CHAPTER 1

GLOBAL OUTLOOK

Subdued Growth, Shifting Policies, Heightened Uncertainty
Stagnant global trade, subdued investment, and heightened policy uncertainty marked another difficult year for the world economy. Global growth in 2016 is estimated at a post-crisis low of 2.3 percent and is projected to rise to 2.7 percent in 2017. Growth in emerging market and developing economies (EMDEs) is expected to pick up in 2017, reflecting receding obstacles to activity in commodity exporters and continued solid domestic demand in commodity importers. Weak investment and productivity growth are, however, weighing on medium-term prospects across many EMDEs. Downside risks to global growth include increasing policy uncertainty in major advanced economies and some EMDEs, financial market disruptions, and weakening potential growth. However, fiscal stimulus in key major economies—in particular, the United States—could lead to stronger-than-expected activity in the near term and thus represent a substantial upside risk to the outlook. In view of the limited room for macroeconomic policy to absorb further adverse shocks, as well as subdued growth prospects, structural reforms that boost potential growth remain a priority. In EMDEs, investment in human and physical capital would help narrow unmet needs in skills and infrastructure and support growth for the long term. Rebuilding policy space, addressing vulnerabilities, and enhancing international integration by promoting services trade and foreign direct investment would also boost resilience and improve growth prospects.

Summary

Stalling global trade, weak investment, and heightened policy uncertainty have depressed world economic activity. Global growth is estimated to have fallen to 2.3 percent in 2016—the weakest performance since the global financial crisis and 0.1 percentage point below June 2016 Global Economic Prospects forecasts (Figure 1.1). Global growth is expected to rise to 2.7 percent in 2017, mainly reflecting a recovery in emerging market and developing economies (EMDEs).

Advanced economies continue to struggle with subdued growth and low inflation in a context of increased uncertainty about policy direction, tepid investment, and sluggish productivity growth. Activity decelerated in the United States and, to a lesser degree, in some other major economies. As a result, advanced-economy growth is now estimated to have slowed to 1.6 percent in 2016, a downward revision of 0.1 percentage point. Advanced-economy growth is expected to recover somewhat, to an average pace of 1.8 percent throughout the forecast period. In the United States, manufacturing activity is expected to rebound, contributing to a modest pickup in growth from 1.6 percent in 2016 to an average of 2.2 percent in 2017-18. This forecast does not incorporate the effects of policy proposals by the new U.S. administration, as their scope and ultimate form are still uncertain. Fiscal stimulus, if implemented, could result in stronger growth outcomes than currently predicted. In the Euro Area and Japan, supportive monetary policies will help stimulate activity throughout the forecast period. Inflation is expected to rise gradually, but it will remain below central banks’ target in the Euro Area and Japan throughout the forecast horizon.

Anemic growth in advanced economies was accompanied by a further weakening of global trade in 2016. Mitigating these headwinds, commodity prices have stabilized and are projected to increase moderately during 2017-19, providing support for commodity-exporting EMDEs. The rise in U.S. yields since early November has led to a notable tightening of financing conditions for EMDEs, in some cases resulting in significant currency depreciation and portfolio outflows. Despite this tightening, financing conditions still remain generally benign, as major central banks maintain accommodative monetary policies.

EMDEs grew at an estimated 3.4 percent in 2016, broadly in line with previous expectations. Commodity exporters as a group continued to expand at markedly lower rates than commodity
### TABLE 1.1 Real GDP

(percent change from previous year)

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**Memorandum items:**

**Real GDP**

- High-income countries: 1.9 - 2.2
- Developing countries: 4.4 - 3.6
- Low-income countries: 6.2 - 4.8
- BRICS: 5.1 - 3.8
- World (2010 PPP weights): 3.5 - 3.3
- World trade volume⁴: 3.7 - 2.8

**Commodity prices**

- Oil price⁵: -7.5 - -47.3
- Non-energy commodity price index: -4.6 - -15.0


Notes: PPP = purchasing power parity. World Bank forecasts are frequently updated based on new information. 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. Country classifications and lists of Emerging Market and Developing Economies (EMDEs) are presented in Annex Table 1. BRICS include: Brazil, Russia, India, China, and South Africa.

2. GDP growth values are on a fiscal year basis. Aggregates that include these countries are calculated using data compiled on a calendar year basis. Pakistan’s growth rates are based on GDP at factor cost. The column labeled 2017 refers to FY2016/17.
3. The column labeled 2016 refers to FY2016/17.
4. World trade volume for goods and non-factor services.
5. Simple average of Dubai, Brent, and West Texas Intermediate.

For additional information, please see www.worldbank.org/gep.

* The U.S. forecasts do not incorporate the effect of policy proposals by the new U.S. administration, as their overall scope and ultimate form are still uncertain. However, simulations indicate that the large reductions in corporate and personal income taxes suggested by the new administration could—if fully implemented and without consideration of any other policy changes—increase both U.S. GDP growth and global growth above baseline projections in 2017 and 2018. See the “Risks to the outlook” section of Chapter 1 for further details.
importers. Growth in commodity exporters for 2016 is estimated at 0.3 percent. Improved performance in some large EMDE exporters—including a more rapid bottoming out in the Russian Federation and an easing in the pace of contraction in Brazil—and an increase in commodity prices from their early-2016 lows offset additional weakness in other exporters, most notably in Sub-Saharan Africa. Meanwhile, commodity importers are estimated to have grown 5.6 percent, reflecting resilient domestic demand, low commodity prices, and generally accommodative macroeconomic policies.

EMDE growth is expected to accelerate to 4.2 percent in 2017 and to an average of 4.7 percent in 2018-19. EMDEs are forecast to contribute 1.6 percentage points to global growth in 2017, accounting for about 60 percent of global growth for the first time since 2013. With the anticipated increases in commodity prices, particularly for oil, the divergence in growth outlooks between commodity exporters and importers is set to narrow. The waning effect of currency depreciations in commodity exporters, and of past declines in energy prices for importers, should also narrow differences in inflation between the two groups. That said, the long-term EMDE outlook is clouded by a number of factors—most prominently, uncertainty about global trade prospects and advanced-economy policies, a weakening in potential output resulting from subdued investment, sluggish productivity growth, and demographic factors.

Within the broader group of EMDEs, growth in low-income countries (LICs) is estimated to have decelerated slightly to 4.7 percent in 2016. Some oil and metal exporters slowed sharply, as they continue to struggle to adjust to low commodity prices. In addition, a number of LICs faced domestic headwinds, including droughts, political tensions, and security challenges. However, many commodity-importing LICs continued to grow solidly. External and domestic conditions should improve gradually, with LICs growth rebounding to 5.6 percent in 2017 and reaching 6.1 percent by 2019.

There is substantial uncertainty around baseline projections (Figure 1.2). For example, while the

**FIGURE 1.1 Summary - Global prospects**

Global growth in 2016 is estimated at a post-crisis low of 2.3 percent. A moderate recovery is expected in 2017 amid heightened uncertainty. Growth projections continued to be downgraded for both advanced economies and emerging market and developing economies (EMDEs), albeit less than in previous forecast rounds. Global goods trade was stagnant for most of 2016, while commodity prices are projected to experience a modest recovery over the forecast period. Among EMDEs, growth in commodity importers is expected to remain solid, while growth in commodity exporters is projected to pick up in 2017 from near stagnation in 2016, helping EMDEs to make their strongest contribution to global growth since 2013.
central forecast for global growth in 2017 is 2.7 percent, there is a 50-percent probability that actual growth will be between 2 percent to 3.2 percent. The materialization of downside risks could derail a fragile global economic recovery. The heightened level of policy uncertainty, especially regarding trade, has been exacerbated by recent political developments—most notably, electoral outcomes in the United States and the United Kingdom. This and other risks—particularly financial market disruptions amid tighter global financing conditions—may be amplified over the medium term by mounting protectionist tendencies, slower potential growth, and elevated vulnerabilities in some EMDEs. However, fiscal stimulus in key major economies could lead to stronger-than-expected activity in the near term and thus represent a substantial upside risk to the outlook—particularly, in the United States, where the new administration has signaled an intention to pursue expansionary fiscal policies, including tax cuts and the facilitation of infrastructure spending.

The sluggish economic outlook underscores the need to implement structural policies that support domestic demand and, especially, reinvigorate investment. In advanced economies, extremely low and negative real equilibrium interest rates constrain the effectiveness of monetary policy and may warrant more supportive fiscal policies. More generally, macroeconomic policies should remain accommodative until evidence of capacity constraints emerge and inflation is on a clear upward trend. In EMDEs, finding an appropriate balance between fiscal adjustment, measures to reduce vulnerabilities, and growth-oriented reforms aimed at raising human capital and physical infrastructure will be challenging for some countries. Policies that boost domestic sources of long-term growth—critically, long-term investment and productivity—are a priority. Investing in human and physical capital will help narrow unmet investment gaps in skills and infrastructure. These policies could be reinforced by efforts to further international integration, such as those that support growth in EMDE services trade, and that create an environment to maximize the benefits of foreign direct investment (FDI).
Major economies: Recent developments and outlook

Advanced economies continue to be afflicted by weak growth and low inflation, amid rising uncertainty about future policy direction. After slowing to 1.6 percent in 2016, growth is projected to recover somewhat in 2017-19, although the range of possible outcomes has significantly widened after the elections in the United States and the United Kingdom’s decision to leave the European Union. In China, projections are unchanged, despite resurfacing concerns about buoyant property markets, as growth slows gradually toward more sustainable levels, with a rebalancing from manufacturing to services.

Across major advanced economies, the deceleration in growth in 2016 to 1.6 percent reflected renewed policy uncertainties, weak external demand, and subdued productivity growth (Figure 1.3). Activity is expected to regain modest momentum in 2017-19, but uncertainty associated with policies of the new administration in the United States and with the United Kingdom’s decision to leave the European Union (Brexit) could significantly influence the growth trajectory of advanced economies. Growth projections for 2017 and 2018 have been revised down for the Euro Area and, especially, for the United Kingdom. For the United States, baseline forecasts for 2017 and 2018 are unchanged from June projections, in the absence of specific details about policy changes to be implemented by the new administration. Whereas constraints to monetary policy have intensified, fiscal policy is likely to play a greater role in the coming years. Weak productivity growth and rising demographic pressures, which weigh on labor supply and could contribute to a lower rate of return on capital, continue to constrain long-term prospects.

United States

Growth in the United States slowed markedly, from 2.6 percent in 2015 to an estimated 1.6 percent in 2016, 0.3 percentage point below previous projections. The U.S. economy was held back in 2016 by soft exports, a continued drawdown in inventories, and a deceleration in private investment (Figure 1.4). In the run-up to the U.S. elections in November, activity had picked up again, and a further tightening of labor markets had led to slowly rising wage growth. This supported continued gains in real disposable income, which could help deliver a further reduction in poverty rates, following a drop in 2015 (Proctor, Semega, and Kollar 2016).

The outcome of the U.S. elections has made macroeconomic projections more uncertain. Proposals for corporate and personal income tax cuts; infrastructure spending; and shifts in trade, immigration, and regulation policies are likely to have sizable effects on the U.S. outlook—as well as spillovers on the rest of the world (Special Focus).
Growth slowed in 2016, held back by weak exports and investment. However, the U.S. labor market remained resilient and wage growth accelerated. Policy uncertainty has increased substantially following the elections; if it persists, it could have potential knock-on effects on investment. Baseline forecasts do not incorporate the effects of policy proposals by the new administration, as their scope is still uncertain. Productivity has been stagnant in recent years, constraining potential output growth. Despite generally subdued activity, unemployment and inflation continued to move closer to policy objectives, signaling further policy normalization.

However, their overall scope has not yet been clearly defined; hence, they are not included in baseline projections. While confidence continued to improve in the immediate aftermath of the election, an increase in policy uncertainty, if persistent, could have a dampening effect on investment. Against this backdrop, growth is expected to regain some momentum, reaching 2.2 percent in 2017 and 2.1 percent in 2018. These projections are unchanged from previous forecasts. As remaining labor market slack is absorbed and policy interest rates approach neutral levels, growth is projected to slow slightly to 1.9 percent in 2019, close to its estimated potential rate. Downward revisions to potential output growth have coincided with further evidence of stagnant productivity (Congressional Budget Office 2016; Federal Open Market Committee 2016). This reflects in part labor force shifts toward lower-productivity service activities, as well as a declining productivity trend within both the manufacturing and services sectors (Vollrath 2016). The most productive firms are growing less rapidly than in the past, while the firm entry rate has declined, and flows in and out of jobs have slowed in the post-crisis period (Decker et al. 2016; Molloy et al. 2016). These factors, combined with slowing gains in educational attainment, might have contributed to a slower pace of productivity growth in recent years (Fernald 2016).

Despite relatively subdued underlying growth, the economy has continued to move closer to the Federal Reserve’s full employment and inflation objectives. The unemployment rate remained slightly below 5 percent in most of the second half of 2016. While labor force participation could recover from current low levels as discouraged workers return to the labor market, demographic pressures make a return of the participation rate to pre-crisis levels unlikely (Aaronson et al. 2014). Following a policy interest rate hike in December 2016, a further normalization of monetary policy is expected throughout the forecast period, as long-term inflation expectations have recovered and growth is predicted to remain above potential. However, the federal funds rate is expected to stabilize over the long run at a lower level than in previous cycles, reflecting further evidence of a
persistently low real equilibrium interest rate (Holston, Laubach, and Williams 2016).

The fiscal policy stance is assumed to be broadly neutral to growth in 2017. However, the new administration has signaled intentions to pursue more expansionary fiscal policies, including tax cuts and measures to upgrade infrastructure, which could lead to stronger growth in the short term. In general, a fiscal stimulus of 1 percent of GDP could be expected to raise U.S. GDP by between 0.7 and 1.5 percent after 2 years, depending on the amount of remaining economic slack and the reaction of monetary policy authorities (Laforte and Roberts 2014; Brayton, Laubach, and Reifschneider 2014; Whalen and Reichling 2015).

In terms of the proposals suggested by the new U.S. administration, simulations indicate that the planned reduction in corporate and personal income taxes could—if fully implemented and without consideration for other policy changes—increase U.S. GDP growth projections to 2.2-2.5 percent in 2017 and 2.5-2.9 percent in 2018. Estimates vary depending on the timing of the tax cuts, the reaction of monetary policy authorities, and how businesses and households adjust their expectations to policy changes. Given limited details to date about the overall scope of all fiscal measures that the new administration plans to implement, including plans to stimulate infrastructure investment and cuts in other federal government outlays, it is difficult to rigorously examine their net effect on the outlook for the U.S. economy.¹

Changes in business regulations could also support private-sector activity, while a relaxation of environmental standards could have important sectoral implications. If implemented, plans to retreat from trade agreements or to raise tariffs and trade barriers could lead to retaliatory action and have negative effects on the outlook for the U.S. economy. The renegotiation of NAFTA could have particularly significant effects on regional trade and industrial prospects (Noland et al. 2016).

¹The “Risks to the outlook” section of this chapter presents further discussion.

FIGURE 1.5 Euro Area

Despite the Brexit vote in June 2016, confidence in the Euro Area has continued to improve. However, investment rates are low, particularly in countries that were most affected by the Euro Area debt crisis. Borrowing costs have eased considerably since the introduction of a negative interest rate policy in June 2014, but concerns about banking sector profitability intensified in 2016. Despite further monetary policy accommodation, headline inflation remains close to zero, and long-term inflation expectations are still below the European Central Bank’s policy target.

A. Change in economic sentiment since Brexit vote

B. Investment rate in selected countries

C. Change in interest rates since the introduction of negative interest rate policies in June 2014

D. Actual inflation and long-term inflation expectations

Sources: European Central Bank, European Commission, Eurostat.
A. European Commission economic sentiment is an average of business climate and consumer confidence indexes. Change from May 2016. Last observation is November 2016.
B. Weighted average of investment rates across sub-groups of Euro Area countries. Last observation is 2016Q3.
C. Euribor is the Euro interbank offered rate. Loan and mortgage rates are for newly originated loans.
D. Long-term inflation expectations are derived from 5-year 5-year forward swap rates. Last observation is November 2016.

Euro Area

Euro Area growth slowed from 2 percent in 2015 to 1.6 percent in 2016, as both domestic demand and exports lost momentum. Confidence in the Euro Area has been resilient following the United Kingdom’s vote to exit the European Union (EU) in June 2016 (Figure 1.5). The U.S. election results could also heighten policy uncertainty in Europe. A rebound in oil prices, from their trough in early 2016, implies diminished support to real income and private consumption growth relative...
Investment rates are particularly low in the Euro Area periphery, with increased policy uncertainty likely weighing further on capital spending in 2017. Labor market and credit conditions continued to improve in 2016. Employment recouped its pre-crisis levels, and the unemployment rate ebbed further, albeit from elevated levels and with wide cross-country variations.

Negative policy interest rates, combined with large-scale asset purchase programs by the European Central Bank, led to a noticeable easing of borrowing costs and generally had a positive effect on lending flows (Arteta et al. 2016; Rostagno et al. 2016). However, renewed concerns about banking sector profitability and elevated non-performing loans in some countries (e.g., Italy) could continue to constrain Euro Area credit and contribute to market volatility. Despite ongoing monetary policy easing, headline and core inflation remain significantly below target. The longer this undershooting continues, the greater the risk of inflation expectations becoming de-anchored from policy objectives (Łyziak and Paloviita 2016). Fiscal policy was slightly expansionary in 2016 partly as a result of refugee-related outlays, but is expected to be broadly neutral to growth in 2017. Fiscal sustainability concerns remain in a number of countries, although debt services costs declined in most Euro Area countries, thanks to the exceptionally low interest rates across the maturity spectrum.

Uncertainty about the Brexit process is expected to weigh on growth in 2017-18 in the United Kingdom and, to a lesser extent, in the Euro Area. Growth in the Euro Area in 2017 is projected to slow marginally to 1.5 percent, as the unwinding of the income boost associated with lower oil prices, increased policy uncertainties, and lingering banking sector concerns offset the benefit of more favorable financial conditions. Growth is expected to remain broadly stable in 2018 and 2019, at 1.4 percent, leading to a very gradual narrowing of the output gap.

Japan

Following the release of new and revised national accounts data, growth in Japan is now estimated at 1 percent for 2016. Investment and exports were generally weak, while private consumption showed some signs of improvement after two years of contraction. Labor shortages underlay a modest increase in wage growth; however, the gains were dampened by low inflation expectations and a rising share of part-time employment (Figure 1.6). The appreciation of the yen during most of 2016 put downward pressure on profit margins for exporters. To support growth, the government announced a series of fiscal stimulus measures, including new public spending amounting to 1.2 percent of GDP.
central bank, and at the same time mitigate adverse effects of negative long-term yields on financial institutions (Arslanalp and Botman 2015; Iwata et al. 2016). Despite the policy shift, the yen appreciated in the earlier part of 2016. Since Japanese exports are often denominated in destination currencies, this dampened profits and investment in 2016. However, the yen depreciated rapidly towards the end of the year, paring most of its earlier gains.

To support growth, the government announced a series of measures. These included postponement of a planned consumption tax hike (from April 2017 to October 2019) and a fiscal stimulus package, with new public spending amounting to 1.2 percent of GDP. This new spending is expected to add around 0.3 percentage point to growth in 2017.

Overall, growth projections for 2017 and 2018 have been revised up—to 0.9 percent and 0.8 percent, respectively—but remain constrained by the low growth potential implied by a shrinking and aging labor force and heightened policy uncertainty in major trading partners. This, in turn, contributes to diminished expectations, which negatively affect investment spending as well as fiscal and monetary policy effectiveness. Growth is projected to slow to 0.4 percent in 2019, mainly resulting from the planned consumption tax hike.

China

Growth in China is estimated to have slightly decelerated to 6.7 percent in 2016. As part of ongoing economic rebalancing, growth has been concentrated primarily in services, while industrial production has stabilized at moderate levels (Figure 1.7; Zhang 2016). The internal rebalancing is also evident on the demand side: consumption growth has been strong, while investment growth has continued to moderate from the post-crisis peak (Lardy and Huang 2016). The decline in investment growth was concentrated in the private sector; investment by the non-private sector accelerated in 2016. Fiscal and credit-based stimulus measures supported growth in 2016, focusing on infrastructure investment and on efforts to stimulate household credit.

Credit growth, which has been moderating since late 2015, stabilized during 2016 but remained well above the pace of nominal GDP growth. On the back of a continued real estate boom, loans to households accounted for an increasing share of credit extension in 2016. Reflecting household lending activity, household debt to GDP has surpassed 40 percent of GDP, up almost 10 percentage points over the past three years (BIS 2016). While credit growth to the industrial sector has moderated, the stock of credit to the non-financial corporate sector continued to rise, reaching 170 percent of GDP in 2016.

Partly as a result of real estate lending, housing prices reached new heights, especially in major
Global trade volumes stagnated in the first half of 2016, reflecting softening demand from advanced economies and still-contracting imports from major commodity exporters. Weak investment growth has also contributed to subdued capital goods trade. The slowdown in global value chain integration seems to have intensified in recent years, contributing to a lower income elasticity of trade. A gradual recovery in global trade is still expected in 2017 and 2018, but at a weaker pace compared to its long-term performance partly due to a less favorable policy environment.

A. Global goods trade growth

B. Global capital goods trade and investment

C. Global value chain growth

D. Import volume growth

A. Average of global merchandise imports and exports. Last observation is September 2016.
B. Capital goods trade and gross fixed capital formation expressed in current U.S. dollars. Trend line shows the pre-crisis (2003-08) trend of the average of capital goods trade.
C. Global value chain growth indicator as computed by Haugh et al. (2016) is a partial measure of participation in global value chains based on import values of intermediate goods, divided by the value of final domestic demand. The indicator is cyclically adjusted.
D. Shaded area indicates forecasts. Goods and services import growth consistent with national accounts data. Aggregate growth rates calculated using constant 2010 U.S. dollars GDP weights.

Notwithstanding, the renminbi remains markedly above its 2005 level in trade-weighted terms and broadly in line with fundamentals. The renminbi was added to the basket of currencies that make up the International Monetary Fund’s Special Drawing Right in October 2016.

Growth is projected to moderate to 6.5 percent in 2017 and to 6.3 percent in 2018-19, reflecting soft external demand, heightened uncertainty about global trade prospects, and, critically, slower private investment. Macroeconomic policies are expected to continue supporting activity to help smooth the adjustment of output in overcapacity sectors (World Bank 2016a). Rebalancing from industry to services, and from investment to consumption, is expected to moderate. Progress in reducing financial excesses will likely be modest, barring deep structural reforms with respect to state-owned enterprises (SOEs) and corporate restructuring (IMF 2016a).

**Global trends**

Global trade growth slowed further in 2016 to its weakest pace since the global financial crisis. Soft imports from major economies continued to depress trade flows, compounded by structural factors and increased protectionism. Financial market conditions for EMDEs, which were generally benign for most of 2016, tightened significantly following the U.S. elections. Commodity prices stabilized in the course of 2016, and are expected to gradually recover. Heightened policy uncertainty in the United States and Europe is likely to weigh on global trade and capital flows.

**Global trade**

Global trade growth in 2016 recorded its weakest performance since the global financial crisis. Stagnant goods trade for most of 2016 (Figure 1.8) was exacerbated by a cyclical drawdown in inventories across advanced economies and contracting imports in China and in major commodity exporters. The sharp drop in oil prices from mid-2014 to early 2016 could have contributed to the weakness in global trade over that period, as income losses were highly concentrated among a few countries, while gains

Cities (Chen, Wang, and Liuc 2015). In 2016, prices rose more than 30 percent in Shanghai, Shenzhen, and Xiamen, although they showed signs of stabilization in recent months, reflecting tighter property regulations. Producer price deflation came to halt as input prices stabilized, but CPI inflation remained below the central bank’s 3-percent target throughout 2016.

Despite some easing, capital outflows from China remained sizable and continued to put downward pressure on the currency. During 2016, the renminbi depreciated around 7 percent against the U.S. dollar and around 5 percent in nominal trade-weighted terms. These movements
were diffused among many—import demand is generally more sensitive to large changes in income than to smaller changes (World Bank 2015a). The observed slowdown in global investment in 2015-16 played an important role as well, as capital goods account for about one third of world goods trade.

Structural forces at work include a slower pace of trade liberalization and of global value chain integration (Constantinescu, Mattoo, and Ruta 2016a). In an environment of weak global trade, stagnant real income gains in major advanced economies, and marked currency movements between major reserve currencies, protectionism has been slowly rising. For example, in 2016, G20 countries have taken more trade-restrictive measures than trade-facilitating ones (Evenett and Fritz 2016). Although subsidies and trade safeguard measures are still by far the most common forms of trade distortion, there has been a shift toward more opaque measures, such as localization requirements, export incentives, and other trade finance measures. The appetite for further trade liberalization has waned, particularly among major advanced economies, which in turn appears to have contributed to the global trade slowdown more than the rise in temporary trade barriers (Constantinescu, Mattoo, and Ruta 2015).

The maturation of global value chains also contributed to a lower income elasticity of trade (the additional trade generated by an increase in global GDP). This trend, which had been observed prior to the global financial crisis, has intensified in recent years (OECD 2016a; Crozet, Emlinger, and Jean 2015; Haugh et al. 2016). Among major advanced economies, the slowdown in global value chain participation is particularly visible in the United States and Japan. Among EMDEs, China’s move toward more mature domestic intermediate production has also contributed in lowering its trade elasticity (Kee and Tang 2015). However, most EMDEs still have a large untapped potential to move up the value chain, by shifting to more complex and higher domestic value-added products (Taglioni and Winkler 2016; Ferrantino and Taglioni 2014).

Services trade continued to show greater resilience than goods trade because of its nature. Services cannot be stored, often represent a fixed cost in production processes, and are less sensitive to changes in credit and trade finance conditions (Borchert and Mattoo 2010; Ariu 2016).

A gradual recovery in global trade is still expected in 2017 and 2018, supported by a projected rebound in import demand from large EMDEs. However, the pace of the recovery is slower than previously expected because of downward revisions to growth prospects in major advanced economies, persistent weakness in global investment, and slower or stalled trade liberalization amid uncertainty about trade policy in the United States and Europe.

Financial markets

While capital inflows to EMDEs generally recovered in 2016, a rapid increase in U.S. bond yields and an appreciation of the U.S. dollar following the U.S. elections led to a sudden tightening of financing conditions for EMDEs toward the end of 2016. In some cases, this tightening lead to significant currency depreciations, portfolio outflows, and slowing debt issuance.

The sudden rise in U.S. yields reflected an uptick in long-term inflation expectations and prospects of a faster normalization of U.S. monetary policy, which contributed to a recovery in term premiums from previous record-low levels (Figure 1.9). U.S. long-term yields increased to the highest levels since September 2014, although they remained below post-Taper Tantrum peaks in 2013-14. In contrast, expectations of continued monetary policy accommodation by the European Central Bank and the Bank of Japan put downward pressure on global bond yields and term premiums for most of 2016 (Hordahl, Sobrun, and Tuner 2016). By the end of 2016, bond yields up to a five-year maturity were still negative in economies accounting for nearly 20 percent of global GDP.

Prior to November 2016, record-low advanced-economy interest rates contributed to a resumption of capital flows to emerging markets, reinforced by a stabilization in commodity prices.
This led to renewed appetite for emerging market assets and to a drop in sovereign credit spreads, benefiting in particular large commodity exporters (Figure 1.10). EMDE spreads have tightened since November 2016, but remained notably below levels prevailing at the start of the year. Demand for higher-yielding debt securities during 2016 has led many EMDEs, particularly oil exporters facing declining fiscal revenues and rising deficits, to issue foreign-currency debt. During the first three quarters of the year, strong issuance activity in Latin America and the Caribbean, Europe and Central Asia, and the Middle East and North Africa offset reductions in Sub-Saharan Africa, where access and cost of primary bond issuances remained severely constrained. Sovereign bond issuance by EMDEs has slowed appreciably since the U.S. elections, while corporate bond issuance generally remained weak throughout 2016.

FDI flows to EMDEs remained subdued throughout 2016, albeit with significant differences across commodity importers and exporters. Among commodity exporters, persistently low commodity prices have reduced the attractiveness of investment in mining and exploration and have reduced the profits and reinvested earnings that supported past inflows. FDI growth is now well below long-term averages in both commodity-importing and commodity-exporting regions. Subdued FDI flows to commodity exporters add to external financing needs at a time when fiscal and current account positions are already under pressure. FDI flows to large commodity importers were generally resilient in 2016. In sum, capital flows to EMDEs recovered some ground during the first three quarters of 2016, following the post-crisis lows reached at the end of 2015, but stayed subdued by historical standards and showed renewed signs of weakness toward the end of the year.

EMDEs could continue to face challenging financial market conditions amid rising global bond yields, a strong U.S. dollar, and heightened policy uncertainty. However, capital inflows are still projected to recover modestly in 2017, assuming improved growth prospects among commodity exporters, rising commodity prices, and a gradual normalization of U.S. policy interest rates.

The benefit for FDI from continued liberalization measures in some large EMDEs, as well as an expected pick-up in mergers and acquisitions, may be partly offset by heightened policy uncertainty in the United States and Europe as investors brace themselves for downside risks. Portfolio and short-term debt flows could be supported by a stabilization in credit ratings for EMDEs, assuming low (albeit gradually increasing) global interest rates and a continued recovery in commodity prices. In contrast, cross-border syndicated bank lending to EMDEs is likely to remain feeble, reflecting tighter lending standards driven by de-risking, regulatory changes, and weak bank profitability. Unconventional monetary policies designed to support domestic lending in some advanced economies might also have had unintentionally negative effects on cross-border bank flows (Forbes, Reinhardt, and Wieladek 2016). Despite a projected recovery, capital inflows as a percent of EMDE GDP should remain significantly below averages over the 2000-08 and 2010-14 periods.
Commodities

Crude oil prices have recovered from a low of $30 per barrel (bbl) at the start of 2016, but are still half of their pre-2015 levels (Figure 1.11). The oil market continues to rebalance, as consumption rises while non-OPEC supply declines—notably in the United States, where oil output is down 12 percent from its peak in early 2015. However, global oil inventories remain high, particularly in the United States. After averaging $43/bbl in 2016—an annual decline of 15 percent relative to 2015, despite the gradual increase throughout the year—oil prices are expected to average $55/bbl in 2017, up 28 percent from 2016 levels.

Following two years of unrestrained output to gain market share, OPEC decided at its November meeting to limit production to 32.5 million barrels per day (mb/d) in the first half of 2017—down 1.2 mb/d from October 2016 production levels—with the possibility of an extension of this limit for the remainder of the year. This decision represented the first agreed production cut by OPEC since 2008. In a subsequent meeting in early December, eleven non-OPEC countries pledged to cut nearly 0.6 mb/d, with Russia expected to account for about half of the reduction. If implemented in full, these agreements could help bring crude oil inventories back to historical balance during the first half of 2017. If the cuts are sustained into the second half of 2017, stock draws could lead to tighter market conditions. Nevertheless, formal commodity agreements in the past had limited ability to influence market conditions over extended periods of time (Baffes et al. 2015; World Bank 2016b). The possibility of partial compliance and the possibility of higher production from Libya and Nigeria could result in a more gradual drawdown of oil inventories throughout 2017.

OPEC’s ability to guide global oil prices higher will likely be challenged by the presence of unconventional oil producers, notably U.S. shale oil, which can respond rapidly to changing market conditions (Special Focus). Rising prices have already led to a rebound in shale drilling, and U.S. production is expected to bottom in 2017. Moreover, average costs have fallen markedly in

As the stock overhang is expected to gradually unwind, oil prices are projected to increase from $43/bbl in 2016 to $55/bbl in 2017. This represents an uptick from June projections, when oil prices for 2016 and 2017 were forecast to reach $41/bbl and $50/bbl, respectively. The outcome of the U.S. election might also lead to some policy-induced changes in energy market fundamentals, but such changes are likely to be
limited. Less strict environmental regulation in the United States could potentially contribute to lower oil prices, while geopolitical uncertainty could make oil prices more volatile. Further disruptions among politically-stressed producers (Iraq, Libya, Nigeria, and República Bolivariana de Venezuela, with the latter holding the world’s largest reserves) could exert additional upward pressures.

Metals prices have risen from lows in early 2016 on strong demand, partly from China’s stimulus to the property and construction sectors. Supply reductions for a few commodities—including zinc and nickel—have also been a factor. Average annual metals prices dropped in 2016, but are expected to rise marginally in 2017 as markets slowly tighten. Metals price risks depend critically on demand from China, given that the country accounts for more than half of global metals consumption. Supply risks entail further outages in Asia, and China’s attempt to reduce excess capacity in steel, aluminum, and coal. The direction of U.S. policies after the elections might also induce some volatility in metal prices. Greater emphasis on infrastructure could lead to higher metal consumption in the United States, putting some upward pressure on prices; however, more protectionist trade policies might negatively affect metals demand, particularly from China.

Agricultural prices are projected to remain broadly stable in 2016 and 2017. Supplies for most commodities are adequate. Fears of supply disruptions in the Southern Hemisphere earlier in the year due to La Niña have diminished. Stocks for the three key grains (maize, wheat, and rice) are at multi-year highs. Global crop conditions have improved for most grains and oilseeds. Since agricultural production is energy-intensive, lower energy costs continued to have a dampening effect on prices in 2016. In addition, low oil prices reduce the incentive to divert land use away from food to biofuels. Indeed, global biofuel production grew at an annual rate of just 1 percent in the past 2 years, versus 17 percent during the preceding decade (World Bank 2016c). However, the expected recovery in energy prices in 2017 could halt these downward pressures.

Emerging and developing economies: Recent developments and outlook

EMDEs grew by an estimated 3.4 percent in 2016, slightly below June projections. Among commodity exporters, output expanded an estimated 0.5 percent, as some improvement in Brazil and Russia and a modest increase in commodity prices was offset by further weakness in other exporters. In commodity importers, growth in 2016 is estimated at 5.6 percent, reflecting resilient domestic demand and generally accommodative macroeconomic policies.

La Niña is characterized by unusually cold ocean temperatures in the Equatorial Pacific, compared to El Niño, which is characterized by unusually warm ocean temperatures in the same region. La Niña often follows El Niño.
**FIGURE 1.12 EMDE developments**

Commodity exporters grew much more slowly than commodity importers in 2016, with the latter accounting for most of the estimated aggregate EMDE growth rate of 3.4 percent. In commodity importers, growth continued to be supported by solid domestic demand. Although investment growth is stronger in commodity importers than in exporters, it is below long-term averages in more than half of all countries within both sub-groups.

**A. GDP growth**

<table>
<thead>
<tr>
<th>Year</th>
<th>Commodity Exporters</th>
<th>Commodity Importers ex. China</th>
</tr>
</thead>
<tbody>
<tr>
<td>2011</td>
<td>5%</td>
<td>4%</td>
</tr>
<tr>
<td>2012</td>
<td>4%</td>
<td>3%</td>
</tr>
<tr>
<td>2013</td>
<td>3%</td>
<td>2%</td>
</tr>
<tr>
<td>2014</td>
<td>2%</td>
<td>1%</td>
</tr>
<tr>
<td>2015</td>
<td>1%</td>
<td>0%</td>
</tr>
<tr>
<td>2016</td>
<td>0%</td>
<td>-1%</td>
</tr>
</tbody>
</table>

**B. Contribution to EMDE growth**

<table>
<thead>
<tr>
<th>Country</th>
<th>Contribution</th>
</tr>
</thead>
<tbody>
<tr>
<td>India</td>
<td>3%</td>
</tr>
<tr>
<td>Russia</td>
<td>2%</td>
</tr>
<tr>
<td>China</td>
<td>1%</td>
</tr>
<tr>
<td>Brazil</td>
<td>0%</td>
</tr>
</tbody>
</table>

**C. Contribution to GDP growth**

<table>
<thead>
<tr>
<th>Component</th>
<th>Percent</th>
</tr>
</thead>
<tbody>
<tr>
<td>Exports</td>
<td>6%</td>
</tr>
<tr>
<td>Consumption</td>
<td>4%</td>
</tr>
<tr>
<td>Investment</td>
<td>2%</td>
</tr>
<tr>
<td>Imports</td>
<td>0%</td>
</tr>
</tbody>
</table>

**D. Growth in EMDE commodity exporters (excluding BRICS)**

<table>
<thead>
<tr>
<th>Year</th>
<th>Commodity Exporters</th>
<th>Commodity Importers</th>
</tr>
</thead>
<tbody>
<tr>
<td>2010</td>
<td>5%</td>
<td>4%</td>
</tr>
<tr>
<td>2011</td>
<td>4%</td>
<td>3%</td>
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<td>2012</td>
<td>3%</td>
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<tr>
<td>2013</td>
<td>2%</td>
<td>1%</td>
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<tr>
<td>2014</td>
<td>1%</td>
<td>0%</td>
</tr>
<tr>
<td>2015</td>
<td>0%</td>
<td>-1%</td>
</tr>
<tr>
<td>2016</td>
<td>0%</td>
<td>-2%</td>
</tr>
</tbody>
</table>

**E. EMDE investment growth**

<table>
<thead>
<tr>
<th>Year</th>
<th>Commodity Exporters</th>
<th>Commodity Importers</th>
</tr>
</thead>
<tbody>
<tr>
<td>2010</td>
<td>5%</td>
<td>4%</td>
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<tr>
<td>2011</td>
<td>4%</td>
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<td>2012</td>
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<td>2013</td>
<td>2%</td>
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<tr>
<td>2014</td>
<td>1%</td>
<td>0%</td>
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<tr>
<td>2015</td>
<td>0%</td>
<td>-1%</td>
</tr>
<tr>
<td>2016</td>
<td>0%</td>
<td>-1%</td>
</tr>
</tbody>
</table>

**F. Share of EMDEs with investment growth below its long-term average**

<table>
<thead>
<tr>
<th>Year</th>
<th>Commodity Exporters</th>
<th>Commodity Importers</th>
</tr>
</thead>
<tbody>
<tr>
<td>2010</td>
<td>5%</td>
<td>4%</td>
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<tr>
<td>2011</td>
<td>4%</td>
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<td>2013</td>
<td>2%</td>
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<tr>
<td>2014</td>
<td>1%</td>
<td>0%</td>
</tr>
<tr>
<td>2015</td>
<td>0%</td>
<td>-1%</td>
</tr>
<tr>
<td>2016</td>
<td>0%</td>
<td>-1%</td>
</tr>
</tbody>
</table>

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

A. Weighted averages of GDP growth. Last observation is 2016Q3.
B. Commodity importers exclude China and India. Commodity exporters exclude Russia and Brazil.
C. Growth is simple average of each country groups excluding BRICS. Gray bars denote inter-quartile ranges.
D. Long-term averages start in 1991 for EMDEs and are based on annual data. Last observation is 2016Q2.
E. Weighted averages. Includes 28 EMDEs with available quarterly data. Long-term averages for commodity exporters are country-specific for 1990-2008.

EMDE growth is projected to pick up to 4.2 percent in 2017 and to an average of 4.7 percent in 2018-19, mainly on a recovery in commodity exporters supported by a gradual increase in commodity prices. However, a number of factors—including advanced-economy policy uncertainty and slowing productivity growth—are expected to weigh on the medium- and long-term EMDE outlook.

**Recent developments**

Growth in EMDEs reached an estimated 3.4 percent in 2016, slightly below June forecasts and the subdued pace in 2015, and well below the long-term average of 4.4 percent. Weak global trade was offset by some pickup in domestic demand and, for most of 2016, by generally benign financing conditions—although the latter experienced a substantial tightening toward the end of the year, reflecting an appreciation of the U.S. dollar and a rise in global bond yields. The marked divergence between commodity exporters and importers continued, although with notable variations within each group (Figure 1.12). Reflecting these divergences, growth in commodity importers in 2016 accounted for almost the totality of EMDE growth.

**Commodity-exporting EMDEs**

Low commodity prices and weak global trade continue to create challenging conditions for commodity-exporting EMDEs (Reinhart, Rogoff, and Trebesh 2016). This group grew by an estimated 0.3 percent in 2016, markedly below the long-term average of 2.8 percent. Relative to June projections, growth in these economies has been slightly downgraded, as improvements in some of the largest exporters—most notably Russia and Brazil—and a modest increase in commodity prices were offset by further weakness in other exporters.

Growth in commodity-exporting EMDEs in 2016 was supported by some stabilization in domestic demand, following a contraction in 2015. Private consumption continued to contract in Brazil and Russia, but at a slowing pace as confidence improved. Investment also contracted again in 2016, especially in Brazil, Colombia, and Russia. More generally, subdued investment across commodity exporters reflected policy tightening, weakness in extractive sectors, soft growth prospects, political and policy uncertainty, and continued adjustment to the earlier terms-of-trade shock (Chapter 3). In contrast, investment growth picked up in several exporters in East Asia and...
Variations in growth among commodity exporters in 2016 reflected the pace of policy adjustment to low commodity prices and country-specific domestic challenges (Gervais, Schembri, and Suchanek 2016). In general, because of the sharper and more recent decline in their terms of trade, growth in energy exporters (Angola, Azerbaijan, Kazakhstan, Nigeria) fell well behind that in metal and agriculture exporters (Ethiopia, Kenya, Peru, Tanzania, Uganda).

Although Brazil and Russia, which together account for about two-fifths of commodity-exporting EMDE output, suffered a second consecutive year of recession in 2016, they have been showing signs of improvement. In Russia, the stabilization in oil prices and the authorities’ policy response—exchange rate adjustment, banking sector capital and liquidity injections—improved the short-term outlook, helped restore confidence, and stabilized the financial system (IMF 2016b; World Bank 2016d). In Brazil, a rebound in confidence following moves to alleviate political uncertainty, combined with improved terms of trade, helped to slow the pace of output contraction (IMF 2016c).

In general, growth was resilient in more diversified commodity exporters, which avoided severe growth slowdowns in 2016 (Chile, Colombia, Costa Rica, Indonesia, Kenya, the Kyrgyz Republic, Malaysia, Myanmar, Peru, Tajikistan, Tanzania, Uganda, Uzbekistan). In many of these countries, various favorable domestic and external factors helped absorb shocks and support their current recovery (Gervais et al. 2016). These include flexible exchange rates, moderate inflation, policy buffers, access to concessional sources of financing, robust foreign direct investment, and stronger growth in their main trading partners. In some cases, greater fiscal space (Chile, Peru) provided more room for stimulus in response to slowing growth (IMF 2016d). In several countries, previous policy tightening helped improve confidence and policy credibility (Indonesia, Malaysia). These factors, combined with relatively benign external financing conditions for most of 2016, helped ease pressures on exchange rates and asset prices and allowed some central banks (Armenia, Indonesia, Malaysia, the Kyrgyz Republic) to move to a policy easing cycle.

In contrast, growth decelerated sharply in 2016 in a number of exporters in Sub-Saharan Africa (Angola, Chad, the Democratic Republic of Congo, Nigeria, Mozambique, South Africa, Zimbabwe), Latin America and the Caribbean (Argentina, Ecuador), Middle East and North Africa (Bahrain, Saudi Arabia), Europe and Central Asia (Azerbaijan, Kazakhstan), and East Asia and Pacific (Mongolia, Papua New Guinea). Incomplete policy adjustment to the global commodity price shock in some countries was compounded by country-specific domestic challenges, including droughts and security issues (Nigeria, South Africa).

Balance of payment pressures, currency weakness, and high inflation prompted these countries to embark on or continue policy tightening in the second half of 2016 despite soft economic activity (Azerbaijan, Angola, Nigeria, Mozambique, Mongolia—IMF 2016e; IMF 2016f). After heavy reserve losses, several large oil exporters with tightly managed exchange rates (Azerbaijan, Angola, Kazakhstan, Nigeria) allowed their exchange rates to weaken in 2015-16 (Horton et al. 2016; Lariau et al. 2016). Fiscal retrenchment supported external adjustment in the less diversified oil exporters, including the Gulf Cooperation Council (Alan et al. 2012; Behar and Foujeu 2016). Growth in these countries is now held back by contractions in non-oil activity, which had previously been supported by public investment (Azerbaijan, Saudi Arabia—IMF 2015a). As a result, labor market and job prospects have deteriorated in a range of commodity exporters.

**Commodity-importing EMDEs**

In commodity-importing EMDEs, growth is estimated at 5.6 percent in 2016—a slight downgrade from June projections and below its long-term average of 6.1 percent. Growth in commodity-importing EMDEs excluding China—a group that accounts for about one third of EMDE output—is estimated to have decelerated to a still-solid 4.3 percent in 2016,
**BOX 1.1 Low-income countries: Recent developments and outlook**

Growth in low-income countries (LICs) remained subdued in 2016, slowing marginally to an estimated rate of 4.7 percent. Low commodity prices, adverse weather conditions, and political and security difficulties were significant factors holding back output in various countries. Growth slowed among commodity exporters, while remaining unchanged from 2015 for commodity importers. Despite some modest improvement in 2016, commodity prices are expected to remain low, and fiscal adjustment needs remain large in commodity-exporting LICs, putting an additional damper on their growth. Overall growth in LICs is expected to recover moderately, to 5.6 percent in 2017 and 6.0 percent a year in 2018-19, as commodity exporters continue to adjust. Risks to the outlook remain tilted to the downside. The main external risk is that the modest expected increase in commodity prices might not materialize, while the main domestic risks lie in worsening drought conditions and deterioration in political and security situations. Maintaining macroeconomic stability and boosting per capita growth remain key policy challenges.

**Subdued growth.** GDP growth in LICs in 2016 is estimated to have edged down to 4.7 percent (Figure 1.1.1). Low commodity prices, adverse weather conditions, and political and security challenges were factors that continued to take a toll in various countries. Severe weather conditions caused a sharp fall in agricultural production in some countries (Ethiopia, Haiti, Malawi, Mozambique, Rwanda, Uganda), destroyed infrastructure in some cases (Haiti), and contributed to food insecurity (Ethiopia, Malawi). The security situation deteriorated notably in Afghanistan and South Sudan.

The slowdown was concentrated in the commodity exporters. GDP contracted in oil exporters (Chad, South Sudan). In Chad, depletion of oil fields exacerbated the negative effects of low oil prices on output, while Boko Haram militant attacks hampered economic activity more broadly. In South Sudan, conflict severely disrupted oil production. Metals exporters struggled, with growth slowing markedly in the Democratic Republic of Congo and Mozambique (Table 1.1.1), as socio-political uncertainties compounded the adverse effects of low metals prices. In Mozambique, the discovery of hitherto undisclosed information on external debt guarantees of the government led to a significant deterioration in investor sentiment. By contrast, growth rebounded in the Ebola-affected countries—Guinea, Liberia, and Sierra Leone—although the recovery was constrained by continued weakness in the price of iron ore, their main export. Per capita GDP growth was barely positive in metals exporting-countries in 2016.

Growth in LIC commodity importers held steady in 2016. These agricultural-based and non-intensive resource economies account for more than two-thirds of LIC output. Among the large economies (Ethiopia, Rwanda, Senegal), growth remained at or above 6 percent, supported by infrastructure investment. Growth was above 5 percent in several other countries, helped by stronger donor aid (Burkina Faso), a gradually improving security situation (Mali), and increased public investment (Togo). However, in a number of fragile countries, growth was feeble (Afghanistan, the Comoros, Malawi), slowed markedly (Nepal), or negative (Burundi). In Afghanistan, droughts and heightened insecurity held back activity. Delays in post-earthquake reconstruction and disruptions in cross-border trade with India adversely affected growth in Nepal. In Haiti, political paralysis and limited access to concessional financing, compounded by heavy flooding and destruction from hurricane Matthew, weighed heavily on growth. Per capita output growth was negative among fragile LICs in 2016.

**Easing inflationary pressures.** Average inflation in LICs in 2016 was unchanged from 2015, with a slight decline in inflation in commodity importers offsetting an increase in commodity exporters (Figure 1.1.2). Moderate currency movements and increased agricultural production helped stabilize prices in some cases. Inflation rose in the metals exporters as a result of currency depreciations and rising food prices due to drought. Some central banks tightened policy to relieve currency and inflationary pressures. Meanwhile, inflation among oil exporters remained low, reflecting weak domestic demand.

**Deteriorating fiscal positions.** Overall fiscal balances deteriorated in LICs in 2016. Fiscal deficits widened markedly, relative to GDP, in commodity importers.

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Note: This box was prepared by Gerard Kambou and Boaz Nandwa. Research assistance was provided by Xinghao Gong.
and commodity exporters (Figure 1.1.2). Fiscal deficits in metals exporters narrowed slightly, after these countries took measures to control expenditures and boost non-resource revenues. By contrast, fiscal deficits widened in the oil exporters as public spending rose, even as oil revenues remained depressed. In commodity importers, developments were mixed, although their average fiscal deficit widened. In some countries, deficits declined (Benin, Haiti), or remained low (Afghanistan, Nepal) helped by slower growth of public spending; in others, they remained high (Togo) or widened (Ethiopia, Uganda) as robust growth encouraged higher expenditures.

Government debt continued to rise in most LICs, particularly in commodity exporters. The increase was especially steep in Mozambique, where gross government debt jumped to over 110 percent of GDP after new information exposed government guarantees on the debt of state-owned enterprises. Among commodity importers, government debt rose markedly in Ethiopia, due to the financing of an ambitious
infrastructure program. They also widened in some fragile countries (Burundi, The Gambia), reflecting increased recourse to central bank advances and the issuance of treasury bills to finance persistently high fiscal deficits.

**Narrowing current account deficits, declining capital inflows.** External current account deficits narrowed but remained large among LICs in 2016 (Figure 1.1.2). The narrowing mainly reflected a reduction of imports by metals exporters; in contrast, deficits of oil exporters widened. Among commodity importers, current account deficits narrowed only slightly, as strong demand for capital goods imports largely offset gains from low oil prices. At the same time, capital inflows fell among LICs. Foreign direct investment (FDI) inflows continued to decline, especially among commodity-exporting LICs in Sub-Saharan Africa. In Mozambique, for example, inward FDI fell by 17 percent in 2016. Among commodity importers, inward FDI rose in Ethiopia, as investors responded to opportunities in construction, light manufacturing, and renewable energy. In contrast to the previous two years, no LIC tapped the international bond market in 2016, reflecting weak investor demand. Heightened political uncertainty reduced private and official bilateral inflows in several LICs.

**Reserve drawdowns and currency depreciations.** Large, albeit reduced, current account deficits, together with lower capital inflows, put pressure on exchange rates and international reserves in 2016. LIC currencies generally depreciated against the U.S. dollar, though by less than in 2015, except among the commodity exporters (Figure 1.1.2). The Democratic Republic of Congo franc and the Mozambican metical fell markedly against the U.S. dollar. The currencies of commodity-importing LICs (Rwanda, Uganda) depreciated by less, as low oil prices benefitted current account balances. In some fragile LICs (Burundi, Haiti), substantial depreciations reflected political uncertainty and low donor flows. Currency pressures were met in part with reserve drawdowns, especially among commodity exporters and some fragile countries. International reserves, in months of imports of goods and services, declined by over 30 percent in Burundi, the Comoros, and Mozambique.

**Moderate growth outlook.** The outlook is for a moderate recovery in growth across LICs, as they continue to adjust to low commodity prices. The external environment confronting LICs is expected to improve gradually, with commodity prices increasing modestly but stabilizing at low levels. GDP in LICs is forecast to expand by 5.6 percent in 2017 and to an average of 6.0 percent in 2018-19. Growth will be weaker in oil exporters than in metals exporters, and quite resilient in commodity importers.

- **Growth among oil exporters** is forecast to rebound moderately. GDP in Chad is expected to contract at a reduced pace in 2017 and expand in 2018, as oil prices continue to stabilize, the security situation improves, and new oil fields come on-stream.

- **The outlook for metals exporters** is relatively more favorable. In Mozambique, recent progress in developing the nascent energy sector will help boost investment in gas production. Post-Ebola recovery is expected to continue in Guinea, Liberia, and Sierra Leone, with improving commodity prices helping to boost investment and exports.

- **Growth in most commodity importers** is expected to remain strong, supported by large public investment and low oil prices. However, fragile countries will see a less vigorous recovery over the forecast horizon (Afghanistan, Burundi, the Comoros, Haiti), as political uncertainty and security challenges continue to hinder private investment.

**Risks tilted to the downside.** External and domestic risks to the growth projection vary across countries but are generally tilted to the downside.

- **External risks.** Rebalancing in China could lead to weaker-than-expected recoveries in growth in commodity-exporting LICs, through lower commodity prices and reduced FDI. Weaker-than-expected growth in advanced economies would have similar effects on commodity exports and remittances (Figure 1.1.3).

- **Domestic risks.** Activity could be adversely affected by persistent drought (Afghanistan, Ethiopia, Malawi, Zimbabwe), rising geopolitical tensions (Afghanistan), heightened political uncertainty (Ethiopia, Haiti, the Democratic Republic of Congo, Zimbabwe), and worsening security (Afghanistan, Mali) (Figure 1.1.3).
Dual policy challenge. Low commodity prices have resulted in a slowdown in GDP growth in commodity-exporting LICs, threatening their recent progress in reducing poverty. Per capita output growth has also continued to lag notably among fragile countries. Commodity-importing LICs, benefitting from low raw materials prices, have experienced more solid growth, but they also suffer from some notable macroeconomic imbalances. Thus, LICs in general face the challenge of boosting per capita output growth, while ensuring macroeconomic stability.

Growth challenges. About two-thirds of the poor in Sub-Saharan Africa’s LICs live in rural households, for which agriculture is the dominant source of income and food security (World Bank 2016e). Increasing the growth of agricultural output and productivity is therefore central to boosting incomes in these countries. This requires significant public investment in rural public goods to strengthen markets and promote the adoption of new technologies. LIC governments will need international support to finance these types of investments. Multilateral development banks can play an important role by expanding access to concessional financial flows. Fragile countries need to achieve a degree of political stability in order to begin to generate steady growth.
Common to all LICs is the need for governments to put in place a positive business environment. While progress has been made across LICs to improve the quality of regulation, more needs to be done. Policy uncertainty should be reduced. Power and trade logistics infrastructure needs to be upgraded (World Bank 2013). Reforms in education and job training would strengthen the skills base. A strong business environment will also help promote economic diversification, which would reduce dependence on raw material exports and help sustain long-term growth.

FDI can help the development of manufacturing and agro-businesses by introducing capital and skills that can be integrated into global value chains (GVC). Cambodia, which graduated from LIC status in 2016, effectively leveraged its comparative advantage in garments production to deepen integration into GVCs. This helped diversify its exports and boost output (IMF 2015b).

Macroeconomic stability: With commodity prices remaining low and capital flows declining, adjustments are needed across LICs to contain fiscal deficits. These includes stronger efforts to improve tax collection, which is held back by limited data on potential taxpayers, limitations of tracking tools, gaps in capabilities and resources, and complex tax procedures. Appropriate measures to improve tax collection will vary across countries, depending on their tax systems. For most LICs, standardizing and simplifying internal processes, closing major tax loopholes, and improving collection procedures would help boost revenues (McKinsey Global Institute 2016).

Fiscal adjustment also calls for more efficient government and the reduction of unproductive expenditures. This implies rationalizing current expenditures and increasing the efficiency of public investment through improved financial management (Dabla-Norris et al. 2012). Within a credible medium-term fiscal plan, it is vital to maintain, or increase, public investment in education and health to build human capital, and in strategic infrastructure to remove transportation bottlenecks and systemic power shortages. Concessional financing can help create space to fund these investments and catalyze additional private sector financing.
above its long-term average of 4 percent. This slowdown partly reflects a downgrade to India’s fast pace of expansion.

Commodity importers continued to benefit from past terms-of-trade improvements and generally sound macroeconomic policies. Low inflation and low energy costs enabled many commodity importers to ease or to maintain accommodative macroeconomic policies (Croatia, Thailand, Tunisia, the Philippines). In some countries, growth has benefited from idiosyncratic factors, such as improved confidence (Thailand), the accelerated implementation of public investment projects (the Philippines), and large cross-border infrastructure investments (Bangladesh, Pakistan).

Domestic demand in commodity importers has remained robust, supported by low commodity prices and accommodative monetary and fiscal policy. Private consumption was strong in many commodity importers, especially in Eastern Europe and South Asia. Investment growth has recovered in a number of countries, particularly in Eastern Europe (Croatia, Romania, Serbia), East Asia and Pacific (Cambodia, the Philippines), and

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**TABLE 1.1.1 Low-income country forecasts**

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

<table>
<thead>
<tr>
<th>Low Income Country, GDP&lt;sup&gt;b&lt;/sup&gt;</th>
<th>2014</th>
<th>2015</th>
<th>2016</th>
<th>2017</th>
<th>2018</th>
<th>2019</th>
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<td></td>
<td></td>
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<td>1.2</td>
<td>1.8</td>
<td>3.0</td>
<td>3.6</td>
</tr>
<tr>
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<td>5.0</td>
<td>4.6</td>
<td>5.2</td>
<td>5.3</td>
<td>5.3</td>
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<td>4.0</td>
<td>4.0</td>
<td>5.2</td>
<td>5.5</td>
<td>6.0</td>
<td>6.0</td>
</tr>
<tr>
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<td>-3.9</td>
<td>-0.5</td>
<td>2.5</td>
<td>3.5</td>
<td>3.5</td>
</tr>
<tr>
<td>Chad</td>
<td>6.9</td>
<td>1.8</td>
<td>-3.5</td>
<td>-0.3</td>
<td>4.7</td>
<td>6.3</td>
</tr>
<tr>
<td>Comoros</td>
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<td>2.0</td>
<td>2.5</td>
<td>3.0</td>
<td>3.0</td>
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<td>6.9</td>
<td>2.7</td>
<td>4.7</td>
<td>5.0</td>
<td>5.0</td>
</tr>
<tr>
<td>Ethiopia&lt;sup&gt;c&lt;/sup&gt;</td>
<td>10.3</td>
<td>9.6</td>
<td>8.4</td>
<td>8.9</td>
<td>8.6</td>
<td>8.6</td>
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<tr>
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<td>0.5</td>
<td>0.8</td>
<td>2.6</td>
<td>2.6</td>
</tr>
<tr>
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<td>0.1</td>
<td>5.2</td>
<td>4.6</td>
<td>4.6</td>
<td>4.6</td>
</tr>
<tr>
<td>Guinea-Bissau</td>
<td>2.5</td>
<td>4.9</td>
<td>4.9</td>
<td>5.1</td>
<td>5.1</td>
<td>5.1</td>
</tr>
<tr>
<td>Haiti&lt;sup&gt;c&lt;/sup&gt;</td>
<td>2.8</td>
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<td>1.2</td>
<td>-0.6</td>
<td>1.5</td>
<td>2.0</td>
</tr>
<tr>
<td>Liberia</td>
<td>0.7</td>
<td>0.0</td>
<td>2.5</td>
<td>5.8</td>
<td>5.3</td>
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<tr>
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<td>3.1</td>
<td>4.1</td>
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<tr>
<td>Nepal&lt;sup&gt;c&lt;/sup&gt;</td>
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<td>2.7</td>
<td>0.6</td>
<td>5.0</td>
<td>4.8</td>
<td>4.8</td>
</tr>
<tr>
<td>Niger</td>
<td>6.9</td>
<td>3.5</td>
<td>5.0</td>
<td>5.3</td>
<td>6.0</td>
<td>6.0</td>
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<tr>
<td>Rwanda</td>
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<td>6.6</td>
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<td>7.0</td>
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<tr>
<td>Sierra Leone</td>
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<td>3.9</td>
<td>6.9</td>
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<td>5.9</td>
</tr>
<tr>
<td>Tanzania</td>
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<td>7.0</td>
<td>6.9</td>
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<tr>
<td>Togo</td>
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<tr>
<td>Uganda&lt;sup&gt;c&lt;/sup&gt;</td>
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<tr>
<td>Zimbabwe</td>
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<td>0.4</td>
<td>3.8</td>
<td>3.4</td>
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</tr>
</tbody>
</table>

| Projections                          |      |      |      |      |      |      |
| Percentage point differences from    | 0.0  | -0.6 | -0.7 | -0.6 |
| June 2016 projections                |      |      |      |      |      |


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

a. Central African Rep., Democratic People’s Republic of Korea, and Somalia are not forecast due to data limitations.

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

c. GDP growth based on fiscal year data.
South Asia (Pakistan). However, investment growth remains below its long-term average in more than half of all commodity-importing countries. More generally, slower growth in some commodity importers is explained by idiosyncratic factors, such as policy uncertainty, spillovers from large trading partners (Belarus, Mexico), and legacy from natural disasters (Fiji, Haiti, Nepal). In India, the immediate withdrawal of a large volume of currency in circulation and subsequent replacement with new notes announced by the government in November contributed to slowing growth in 2016.  

Weaker demand growth from major markets depressed export growth in many commodity importers. Exceptions were Germany’s trading partners, which benefited from that country’s solid performance (Hungary, the former Yugoslav Republic of Macedonia, Poland, Romania); Asian economies with improving competitiveness (Cambodia, India); and economies with robust services exports (Croatia, India, Lebanon, the Philippines, Sri Lanka, Thailand).

Low-income countries

Within the broader group of EMDEs, growth in low-income countries (LICs) is estimated at 4.7 percent in 2016 (Box 1.1). Activity contracted in oil exporters (Chad, South Sudan), and decelerated in a number of metal exporters (the Democratic Republic of Congo, Mozambique, Zimbabwe) as they continued to struggle to adjust to low commodity prices. The post-Ebola recovery in Guinea, Liberia, and Sierra Leone was held back by the decline in the price of iron ore, their main export. Compounding the effect of depressed commodity prices, a number of LICs were subject to negative domestic shocks. El Niño-related drought affected agricultural production in Chad, Ethiopia, Malawi, Mozambique, Rwanda, and Uganda. The release of previously undisclosed information on external debt guarantees of the government in Mozambique weakened investor sentiment, resulting in a sharp reduction in FDI flows. Elsewhere, political tensions (Burundi, The Gambia, the Democratic Republic of Congo, Haiti, Nepal), and security challenges (Afghanistan, Chad, Niger) continued to cause strains on economic activity. However, growth in many commodity importers (Ethiopia, Rwanda, Senegal, Tanzania) remained solid in 2016, supported by strong infrastructure investment.

**Outlook**

Growth in EMDEs is projected to pick up to 4.2 percent in 2017 and about 4.7 percent on average in 2018-19 (Figure 1.13). This acceleration mainly reflects a recovery in commodity-exporting

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3Chapter 2 discusses the short-term impact of this action on India’s growth.

4For the current fiscal year, the World Bank Group defines low-income economies as those with an annual GNI per capita, calculated using the World Bank Atlas method, of $1,025 or less in 2015.
**BOX 1.2 Regional perspectives: Recent developments and outlook**

EMDE regions with substantial numbers of commodity-importing economies—East Asia and the Pacific, and South Asia—are projected to experience solid growth. In contrast, the outlook for EMDE regions with large numbers of commodity exporters is mixed. Growth in Latin America and the Caribbean, and in Europe and Central Asia, is expected to accelerate in 2017, mainly reflecting a bottoming out in activity in Brazil and Russia. Growth in the Middle East and North Africa will pick up modestly, as oil prices recover. While growth should also rebound in Sub-Saharan Africa, the improvement is notably weaker than previously expected, as some commodity exporters struggle to adjust to low commodity prices.

**East Asia and Pacific.** Regional growth is estimated to have reached 6.3 percent in 2016, slightly below the 6.5 percent registered in 2015, and in line with June projections (Figure 1.2.1). Solid domestic demand, supported by generally benign financing conditions for most of the year, was accompanied by soft export growth. The growth contour continued to follow China’s gradually declining path. Excluding China, regional output is estimated to have expanded 4.8 percent in 2016, the same pace as in 2015. A pickup in growth in commodity importers in the region offset weaker growth in some commodity exporters, which continue to adjust to low prices. Regional growth is projected to moderate to 6.1 percent on average in 2017-19, in line with June forecasts. Further moderation in Chinese growth will be partly offset by acceleration in the rest of the region, reflecting recovery in commodity exporters and continued solid performance in commodity importers. Key risks to the region include financial market volatility related to heightened policy uncertainty and growth disappointments in major economies, as well as rising protectionist sentiments.

**Europe and Central Asia.** Regional GDP is estimated to have expanded at a 1.2 percent pace in 2016, reflecting an easing recession in Russia, stabilization of commodity prices, and reduced geopolitical tensions in Ukraine. The 2016 estimate is broadly in line with June projections, as an upward revision for Russia was offset by weakness in some other commodity exporters and Turkey. Growth in the western part of the region remained generally solid, reflecting robust consumption and net export growth. In contrast, growth slowed in the eastern part, excluding Russia, due to deceleration in energy-exporting countries. Looking ahead, regional growth is projected to pick up to 2.4 percent in 2017 and an average of 2.9 percent in 2018-19, as Russia bounces back and other commodity exporters and Turkey recover. The main downside risks to the outlook include renewed declines in commodity prices, disruptions in financial markets amid tightening financing conditions, a sharper-than-expected slowdown in Euro Area growth, and elevated political uncertainty.

**Latin America and the Caribbean.** Regional output is estimated to have contracted 1.4 percent in 2016—the second consecutive year of negative growth—against the backdrop of low commodity prices, macroeconomic imbalances, and other domestic challenges. In South America, GDP contracted 2.8 percent, with a further decline in Brazil and recession in Argentina. Aggregate output in Mexico and Central America expanded 2.3 percent, while that of Caribbean grew 3.2 percent. Relative to June projections, regional growth in 2016 was slightly downgraded, as an upward revision for Brazil, partly reflecting improved confidence in the new government, was offset by downward revisions to growth in several other commodity exporters and Mexico. Regional growth is projected to recover to 1.2 percent in 2017, and to further strengthen to an average of 2.4 percent in 2018-19, as domestic headwinds in Brazil and other economies abate and fiscal consolidation across the region is completed. The main downside risks to the outlook include rising policy uncertainty in advanced-economy trading partners, particularly the United States; a renewed slide in commodity prices; and more protracted contractions among the region’s largest economies.

**Middle East and North Africa.** After reaching 3.2 percent in 2015, growth in the region is estimated to have fallen to 2.7 percent in 2016, slightly below June projections, and reflecting downward revisions in oil exporters, particularly some Gulf Cooperation Council (GCC) countries, as weakness spread from the oil to the non-oil sector. Regional growth is projected to accelerate following the bottoming out of oil prices in 2016, reaching 3.1 percent in 2017 and 3.3 percent in 2018–19. For oil exporters, despite a continued robust expansion in the Islamic Republic of Iran, growth will be somewhat slower than June projections, due to fiscal consolidation plans in Saudi Arabia, and oil production capacity constraints in Iraq. For oil importers, rising growth mainly reflects an agricultural sector recovery in Morocco and improving activity in Egypt after severe foreign exchange shortages in fiscal year 2016. However, recovery in Egypt is highly dependent on the pace of fiscal consolidation and adjustment to the recent floating of the currency. The main downside risks to the regional outlook continue to be a weaker-than-
expected rise in oil prices, as well as spillovers from the severe conflicts in several countries.

**South Asia.** Regional output is estimated to have expanded by 6.8 percent in 2016, a bit below June projections, buoyed by strength in domestic demand. Indian growth is estimated to have decelerated to a still robust 7 percent, with continued tailwinds from low oil prices and solid agricultural output partly offset by challenges associated with the withdrawal of a large volume of currency in circulation and subsequent replacement with new notes. Excluding India, regional growth reached 5.3 percent in 2016, with notable heterogeneity among countries. Looking forward, regional growth is projected to edge up to 7.1 percent in 2017 and pick up to an average of 7.4 percent in 2018-19, supported by ongoing dividends from policy reforms and solid domestic demand amid a favorable macroeconomic environment. Downside risks to the outlook include reform setbacks, worsened political tensions, a further unexpected tightening of financing conditions, a slowdown in remittances inflows, and bank asset quality problems.

**Sub-Saharan Africa.** Regional growth is estimated to have decelerated from 3.1 percent in 2015 to 1.5 percent in 2016, the lowest level in over two decades, and almost one percentage point below June projections. As a result, regional per capita GDP is estimated to have contracted 1.1 percent in 2016, following an expansion of 0.4 percent in 2015. Commodity exporters continued to struggle to adjust to low prices, which is threatening recent progress on poverty and social indicators. The deterioration in economic activity in commodity exporters in 2016—particularly in South Africa and in oil exporters, which together account for two-thirds of regional output—was only partially offset by solid growth in most commodity importers. While the forecast for regional growth has been downgraded, a rebound is still expected—to 2.9 percent in 2017, and to 3.7 percent in 2018-19—as commodity prices stabilize and the adjustment to earlier negative terms-of-trade shocks continues. Downside risks include a slower pace of adjustment to persistently low commodity prices, a further decline in these prices, and an additional tightening of global financial conditions.
EMDEs, where growth is projected to increase to 2.3 percent in 2017 and to an average of 3.1 percent in 2018-19—slightly above its long-term average of 2.8 percent, but substantially lower than the average of 5.9 percent achieved during the commodity price boom years of 2003-2008. In commodity-exporting EMDEs, a faster-than-expected recovery in some large countries (Brazil, Russia) and the modest rise in commodity prices will be offset by negative domestic factors in a number of countries still struggling to adjust to low commodity prices (Angola, Nigeria).

Growth in commodity-importing EMDEs is projected to remain stable throughout the forecast horizon, at around 5.7 percent on average, and slightly below its long-term average rate. The gradual slowdown in China is projected to be offset by a moderate acceleration in the rest of the group, including a robust expansion in India. As a result, divergences between exporters and importers are expected to narrow.

The external environment confronting LICs is expected to improve only gradually, with commodity prices stabilizing, but staying low, and global growth picking up only moderately. This is expected to provide some support to growth in commodity-exporting LICs. The majority of commodity-importing LICs will continue to benefit from low oil prices. Against this backdrop, growth in LICs is forecast to rebound to 5.6 percent in 2017, a moderate recovery by recent standards, before picking up to 6.1 percent by 2019.

Considerable differences will persist across LICs. Growth among oil exporters will remain weak in 2017. Other commodity exporters will continue to struggle to adjust to low commodity prices, with activity expanding at a moderate pace, such as Mozambique, the Democratic Republic of Congo, and Zimbabwe. Security issues, and political uncertainties will hold back activity in Afghanistan, Burundi, The Gambia, and Mali. However, growth is expected to strengthen in Nepal as political tensions ease and reconstruction of infrastructure picks up. Large infrastructure investment and low oil prices are expected to continue to support robust growth in Ethiopia, Rwanda, Senegal, and Tanzania.

More generally, a number of mostly structural factors are expected to weigh on the medium- and long-term EMDE growth outlook. External factors include structural weakness in advanced-economy growth, heightened uncertainty about the direction of policies in key advanced economies, subdued global trade, persistently low commodity prices, and rebalancing in China. Domestic factors include unfinished adjustments in some commodity exporters to low commodity prices and slowing productivity growth. In general, potential growth has slowed in EMDEs since the global financial crisis, reflecting worsening demographics, lack of productive investment, depressed productivity growth, and weak investment growth. The deterioration in potential growth has, in turn, contributed to weaker investment prospects over the medium term. Total factor productivity growth has decelerated in EMDEs, particularly in commodity exporters and in EMDEs with the slowest investment growth (Chapter 3).

**Risks to the outlook**

Uncertainty surrounding global growth projections has increased and risks continue to be tilted to the downside. This reflects the possibility of a prolonged period of heightened policy uncertainty following recent electoral outcomes in key major economies, mounting protectionist tendencies, and potential financial market disruptions associated with sharp changes in borrowing costs or exchange rate movements. Weakening potential growth could further erode EMDEs’ ability to absorb negative shocks. However, significant fiscal stimulus in major economies—in particular, the United States—could support a more rapid recovery in global activity in the near term than currently projected, and thus represents a substantial upside risk to the outlook.

Baseline forecasts envisage that global growth will pick up from 2.3 percent in 2016 to 2.7 percent in 2017, reaching 2.9 percent by the end of the forecast horizon. While these projections represent the latest of a series of downgrades over recent forecast exercises, revisions are less pronounced than in the past (Figure 1.14).
There is, however, substantial uncertainty around these forecasts, which has been heightened by recent political developments—in particular, electoral outcomes in the United States and the United Kingdom. Uncertainty around global growth projections for 2017 has increased, and the balance of risks remains tilted to the downside, amid unclear prospects for policy direction in major economies. At present, the 90 percent confidence interval around global growth forecasts for 2017 lies between 1.1 percent and 4 percent. The 50 percent confidence interval ranges from 2 percent to 3.2 percent. While the probability that global growth could be more than 1 percentage point below baseline projections in 2017 is currently estimated at about 17 percent, the probability of global growth being 1 percentage point above the baseline projection is estimated at 9 percent.

The main downside risks to the global outlook include prolonged periods of heightened policy uncertainty in major advanced economies and some EMDEs, as well as financial market disruptions amid tighter global financing conditions and renewed U.S. dollar appreciation. A number of events could trigger the realization of these downside risks. These include electoral outcomes in some large economies that further contribute to policy uncertainty, as well as monetary policy actions by major central banks that result in sharp swings in EMDE borrowing costs. Political and policy uncertainty could increase in a climate of mounting protectionist tendencies, which could undermine the expected recovery in global trade and investment. Global financial market volatility could be particularly disruptive in EMDEs with limited policy space and elevated vulnerabilities. Slower potential growth could further erode the ability of EMDEs to absorb negative shocks, including those emanating from lower-than-expected growth in major economies. However, well-targeted fiscal loosening and other growth-enhancing policies in major economies—particularly in the United States—could lead to stronger growth and a more balanced policy mix than currently assumed and thus represent a substantial upside risk to the forecast.

**FIGURE 1.14 Risks to global growth**

Global growth projections continued to be downgraded, albeit less than in previous forecast rounds. Forecast uncertainty and downside risks to global growth have increased, reflecting in part heightened global policy uncertainty. The probability that global growth could be more than 1 percentage point below baseline projections in 2017 is estimated to be 17 percent. In contrast, the probability of global growth being 1 percentage point above the baseline projection is estimated at 9 percent.

A. Global growth forecasts over time

B. EMDE growth forecasts over time

C. Standard deviation of global growth forecasts

D. Skewness of global growth forecasts

E. Risks to global growth projections

F. Probability of 1 percentage-point change in global growth forecasts

Sources: Bloomberg, World Bank.

A.B. The dates indicate the editions of Global Economic Prospects.

C.D. Vertical lines denote the cut-off date of the June 2016 Global Economic Prospects (May 31, 2016). The time-varying standard deviation and skewness of global growth forecasts are computed as the weighted average of the standard deviation and skewness of the forecast distribution of three underlying risk factors (oil price futures, the S&P 500 equity price futures and term spread forecasts). Each of the three risk factor’s weight is estimated using the variance decomposition of global growth forecasts derived from the vector autoregression model described in Ohnsorge, Stocker, and Some (2016). The median standard deviation and skewness is computed over the period 2006-16. 3-month moving average. Last observation for market data is December 19, 2016.

E. F. The fan chart and corresponding probabilities are constructed based on the recovered standard deviation and skewness, assuming a two-piece normal distribution.
FIGURE 1.15 Risks - Policy uncertainty and protectionism

Political and policy uncertainty increased against the backdrop of national elections and referendums and an intensifying debate about income inequality and the benefits of trade liberalization in advanced economies. Rising uncertainty about U.S. policies could trigger financial market volatility and, if sustained, dampen EMDE investment. The number of temporary trade barriers measures continued to increase. Tariffs could be raised significantly in a scenario of retaliatory trade restrictions.

Policy uncertainty has increased notably, amid elections or referendums in countries accounting for close to 50 percent of global GDP in 2016 and more than 25 percent of GDP in 2017 (Figure 1.15). In advanced economies, the outcome of the Brexit vote in the United Kingdom and of the elections in the United States has led to heightened uncertainty about future policy direction, particularly regarding trade, which could continue to intensify in 2017. Rising within-country income inequality during the period of rapid globalization, as well as stagnant real median wages, has fueled an intense debate about the benefits of trade liberalization and immigration in advanced economies (Lakner and Milanovic 2016; Niño-Zarazúa, Roope, and Tarp 2016; Milanovic 2016). Upcoming elections, particularly in Europe, could trigger a further shift toward protectionist and populist policies against the backdrop of sluggish growth, and, in Europe, sizable refugee inflows.

Policy uncertainty, including around elections, tends to raise risk premiums, depress investment, and reduce incentives for market entry and technological upgrading (Baker, Bloom, and Davis 2013; Kelly, Pastor, and Veronesi 2014; Handley 2014; Handley and Limao 2015). When faced with high uncertainty, households also tend to reduce durable goods consumption and increase precautionary savings. These dampening effects on growth can be amplified by financial market disruptions, as credit conditions tighten. Large increases in policy uncertainty are associated with persistently slower growth (Kose and Terrones 2015). Heightened uncertainty about trade policy in major economies could erode already feeble international trade conditions. The current unusually high levels of uncertainty could continue to weigh on a fragile global economy.

Policy uncertainty in the United States. The initial financial market reaction to the U.S. elections was orderly. However, there is increased uncertainty around the future direction of fiscal, trade, immigration, and foreign policies in the United States. While some of the proposals...
suggested by the new administration (e.g., fiscal stimulus and infrastructure spending) could have positive growth effects, others (e.g., tariff increases) could have a dampening impact. More generally, the United States plays a major role in the global economy (Special Focus); accordingly, a sustained increase in policy uncertainty in the United States could have negative repercussions for both the domestic and global economic outlooks. According to model estimates, a modest 1 standard-deviation shock to the U.S. index of economic policy uncertainty could reduce U.S. GDP and investment growth by 0.4 and 0.8 percentage points, respectively, within two years. Uncertainty in the United States could also weigh on investment in other countries, particularly EMDEs. A 10-percent increase in the implied volatility of the U.S. stock market (VIX) would reduce EMDE GDP growth by about 0.2 percentage point and EMDE investment growth by about 0.5 percentage point after one year.

Policy uncertainty in Europe. The Brexit vote had limited short-term cross-border financial market spillovers, partly reflecting the commitment for further policy accommodation by major central banks. However, it will take time to resolve the uncertainty surrounding the future relationship between the United Kingdom and the EU, given the protracted nature of the negotiations for international trade agreements, and the unusual complexity of the issues in this case. This, in itself, could set back longer-term growth prospects across the EU. The magnitude of adverse long-run effects will depend on the type of relationship that the United Kingdom will negotiate with the EU, as well as associated political and institutional risks.\(^5\) Policy uncertainty in Europe has considerable adverse implications for investment growth in EMDEs, particularly in the Eastern Europe and Central Asia (ECA) region, for which Europe is an important export market and source of finance. A 1 standard-deviation economic policy shock in Europe could reduce investment growth by 1.5 percentage points within a year in EMDEs in ECA that are close trading partners (Chapter 3).

Policy uncertainty in EMDEs. In some EMDEs, political and policy uncertainty reached new highs in 2016. According to model estimates, a 1 standard-deviation shock to an index of country-specific political risks reduces EMDE investment by about 2 percent below the baseline within a year (Chapter 3, Box 3.3). A confidence shock in major advanced economies, still the main trading partners for many EMDEs, could further dent EMDE investment growth.

Protectionism. Heightened policy uncertainty could coalesce around increased protectionism. New trade restrictions already reached a post-crisis high in 2016 (WTO 2016; Evenett and Fritz 2016). Trade defense measures (anti-dumping measures, countervailing duties, and safeguards) have been the most commonly used instruments in advanced economies, while EMDEs have used a broader set of restrictive measures, including import tariffs and export taxes. Even within the parameters of current international safeguards, WTO members could, legally, triple import tariffs, which would lead to a 10-percent drop in world trade from the baseline, and large welfare losses for the world economy (Bouet and Laborde 2008). These losses would disproportionately affect the poorest EMDEs, which rely on trade as a key engine for growth and development (Foletti et al. 2008; Evenett and Fritz 2015). The possible undoing of existing trade agreements amid increased protectionism would greatly exacerbate welfare losses in EMDEs. A scenario of retaliatory trade restrictions between the United States and China could also lead to substantially slower growth in the United States (Nolan et al. 2016).

Financial market risks

The prospects for increasing monetary policy divergence and heightened policy uncertainty in advanced economies, combined with deteriorated credit quality in EMDEs, raises risks of financial market disruptions. In the United States, policy rates are expected to increase further, and there is a risk that market expectations could adjust abruptly to signs of emerging inflation,
private sector credit-to-GDP ratio is larger than 1.65 times its standard deviation in at least one year. Slowdown (occurred in two years around t=0, in red), and deleveraging episodes without investment are among key vulnerabilities. Private sector debt deleveraging tends to be accompanied by a significant deceleration in activity, particularly in an environment of weak investment.

FIGURE 1.16 Risks - EMDE vulnerabilities

EMDE rating downgrades continued to outnumber upgrades in 2016, particularly among oil exporters. High external financing needs in some countries, widening fiscal and current account deficits among commodity exporters, and elevated private sector debt are among key vulnerabilities. Private sector debt deleveraging tends to be accompanied by a significant deceleration in activity, particularly in an environment of weak investment.

A. Total number of sovereign rating changes from the three main credit rating agencies: Standard & Poor’s, Moody’s, and Fitch. Last observation is December 19, 2016.
B. Current account position is the share of current account deficit or surplus of EMDE country group in percent of world GDP in current U.S. dollars. 2016/1Q2 is based on data up to 2016Q3.
C. Group median of the cyclical components of GDP in percent of its trend (derived using a Hodrick-Prescott filter) for all deleveraging episodes (in blue), deleveraging episodes with investment slowdown (occurred in two years around t=0, in red), and deleveraging episodes without investment slowdown (in yellow).
D. A credit boom is defined as an episode during which the cyclical component of the nonfinancial private sector credit-to-GDP ratio is larger than 1.65 times its standard deviation in at least one year. Investment surge is defined as years when the cyclical component of the investment-to-GDP ratio is at least 1 times its standard deviation while investment slowdown is a year when the cyclical component of the investment-to-GDP ratio is below minus one times its standard deviation.

potentially resulting in sharp swings in borrowing costs and exchange rates.

The capacity of many EMDEs to absorb these kinds of negative shocks remains limited, and it has shrunk further for some commodity exporters. Weak growth and persistent vulnerabilities have led to EMDE rating downgrades, which significantly outnumbered upgrades in 2016, particularly among oil exporters (Figure 1.16). Many EMDEs continue to be vulnerable to sharp increases in borrowing costs, reflecting sizable external financing needs, limited levels of foreign reserves, and elevated domestic debt (Ghosh 2016). Several major EMDEs are running elevated current account deficits, which are often financed by volatile portfolio flows. Despite recent efforts to lengthen the maturity of external debt, several large EMDEs still have excessive short-term external financing needs relative to reserves.

In most EMDEs, private debt buildups have been below the pace associated with destabilizing surges in the past, and EMDE banking sectors remain well capitalized (World Bank 2016f). However, some EMDEs that had rapid credit growth in the aftermath of the global financial crisis are still saddled with elevated domestic debt (Reinhart, Rogoff, and Trebesch 2016; World Bank 2016f). Moderating growth has increased the burden of carrying this debt. Private-sector debt deleveraging in some countries could cause a further deceleration in activity, as firms seek to shrink their balance sheets and banks are negatively affected by rising non-performing loans. This risk is particularly high when investment starts to slow, prior to the end of a credit boom.

Short-term risks of sharp increases in borrowing costs. Long-term interest rates in the United States remain low, but have started increasing amid rising prospects of a continued normalization of U.S. monetary policy and of rising inflation expectations (Fischer 2016; Williams 2016). Uncertainty about the underlying strength of the U.S. economy, future economic policy direction, and the appropriate course of monetary policy remains elevated. Furthermore, market expectations of interest rate levels expected to prevail over the long run continue to be below those of the U.S. Federal Open Market Committee (Figure 1.17). An increase in yields driven by a reassessment of monetary policy expectations could have large adverse effect on EMDE financial markets, capital flows, and activity (Arteta et al. 2015). Eroding confidence in the ability or willingness of the European Central Bank and the Bank of Japan to deliver further policy easing, combined with concerns about the health of the European banking sector, could heighten volatility in global bond yields.

Short-term risks of renewed U.S. dollar appreciation. A continued appreciation of the U.S. dollar, as monetary policies in the United States and other major advanced economies
dive or policy risks materialize, could raise debt servicing costs and credit risks for EMDEs (Hofmann, Shim, and Shin 2016). The U.S. dollar continues to play a unique role in the international transmission of monetary policy shocks, and its appreciation generally coincides with tighter global financial conditions and weak commodity prices (Special Focus; Bruno and Shin 2015). The share of both private and public debt denominated in foreign currency, and the number of countries with currency regimes tightly linked to the U.S. dollar, have declined. However, some countries with elevated short-term foreign-currency-denominated debt and weak or deteriorating current account positions, are vulnerable to rollover and interest rate risks, as well as to a drying up of foreign exchange liquidity (Chow et al. 2015).

Longer-term risks associated with persistently low interest rates. While a sudden increase in borrowing costs and risk aversion from current low levels are dominant risks in the short term, a more prolonged period of low interest rates could heighten financial stability risks over time. Adverse effects include the erosion of profitability of banks and other financial intermediaries, excessive risk-taking, and distorted asset valuations that increase the risk of booms and busts in asset prices. Negative policy rates in several advanced economies, if maintained for a significant period of time, could amplify these risks (Arteta et al. 2016; Claessens, Coleman, and Donnelly 2016; Borio, Gombacorta, and Hofman 2015).

Euro Area banks remain under significant pressure, partly reflecting concerns about future earnings and, for a number of vulnerable institutions, insufficient capital buffers (Figure 1.18). Further escalation of these pressures could have international spillovers, as Euro Area banks play a major role in the provision of syndicated bank loans to EMDEs, accounting for about 23 percent of their global bank inflows. Under persistently low- or negative-yielding bonds, pension funds and life insurance companies might also struggle to generate adequate returns to meet their long-term liabilities (Hannoun 2015; Geneva Association 2015; IMF 2015c). In an effort to compensate for negative or extremely low interest rates, insurance companies and other institutional investors might increase their exposure to higher-yielding, lower quality debt. Greater risk-taking might eventually contribute to the formation of asset bubbles, which could be particularly damaging for the real economy if they take place in housing markets (Claessens, Kose, and Terrones 2012; Mian, Sufi, and Verner 2015).

Weakening potential growth

While partly reflecting cyclical factors, repeated growth disappointments in recent years in both advanced economies and EMDEs suggest that structural factors are at work. Falling potential output growth could reduce available fiscal space by reducing fiscal revenues and weakening cyclically-adjusted primary balances. By depressing real equilibrium interest rates, low potential growth also exacerbates problems associated with the lower bound of monetary policy interest rates. In both advanced economies and EMDEs,
potential growth estimates have been reduced considerably since the crisis (Didier et al. 2015). This has reflected persistently low productivity growth and, increasingly, weak investment growth.

- **Slowing productivity growth.** Productivity growth has slowed considerably since the global financial crisis, both in advanced economies and EMDEs (Figure 1.19). The rate of technological progress appears to have declined since the early 2000s. Diffusion across countries might have been hampered by slower trade liberalization and financial integration (Buera and Oberfield 2016). Rapid population aging may exert additional pressure on productivity growth. In particular, a rising proportion of older workers has been associated with lower average productivity, as well as slower innovation and technological diffusion (Aksoy et al. 2015; Feyrer 2008; World Bank 2015b).

- **Weak investment growth.** Investment growth in EMDEs slowed steadily from 10 percent in 2010 to 3.4 percent in 2015, below its long-term average of 5.1 percent (Chapter 3).

By slowing the rate of capital accumulation and technological progress embedded in investment, weak investment has set back potential output growth (OECD 2015). Should investment continue to grow at a sluggish pace and long-term prospects be further downgraded, the resulting slowdown in capital accumulation could reduce EMDE potential output growth substantially. The largest slowdowns would be felt in commodity-exporting EMDEs, where investment remains particularly weak.

By reducing policy space, weakening potential growth further diminishes the ability of EMDEs to absorb adverse shocks. One important type of shock relates to growth disappointments in major economies. In particular, weaker-than-expected growth in the United States, the Euro Area, or China could have severe consequences for the rest of the world, given that these economies are deeply integrated into regional and global supply chains and finance, rendering them an important source of spillovers to EMDEs (World Bank 2016a).

**Upside risk: fiscal stimulus in major economies**

While downside risks continue to dominate the outlook, significant fiscal easing in major economies could support a more rapid pace of growth in global activity and investment in the near term than currently expected, and thus represents a substantial upside risk to the global outlook.

**United States**

Proposals for sizable fiscal stimulus measures put forward by the new administration in the United States—which have not been factored into baseline projections in the absence of further details about their scope—could result in faster-than-anticipated U.S. growth in the near term. These measures include reductions of corporate and personal income tax rates, as well as plans to stimulate infrastructure investment. However, the positive growth impact of these actions could be offset by shifts in the pattern of federal government outlays that result in sizable net
spending cuts, or by fiscal sustainability concerns. Changes in some other U.S. policies, such as changes in trade policy, could also offset the positive effects of fiscal stimulus, or might even set back growth.

**Reduction in corporate and personal income taxes.** The fiscal proposals put forward by the new U.S. administration include a cut in the statutory corporate income tax rate from 35 to 15 percent. Such a corporate income tax cut could—by itself and without considering other policies by the new administration—boost U.S. GDP growth by around 0.6 percentage point after four quarters following implementation, and by cumulatively 0.9 to 1.3 percentage points after eight quarters, depending in particular on the reaction of monetary policy authorities.

Another proposal suggested by the new administration is to cut personal income taxes, especially for the highest-income earners; reduce the number of individual income tax brackets; and change the structure of tax deductions. If fully implemented, these measures could reduce the average tax rate on personal income by about 2.5 percentage points, and by over 7 percentage points for top income earners (Nunns et al. 2016). Such a cut could—again, by itself—increase U.S. GDP growth by around 0.3 percentage point after four quarters following implementation and by cumulatively 0.4 to 0.6 percentage point after eight quarters, again depending in particular on the reaction of monetary policy authorities.

Taken together, these corporate and personal income tax reforms could—without consideration of additional policy changes by the new administration—raise U.S. GDP growth forecasts to 2.2-2.5 percent in 2017 and 2.5-2.9 percent in 2018. These estimates depend on the timing of the tax cuts, the reaction of monetary policy authorities, the amount of slack remaining in the U.S. economy, and how businesses and households adjust their expectations to these policy changes. In particular, the upper bound of these ranges assumes that both corporate and personal income tax cuts are fully implemented in

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*FIGURE 1.19 Risks - Weakening potential growth*

Falling productivity growth has narrowed policy options by reducing fiscal space and depressing real interest rates. Rapid population aging may exert additional pressure on productivity growth in coming years.

**A. Labor productivity growth**

**B. Median productivity growth and old worker ratios in G20 economies**

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*These results are based on simulations using the Federal Reserve Board’s model for the U.S. economy (FRB/US). Simulations assume full implementation of both corporate and personal income tax cuts at once (i.e. no phasing in). The lower estimate of the growth impact after eight quarters assumes that monetary policy adjusts following a traditional Taylor Rule. The upper estimate assumes no monetary policy reaction. The net loss of corporate tax revenues, caused by a 15 percentage-point reduction in the effective marginal tax rate implied by a 20 percentage-point statutory corporate income tax cut (Nunns et al. 2016), could amount to 1.2 percent of GDP in the first year. Implicitly, the fiscal multiplier—the additional output generated for each additional dollar of tax losses—would be 0.4 in the first year, which is within the range of available estimates (Chahrour, Schmitt-Grohé, and Uribe 2012).

*Results are also based on simulations using the FRB/US model. The net loss of personal income tax revenues caused by a 2.5 percentage point reduction in the average effective marginal tax rate is estimated to be around 1.0 percent of GDP in the first year, with a corresponding fiscal multiplier of 0.3. This is at the lower end of the range of estimated fiscal multipliers generally associated with personal income tax cuts (0.3-1.5), but within the range of estimated fiscal multipliers associated with personal income tax cuts targeted to higher-income households (0.1-0.6; Whalen and Reichling 2015).

*Tax cuts can support stronger near-term growth by boosting households’ real disposable income and companies’ after-tax earnings and profit margins. According to FRB/US model simulations, the largest short-term growth effect would be associated with corporate income tax cuts, with investment being boosted by a rise in corporate profits and a reduction in the cost of capital. The effect on consumption would be more limited, as household savings are projected to increase following the personal income tax cut. In the case where monetary policy is allowed to react to a more rapid closing of the output gap, interest rates are estimated to increase by an additional 60 basis points after four quarters, and by up to 100 basis points after eight quarters. The dollar would also appreciate, while inflation would remain broadly unchanged. The revenue loss for the government would increase the budget deficit by around 2.4 percent of GDP after eight quarters.*
the second quarter of 2017, and monetary policy does not react to the change in fiscal policy. In a more realistic scenario where monetary policy authorities adjust their policy stance, the growth impact is somewhat reduced, particularly in 2018. The lower bound of the range assumes both delayed implementation of the tax cuts to the first quarter of 2018 and a tightening of monetary policy in reaction to changes in fiscal policy. In addition, these estimates do not specifically take into account fiscal sustainability considerations.

**Increase in infrastructure investment.** The new U.S. administration has signaled a number of measures to stimulate infrastructure investment, but specifics remain to be formulated for both the overall size and the choice of measures (and, hence, their impact on activity). There have been suggestions of increasing both public investment in transportation and infrastructure and of boosting private investment through tax credits. Empirical studies suggest that increases in government infrastructure investment tend to have large immediate effects on activity, with fiscal multipliers often estimated to be markedly above 1 (Auerbach and Gorodnichenko 2013; Bivens 2014; Whalen and Reichling 2015). Empirical evidence regarding the effect of tax credit and policy-driven support to private investment in infrastructure in the United States is limited. Studies of comparable initiatives in Europe point to positive but limited net effects (Claeys and Leandro 2016). Until additional details are unveiled, it is difficult to quantify the potential impact of these measures on the outlook.

**Changes in federal spending.** The new U.S. administration has suggested sizable cuts in non-defense spending, likely accompanied by increases in defense spending. While specific proposals have not yet been made, it is possible that, on net, overall federal spending will be substantially reduced. Accordingly, the impact of corporate and personal income tax cuts and infrastructure spending on aggregate demand could be offset in the short term if overall federal spending is also cut. This offsetting effect would depend on the size of the net reduction in government outlays and on the estimated fiscal multiplier of various spending categories (Whalen and Reichling 2015).

**Euro Area**

While fiscal policy in the Euro Area is currently expected to be broadly neutral to growth in 2017, the European Commission has recommended a more expansionary stance, as it would lead to a more rapid closing of the output gap and restore space for monetary policy action (European Commission 2016). A fiscal expansion of up to 0.5 percent of GDP for the Euro Area as a whole could help reduce the wedge between projected inflation and the ECB’s 2 percent inflation target in 2017, without creating undue overheating in some member states or concerns about fiscal sustainability. Fiscal multipliers could be particularly elevated in the current environment of low interest rates and persistent economic slack (In’t Veld 2016; Blanchard, Erceg, and Lindé 2015). The optimal distribution of fiscal stimulus measures across Euro Area countries would need to take into consideration available fiscal space and cyclical conditions.

**Other major economies**

If these fiscal stimulus measures in the United States and the Euro Area were to materialize, they would follow analogous growth-enhancing actions announced or already implemented by other major economies—particularly Japan and China. In mid-2016, Japan’s government announced a fiscal package aimed at supporting growth, including new public spending and income support measures. These measures are expected to add around 0.3 percentage point to growth in 2017, and account for the bulk of upside revisions to Japan’s growth forecast. In China, growth-enhancing fiscal policies throughout 2016—including infrastructure investment and a reduction of the tax burden on businesses—continued to support economic activity amid ample policy buffers. Chinese authorities recently indicated that, in 2017, they will step up fiscal measures aimed at supporting growth. Fiscal policy targets will be published in March 2017.

**Spillovers to the rest of the world**

Fiscal loosening in major economies could lead to faster-than-envisioned global growth in the near-
term. Stronger U.S. growth would help global activity by raising U.S. demand for trading partners’ exports (Special Focus). Empirical estimates indicate that a 1 percentage-point shock to U.S. growth could boost growth after one year by 0.8 percentage point in other advanced economies, and by 0.6 percentage point in EMDEs (Figure 1.20).

In the illustrative scenario of reforms to U.S. corporate and personal income taxes discussed earlier, global growth (including the United States) could rise by up to 0.1 percentage point in 2017 if the tax cuts are fully implemented in the second quarter of the year. In addition, global growth could rise by at least 0.3 percentage point in 2018, depending on the timing of the tax cuts and the reaction of U.S. monetary policy authorities. While some of the proposed U.S. corporate tax reforms could potentially affect corresponding fiscal revenues in other countries where U.S. corporations operate, the net global impact of stronger activity and investment in the United States is likely to be positive (Clausing, Kleinbard, and Matheson 2016; Nicar 2015).

Beyond changes in corporate and personal income taxes, some other U.S. policy changes should also have beneficial cross-border effects. While the import content of U.S. infrastructure is relatively limited, additional infrastructure spending in the United States should have positive domestic supply-side effects and lead to beneficial spillover effects for the rest of the world. However, as discussed earlier, these positive spillovers could be offset by changes in other U.S. policies—most notably, trade policies, particularly in the hypothetical scenario that the United States imposes tariff increases, and such increases trigger retaliatory action by other countries.

An easing of the fiscal stance in the Euro Area could further reinforce the positive impact on global growth. Econometric analysis suggests that a 1 percentage-point increase in Euro Area growth could boost global growth by 0.9 percentage point after one year, with particularly sizable benefits for regional trading partners. In general, simultaneous loosening of fiscal policy across the United States, the Euro Area, and other major economies could help prevent excessive real effective exchange rate adjustments and lead to additional positive effects for global growth (Frankel 2016; Auerbach and Gorodnichenko 2016).

**Policy challenges**

**Challenges in major economies**

Among advanced economies, unconventional monetary policies have become a common feature of central banks’ toolkits in the post-crisis period. These policies, while still needed in a number of countries to support growth and bring inflation back in line with policy objectives, are facing increasing constraints. As real equilibrium interest rates are expected to remain low, the materialization of downside risks to growth might necessitate more supportive fiscal policies. A shift towards more expansionary fiscal policies is underway in Japan and may materialize in the United States. Although macroeconomic policies should remain accommodative until clear evidence of capacity constraints emerge, they need to be combined with prompt implementation of structural reforms to boost productivity and long-term growth. In China, the main policy challenge is to increase the role of markets and facilitate resource reallocation to high-productivity sectors, while reining in credit growth.
flexibly in order to stabilize long-term interest rates at zero. Central banks in the Euro Area and Japan are expected to maintain exceptional levels of policy accommodation until wage growth is on a clear upward trend, and inflation expectations are firmly anchored around policy objectives.

While needed to support activity and inflation in the short term, persistently low or negative interest rates could entail growing challenges for financial stability (Arteta et al. 2016; Hannoun 2015, Shin 2016). Risks of asset price bubbles reinforce the need for timely and effective macro-prudential policies. The implementation of borrower-based measures, such as loan-to-value and debt-to-income ratio caps, can help mitigate credit cycles (Cerutti, Claessens, and Laeven 2016). The business models of financial institutions in advanced economies will need to continue to adapt; further consolidation and cost-cutting measures may be required to maintain profitability in an era of low interest rates.

Monetary and financial policies in advanced economies

Faced with a secular decline in real equilibrium interest rates and with policy rates at or near their lower bound, most major central banks are expected to maintain low, and in some cases negative, nominal policy interest rates over the projection horizon. In the United States, where inflation is approaching the 2 percent target and the unemployment rate is below 5 percent, policy rates will increase, but are expected to settle at a lower level than in previous cycles (Figure 1.21). A very gradual tightening of U.S. monetary policy would eventually stimulate investment and labor participation, and might therefore help reverse some of the post-crisis deterioration in U.S. potential growth (Yellen 2016).

In the Euro Area, negative policy interest rates and extensive unconventional measures implemented by the European Central Bank have helped support activity, but have so far failed to lift long-term inflation expectations, which remain below target and have shown increasing sensitivity to transitory price shocks. In Japan, the Bank of Japan tested new ground in September 2016 by calibrating its asset purchase programs more
be prioritized. Stronger and more predictable counter-cyclical fiscal policies would support faster recoveries and reduce deflation risk in future downturns, without jeopardizing debt sustainability (Elmendorf 2016; Buti and Gaspar 2015).

Despite higher debt-to-GDP ratios in the post-crisis period (Figure 1.22), ultra-low borrowing costs have led to a reduction in interest payments across most advanced economies. This, combined with infrastructure deficiencies in many economies, has reinforced the case for boosting public investment. Enhancing the efficiency of public administration and regulation could increase the thresholds above which public debt becomes detrimental to growth (Masuch, Moshammer, and Pierluigi 2016b).

In the United States, as discussed earlier, the new administration’s campaign pledge to significantly reduce corporate and personal income taxes and stimulate infrastructure investment would result in a more expansionary fiscal stance, if implemented. In 2016, Japan announced the implementation of a series of fiscal stimulus measures aimed at supporting growth. In the Euro Area, a more supportive fiscal stance to support economic activity has been formally recommended to members states, but has not yet been implemented (European Commission 2016). Discussions on the need for a more robust system of coordination of fiscal policy have also made some progress, although a more centralized fiscal capacity remains a distant prospect (IMF 2016h).

**Structural policies in advanced economies**

Structural reforms in advanced economies could further spur confidence in medium-term growth prospects, reverse the weakening of productivity growth, and meet growing demographic challenges. Moreover, a renewed commitment to trade liberalization in advanced economies would support trade prospects, as these economies still account for over 60 percent of global trade. Although existing regional trade agreements have a wide coverage, the numbers of new signed agreements dropped in 2015 to its lowest level since 1999 (Figure 1.23). To reduce protectionist pressures, it is important that the benefits of trade liberalization be shared more broadly. In particular, national policies should be reinforced to lower adjustments costs for those people most exposed to risks. This includes greater efforts to support skills development and re-training, to modernize social protection systems, and to support labor mobility.

Policies that deliver more immediate support to both private and public investment should be prioritized, including improvements in physical...
infrastructures and human capital. In the absence of sufficient space for monetary stimulus, fiscal expansion, where appropriate, could be a useful complement to front-load the benefit of structural reforms (Eggertsson, Ferrero, and Raffo 2013).

Easier market entry for new companies, which has dropped since the global financial crisis, should help boost productivity (Bourles et al. 2013). Product market reforms that facilitate competition among firms and lessen the cost of market entry through reduced regulatory barriers, particularly in services, could help reduce the transition costs associated with labor market reforms (Cacciatore and Fiori 2016; Blanchard and Giavazzi 2003). In the Euro Area, the integration of refugees into the labor market has become a key policy challenge (Fasani 2016). While integration has typically been slow in the past, targeted activation programs and tax exemptions for employers might help kick-start the process (Aiyar et al. 2016; Bilgili, Joki, and Huddleston 2015; Butschek and Walter 2014).

**Policy challenges in China**

A number of reforms have already been implemented in China to facilitate the country’s transition to a more market-oriented economy, and to reduce its dependence on investment (IMF 2016a; World Bank 2016f). A revised budget law and new rules on local borrowing have been introduced, and a pilot property tax system has been rolled out in a few cities, in an attempt to put local government finances on a stronger position. Regulations on nontraditional banking activities have been tightened to reduce financial risks. Interest rates have been liberalized, and deposit insurance has been introduced, to support a more efficient allocation of credit. In addition, reforms to eliminate excess capacity in state-owned enterprises have been initiated, which should foster productivity growth and support sectoral rebalancing (Figure 1.24). For example, the authorities have announced additional capacity reduction targets for coal and steel, and some provinces have begun to restructure unviable SOEs. As a result, employment in key overcapacity sectors has declined.

The key policy challenge is to achieve a gradual slowing to a sustainable growth rate in the medium term while avoiding a sharp slowdown (World Bank 2016f). Additional fiscal reforms, focused on relations across different levels of government, would place local government finances on a more solid footing. Further reform of SOEs, such as additional restructuring of unviable provincial enterprises, would boost productivity and create new private sector jobs. Reforms to address excess industrial capacity, which have been initiated, remain to be completed. Land and hukou (labor market) reforms could yield significant benefits in terms of growth and employment. If accompanied by measures to reduce financial risks, capital account and exchange rate liberalization could contribute to improved financial stability in the long term.

Elevated credit growth, which has been accompanied by rapidly rising housing prices, is an important challenge. China’s credit gap—the difference between the credit-to-GDP ratio and its long-term trend—is well above that of other EMDEs and of advanced economies. Reforms in the corporate sector, and tighter prudential measures, would help rein in credit growth and thereby reduce macroeconomic and financial stability risks. In this context, recent measures to strengthen financial regulations—including those pertaining to shadow banking activities, such as
wealth management products and peer-to-peer lending—could be expanded. Strengthening the responsibility and capacity of local governments to manage debt, including contingent liabilities from off-budget activities, could help limit financial risks.

Challenges in emerging and developing economies

In the short term, macroeconomic policy challenges vary across EMDEs. While many commodity exporters face continued pressure to tighten monetary and fiscal policy, commodity importers need to maximize the benefits of past terms-of-trade gains. Over the medium term, both groups need to reduce vulnerabilities and rebuild policy space to cope with future shocks, including those that could emanate from policy changes in advanced economies. The need for domestic sources of growth in EMDEs increases the urgency of structural reforms, particularly those that boost investment in human and physical capital. Finding an appropriate balance between fiscal adjustment needs and these long-term investments will be challenging for some countries, suggesting a need to mobilize multilateral resources. Enhancing international integration by promoting services trade and foreign direct investment could also help support productivity and investment.

Monetary and financial policies

The decline in commodity prices in recent years has resulted in diverging inflation trends among EMDEs (Figure 1.25). Whereas inflation has generally moderated in commodity importers, it has picked up in commodity exporters—particularly in those with floating exchange rate regimes that experienced significant currency depreciation. As a result, monetary policy has been tightened across commodity exporters.

Since the start of 2016, this divergence has narrowed, reflecting the waning effects of earlier depreciation on inflation. However, inflation in commodity exporters is still generally above targets, limiting the ability of monetary authorities to provide accommodation. In some commodity exporters (Angola, Azerbaijan, Mongolia, Nigeria, Mozambique), the monetary policy stance still remains notably contractionary. Inflation in commodity importers generally remains below target, indicating that there is scope for some central banks to loosen monetary policy (Hungary, Poland). This means that the paths of policy interest rates in importers and exporters will continue to diverge in the near term. However, the projected modest rebound in commodity prices in the next few years is likely to push up inflation in commodity importers and eventually limit the scope for additional accommodation.

FIGURE 1.25 EMDE monetary and financial policies

Divergence in inflation trends between commodity exporters and importers continued in 2016. Inflation remains markedly high in commodity exporters with floating exchange rates, and it is still above target levels in commodity exporters more broadly, supporting a continued divergence in the path of policy interest rates between exporters and importers. However, the waning effect of currency depreciations in commodity exporters and of past declines in energy prices for importers should narrow these divergences in 2017. The U.S. dollar remains a dominant currency for capital flows to EMDEs, which increases the likelihood that sharp U.S. dollar appreciation could cause EMDE financial distress.
The implementation of negative interest rate policies by a number of major central banks has helped contain the overall level of global interest rates (Arteta et al. 2016). Easy financial conditions supported a resumption of capital flows to EMDEs for most of 2016 and may have contributed to diversification of the currency composition of capital inflows. However, sudden changes in market sentiment, or advanced-economy policy changes, could make capital inflows more volatile, while ongoing inflows could, over time, generate vulnerabilities (Arslan and Taskin 2014; Lane and McQuade 2014). In addition, a more pronounced divergence in monetary policies between the U.S. Federal Reserve and other major central banks would contribute to further dollar appreciation and hence heavier debt servicing costs and credit risks for some EMDEs.

The weak macroeconomic environment in a number of EMDEs may erode bank asset quality and lead to an increase in non-performing loans. This suggests the need for macro-prudential tools to assess and bolster the resilience of the financial system, including more frequent or more stringent stress testing of bank and corporate balance sheets and regulation to facilitate restructuring of non-performing corporate loans. A general strengthening of the institutional environment—including the speedy resolution of bankruptcies and troubled assets, as well as the timely restructuring of financial institutions—could improve growth prospects while reducing vulnerabilities.

**Fiscal policy**

In general, fiscal space in EMDEs remains limited. With fiscal deficits in commodity exporters having bottomed out in 2016, the most acute negative impacts of the extended period of low commodity prices on the government finances of these countries may have now passed (Figure 1.26). However, as deficits remain high, especially in oil-exporting countries, fiscal policy adjustment to low prices will need to continue through the medium term in both groups of countries.
Continued weakness in global trade will also constrain improvements in fiscal positions, particularly for commodity exporters.

Low interest rates in advanced economies have helped contain borrowing costs, particularly for creditworthy borrowers. Broadly, though, EMDEs need to improve their fiscal profiles in order to reach a position where budgets are sustainable even as global financing conditions tighten. In the medium term, credible and well-designed fiscal targets, medium-term expenditure frameworks, broader tax bases, improved tax administration, and replenished stabilization funds can help restore fiscal space. In a number of large EMDEs, some of these aspects are included in ambitious reform programs now in progress (e.g., implementation of the Goods and Services Tax in India, the National Transformation Plan in Saudi Arabia) and will dominate the medium-term domestic fiscal policy agenda. Follow-through on the implementation of these programs is essential. More generally, policymakers need to consider the country-specific short-term and long-term ramifications of changes in tax structures and public spending composition for growth and investment.

**Structural Policies**

The limited room for macroeconomic policies to boost EMDE activity in the short term highlights the pressing need for structural policies that improve longer-term growth prospects. These policies have complementary domestic and international dimensions. On the one hand, during a time of stalling trade liberalization and a rising risk of protectionism, policies to promote further EMDE trade and financial integration are essential. Reforms to support the integration of EMDEs in global value chains, boost the growth of services trade, and maximize the benefits from FDI would be particularly helpful. Policy measures aimed to liberalize services trade and FDI are especially important for EMDEs where barriers remain significant. These reforms would need to be accompanied by measures to mitigate adverse distributional effects of trade openness, such as the loss of certain types of jobs or increased income inequality. On the other hand, the protracted weakness and heightened policy uncertainty in advanced economies, and limited support from external demand, highlights the importance of EMDE policies that strengthen domestic demand and expand domestic sources of productivity and long-term output growth, such as investment in human and physical capital.

**Services trade**

Services account for about two-thirds of global economic output, and over 50 percent of output in most EMDE regions (Figure 1.27). The size of the services sector also exhibits a positive association with per-capita income levels. Services trade can be a stabilizing factor during an
Despite softness in recent years, aggregate FDI stocks in EMDEs have been growing at a faster pace than those in advanced economies during the last decade. While FDI flows between advanced economies are still prevalent, EMDEs are becoming more attractive destinations for FDI, especially for greenfield investment. In many EMDEs, barriers to FDI are still significant or completely prohibitive, highlighting the scope for further liberalization.

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Under appropriate conditions, FDI boosts output growth in both home and host countries. FDI is a stable source of a financing that can bridge the gap between savings and investment of the host country (Kose et al. 2009). Multinational corporations (MNCs) are a prominent source of technology transfer and technical/management skills (Gorg and Greenway 2004). Employment effects on the host countries are generally beneficial, as MNCs create additional employment opportunities and, typically, pay higher wages than domestic companies (Javorcik 2015; Martins 2004; World Bank 1997). MNCs can encourage competition in the host country markets and thus boost innovation. In addition, MNCs can bring indirect benefits by encouraging domestic reforms.

Notable barriers to services trade remain. The most restrictive barriers involve limitations on the entry and establishment of foreign firms, local content requirements, restrictions on the movement of professionals, and discrimination in obtaining business licenses and permits. Negotiations have resumed on provisions of the Trade in Services Agreement (WTO 2016a). Appropriate policies to improve the linkages of services trade with other domestic sectors, and to enhance the export capacity of EMDEs, could mobilize untapped sources of growth (Hoekman and Mattoo 2008; World Bank 2016i).

Foreign direct investment

Despite softness in 2015 and 2016, particularly in commodity exporters, and regional differences notwithstanding, aggregate FDI stocks in EMDEs have been growing at a faster annual average pace than those in advanced economies during the last decade (Figure 1.28). Foreign affiliates generated value-added of $7.9 trillion in 2015, or about 11 percent of world GDP, while employing about 79 million people (UNCTAD 2016). While FDI flows between advanced economies are still prevalent, EMDEs are becoming more attractive destinations for FDI for greenfield investment, but less so for mergers and acquisitions.

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In many EMDEs, barriers to FDI are still significant, and sometimes prohibitive—e.g., in real estate development, engineering services, and legal and accounting services. Because of the
large number of existing bilateral investment agreements, and the lack of a unified and consistent FDI liberalization agenda, the international investment system risks fragmentation and incoherence. Coordination at the multilateral level is necessary to ensure that international investment agreements promote integrated and coherent investment policies that favor development goals (World Bank 2001).

**Investment in human and physical capital**

Investment in infrastructure and human capital is a key component of a comprehensive effort to promote long-term EMDE growth. Well-managed public investment supports domestic demand in the short run, crowds-in private investment and trade under the right circumstances, and increases potential output in the long run (Chapter 3).

Investment in human and physical capital is critical for both growth and poverty alleviation (Aturupane, Glewwe, and Isenman 1994; World Bank 2014). Externalities from such investment can result in increasing return to scale and higher long-run growth. Investment in human capital raises labor productivity through the provision of services such as health, education, and nutrition (Gramlich 1994; World Bank 2008; Straub 2008; World Economic Forum 2016). However, expenditure on these services in EMDEs is still much below the average in advanced economies (Figure 1.29). Universal access to services such as water, energy, health, and education have been defined as core principles of the Sustainable Development Goals (World Bank 2016).

Investment in physical capital boosts capital deepening and thus labor productivity growth. The contribution of capital deepening to labor productivity growth has been increasing since the 1990s and has become a driving force of growth in productivity in both EMDEs and LICs (World Bank 2004a). In particular, higher levels of public capital stock are closely associated with higher levels of income per capita and tend to enhance the productivity of other inputs (Jimenez 1995). Commodity exporters, in particular, depend strongly on reliable domestic road and port infrastructure—especially some landlocked countries facing logistical obstacles to foreign trade. Water and sanitation infrastructure investment in LICs is essential to stay in pace with population growth and urbanization: currently, only one in four people have access to adequate sanitation facilities in LICs (World Bank 2004b; World Bank 2016).

The urgent need to undertake these investments is highlighted by unmet investment gaps associated with the U.N. Sustainable Development Goals (UNCTAD 2014). The investment gap is particularly large for power, transport, education, and climate change. Undertaking these types of investments will require public spending and
Determined policy action to reduce income inequality. The eradication of extreme poverty will therefore require both robust growth and determined policy action. Such policy action includes domestic policies focusing on safety nets, human capital, and infrastructure development. Beyond country specificities, key policy areas include early childhood development, universal health care, universal access to good-quality education, conditional cash transfers, investments in rural roads and electrification, and taxation. If well-designed, these policies can have favorable effects on both inequality and poverty reduction, without major efficiency and equity trade-offs.
## ANNEX TABLE 1 List of emerging market and developing economies

<table>
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<tr>
<th>Commodity Exporters&lt;sup&gt;2&lt;/sup&gt;</th>
<th>Commodity Importers&lt;sup&gt;3&lt;/sup&gt;</th>
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</table>

1 Emerging Market and Developing Economies (EMDEs) includes all those that are not classified as advanced economies. Advanced economies include Australia; Austria; Belgium; Canada; Cyprus; the Czech Republic; Denmark; Estonia; Finland; France; Germany; Greece; Hong Kong SAR, China; Iceland; Ireland; Israel; Italy; Japan; the Republic of Korea; Latvia; Lithuania; Luxembourg; Malta; Netherlands; New Zealand; Norway; Portugal; San Marino; Singapore; the Slovak Republic; Slovenia; Spain; Sweden; Switzerland; the United Kingdom; and the United States.

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

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