in domestic credit conditions. Credit cycles have also turned in developing countries, and high stock levels, which are the result of past rapid expansions in credit, remain a source of concern where growth is slowing or economies are already in recession. This highlights the need to reinforce macro-prudential policies aimed at mitigating systemic risk and reducing the pro-cyclicality in domestic financial sectors (World Bank 2015b). Beyond the implementation of counter-cyclical capital buffers under Basel III requirements, macro-prudential frameworks can be strengthened through a range of instruments, including caps on loan-to-value or debt-to-income ratios, dynamic provisioning, and credible stress tests.

Banking sector vigilance and prudential monitoring also need to be stepped up where credit and solvency risks are high due to dollarized banking systems and currency depreciations (Central Asia and South Caucasus). In Europe and Central Asia and, to a lesser extent, the Middle East and North Africa, South Asia, and Sub-Saharan Africa, banking sectors are weighed down

FIGURE 1.29 Fiscal frameworks and financial stability

A growing number of developing countries have adopted fiscal rules but many still need to strengthen fiscal management, including of commodity revenues for exporting countries. Banking sectors have elevated nonperforming loans in ECA, MNA, and South Asia. This warrants close supervision and monitoring.



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

Note: A. Number of national and supranational fiscal rules in 89 LIC, MIC and HIC countries, covering four types: budget balance rules, debt rules, expenditure rules, and revenue rules, applying to the central or general government or the public sector.

B. Bank nonperforming loans to total gross loans are the value of nonperforming loans divided by the total value of the loan portfolio (including nonperforming loans before the deduction of specific loan-loss provisions). The loan amount recorded as nonperforming should be the gross value of the loan as recorded on the balance sheet, not just the amount that is overdue.

by high levels of non-performing loans, and rising concerns about asset quality and bank solvency (Figure 1.29). This necessitates measures to recapitalize banks and address problem loans and longer-term reforms to improve governance, particularly in countries with a high share of state-owned banks.

Fiscal policy

Like monetary policy, fiscal policies have diverged among oil-importing and oil-exporting countries (Figure 1.30). For oil importers, the fall in oil prices has been fortuitous. Coupled with domestic policy efforts, which include reducing energy subsidies, fiscal deficits have shrunk, especially in South Asia, East Asia and the Pacific, and Europe and Central Asia. In many countries (including Egypt and Lebanon) windfalls were typically saved to rebuild fiscal buffers. This fiscal consolidation amounted to about 0.5 percent of GDP, on average. In some countries, they were used to support investment spending (including India and Peru). Commodity exporters have seen a widening in fiscal deficits due to revenue losses from the resource sector.

Fiscal consolidation is expected to weigh increasingly on growth in commodity-exporting

countries. For commodity exporters in Sub-Saharan Africa, developing Middle East and North Africa, and (to a lesser extent) Latin America and the Caribbean, fiscal spending sustained by high commodity prices has been an important driver of growth in the non-tradable sector (IMF 2015g). With revenues under pressure, and relatively small non-oil sectors, major fiscal adjustments have begun in several countries (Angola, Ecuador, Iraq, Nigeria). However, there has been considerable heterogeneity, with some oil-exporters with ample reserves implementing fiscal stimulus to support growth (Kazakhstan, Peru). Breakeven oil prices are particularly high in several Middle East and North African countries (Libya, the Republic of Yemen), and non-oil fiscal deficits exceed 50 percent of non-oil GDP in some GCC countries. In Bolivia, Colombia, and Ecuador, fiscal revenues over 2015-19 are expected to fall well below peak levels of 2011-14 (IMF 2015).

Fiscal policy as a countercyclical tool becomes particularly important to address cyclical weakness when monetary policy is constrained by inflation, exchange rate movements, or financial stability risks. However, in order for fiscal policy to be implemented and be effective, economies need to have the necessary fiscal space to employ countercyclical measures (World Bank 2015a). Yet buffers have been significantly depleted since 2009, partly due to stimulus deployed during the Great Recession. Rebuilding fiscal space therefore remains a priority in order to expand buffers and reduce sovereign funding risks in case of an adverse shock. In addition, rebuilding buffers will enhance policy credibility and anchor investor confidence in major developing countries where external and domestic imbalances remain large.

Fiscal consolidation could also represent an opportunity for major public expenditure and revenue reforms, for instance through better targeted social welfare spending, subsidy reforms, and more productive public investment spending to alleviate supply side constraints. Governments need to look more closely at the composition and efficiency of public spending and address fiscal risks that may be emerging from the way public infrastructure investments are financed. Better

information on sources of fiscal risks from contingent liabilities (e.g., from subnational borrowings, special purpose financial vehicles, and public-private partnerships) and improved public debt management will be of critical importance. Although many commodity exporting developing countries have made progress in enhancing transparency in the extractive sector—11 are compliant with the Extractive Industries Transparency Initiative—only nine have fiscal rules or stabilization funds to act as buffers. Moreover, fiscal policy appears to have become more pro-cyclical in the years following the Great Recession, suggesting the need to further strengthen fiscal management of commodity revenues (World Bank 2015b).

Structural reforms

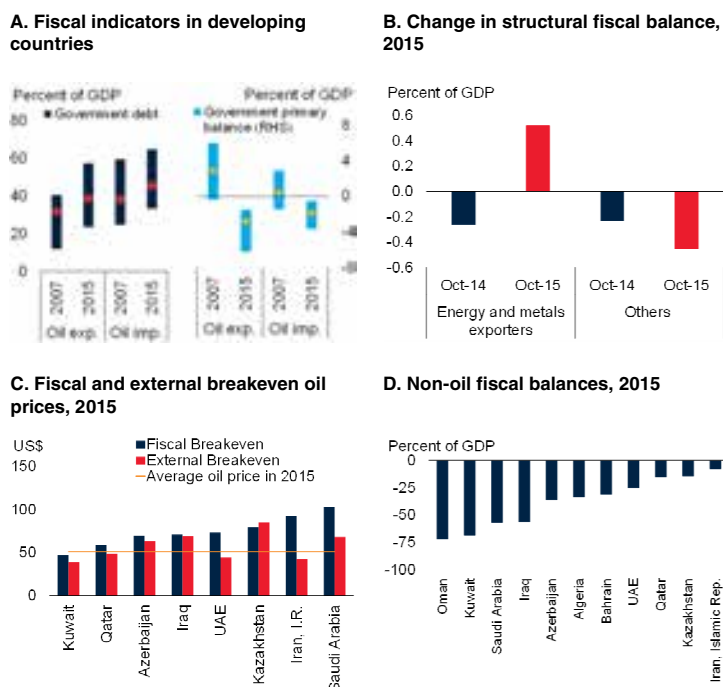
The deceleration of growth in emerging and developing economies is partly due to slower productivity growth. Structural reforms are therefore essential to support long-term growth. In the short run, a credible reform agenda could help lift investor confidence. In the longer run, reforms that improve economic governance, labor market functioning, and the efficient allocation of capital will help boost productivity, and may also help offset demographic headwinds facing many countries.

The benefits from governance and business environment reforms are potentially large. Past governance reform episodes in emerging markets have been associated with increased growth rates (Didier et al. 2015). Similarly, large improvements in business environments are associated with a significant increase in annual per capita growth (Divanbeigi and Ramalho 2015). Banking, trade, and agricultural liberalization can have particularly large economic benefits, while lower startup costs, easier registration requirements, improved management practices, and better access to finance, have been linked to more firm entry and employment creation in a range of countries.¹⁵

¹⁵The positive effects of market liberalization are highlighted in Beck and Demirguc-Kunt (2006); IMF (2008); Klapper and Love (2004); Topoleva and Khandelwal (2011), while factors supporting market entry are described in Desai, Gompers, and Lerner (2003); Klapper and Love (forthcoming); Klapper, Laeven, and Rajan (2006); McKenzie and Woodruff (2015).

FIGURE 1.30 Fiscal policy challenges in developing countries

Fiscal buffers in developing countries have been significantly depleted post-crisis, partly due to stimulus deployed to support growth, and more recently due to the impact of falling global commodity prices. Although commodity exporters on average have provided fiscal stimulus in 2015, several are implementing or planning to implement fiscal consolidation.



Sources: World Bank; International Monetary Fund; Haver Analytics, Federal Reserve Board. A. Data includes 23 oil exporting and 112 oil importing developing countries. Bars show interquartile range, dots show median across countries. B. Structural balances are available for five energy-exporting developing countries (Colombia, Ecuador, Indonesia, Kazakhstan, Malaysia, Peru, and South Africa) and 25 non-energy exporting developing countries (Bosnia and Herzegovina, Brazil, Bulgaria, China, Dominican Republic, Egypt, Georgia, Guyana, India, Lebanon, Mauritius, Mexico, Morocco, Panama, Paraguay, the Philippines, Romania, Serbia, Suriname, Thailand, Tunisia, Turkey, and Ukraine). C. Fiscal break-even prices are oil prices associated with a balanced budget, while external break-even prices are those that balance the current account. D. Non-oil fiscal balances are fiscal balances that excludes revenues from the oil sector.

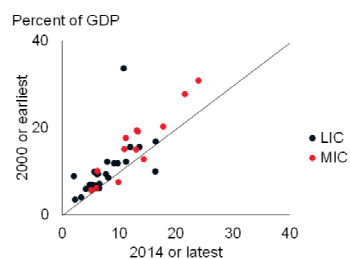
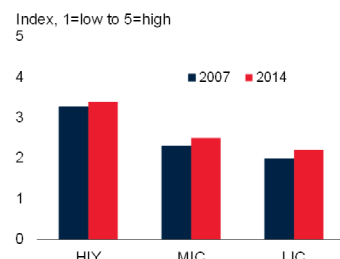
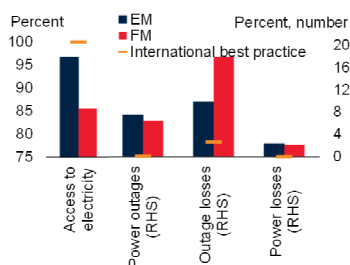
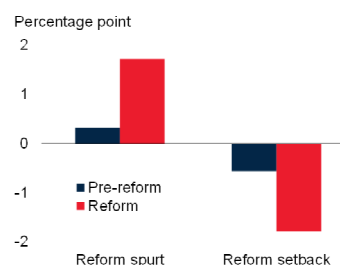
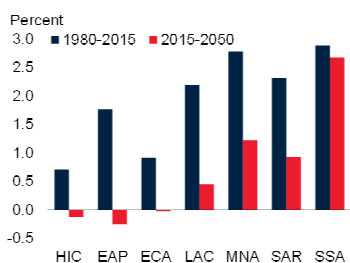
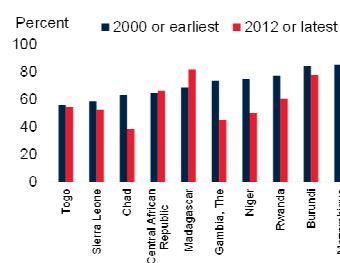
However, reform payoffs may take some time to be realized. It is therefore important to tailor policies to the stage of development and the technology level of the country (Dabla-Norris et al. 2013a-b).

Structural reforms combined with infrastructure investment can have especially potent growth effects. In China, for example, the long-term increase in real incomes from eliminating hukou restrictions allied to large-scale infrastructure investment is larger than that from infrastructure investment alone (Bosker, Deichmann and Roberts 2015).

Major changes in the size of working-age populations have taken place (Figure 1.31). More

FIGURE 1.31 Structural reform needs

Commodity-boom years have left many exporters with small or shrinking manufacturing sectors. The quality of infrastructure and access to electricity remain key bottlenecks for many developing countries. Structural reforms are generally associated with higher growth and will become increasingly necessary in the face of significant demographic shifts and to prevent a reversal of hard-won achievements in poverty reduction.

A. Size of manufacturing sectors in commodity exporters, 2000 and 2014

B. Infrastructure quality index

C. Access to electricity

D. Growth differential during episodes of reforms and setbacks in governance quality since 1996

E. Working-age population growth

F. Extreme poverty in low-income countries


Sources: World Bank; International Monetary Fund; Haver Analytics; World Bank Doing Business database; Didier et al. (2015).

C. Shows access to electricity as a percent of population; number of power outages; value lost due to power outages in percent of sales; and electricity transmission and distribution losses in percent of total output. International best practice is the average of values for the top 5th percentile for access to electricity and the average of the bottom 5th percentile for power outages, value lost to power outages, and power losses.

D. Based on an event study of episodes of significant reform spurts and setbacks (two standard-error change in at least one of four WGI ratings) for 64 EM and FM countries for 1996-2014 (Didier et al. 2015). Growth differential from baseline without significant reform spurts or setbacks.

E. Working-age population is population aged 15-64 years.

F. Measured as poverty headcount ratio (% of population) at \$1.25 a day (purchasing power parity).

than 90 percent of poverty is concentrated in pre- and early-dividend countries with young populations that lag in key human development indicators, register rapid population growth, and are seeing their working-age populations swell.¹⁶ In these countries, the demographic transition to lower fertility should help raise living standards and should be supported by policies investing in better education, health, and women empowerment. In late- and post-dividend countries, which exhibit much lower fertility rates and more pronounced population ageing, it will be especially important to mobilize savings for productive investment and reforming welfare systems to ensure fiscal sustainability, while supporting the elderly and more vulnerable (World Bank 2015b). Most countries in East Asia and the Pacific and Europe and Central Asia already have shrinking working-age populations. Incentives for greater or longer labor force participation may offset these demographic pressures. The associated reduction in benefits and increased social contributions could also help increase fiscal space. In many countries in Europe and Central Asia, however, policies need to go beyond reforming transfer and pension systems, and must encompass improvements in health and education that increase productive lifetimes, and labor market reforms that encourage greater participation by older people and women (World Bank 2015l).

Where the working-age population is expanding, structural reforms are vital for other reasons. In South Asia, for instance, an estimated 300 million-plus working-age adults are expected to enter the labor force by 2040, more than half of them in a handful of historically slow-growing and less-developed sub-regions. Reforms that equip new cohorts of workers entering the labor force with the right skills will accordingly remain key to absorbing the growing workforce. Important areas of policy intervention for South Asian governments include improving access and quality of education, as well as strengthening accountability mechanisms, particularly in public schools (Dundar et al. 2014).

¹⁶See World Bank 2015c for a description of typologies.

Poverty-related policy challenges

There are growing concerns that poverty will become increasingly concentrated in natural-resource-based economies, and in fragile and conflict states. Many of these are in Sub-Saharan Africa (World Bank 2015c). This region, which has very high poverty rates, will account for more than half of working age population growth through 2050. For low-income commodity

exporters in the region, where extreme poverty rates average 43 percent in the region, even the limited gains in poverty reduction made over the past decade could rapidly reverse. Poor households in these countries have been hit by higher import prices from sharp currency declines, the disappearance of jobs in construction and other non-tradable sectors, and cutbacks in relief programs because of fiscal pressures (World Bank 2015a-b).

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