2

Global macroeconomic performance and outlook

Chapter 2[1] reviews recent developments and short-term prospects for the global economy and examines the main risks facing recovery from the Great Recession. Rapid growth in the international economy is critical to support growth in developing countries. The key messages are:

- While growth disappointed in the first semester of 2014, the pace of global growth is expected to pick up to about 4 percent in 2015. Although the recovery is uneven, the advanced economies (AE) will grow more than 2 percent for the first time since 2010. Growth in emerging market and developing countries (EMDC) will also pick up to 5 percent after declining for the past four years. Downside risks to this outlook include geopolitical risks linked to political tensions in Eastern Europe and the Middle East and the potential for a tightening of financial conditions in emerging markets that could impact negatively on investments.
- Growth in emerging-market and developing countries is expected to pick up modestly in the remainder of 2014 and into 2015. However, there are large differences across regions and many countries continue to be negatively affected by political turmoil. Growth will take place against the background of relatively stable prices in most countries.
- Low-income developing countries are continuing to record strong growth but remain vulnerable to external shocks, notably those that work through weakened demand for commodities (as would occur, for example, were there a protracted slowdown in emerging market economies). The impact of specific shocks on individual countries would vary markedly, depending on country characteristics including export composition and size of available macroeconomic buffers.

Recent developments and short-term prospects

In 2013, AE and EMDC grew 1.4 percent and 4.7 percent, respectively (table 2.1).[2] This marked the third year of declining growth after the strong rebound from the Great Recession. In consequence, global growth gradually slowed from 5.4 percent in 2010 to 3.3 percent in 2013. This slowing of growth has taken place in an environment of low inflation and sluggish international trade.

TABLE 2.1 Global output

Annual percent change

							Projections	
	2008	2009	2010	2011	2012	2013	2014	2015
World	**3.0**	**0.0**	**5.4**	**4.1**	**3.4**	**3.3**	**3.3**	**3.8**
Advanced Economies	0.1	–3.4	3.1	1.7	1.2	1.4	1.8	2.3
Emerging Market and Developing Countries	5.8	3.1	7.5	6.2	5.1	4.7	4.4	5.0
Commonwealth of Independent States	5.4	–6.2	5.0	4.8	3.4	2.2	0.8	1.6
Emerging and Developing Asia	7.1	7.5	9.5	7.7	6.7	6.6	6.5	6.6
Emerging and Developing Europe	3.2	–3.6	4.7	5.5	1.4	2.8	2.7	2.9
Middle East, North Africa, Afghanistan, and Pakistan	5.2	2.3	5.3	4.4	4.8	2.5	2.7	3.9
Latin America and the Caribbean	3.9	–1.3	6.0	4.5	2.9	2.7	1.3	2.2
Sub-Saharan Africa	6.3	4.1	6.9	5.1	4.4	5.1	5.1	5.8
Low-Income Developing Countries	6.1	6.0	7.3	5.2	5.2	6.0	6.1	6.5
Emerging Market Countries	5.8	2.9	7.5	6.3	5.1	4.6	4.3	4.8
Fragile States	4.3	4.5	5.1	1.0	15.0	3.9	1.2	5.5
Small States	4.0	0.6	2.9	3.5	2.7	2.1	2.7	2.3

Source: World Economic Outlook.
Note: Country groupings are defined in Appendix Table F.2.

The sluggish growth in the AE in 2013 was on account of low growth in the United States, where fiscal consolidation weighed on demand. In most other AE, growth picked up. The euro area emerged from recession as private domestic demand strengthened albeit unevenly across countries and sectors. In other countries growth was supported by easier credit conditions and increased confidence. Growth slowed in 2013 in the EMDC reflecting tepid growth across the Middle East and North Africa as well as in the Commonwealth of Independent States. In many countries in these regions growth was held back by weak investments and political tensions exacerbated in some instances also by declines in oil production. Bucking the trend, growth in low-income developing countries (LIDC) accelerated to 6 percent owing to improved agricultural production and natural resource and infrastructure investments.

Whereas average growth in AE and LIDC in 2013 was about in line with what had been projected in the GMR 2013, growth in emerging market countries fell short of what had been foreseen (an outcome of 4.6 percent versus a projected 5.2 percent). The forecast errors were particularly large for some countries in the Middle East, North Africa and the Commonwealth of Independent States.

Growth in 2014 is now expected to be significantly lower than envisaged in the projections in GMR 2013. Growth in AE has been revised down from 2.2 percent to 1.8 percent on account of lower growth in the United States. Growth in emerging market countries has been revised down from 5.7 percent to 4.4 percent owing to broad-based downward revisions in all regions (but particularly large revisions in Latin America and the Commonwealth of Independent States). Notwithstanding this revised downcast outlook, the expectation for growth in LIDC remains unchanged at above 6 percent in 2014.

The global economy is expected to strengthen in the run-up to the end of the MDG monitoring period in 2015. The pick-up in global growth will be in both the AE and EMDC, but growth in the latter group will continue to be significantly larger than in the former group. In 2015, overall global growth is expected to be about 4 percent as AE grow 2 percent, emerging market countries 5 percent and LIDC 6–7 percent. The growth prospects in fragile states and small states continue to lag those of other EMDC. In the context of rising global growth, per capita income is expected to increase in most countries (figure 2.1).

The better outlook for growth in 2015 is to a great extent driven by higher growth in the United States and the euro area. Growth will be supported by accommodative monetary policies and a recovering housing sector; a tapering off of fiscal consolidation will also help. Growth in the euro area will also be underpinned by improved confidence and a recovering banking sector.

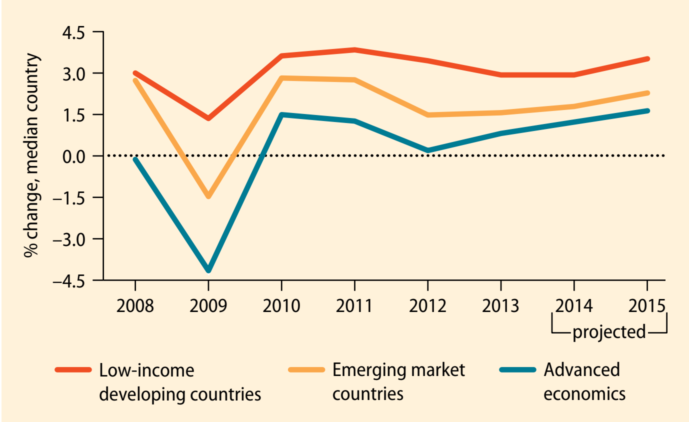
The growth slowdown in the EMDC should come to an end in 2014, and a significant pick up is expected for 2015. Growth will benefit from higher export demand to AE as well as the normalization of economic activity in countries in the Middle East, North Africa, and the Commonwealth of Independent States. Growth in India will benefit from higher investments and confidence following the elections.

There are several downside risks to these projections. In AE, there is a risk that the current very low inflation becomes entrenched especially in the context of an adverse shock to growth. If very low inflation were to take hold, there could be an additional impact on growth and private and public debt burdens would become more onerous. Another possible risk to the outlook in AE is reform fatigue. If there is little tangible progress toward addressing vulnerabilities in the financial sector and bringing down the high levels of unemployment, the political consensus on pursuing reforms could be undermined, which in turn could lead to a loss of market confidence.

Downside risks in EMDC include those relating to how private investments and durable consumption may be impacted by a higher cost of capital. An unexpectedly rapid normalization of monetary policy in the United States could lead to financial sector stress with knock-on effects on growth. A similar growth-subtracting financial shock could materialize were there to be an increase in global risk aversion that would trigger safe-haven capital flows out of EMDC. The Ebola virus has caused a severe health crisis in West Africa. This crisis could worsen or spread to neighboring countries, many of whom would be ill-equipped to confront it.

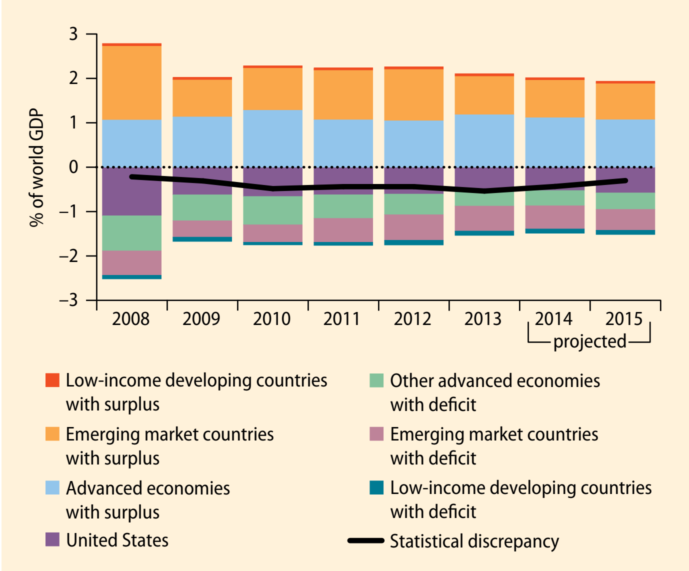
Geopolitical risks are also on the rise. Political tensions in some countries—for example, in Iraq, the Syrian Arab Republic, or Ukraine—could deepen with negative economic consequences for neighboring countries and beyond. Were a widening

FIGURE 2.1 GDP per capita growth



Source: World Economic Outlook.
Note: Country groupings are defined in Appendix Table F.2.

FIGURE 2.2 Global current account imbalances



Source: World Economic Outlook.
Note: Country groupings are defined in Appendix Table F.2.

of hostilities in Iraq to lead to a halt in oil production in that country, international oil prices could quickly shoot up with knock-on effects on global growth prospects if such higher prices were to be sustained.

In the years leading up to the Great Recession, global current account imbalances widened gradually by 1 percent of global GDP to reach close to 3 percent of global GDP. The Great Recession proved these larger imbalances unsustainable: as the crisis hit the current account deficits in the United States and some smaller advanced economies narrowed sharply as did the surpluses in emerging market capital exporting countries (figure 2.2). From 2009 onwards, the global current account imbalances have remained relatively constant at close to 2 percent of global GDP and no major shifts are projected for the period ahead.

Strong domestic government revenue mobilization is key to EMDC having the resources needed to address their development challenges, including enhancing infrastructure provision and achieving the MDG. In that regard, the global Great Recession was a major setback as the recession led to a 3 percentage points of GDP drop in revenues (table 2.2). Since then only a third of this revenue loss has been recovered and there is no prospect for a full recovery of this revenue loss by 2015.

External resources are also of paramount importance if the developing world is to achieve the MDG. As with domestic revenues, the Great Recession negatively affected capital inflows into developing countries (table 2.3). Capital inflows are critical to LIDC; relative to GDP, these countries receive net inflows that are about three times that of emerging market countries. Fragile states and small states also receive significant inflows relative to these countries' GDP level.

For the second year in a row, world trade was subdued in 2013 reflecting low economic growth and stable traded goods prices. In AE, there was no change in the value of trade (exports and imports of goods and services in U.S. dollar terms) from 2011 to 2013. Over the same two-year period, trade in EMDC rose by just 8 percent. Against the background of broadly stable prices of traded goods and services, a modest uptick in world trade is expected through 2015 as global growth strengthens. Commodity prices—which were on a roller coaster during

TABLE 2.2 General government revenue excluding grants

Weighted averages, percent of GDP

							Projections	
	2008	2009	2010	2011	2012	2013	2014	2015
Emerging Market and Developing Countries	**30**	**27**	**27**	**29**	**30**	**29**	**28**	**28**
Commonwealth of Independent States	39	35	35	37	37	36	36	35
Emerging and Developing Asia	22	22	23	25	25	25	25	25
Emerging and Developing Europe	36	35	35	37	36	37	36	36
Latin America and the Caribbean	30	28	30	30	31	31	31	30
Middle East, North Africa, Afghanistan, and Pakistan	41	31	33	34	37	35	35	34
Sub-Saharan Africa	25	20	21	24	22	21	20	20
Low-Income Developing Countries	20	16	17	19	18	17	17	17
Emerging Market Countries	30	27	28	30	30	30	29	29
Fragile States	36	28	31	30	36	32	28	29
Small States	32	29	28	34	33	32	32	32

Source: World Economic Outlook.
Note: Country groupings are defined in Appendix Table F.2.

TABLE 2.3 Net financial flows

Percent of GDP, equally weighted

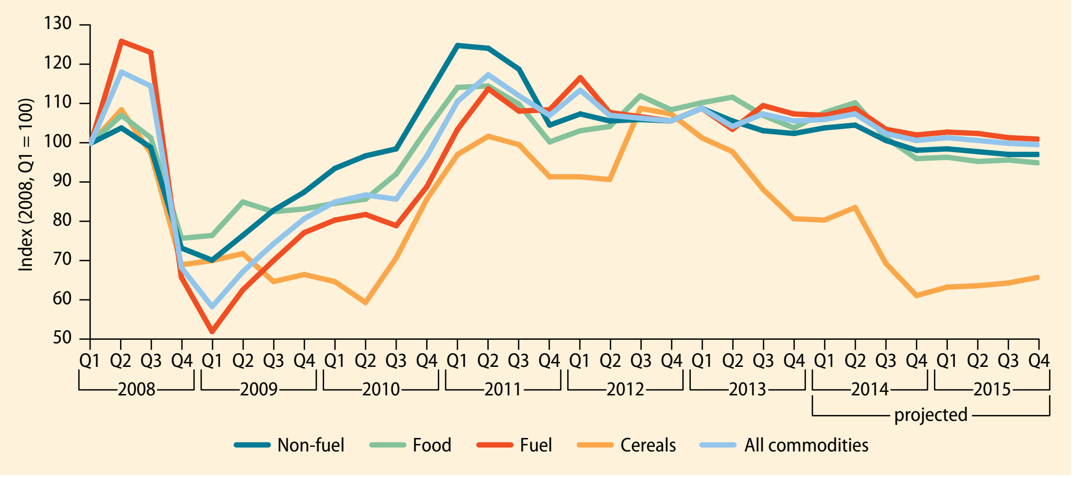
	2008	2009	2010	2011	2012	2013	Projections 2014	Projections 2015
Emerging Market Countries	**10.2**	**10.1**	**8.4**	**7.7**	**7.2**	**6.3**	**6.3**	**6.6**
Direct investment, net	5.3	4.6	3.8	3.6	3.4	3.3	3.4	3.6
Portfolio investment, net	−1.2	−0.3	0.1	0.0	0.0	−0.2	0.1	−0.2
Other investment, net	0.9	0.6	−0.4	−0.5	−1.1	−1.3	−2.0	−1.1
Transfers, net	5.2	5.1	4.9	4.6	4.8	4.6	4.7	4.2
Memorandum item:								
Change in reserve assets (–, accumulation)	−2.8	−2.2	−1.8	−1.8	−1.7	−1.3	−0.6	−0.2
Low-Income Developing Countries	**18.7**	**16.0**	**16.4**	**21.2**	**21.8**	**19.7**	**19.5**	**19.2**
Direct investment, net	5.8	4.5	5.6	6.8	6.4	5.8	4.8	5.3
Portfolio investment, net	0.0	0.0	0.1	0.1	0.5	0.1	0.3	0.2
Other investment, net	−0.5	−1.0	−2.1	2.6	2.9	2.8	3.5	3.7
Transfers, net	13.4	12.4	12.8	11.7	11.9	11.0	10.9	10.0
Memorandum item:								
Change in reserve assets (–, accumulation)	−1.8	−2.4	−1.5	−2.0	−1.2	−0.3	−0.5	−0.9
Fragile States	**17.6**	**16.8**	**15.0**	**21.0**	**18.4**	**15.6**	**17.4**	**17.4**
Direct investment, net	3.8	3.8	5.2	4.8	3.4	3.2	2.2	2.9
Portfolio investment, net	−2.0	−1.8	−2.2	−1.4	−1.7	−1.7	−0.9	−0.9
Other investment, net	−2.6	−3.3	−5.7	2.1	0.8	0.0	1.2	2.6
Transfers, net	18.5	18.1	17.6	15.6	16.0	14.1	14.9	12.7
Memorandum item:								
Change in reserve assets (–, accumulation)	−3.0	−2.6	−1.9	−2.3	−1.4	−1.0	0.9	0.5
Small States	**19.1**	**19.0**	**17.6**	**16.0**	**14.3**	**12.8**	**15.3**	**14.8**
Direct investment, net	9.5	7.9	7.6	6.1	6.2	6.3	6.2	6.5
Portfolio investment, net	−1.0	0.1	−0.4	−0.4	−1.2	−0.9	−0.2	−0.1
Other investment, net	1.7	1.6	0.7	1.8	0.0	−0.4	0.9	1.2
Transfers, net	9.0	9.4	9.7	8.4	9.3	7.8	8.3	7.3
Memorandum item:								
Change in reserve assets (–, accumulation)	−1.8	−3.2	−1.8	−1.4	−1.6	−2.5	−1.6	−0.4

Source: World Economic Outlook.
Note: Country groupings are defined in Appendix Table F.2.

the Great Recession—trended slightly lower during 2013 and the first half of 2014 (figure 2.3). The expectation is that stable or slightly lower prices will be maintained through the end of 2015 although, were geopolitical risks to materialize, international oil prices in particular could easily spike.

In the developing world, commodity price changes impact households and firms to a far greater extent than in advanced economies. In poorer countries tradable goods—including, importantly, food—constitute a larger share of the consumption basket. Many poorer countries are also dependent on the exports of a few commodities or need to import grains and other critical commodities. As the prices of such export or import commodities change so does real income. Price

FIGURE 2.3 Commodity price indexes

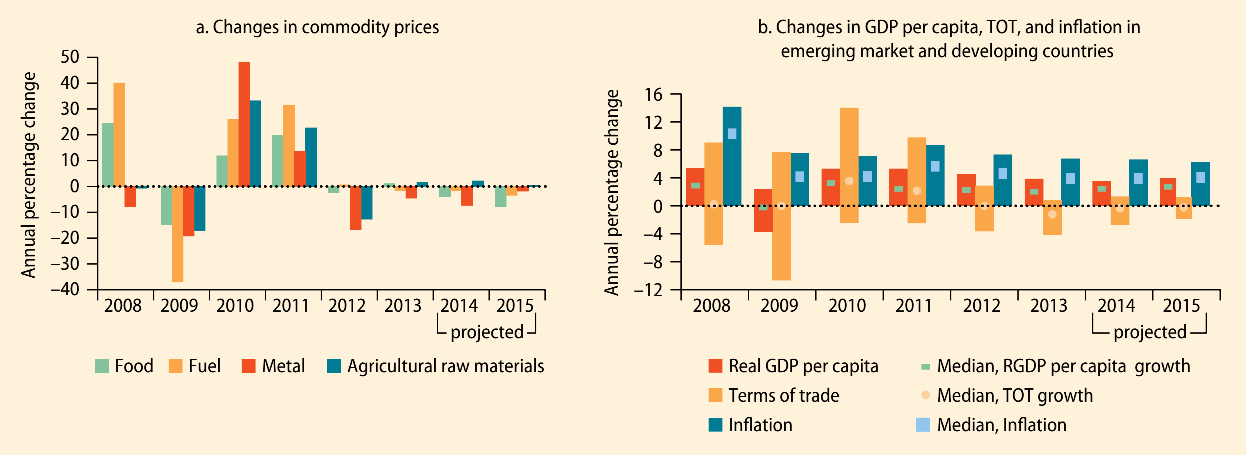


Source: World Economic Outlook.
Note: Indices are in U.S. dollars.

changes for petroleum products can also have broad-based and important effects on living standards in importing countries. EMDC both import and export commodities, but on average these countries tend to benefit from higher commodity prices (figure 2.4). Higher commodity prices in 2010 and 2011 were associated with terms of trade gains for the majority of EMDC. As commodity prices weakened in 2012 and 2013, these terms of trade gains were eroded. While the terms of trade are expected to remain fairly constant through 2015, in the majority of EMDC terms of trade will fall rather than increase.

The typical low-income developing country is well integrated into the world economy with imports and exports shares of GDP of about 50 percent and 32 percent, respectively (figure 2.5). The current account deficit (defined here as net of foreign direct

FIGURE 2.4 Changes in commodity prices and changes in GDP per capita, terms of trade, and inflation in emerging markets and developing countries



Source: World Economic Outlook.
Note: Indices are in U.S. dollars. Bars represent the range between the 25th and 75th percentiles. Country groupings are defined in Appendix Table F.2.

investments to focus attention on the residual deficit) for the typical LIDC has increased from around 2 percent of GDP in 2010–11 to 4 percent thereafter.

Official reserves, in months of imports—a standard measure of reserve coverage in both emerging market countries and low-income developing countries—changed little in 2013 and are expected to remain relatively stable through 2015 (figure 2.6). The typical emerging market country holds somewhat larger reserves than the typical low-income developing country. Close to one half of LIDC hold reserves of less than 3 months of imports. These countries are highly vulnerable to external shocks.

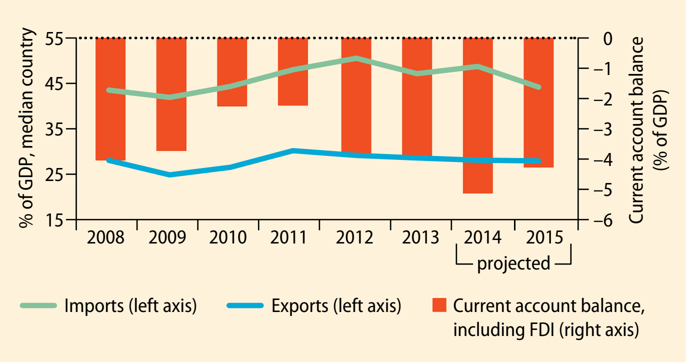
Macroeconomic policies

In the aftermath of the Great Recession, the feeble recovery in AE has been supported by a macroeconomic policy stance that has underpinned demand and private sector confidence while at the same time contained risks in the financial sector and to medium term fiscal sustainability. In 2013, AEs' average fiscal deficit dropped sharply, falling to below 5 percent of GDP. As fiscal accounts improved, monetary policy easing was maintained against the background of well-anchored inflation expectations and continued low inflation. A further tightening of fiscal policies in AE is projected to take place in 2014 and 2015.

The fiscal deficit in 2013 in both the typical emerging market country and low-income developing country widened (figure 2.7). Thus, further progress toward rebuilding the fiscal buffers that were put to such good use during the Great Recession has stalled. Four years after the crisis, less than half of this buffer has been reconstituted and there is no prospect for any further improvement through 2015. The widening fiscal deficit in a typical LIDC is reflected in part in the widening of the external current account deficit (see figure 2.5).

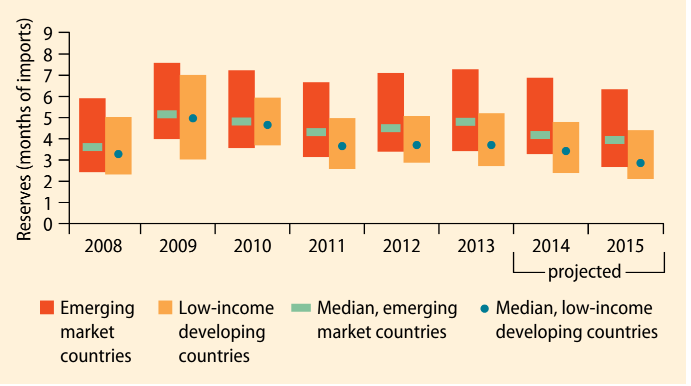
About half of all EMDC loosened monetary policy in 2013 with the other half tightening their policies (figure 2.8). Relatively

FIGURE 2.5 Low-income developing countries—imports, exports, and current account balance including FDI



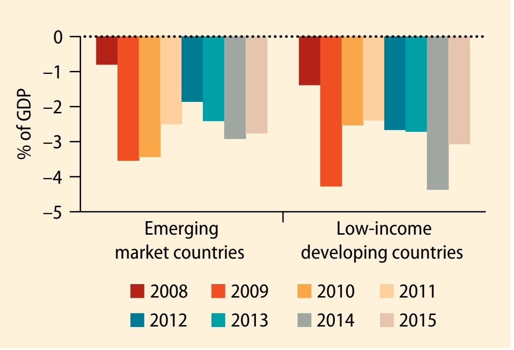
Source: World Economic Outlook.
Note: Country groupings are defined in Appendix Table F.2.

FIGURE 2.6 Official reserves



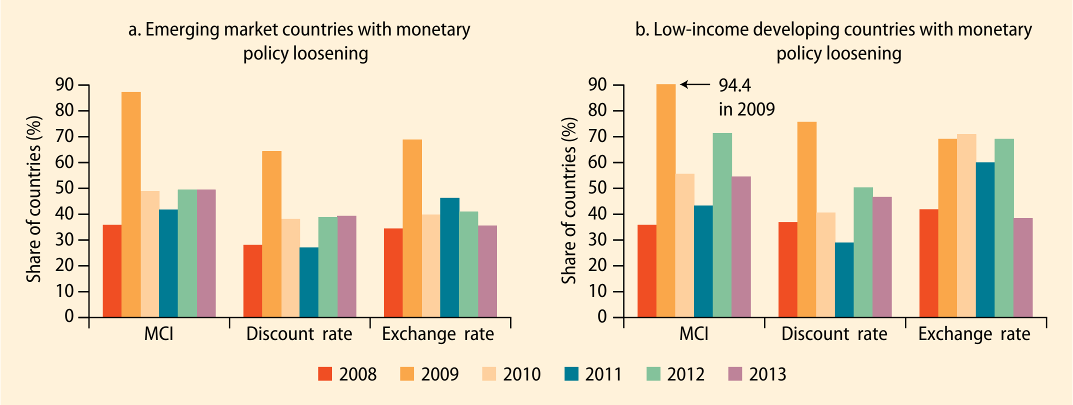
Source: World Economic Outlook.
Note: Bars represent the range between the 25th and 75th percentiles. Country groupings are defined in Appendix Table F.2.

FIGURE 2.7 Fiscal deficit



Source: World Economic Outlook.
Note: General government balance (net lending/ net borrowing) is as defined by IMF Government Finance Statistics Manual 2001. Country groupings are defined in Appendix Table F.2.

FIGURE 2.8 Monetary policy loosening

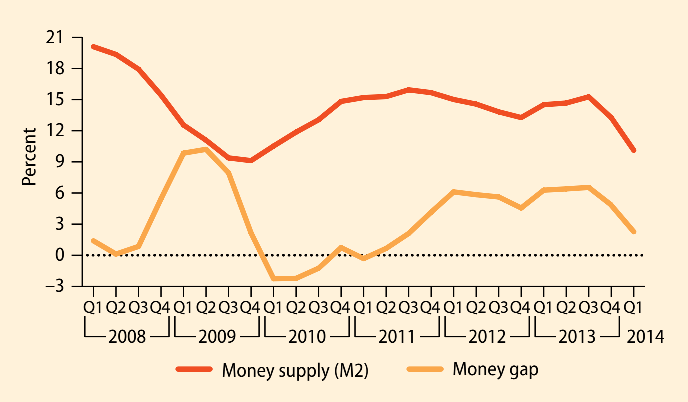


Source: International Financial Statistics.
Note: Monetary policy loosening in based on Monetary Conditions Index (MCI) calculations. MCI is a linear combination of nominal short-term interest rates and the nominal effective exchange rate (with one-third weight for the latter). Country groupings are defined in Appendix Table F.2.

more LIDC than emerging market countries loosened monetary policies, but the difference between the two groups was not large. In LIDC, there was a relatively greater reliance on monetary policy loosening in the form of a lowering of short term interest rates rather than allowing for a depreciation of the exchange rate. Against the background of these policy measures, monetary aggregates continued to grow faster than nominal GDP in emerging market countries (figure 2.9).

In 2013, about a third of emerging market countries and about a fourth of LIDC loosened macroeconomic policies; i.e., they loosened both fiscal and monetary policies (figure 2.10). In contrast, relatively more LIDC than emerging market countries tightened macroeconomic policies. About half of all emerging market countries and LIDC changed the policy mix by simultaneously tightening and loosening policies. Among these countries, emerging market countries were more likely to loosen fiscal policy and tighten monetary policy than the other way around. Among LIDC, more countries loosened monetary policy and tightened fiscal policy than the other way around.

FIGURE 2.9 Average year-on-year growth in money and the money-gap in emerging market countries



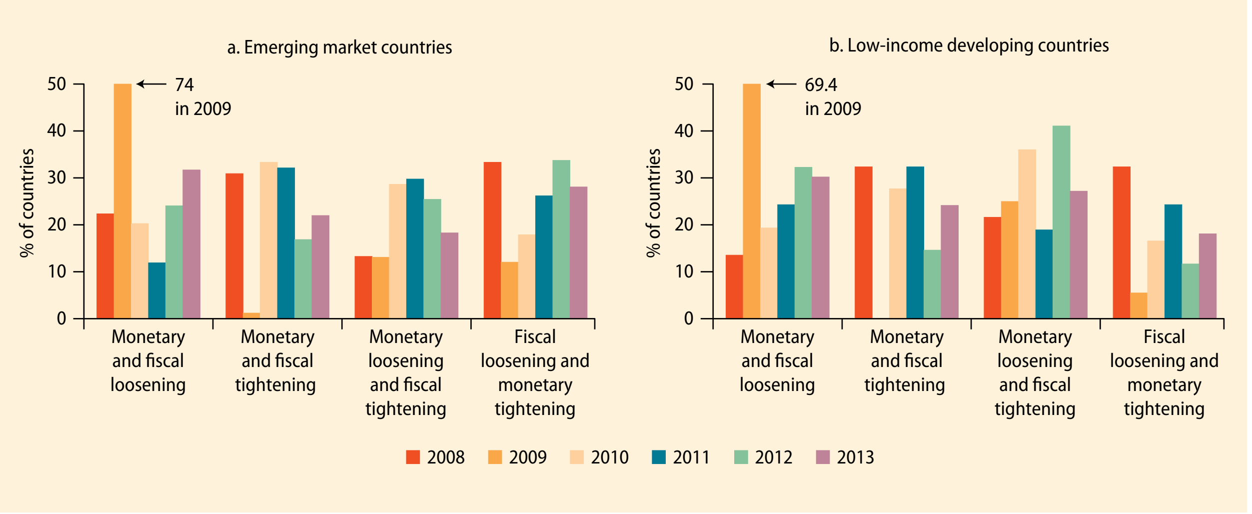
Source: International Financial Statistics.
Note: The money gap is the difference between year-on-year growth rates of M2 and nominal GDP. The sample includes emerging market economies that have data on both for the whole sample period shown. Country groupings are defined in Appendix Table F.2.

Quality of macroeconomic policies in low-income countries

In order to gain a better perspective on the quality of macroeconomic policies in low-income countries, IMF country desks in these countries are surveyed about their assessment about the quality of countries' economic policies.[3] In the period leading up to the Great Recession, the quality of economic policies greatly improved especially in countries in Sub-Saharan Africa. Subsequently, the assessments have fluctuated with no clear trend.

The survey results for 2013 suggest a deterioration in the quality of policies as compared with 2012 (figure 2.11). Fiscal policy is the area of most concern with the number

FIGURE 2.10 Macroeconomic policy mix



Source: International Financial Statistics.
Note: Country groupings are defined in Appendix Table F.2. Fiscal conditions are defined based on annual change in government balance (net lending/ net borrowing) as a percent of GDP in 2008, 2009, 2010, 2011, 2012, and 2013. Monetary conditions are based on the change in the MCI; changes are calculated Q4 over Q4. MCI is a linear combination of nominal short-term interest rates and the nominal effective exchange rate (with a one-third weight for the latter).

of countries with unsatisfactory fiscal policy now exceeding 20 percent (the number has increased for three years in a row). An appropriate composition of public spending is key to achieving the MDGs, but in more than half of countries surveyed the composition of public spending is considered unsatisfactory.

In contrast, less concern is raised about monetary policy implementation. For the overwhelming number of countries, monetary policy implementation and access to foreign exchange are rated as good. Governance in monetary and financial institutions—which is mostly rated as good or as adequate—is assessed as being of a higher quality than governance in the broader public sector.

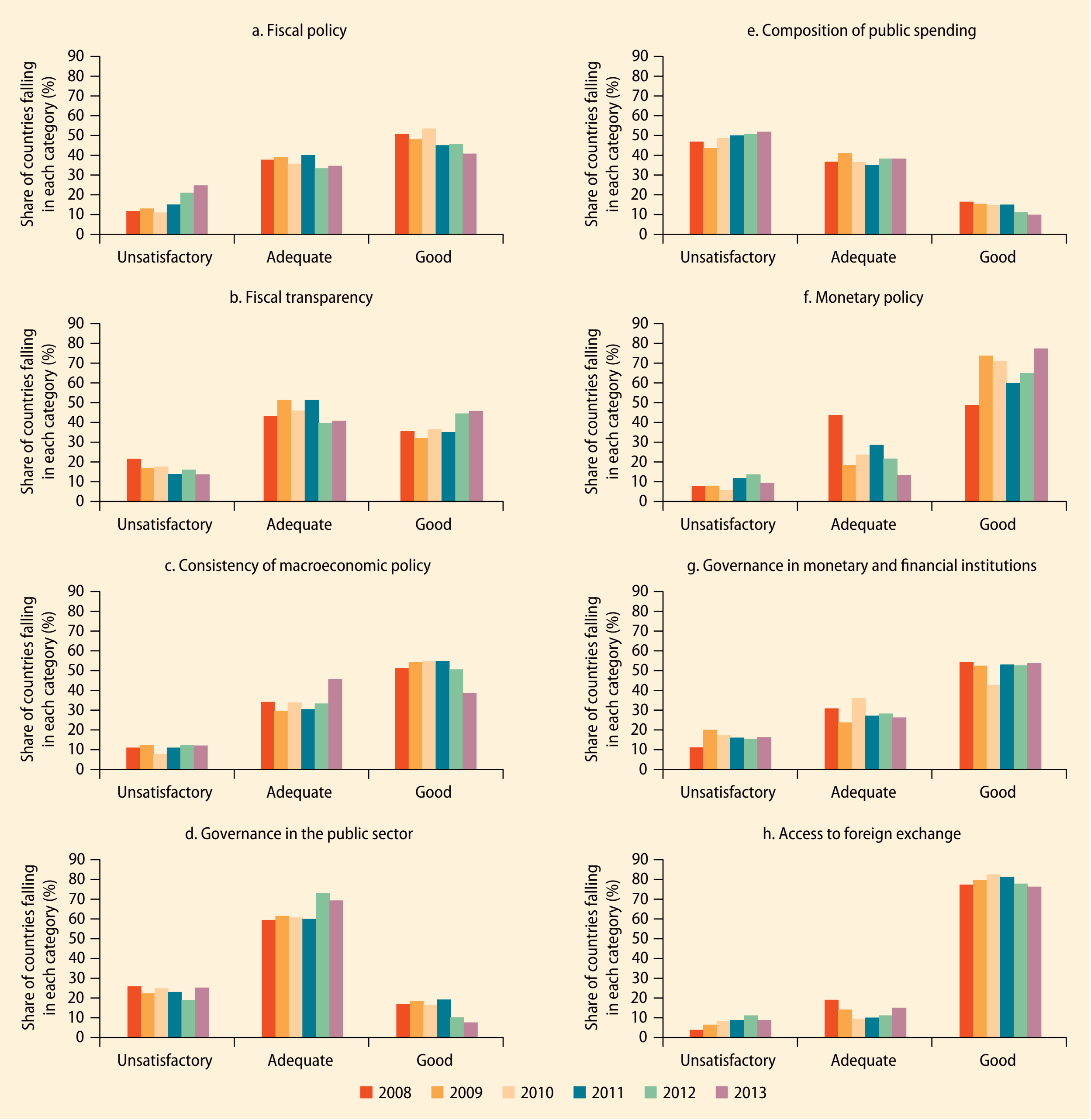
Shifting medium-term vulnerabilities for low-income developing countries[4]

The low-income developing countries are not only the most vulnerable countries; they are also the countries that are most challenged in meeting the MDGs. The 60 LIDC account for about one-fifth of the world's population, but their share in global PPP-weighted GDP is only 3.5 percent. The LIDC share many common development characteristics, but they are quite diverse across other important dimensions, such as macroeconomic and political fragility, financial market access, and export structure.

The medium-term outlook for LIDC is for resilient growth to continue over the medium term at around the current level of 6 percent. This strong growth is expected to take place together with low inflation in the context of relatively stable moderate fiscal and external deficits (figure 2.12). While the outlook is benign, LIDC face critical challenges arising from softer commodity prices, moderating FDI and external aid inflows.

While LIDC grow resiliently on average, the LIDC are very vulnerable countries and when hit by negative shocks, these countries often find it challenging to muster the necessary resources with which to overcome these shocks. An analytical framework underlying the vulnerability assessment for LIDC was simulated to assess the impact of protracted period of slower growth in advanced and

FIGURE 2.11 Quality of macroeconomic policies in low-income countries, 2008–13

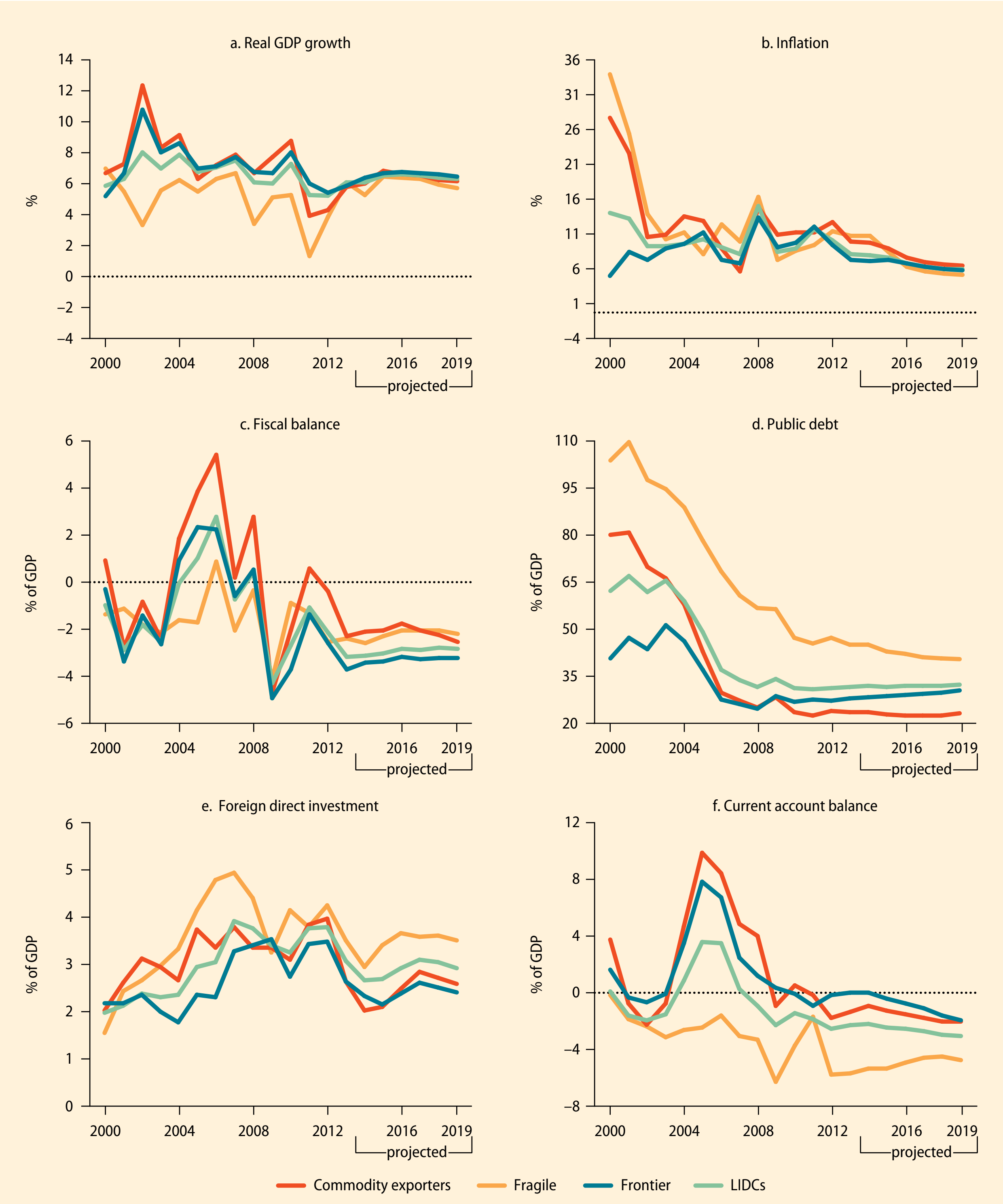


Source: IMF estimates.
Note: IDA-eligible countries.

major emerging markets, including China on the LIDC with slower growth through 2018 affecting trading partner growth and key commodity prices (figure 2.13). Under this scenario, trend growth is lower as a result of weaker-than-expected productive capacity and human capital. The weaker global growth would result in a marked reduction in the demand for commodities, producing lower oil and non-oil commodity prices.

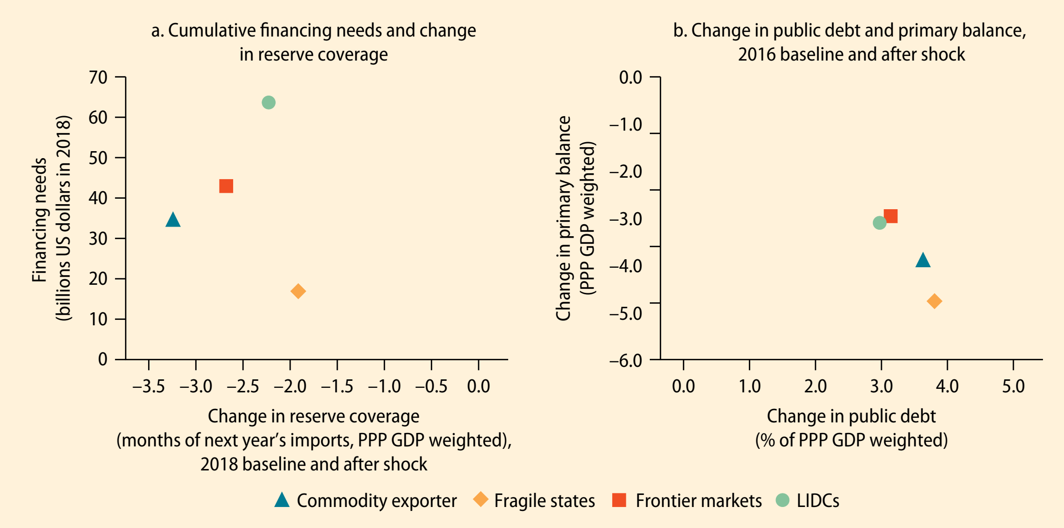
FIGURE 2.12 Selected macroeconomic indicators in low-income developing countries, 2000–19

Averages, PPP weighted



Source: World Economic Outlook.
Note: Country groupings are defined in endnote 4.

FIGURE 2.13 Low-income developing countries—impact of protracted slowdown in EM



Source: World Economic Outlook.
Note: Country groupings are defined in Appendix Table F.2.

This scenario would impact negatively on growth performance in LIDC. The slowdown in economic activity emanates from depressed demand for LIDC exports, lower remittances and FDI inflows. Fragile states, frontier economies and commodity exporters would be affected differently, with countries with stronger trade ties with emerging markets experiencing pronounced decline in exports. Real GDP growth over the medium term (2014–18) would fall short of the baseline by about 1.4 percentage points on a cumulative basis.

Fiscal and external buffers in LIDC would deteriorate, as output loss accumulates over time. The fiscal balance in LIDCs would deteriorate by about 4 percent of GDP on a cumulative basis compared to the baseline, with debt ratios higher than the baseline by 3 percent of GDP. In addition, reserves (relative to imports) would fall most among commodity exporters, though other LIDC, particularly fragile states, would still encounter large financial need to maintain sufficient import coverage. The potential cumulative additional external financing need during 2014–18 for LIDC as a group is estimated at US$64 billion in order to restore international reserve levels to three months of import cover (or to pre-shock import coverage levels, if this was below three months).

An energy price shock arising from an escalation of geopolitical tensions with the effects concentrated in 2014–15 would have a significant but less severe impact overall on LIDC than advanced economy/major emerging market slowdown, but with important differences across subgroups. The key transmission channels would be through the impact of this shock on commodity prices, trade, and remittances. While oil exporters would benefit, countries with strong export links to adversely-hit economies would be negatively affected. A key channel through which the price shock would affect the fiscal positions is through its impact on energy subsidies. With a partial pass-through to retail prices, in line with historical patterns, the additional fiscal cost from fuel subsidies is estimated at about 1 percent of GDP on average.

The impact of an asynchronous normalization of monetary policies in advanced economies (early tightening in the United States, delayed tightening in Europe and Japan) would be significant, but the overall impact on LIDC would be very limited. However, frontier markets could prove an important exception to this rule. Relative to other LIDC, they are more exposed to the transmission of global financial shocks and their relatively more developed domestic financial markets imply a greater potential for adverse feedback loops on the real economy.

In managing a response to potential global shocks (especially the one relating to substantial and protracted slowdown in major emerging markets and advanced economies), rebuilding fiscal buffers should go hand in hand with the utilization of other available policy levers. LIDC with monetary autonomy and a flexible exchange rate have additional policy tools to handle external shocks. Structural reforms can also play a role in limiting vulnerabilities in LIDC:

- The appropriate balance (and timing) of policy adjustment versus higher external financing depends on both country circumstances and the availability of such financing. Of particular importance will be the need to provide assistance to countries that are highly vulnerable and have limited alternative financing options, particularly fragile states. It would be particularly desirable to provide such financial support in the form of grants to limit the build-up of public debt and mitigate fiscal vulnerabilities.
- Many LIDC have little room to conduct countercyclical policies in the event of shocks unless fiscal positions are strengthened. For countries with insufficient fiscal buffers or access to financing at concessional terms, fiscal adjustment is likely to be needed. Where fiscal adjustment is undertaken, it should be implemented in a manner that safeguards priority spending, such as infrastructure and poverty-related spending. Countries with moderate debt levels and adequate window to borrow domestically without disrupting credit markets have more room for fiscal maneuver, but will still likely need to pursue some degree of fiscal consolidation.
- LIDC with monetary autonomy and a flexible exchange rate have additional policy tools to handle external shocks. Deploying such policies where available could mitigate the impact of shocks and limit further the additional financing needs. With inflation well-contained and falling in most LIDC, monetary easing can be deployed to support demand without destabilizing price movements and expectations. Exchange rate depreciation also offers scope for accommodating external shocks without sizeable output losses, particularly in larger countries where inflation pass-through is more likely to be modest.

There are several key measures that policy makers can deploy over time to limit vulnerabilities in LIDC:

- Improvements in the composition of public spending—such as the phasing out of universal energy subsidies, while implementing appropriately targeted social safety nets—can support more inclusive growth. Similarly, well-designed tax reforms and strengthened tax administration will expand revenue bases and hence ease difficult fiscal trade-offs.
- Commodity exporters (and especially countries that are heavily dependent on natural resource revenues and exports) can address the key source of domestic vulnerability—resource revenue volatility—by building an adequately resourced stabilization fund in the "good years" to avoid the need for procyclical fiscal adjustments that would amplify the negative macroeconomic and social impact of volatile swings in commodity prices.
- Frontier market economies in LIDC that have attracted potentially volatile foreign portfolio investment into domestic capital markets face a new source of vulnerability. Managing this new risk requires accumulating higher levels of foreign reserves, but also strengthening oversight of domestic financial markets and institutions.

- Strengthening institutional capacity is also critical to enhance the resilience of LIDC, especially in fragile states. Coordinated support for capacity-building from both multilateral agencies and bilateral donors is needed to strengthen those government functions that underpin resilience—including revenue collection, public financial management, debt management, and financial sector supervision.

Increasing resilience through economic diversification is key for countries that have highly concentrated export sectors. LIDCs should promote progress in structural reforms that enhance long-term resilience to shocks. These would include productivity-enhancing infrastructure spending and investments in improving human capital, including in health and education.

Notes

1. This chapter draws on the IMF's October 2014 *World Economic Outlook*.
2. The classification of countries follows the one used in the IMF's *World Economic Outlook*. Emerging market and developing countries are those countries that are not designated as advanced. Low-income developing countries are countries eligible for IMF's concessional financial assistance with a per capita Gross National Income (measured according to the World Bank's *Atlas* method) in 2011 of below twice IDA's effective operational cut-off level, and Zimbabwe. Other emerging market and developing countries are considered emerging market countries. Small states are emerging market and developing countries with a population of less than 1.5 million. Fragile states are countries included in the World Bank's list of Fragile and Conflict-Affected States as of July 2014. Appendix Table F.2 includes the list of all countries and the groupings to which they belong.
3. Each low-income country has been assessed according to a common set of criteria. For example, a country's quality of fiscal policy is assessed by considering its fiscal deficit and the sustainability of its public debt (a country with a large fiscal deficit and an unsustainable level of public debt would be judged to have an unsatisfactory fiscal policy). The assessment has been carried out annually since 2003.
4. This section draws on *Macroeconomic Developments in Low-income Developing Countries: 2014 Report* (IMF, 2014). Fragile states are here defined to also include Malawi, Nepal, and the Republic of Congo. Commodity exporters are fuel exporters and primary commodity exporters as defined in the World Economic Outlook. Frontier markets are 14 low-income countries whose financial systems share similar characteristics with those of emerging market countries (Bangladesh, Bolivia, Côte d'Ivoire, Ghana, Kenya, Mongolia, Mozambique, Nigeria, Papua New Guinea, Senegal, Tanzania, Uganda, Vietnam, and Zambia).