CHAPTER 1

# GLOBAL OUTLOOK

## A Fragile Recovery

*Global activity is firming broadly as expected. Manufacturing and trade are picking up, confidence is improving, and international financing conditions remain benign. Global growth is projected to strengthen to 2.7 percent in 2017 and 2.9 percent in 2018-19, in line with January forecasts. In emerging market and developing economies (EMDEs), growth is predicted to recover to 4.1 percent in 2017 and reach an average of 4.6 percent in 2018-19, as obstacles to growth in commodity exporters diminish, while activity in commodity importers continues to be robust. Risks to the global outlook remain tilted to the downside. These include increased trade protectionism, elevated economic policy uncertainty, the possibility of financial market disruptions, and, over the longer term, weaker potential growth. A policy priority for EMDEs is to rebuild monetary and fiscal space that could be drawn on were such risks to materialize. Over the longer term, structural policies that support investment and trade are critical to boost productivity and potential growth.*

## Summary

Global growth is firming, contributing to an improvement in confidence. A recovery in industrial activity has coincided with a pickup in global trade, after two years of marked weakness (Figure 1.1). In emerging market and developing economies (EMDEs), obstacles to growth among commodity exporters are gradually diminishing, while activity in commodity importers remains generally robust. As a result, and despite substantial policy uncertainty, global growth is projected to accelerate to 2.7 percent in 2017, up from a post-crisis low of 2.4 percent in 2016, before strengthening further to 2.9 percent in 2018-19, broadly in line with January projections.

Activity in advanced economies is expected to gain momentum in 2017, supported by an upturn in the United States, as previously anticipated. In the Euro Area and Japan, growth forecasts have been upgraded, reflecting strengthening domestic demand and exports. Investment across advanced economies has firmed, while private consumption growth has moderated. As actual growth continues to exceed potential growth, increasing inflation and narrowing output gaps have raised the prospects of less accommodative monetary policy. Advanced economy growth is expected to accelerate to 1.9 percent in 2017, before moderating gradually in 2018-19. As usual, the outlook is predicated only on legislated fiscal and trade policies.

The recovery in global trade coincides with strengthening investment, which is more import-intensive than other components of aggregate demand. Nevertheless, structural headwinds, including slower trade liberalization and value chain integration, as well as elevated policy uncertainty, continue to weigh on the outlook for trade.

Global financing conditions have been benign and benefited from improving market expectations about growth prospects. Financial market volatility has been low despite elevated policy uncertainty, reflecting investor risk appetite and, perhaps, some level of market complacency. Renewed risk appetite has supported EMDE financial markets and led to a narrowing of corporate bond spreads globally. Capital inflows to EMDEs were robust in the first half of 2017, partly in a rebound from late-2016 weakness. Over time, however, a gradual tightening of international financing conditions may weigh on capital flows to EMDEs. Commodity prices have continued to rise moderately, although prospects for increased U.S. shale oil production are weighing on the outlook for oil prices.

Against an improving international backdrop, growth in EMDEs has strengthened from a post-crisis low of 3.5 percent in 2016. It is projected to reach 4.1 percent in 2017 and 4.5 percent in 2018. In commodity exporters, firming commodity prices, recovering industrial activity, stabilizing investment, and improving confidence are supporting a gradual recovery, following near-stagnation in the past couple of years. This

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## TABLE 1.1 Real GDP[1]

(percent change from previous year)

| | 2014 | 2015 | 2016 | 2017 | 2018 | 2019 | 2016 | 2017 | 2018 | 2019 |
|---|---|---|---|---|---|---|---|---|---|---|
| | | | Estimates | Projections | | | Percentage point differences from January 2017 projections | | | |
| **World** | **2.8** | **2.7** | **2.4** | **2.7** | **2.9** | **2.9** | **0.1** | **0.0** | **0.0** | **0.0** |
| **Advanced economies** | **1.9** | **2.1** | **1.7** | **1.9** | **1.8** | **1.7** | **0.1** | **0.1** | **0.0** | **0.0** |
| United States | 2.4 | 2.6 | 1.6 | 2.1 | 2.2 | 1.9 | 0.0 | -0.1 | 0.1 | 0.0 |
| Euro Area | 1.2 | 2.0 | 1.8 | 1.7 | 1.5 | 1.5 | 0.2 | 0.2 | 0.1 | 0.1 |
| Japan | 0.3 | 1.1 | 1.0 | 1.5 | 1.0 | 0.6 | 0.0 | 0.6 | 0.2 | 0.2 |
| **Emerging and developing economies (EMDEs)** | **4.3** | **3.6** | **3.5** | **4.1** | **4.5** | **4.7** | **0.1** | **-0.1** | **-0.1** | **0.0** |
| Commodity-exporting EMDEs | 2.2 | 0.3 | 0.4 | 1.8 | 2.7 | 3.0 | 0.1 | -0.5 | -0.3 | -0.1 |
| Other EMDEs | 6.0 | 6.0 | 5.7 | 5.7 | 5.7 | 5.8 | 0.1 | 0.1 | 0.0 | 0.0 |
| Other EMDEs excluding China | 4.5 | 5.0 | 4.5 | 4.6 | 4.9 | 5.1 | 0.2 | 0.0 | -0.1 | 0.0 |
| East Asia and Pacific | 6.8 | 6.5 | 6.3 | 6.2 | 6.1 | 6.1 | 0.0 | 0.0 | 0.0 | 0.0 |
| China | 7.3 | 6.9 | 6.7 | 6.5 | 6.3 | 6.3 | 0.0 | 0.0 | 0.0 | 0.0 |
| Indonesia | 5.0 | 4.9 | 5.0 | 5.2 | 5.3 | 5.4 | -0.1 | -0.1 | -0.2 | -0.1 |
| Thailand | 0.9 | 2.9 | 3.2 | 3.2 | 3.3 | 3.4 | 0.1 | 0.0 | 0.0 | 0.0 |
| Europe and Central Asia | 2.3 | 1.0 | 1.5 | 2.5 | 2.7 | 2.8 | 0.3 | 0.1 | -0.1 | -0.1 |
| Russia | 0.7 | -2.8 | -0.2 | 1.3 | 1.4 | 1.4 | 0.4 | -0.2 | -0.3 | -0.4 |
| Turkey | 5.2 | 6.1 | 2.9 | 3.5 | 3.9 | 4.1 | 0.4 | 0.5 | 0.4 | 0.4 |
| Poland | 3.3 | 3.9 | 2.8 | 3.3 | 3.2 | 3.2 | 0.3 | 0.2 | -0.1 | -0.2 |
| Latin America and the Caribbean | 0.9 | -0.8 | -1.4 | 0.8 | 2.1 | 2.5 | 0.0 | -0.4 | -0.2 | -0.1 |
| Brazil | 0.5 | -3.8 | -3.6 | 0.3 | 1.8 | 2.1 | -0.2 | -0.2 | 0.0 | -0.1 |
| Mexico | 2.3 | 2.6 | 2.3 | 1.8 | 2.2 | 2.5 | 0.3 | 0.0 | -0.3 | -0.3 |
| Argentina | -2.5 | 2.6 | -2.3 | 2.7 | 3.2 | 3.2 | 0.0 | 0.0 | 0.0 | 0.0 |
| Middle East and North Africa | 3.4 | 2.8 | 3.2 | 2.1 | 2.9 | 3.1 | 0.5 | -1.0 | -0.4 | -0.3 |
| Saudi Arabia | 3.7 | 4.1 | 1.4 | 0.6 | 2.0 | 2.1 | 0.4 | -1.0 | -0.5 | -0.5 |
| Iran, Islamic Rep. | 4.3 | -1.8 | 6.4 | 4.0 | 4.1 | 4.2 | 1.8 | -1.2 | -0.7 | -0.3 |
| Egypt, Arab Rep.[2] | 2.9 | 4.4 | 4.3 | 3.9 | 4.6 | 5.3 | 0.0 | -0.1 | -0.1 | -0.1 |
| South Asia | 6.7 | 6.9 | 6.7 | 6.8 | 7.1 | 7.3 | -0.1 | -0.3 | -0.2 | -0.1 |
| India[3] | 7.2 | 7.9 | 6.8 | 7.2 | 7.5 | 7.7 | -0.2 | -0.4 | -0.3 | -0.1 |
| Pakistan[2] | 4.0 | 4.0 | 4.7 | 5.2 | 5.5 | 5.8 | 0.0 | 0.0 | 0.0 | 0.0 |
| Bangladesh[2] | 6.1 | 6.6 | 7.1 | 6.8 | 6.4 | 6.7 | 0.0 | 0.0 | -0.1 | 0.0 |
| Sub-Saharan Africa | 4.6 | 3.1 | 1.3 | 2.6 | 3.2 | 3.5 | -0.2 | -0.3 | -0.4 | -0.2 |
| South Africa | 1.6 | 1.3 | 0.3 | 0.6 | 1.1 | 2.0 | -0.1 | -0.5 | -0.7 | 0.2 |
| Nigeria | 6.3 | 2.7 | -1.6 | 1.2 | 2.4 | 2.5 | 0.1 | 0.2 | -0.1 | 0.0 |
| Angola | 4.8 | 3.0 | 0.0 | 1.2 | 0.9 | 1.5 | -0.4 | 0.0 | 0.0 | 0.6 |
| ***Memorandum items:*** | | | | | | | | | | |
| **Real GDP[1]** | | | | | | | | | | |
| High-income countries | 1.9 | 2.2 | 1.7 | 1.9 | 1.9 | 1.7 | 0.1 | 0.1 | 0.1 | 0.0 |
| Developing countries | 4.4 | 3.6 | 3.6 | 4.3 | 4.7 | 4.9 | 0.1 | -0.1 | -0.1 | 0.0 |
| Low-income countries | 6.3 | 4.7 | 4.4 | 5.4 | 5.8 | 5.8 | -0.3 | -0.2 | -0.2 | -0.3 |
| BRICS | 5.1 | 3.9 | 4.2 | 5.0 | 5.2 | 5.4 | -0.1 | -0.1 | -0.2 | -0.1 |
| World (2010 PPP weights) | 3.5 | 3.3 | 3.1 | 3.4 | 3.6 | 3.7 | 0.1 | -0.1 | -0.1 | 0.0 |
| **World trade volume[4]** | 4.1 | 2.7 | 2.5 | 4.0 | 3.8 | 3.8 | 0.0 | 0.4 | -0.2 | -0.1 |
| **Commodity prices** | | | | | | | | | | |
| Oil price[5] | -7.5 | -47.3 | -15.6 | 23.8 | 5.7 | 5.4 | -0.5 | -4.4 | -2.7 | 0.8 |
| Non-energy commodity price index | -4.6 | -15.0 | -2.6 | 4.0 | 0.7 | 1.0 | 0.0 | 2.6 | -1.5 | -1.1 |

Source: World Bank.

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 World Bank documents, even if basic assessments of countries' prospects do not differ at any given moment in time. Country classifications and lists of emerging market and developing economies (EMDEs) are presented in Table 1.2. BRICS include: Brazil, Russia, India, China, and South Africa.

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

2. GDP growth values are on a fiscal year basis. Aggregates that include these countries are calculated using data compiled on a calendar year basis. Pakistan's growth rates are based on GDP at factor cost. The column labeled 2017 refers to FY2016/17.

3. The column labeled 2016 refers to FY2016/17.

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

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

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

recovery will be broad-based, impacting nearly 70 percent of commodity exporters in 2017. However, lingering fiscal and external adjustment needs dampen growth prospects in a number of countries. As a result, growth in commodity exporters is projected to rise from 0.4 percent in 2016 to 1.8 percent in 2017 and 2.7 percent in 2018—somewhat below January forecasts, reflecting longer-than-expected adjustment to low commodity prices in some countries and, to a lesser degree, slightly lower oil price projections.

Growth continues to be robust among commodity importers. Windfalls from the recent decline in commodity prices is waning, but accommodative policies are supporting domestic demand and export growth is being bolstered by a recovery in global trade. The forecast for growth in commodity importers remains stable, at an average of 5.7 percent in 2017-19.

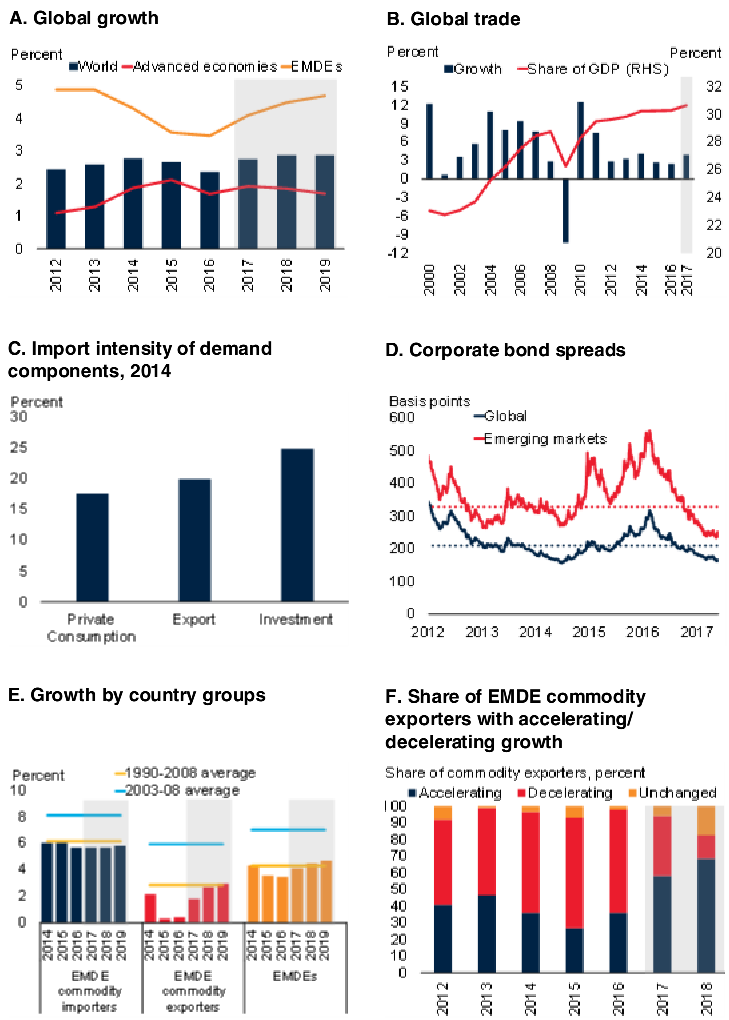
In low-income countries, growth is rebounding, as rising metals prices lift production in metals exporters and infrastructure investment continues in non-resource-intensive economies. However, some low-income countries are still struggling with declining oil production, conflict, drought, and security and political challenges. Growth in low-income countries is expected to strengthen during 2017-19, as activity firms in commodity exporters.

A number of factors weigh on longer-term EMDE growth prospects, including structural headwinds to global trade, worsening demographics, slowing productivity growth, and governance and institutional challenges. Even if the expected modest rebound in investment across EMDEs materializes, slowing capital accumulation in recent years may already have reduced potential growth.

Substantial risks cloud this outlook, despite the possibility of fiscal stimulus in some major advanced economies, particularly the United States (Figure 1.2). Escalating trade restrictions could derail a fragile recovery in trade and undo gains from past liberalization efforts. A further increase in policy uncertainty from already high levels could dampen confidence and investment and trigger financial market stress, after a period of

## FIGURE 1.1 Global prospects

*Growth is projected to gain strength in both advanced economies and emerging market and developing economies (EMDEs). Global trade growth has firmed and is expected to outpace GDP growth after two years of marked weakness. The pickup in global trade partly reflects a bottoming out of global investment, which is relatively import-intensive. Global financing conditions remain benign. The projected recovery in EMDEs is largely driven by expectations of diminishing obstacles to activity in commodity exporters.*

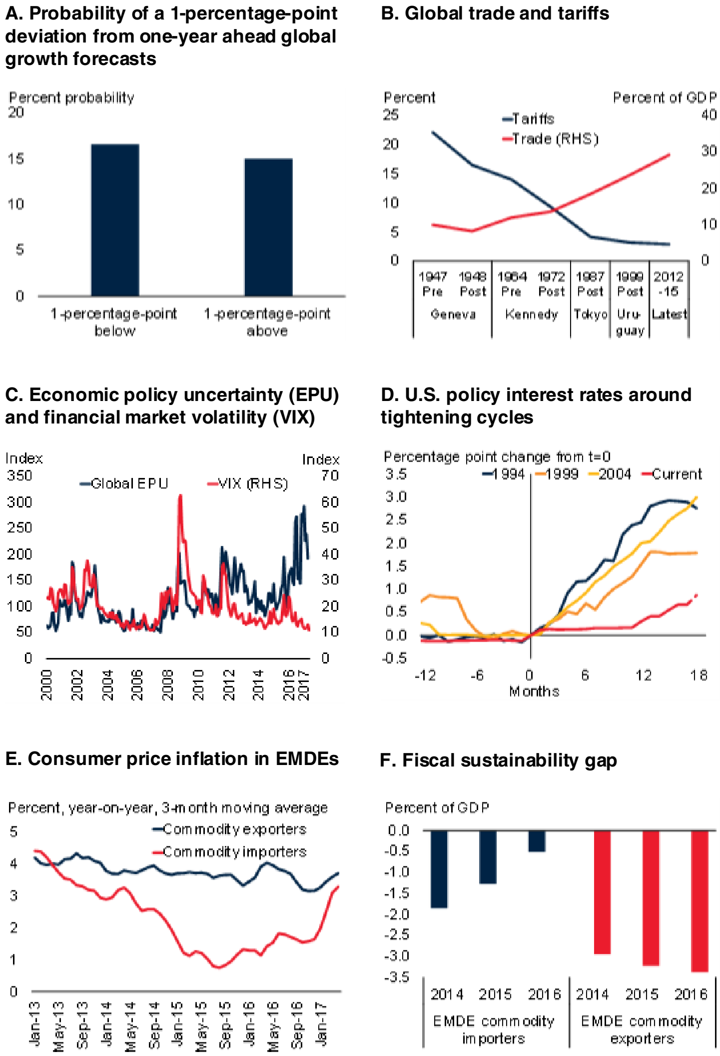



Sources: Bloomberg, World Bank, World Input-Output Database.
A.B.E.F. Shaded areas indicate forecasts.
A. Aggregate growth rates calculated using constant 2010 U.S. dollars GDP weights.
B. Global trade is measured as volume of goods and services.
C. Import intensity for each GDP component computed from input-output tables based on Hong et al. (2016). GDP-weighted average of 25 advanced economies and 7 EMDEs.
D. Spread between yields on non-sovereign debt with at least 18 months to final maturity and U.S. Treasury yields of equivalent maturity. Individual bonds are weighted by market capitalization. Dotted lines indicate the median values since 2005. Last observation is May 24, 2017.
E. Aggregate growth rates calculated using constant 2010 U.S. dollars GDP weights.
F. Accelerating / decelerating growth are changes of at least 0.1 percentage point in growth rates from the previous year. Sample includes 86 commodity-exporting EMDEs.

unusually low financial market volatility. Market reassessment of advanced-economy monetary policy, or disorderly exchange rate developments, could contribute to swings in EMDE asset prices

**FIGURE 1.2 Global risks and policy challenges**

*Downside risks to global growth include rising protectionism, high policy uncertainty, and the possibility of financial market disruptions. U.S. monetary policy has tightened gradually so far, but a faster pace would impact global financing conditions. Inflation has eased among EMDE commodity exporters, allowing room for cuts in policy interest rates. With deficits prevailing across EMDEs, and debt on a rising path, especially in commodity exporters, fiscal space remains constrained.*




Sources: Baker, Bloom, and Davis (2015); Bloomberg; Bown and Irwin (2015); Federal Reserve Board; Haver Analytics; International Monetary Fund WEO; World Bank.

A. Probabilities computed from forecast distribution of 18-month ahead oil price futures, S&P500 equity price futures, and term spread forecasts. Last observation is April 2017.

B. Global trade is defined as the average of exports and imports in percent of GDP. Applied tariff rates based on weighted mean for all products.

C. VIX is the implied volatility of option prices on the U.S. S&P 500. EPU is the Economic Policy Uncertainty index computed by Baker, Bloom, and Davis (2015). Last observation is April 2017 for EPU and May 24, 2017 for VIX.

D. t=0 refers to the start of U.S. monetary policy tightening cycles (January 1994, June 1999, June 2004, and December 2015 ("current"). Dashed lines show market implied changes. Last observation is May 24, 2017.

E. Sample includes 75 commodity-exporting and 54 commodity-importing EMDEs and shows the median in each respective group. Last observation is April 2017.

F. Sustainability gap is measured as the difference between the primary balance and the debt-stabilizing primary balance, assuming historical average (1990–2016) interest rates and growth rates. A negative gap indicates that government debt is on a rising trajectory; a positive gap indicates government debt is on a falling trajectory. Figure shows median in each country group. Sample includes 44 commodity-exporting and 28 commodity-importing EMDEs.

and capital flows, potentially amplified by vulnerabilities in some countries. Over the longer term, persistent weakness in productivity and investment growth would erode potential growth.

Policymakers face the challenge in nurturing the recovery, confronting downside risks, and fostering longer-term growth. Central banks in advanced economies will gradually normalize monetary policy as inflation increases and economic slack diminishes. While the U.S. tightening cycle is well ahead of other major advanced economies, it is proceeding at a substantially slower pace than in the past. Expansionary fiscal policy could help support the recovery, as long as it is consistent with medium-term fiscal sustainability. Policy priorities include measures to support workers most affected by sectoral shifts in employment through better training and job search programs, and to share the dividends of growth and gains from globalization more widely.

Inflation rates in EMDE commodity exporters and importers are converging. Easing inflation among commodity exporters since mid-2016 has allowed a more accommodative monetary policy stance in some countries. Although the impact of the earlier drop in commodity prices on the government budgets of commodity exporters is dissipating, fiscal space remains constrained in many EMDEs, suggesting the need for continued fiscal adjustment. EMDEs will need to continue to pursue structural reforms to improve their longer-term growth prospects, diversify their economies, and develop domestic as well as foreign markets. These efforts include policies to improve the business climate, support investment in human and physical capital, and enhance regional and global trade integration of EMDEs.

## Major economies: Recent developments and outlook

*Growth in major advanced economies has strengthened, and their short-term outlook has improved, despite elevated policy uncertainty. A modest recovery should continue, with output gaps narrowing and inflation gradually converging toward central bank* *targets. U.S. monetary policy normalization is expected to proceed at a measured pace. China's policy-guided gradual transition to slower but more sustainable growth continues as expected.*

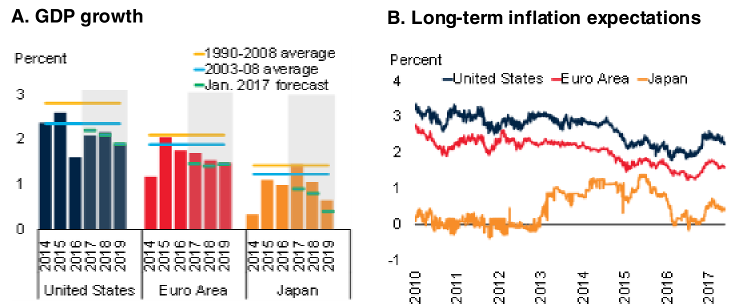
Advanced economies started the year on a solid note, with investment and exports regaining momentum after subdued growth in 2016. Private consumption decelerated somewhat in early 2017, but has been supported by labor market improvements. Import demand has strengthened, further contributing to a recovery in global trade. In 2017, growth is expected to pick up in the United States and Japan, and to remain broadly stable in the Euro Area (Figure 1.3). Forecasts for several major economies have been upgraded. Economic slack continues to diminish, and inflation expectations are rising, albeit at different rates.

## United States

Following a slowdown in 2016 that reflected investment and export weakness, growth is expected to recover this year. At the start of 2017, activity was temporarily held back by a deceleration in consumer spending, largely due to one-off factors and despite high consumer confidence (Figure 1.4). This was partly offset by an appreciable pickup in private investment, after subdued gains in 2016. Capital expenditure in the energy sector showed signs of bottoming out, following two years of heavy retrenchment and productivity gains in the shale oil sector. Labor market conditions have continued to improve in 2017, but wage and productivity growth remain sluggish. Stagnant productivity partly reflects diminished firm entry rates, including a decline in the startup rate in key innovative sectors, as well as lower job flows (Haltiwanger 2015; Decker et al. 2017). Economic slack remains, as reflected in underemployment and unused capacity in manufacturing above levels of earlier cyclical peaks (Yellen 2017). However, slack is diminishing, and the unemployment rate is close to its estimated long-run equilibrium (FOMC 2017). Following its March 2017 policy rate hike, the U.S. Federal Reserve is expected to continue to tighten monetary policy—but at a more gradual pace than in the past three tightening cycles, reflecting

**FIGURE 1.3 Advanced economies**

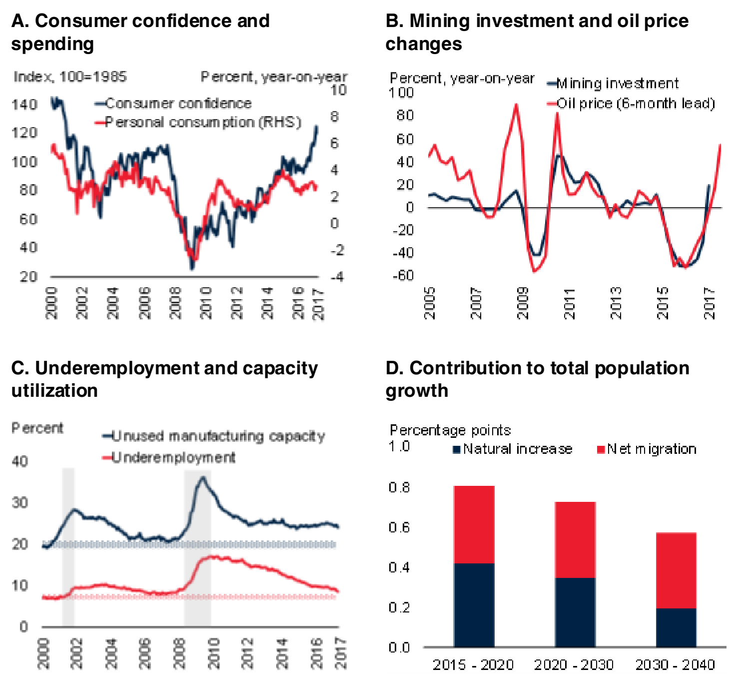
*Growth in the United States is expected to recover in 2017 and to continue at a moderate pace in 2018, as previously envisaged. The forecasts for the Euro Area and Japan have been revised upward, reflecting robust growth at the start of 2017. Inflation expectations have increased from 2016, albeit from low levels in the Euro Area and Japan.*




Sources: Bloomberg, World Bank.
A. Shaded areas indicate forecasts.
B. Long-term inflation expectations are derived from 5-year/5-year forward swap rates. Last observation is May 24, 2017.

**FIGURE 1.4 United States**

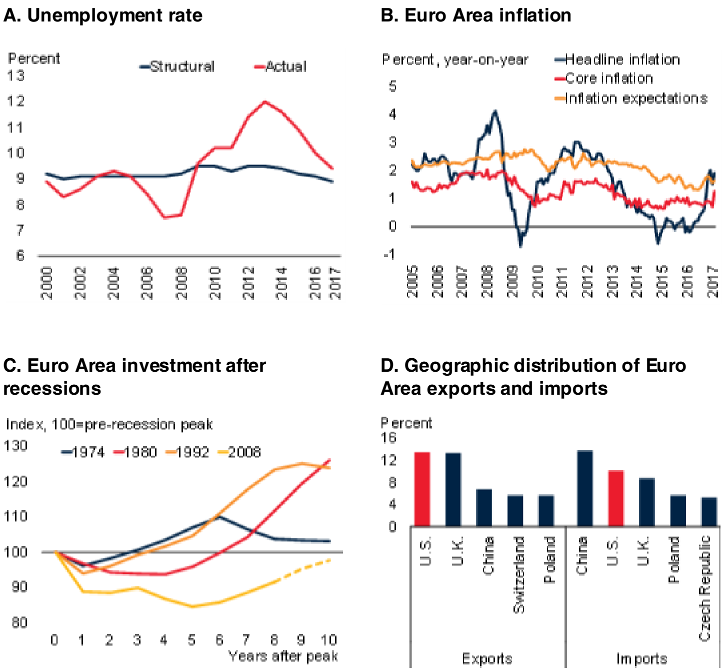
*Private consumption moderated in early 2017, despite strong consumer confidence. Private investment strengthened, whereas capital expenditures in the energy sector showed signs of bottoming out. Economic slack is diminishing, but unused capacity remains above pre-crisis levels. Over the long run, net migration is expected to account for the bulk of population growth, assuming no policy change.*




Sources: Board of Governors of the Federal Reserve System, Haver Analytics, U.S. Bureau of Labor Statistics, U.S. Census Bureau, World Bank.
A. Last observation is April 2017 for consumer confidence and March for real personal consumption.
B. Last observation is 2017Q1.
C. Underemployment is the sum of unemployed, people marginally attached to the labor market, and involuntary part-time workers, in percent of the labor force. Ranges denote values of each data series at cycle peaks. Shaded areas denote U.S. recessions. Last observation is April 2017.
D. Net migration includes the international migration of both native and foreign-born populations. Based on the 2014 U.S. Census Bureau population projections.

**FIGURE 1.5 Euro Area**

*Unemployment fell rapidly throughout 2016, but remains slightly above structural levels. Actual and expected inflation increased somewhat since the start of the year. Investment is recovering, but remains on a lower trajectory than in previous upturns. The United States and the United Kingdom remain the single largest destination of extra-Euro Area exports.*




Sources: Bloomberg, European Commission, Eurostat, Haver Analytics, World Bank.
A. Structural unemployment is the non-accelerating wage inflation rate of unemployment (NAWRU) estimated by the European Commission.
B. Long-term inflation expectations are derived from 5-year/5-year forward swap rates. Last observation is April 2017.
D. Share of extra-Euro Area exports and imports in 2016.

persistent legacies from the financial crisis and lower equilibrium interest rates. Thus far, financial markets have been resilient despite rising U.S. policy interest rates, possibly because rate increases were interpreted as a recognition of strengthening U.S. growth prospects (Arteta et al. 2015). As a result, financing conditions remain accommodative and broadly supportive of a continued recovery.

Overall, a moderate expansion in activity is expected to continue. Growth is projected to rise from 1.6 percent in 2016 to 2.1 percent in 2017 and 2.2 percent in 2018, before slowing to 1.9 percent in 2019 as it moves closer to potential. The remaining output gap could close by 2018 and become positive in 2019. The possibility of significant additional policy changes presents upside as well as downside risks to the U.S. growth forecast for 2018-19. Tax cuts and infrastructure programs could lead to stronger-than-expected growth in the short term, but also to a more rapid increase in policy interest rates (World Bank 2017a). In contrast, should substantial changes in trade policies emerge, they might trigger retaliatory measures, damaging activity in both the United States and its trading partners. U.S. multinationals are tightly interconnected in regional and global supply chains and account for a substantial share of exports, domestic sales, and employment in the United States (Kose et al. 2017a). The impact on trade and activity of border tax adjustments in corporate taxation would largely depend on the reaction of the exchange rate and on associated policy uncertainties (Auerbach and Holtz-Eakin 2016). Over time, more restrictive immigration rules could reduce potential output growth. Net migration contributes to both employment and productivity growth, and is expected to account for the bulk of population growth in coming decades (Alesina, Harnoss, and Rapoport 2013; Borjas 2013; Jaumotte, Koloskova, and Saxena 2016; Peri 2012).[1]

## Euro Area

Growth was robust in 2016 and continued at a sustained pace at the start of 2017. Manufacturing activity and goods exports have been lifted by strengthening global trade and investment. The unemployment rate fell throughout 2016 to reach 9.5 percent in the first quarter of 2017, about 2.5 percentage points below its peak in 2013. However, the jobless rate remains above structural levels, indicating that some labor market slack persists (Figure 1.5). Headline inflation has risen as the energy price decline of early 2016 has unwound, but core inflation and inflation expectations remain below the European Central Bank (ECB) target, pointing to prospects of continued monetary policy accommodation.

[1]The global implications of possible U.S. policy changes are discussed in greater detail in the risks and policy challenges sections.

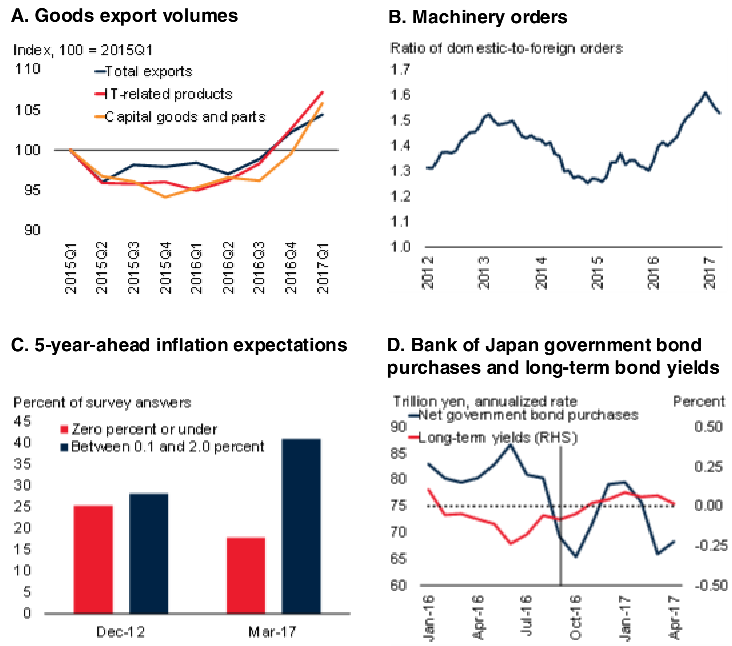
Accommodative monetary policy is expected to help sustain domestic demand in the near term. Unconventional measures undertaken by the ECB since 2014 have helped stimulate credit growth, lift inflation expectations, and foster a gradual recovery (Arteta et al. 2016; Andrade et al. 2016). Fiscal policy is expected to be broadly neutral to growth in 2017 (European Commission 2017). The recovery in private investment and export growth is projected to continue, while private consumption decelerates on receding tailwinds from low energy prices. On balance, growth is projected to remain at 1.7 percent in 2017, better than anticipated in January. In 2018-19, growth is expected to moderate to 1.5 percent, as economic slack diminishes and the ECB gradually unwinds exceptional policy measures. Nevertheless, growth should remain well above potential growth, currently estimated at about 1.2 percent (European Commission 2017). Prospects remain clouded by elevated policy uncertainties, including election outcomes, the direction of Brexit negotiations, and financial sector fragilities such as high levels of non-performing bank loans in some economies. Policy changes in the United States, the single largest destination of Euro Area exports, also remain a source of uncertainty.

## Japan

Growth has picked up in 2017, supported by a recovery in external demand. Exports have strengthened, especially for information technology-related products and capital goods (Figure 1.6). Business investment has gained momentum, as reflected by a gradual shift from foreign to domestic machinery orders. The pickup in capital spending has been supported by elevated corporate profits as well as preparations for the 2020 Tokyo Olympics (Osada et al. 2016; Brückner and Pappa 2015). Despite some strengthening, consumption continues to be on a subdued trend, and wage increases have been weak despite a tight labor market. While headline inflation has been positive in 2017, inflation expectations remain low, despite a steady increase since the introduction of quantitative easing measures in 2013 (Bank of Japan 2016). Administered prices, as well as some services prices, appear unresponsive to tighter labor market conditions (Shintani et al. 2016).

**FIGURE 1.6 Japan**

*Exports have picked up, especially for information technology-related products and capital goods. A relative increase in domestic versus foreign machinery orders is consistent with strengthening investment. Inflation expectations have risen, but remain below the central bank's target. The Bank of Japan policy shift to targeting long-term interest rates around zero slowed its asset purchases.*

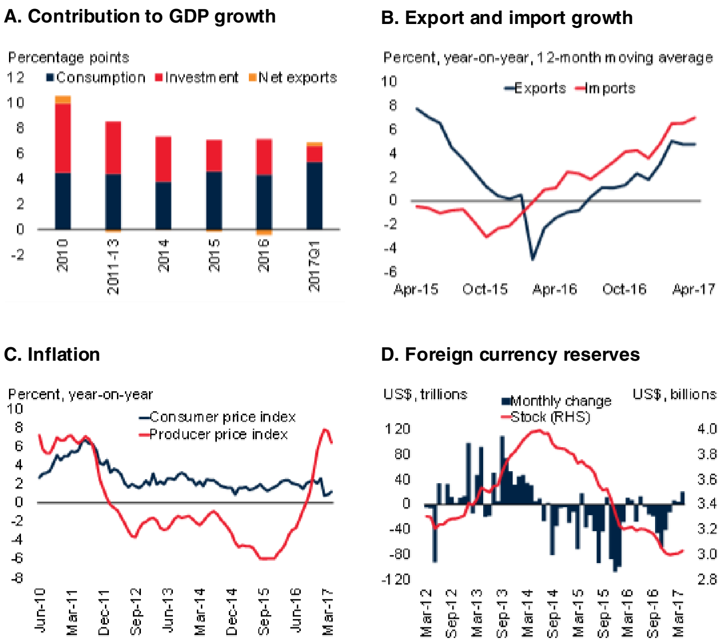



Sources: Bank of Japan, Haver Analytics, Japan Cabinet Office, World Bank.
A. Last observation is 2017Q1.
B. Data represent a 12-month moving average. Last observation is March 2017.
C. Percent of surveyed households.
D. Data for asset purchases are 3-month moving averages. Last observation is April 2017. The vertical line denotes the start of the Bank of Japan policy of adjusting asset purchases to stabilize 10-year government bond yields at zero.

Continued accommodative monetary and fiscal policies should support growth, which is projected to edge up to 1.5 percent in 2017, a significant upgrade from previous forecasts. Growth is expected to moderate to 1.0 percent in 2018—a rate that remains somewhat above estimated potential growth, which has been upgraded following the release of revised capital stock and national accounts data (Kawamoto et al. 2017). The Bank of Japan's policy shift in 2016 to targeting long-term interest rates around zero is expected to keep interest rates at low levels throughout 2017. Supplementary public spending, amounting to 1.2 percent of GDP, is expected to support activity throughout 2017, and to a lesser degree in 2018. In 2019, growth is forecast to slow to 0.6 percent, as a planned consumption tax hike is implemented.

**FIGURE 1.7 China**

*Domestic rebalancing from investment to consumption resumed in 2017, reflecting strengthening consumer spending and the waning effect of state-driven infrastructure spending. Import and export growth have rebounded. Consumer price inflation remains below target, while producer price inflation has increased sharply, reflecting higher commodity prices and reduced overcapacity in heavy industry. Reserves remain at around $3 trillion, helped by a tightening of capital controls and measures to encourage FDI.*




Sources: China National Bureau of Statistics, Haver Analytics, World Bank.
A. Investment refers to gross capital formation, which includes change in inventories.
B.-D. Last observation is April 2017.

## China

GDP expanded 6.7 percent in 2016, as expected. Domestic rebalancing from investment to consumption slowed toward the end of 2016, as infrastructure spending by state-owned companies and the public sector accelerated, more than offsetting a sharp slowdown in private sector investment (Lardy and Huang 2017). However, rebalancing from industry to services and from exports to domestic sources of demand continued (Figure 1.7). The current account surplus narrowed to 1.8 percent of GDP in 2016, reflecting stronger import demand and declining exports.

Steady growth continued in early 2017. Easing state-driven investment growth was offset by strengthening export growth against the backdrop of robust consumption growth and still-weak private sector investment growth. Despite monetary tightening, credit growth still outpaces nominal GDP growth. A housing market correction in the largest (Tier 1 and Tier 2) cities is unfolding alongside stable growth of both sales and prices in smaller (Tier 3) cities (Chen and Wen 2017; World Bank 2017b). While consumer price inflation remains below target, producer price inflation has increased sharply, reflecting higher commodity prices and reduced overcapacity in heavy industry. Exchange rate pressures have eased from late 2016, partly as a result of a tightening of capital controls and measures to encourage inward foreign direct investment (FDI), which are also helping maintain reserves at around US$3 trillion.

Growth is projected to slow to 6.5 percent in 2017, in line with January expectations. This forecast envisages strengthening trade this year, with a moderate recovery of imports, amid robust domestic demand, and a gradual acceleration of exports, reflecting firming external demand. Intermittent fiscal support will continue to be used to calibrate growth as monetary policy tightens further. Growth is expected to moderate to 6.3 percent on average in 2018-19, as simulative policies are slowly withdrawn. Key downside risks to the outlook stem from financial sector vulnerabilities and increased protectionist policies in advanced economies.

# Global trends

*Global trade has strengthened in 2017, as manufacturing activity firmed and investment growth bottomed out, especially in advanced economies. Appetite for EMDE assets has returned, reflecting market expectations of strengthening growth and still favorable international financing conditions. Moderate increases in commodity prices are expected to continue, although oil price projections have been revised slightly down, reflecting the prospect of increased U.S. shale oil production.*

## Global trade

Global trade growth has rebounded from a post-crisis low of 2.5 percent in 2016, despite rising trade policy uncertainty. The recovery, which began in the second half of 2016, has been supported by stronger industrial activity (Figure 1.8). Just as a slowdown in global investment growth was an important factor behind the deceleration of global goods trade, strengthening investment may support trade in 2017 (Freund 2016; Boz et al. 2015; Bussière et al. 2013; World Bank 2015a). Investment growth in advanced economies is firming, and the post-crisis deceleration in capital spending observed in EMDEs appears to be easing as the earlier terms-of-trade shock for commodity exporters wanes. A recovery in goods trade is supporting an upturn in China's exports, which in turn boosts imports of intermediate products across regional and global value chains. Policy-induced infrastructure spending in China has also supported demand for industrial commodities, benefiting countries exporting raw materials.

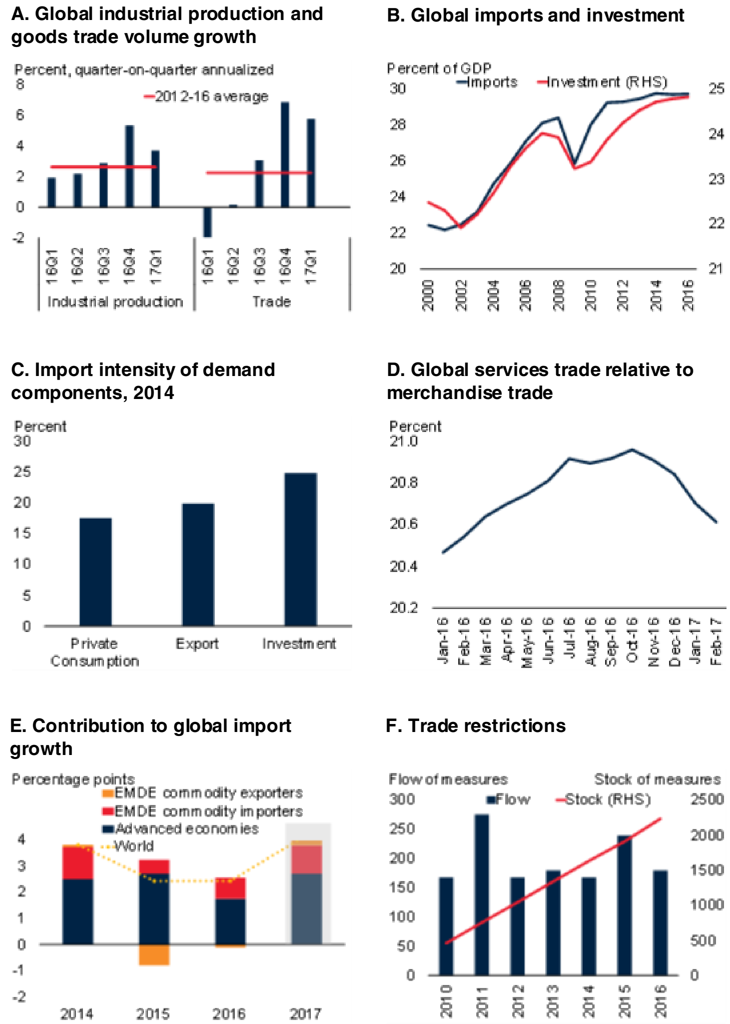
Services trade was resilient throughout 2016, supported by robust global consumer spending, particularly in major advanced economies. The ongoing recovery in goods trade may also boost services exports embodied in traded products (Lanz and Maurer 2015). Overall, trade in services continues to play a stabilizing role, being less volatile and pro-cyclical than goods trade (Borchert and Mattoo 2009; Ariu 2016; World Bank 2016a).

Global trade growth is expected to rebound to 4 percent in 2017, a faster pace than previously forecast. The recovery in trade growth in 2017 is supported by stronger import demand from major advanced economies, increased trade flows to and from China, and a diminished drag from weak import demand from commodity-exporting EMDEs. Nevertheless, trade growth will continue to be held back by structural impediments, such as maturing global value chains and a slower pace of trade liberalization (World Bank 2015a; ECB 2016).

Protectionist measures do not appear to have been a significant factor behind weak trade since the global financial crisis. According to the WTO, the number of new trade restrictions in 2016 was broadly in line with previous years. And although the use of non-tariff restrictions appears to have increased recently (Evenett and Fritz 2016), their dampening effect has been limited so far (Ghodsi, Jokubauskaite, and Stehrer 2015). Nevertheless, an expanding stock of restrictions and growing uncertainty about the direction of trade policy in some major economies could at some point have a material negative impact.

**FIGURE 1.8 Global trade**

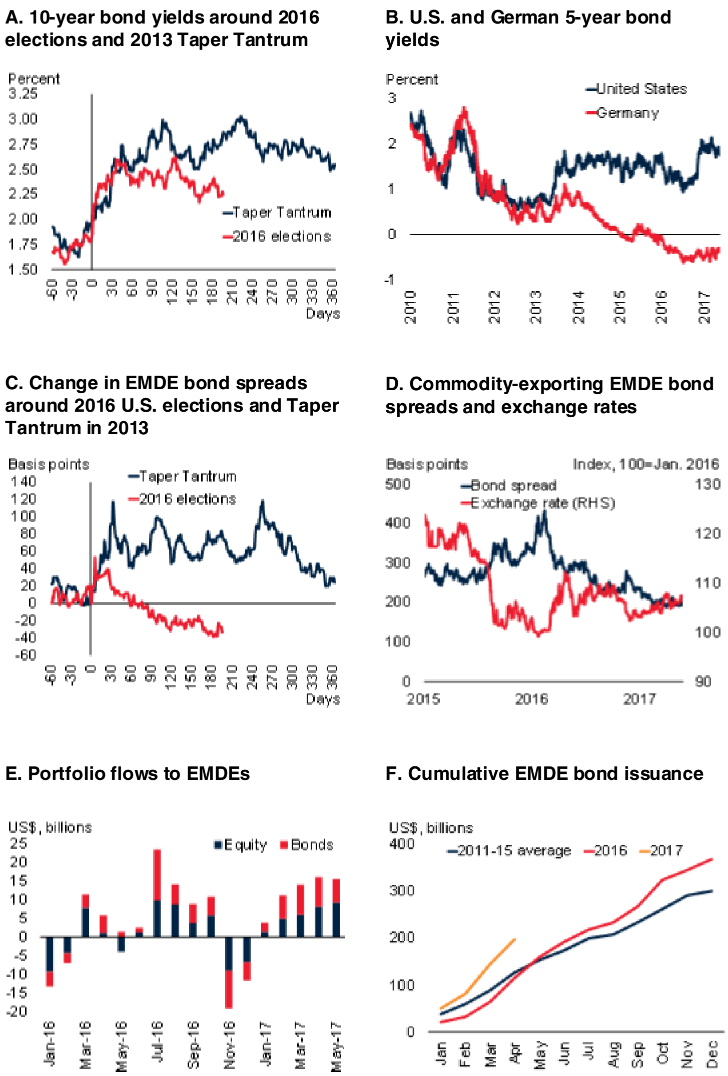
*Global goods trade growth has rebounded since mid-2016, supported by a recovery in manufacturing activity, and remained strong in the first quarter of 2017. The improvement coincided with the bottoming out of global investment, which is relatively trade-intensive. Services trade continued to play a stabilizing role, outperforming goods trade during a period of marked weakness in the first half of 2016. The number of newly adopted protectionist measures has generally been in line with past years.*




Sources: CPB Netherlands Bureau for Economic Policy Analysis, World Bank, World Input-Output Database, World Trade Organization.
A. Last observation is 2017Q1.
B. World investment, imports, and GDP calculated using constant 2010 U.S. dollars weights.
C. Import intensity for each GDP component computed from input-output tables based on Hong et al. (2016). GDP-weighted average of 25 advanced economies and 7 EMDEs.
D. 12-month moving average of global import and export values. Last observation is February 2017.
E. Aggregate imports calculated using constant 2010 U.S. dollar weights. Shaded area indicates forecasts.
F. Trade restrictions include trade remedy measures. 2016 data as of October.

## FIGURE 1.9 Financial markets

*U.S. long-term yields have stabilized since the start of 2017, following a marked increase around the November 2016 elections. Long-term yields in core Euro Area countries remain low, helping to maintain favorable global financing conditions. Improved growth prospects and increased investor risk appetite have led to a benign reaction of emerging-market assets to rising U.S. yields, especially when compared with the mid-2013 Taper Tantrum. Capital inflows and bond issuance in EMDEs continue to be robust.*




Sources: Bloomberg, Dealogic, Haver Analytics, J.P. Morgan, World Bank.

A. Day 0 refers to May 22, 2013, and November 8, 2016. Last observation is May 24, 2017.

B. Last observation is May 24, 2017.

C. EMDE bond spreads are market-value weighted spreads between U.S. dollar-denominated EMDE sovereign bonds and U.S. Treasury bonds. Last observation is May 24, 2017.

D. Medians of a nine-country group of EMDE commodity exporters are shown. Exchange rates are bilateral against the U.S. dollar, with upward movement showing an appreciation. Last observation is May 24, 2017.

E. Net flows into EMDE bond and equity funds. Last observation is May 24, 2017.

F. Data include both international sovereign and corporate issuances. Last observation is April 2017.

## Financial markets

Global financing conditions have been benign since the start of 2017. Shortly after the U.S. elections of November 2016, U.S. long-term yields rose sharply, similar to their surge during the mid-2013 Taper Tantrum (Figure 1.9). Unlike the Taper Tantrum, the late-2016 increase reflected market expectations of strengthening growth and higher inflation in the United States, and was not accompanied by a sudden and sustained re-pricing of risk, including of emerging market assets. Since early 2017, U.S. long-term yields have plateaued, even as the Federal Reserve has continued to raise short-term rates.

Euro Area bond yields have remained exceptionally low, supported by continued monetary policy accommodation by the ECB (Mojon 2017). The decoupling of Euro Area and U.S. long term yields is expected to help maintain low global interest rates, even as the Federal Reserve pursues policy normalization. In some Euro Area countries, however, upcoming political events and renewed banking sector concerns have contributed to a rise in risk premiums (De Santis 2017).

In an environment characterized by low market volatility and robust investor risk appetite, emerging market bond spreads have narrowed and equity prices have recovered. This provides another sharp contrast with the Taper Tantrum, which was accompanied by a substantial deterioration in financing conditions for EMDEs. Bond spreads have narrowed most notably among commodity exporters, while their currencies have generally regained ground. Overall, capital inflows to EMDEs have been robust in the first half of 2017, with EMDE bond issuance activity increasing at a record pace. Corporate bond issuance has been particularly buoyant, notably in Latin America, as companies aimed at extending maturity and lowering interest costs. Amid rising fiscal deficits, the Middle East and North Africa region has accounted for about half of total EMDE sovereign bond issuances since the start of 2017. Fewer credit downgrades and improving growth prospects have supported a recovery in capital flows to some commodity-exporting EMDEs, despite continued weak FDI in resource sectors.

Capital flows are expected to remain steady in 2017 and 2018, reflecting the offsetting effects of gradually tighter international financing conditions and strengthening growth prospects in EMDEs (Eichengreen, Gupta, and Masetti 2017).

## Commodities

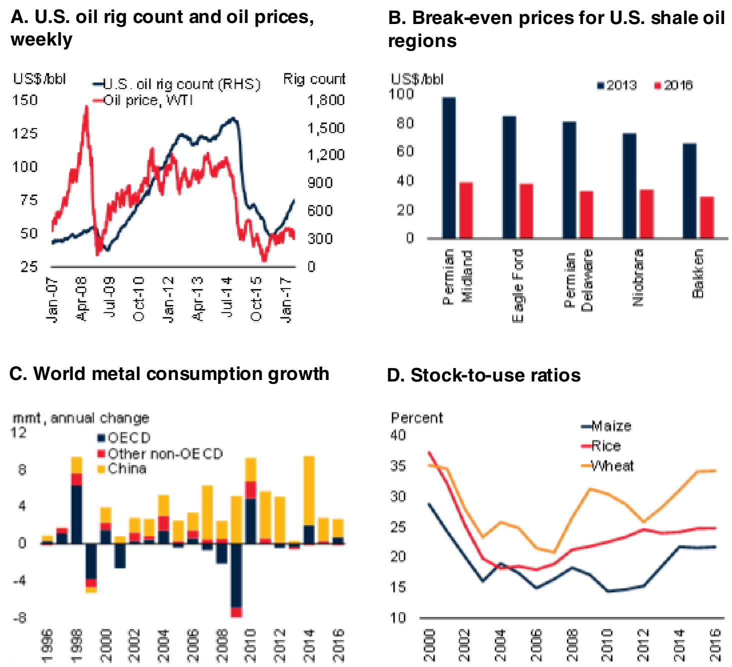
After averaging $53 per barrel (bbl) during the first quarter of 2017, oil prices dropped below $50/bbl in early May, amid stubbornly high OECD stocks and rising Libyan production (Figure 1.10). Global oil consumption is expected to grow at a moderate 1.4 percent in 2017-18 despite global growth gathering momentum. Oil production declined in early 2017 as a result of the implementation of cuts agreed in November 2016 by some Organization of the Petroleum Exporting Countries (OPEC) and non-OPEC oil producers. However, these cuts were partly offset by stronger-than-expected shale oil production in the United States, following steep productivity improvements. A rebound in drilling activity doubled the U.S. oil rig count from its 2016 low. As a result, oil inventories remain high, particularly in the United States—a key factor behind persistent weakness in oil prices.

Oil prices are expected to average $53/bbl in 2017, up 24 percent from 2016, but $2/bbl less than January forecasts. Large stocks are expected to unwind during the second half of the year. This will support an increase in oil prices to $56/bbl on average in 2018, down $4/bbl from January projections. These forecasts reflect expectations of increased U.S. shale oil production following productivity gains that have reduced costs considerably, as well as an extension of production cuts by OPEC and non-OPEC producers until March 2018. Downside risks for oil prices arise mainly from the resilience of the U.S. shale oil industry or weak compliance to the production cuts. Conversely, further disruptions among politically stressed producers (e.g., Iraq, Libya, Nigeria, República Bolivariana de Venezuela), as well as commitments to additional production cuts into 2018, could temporarily lift prices.

Metals prices continue to increase from their late-2015 lows, partly due to China's policy-driven increase in infrastructure investment. In addition,

### FIGURE 1.10 Commodity markets

*Oil prices weakened in March and April, reflecting an improved production outlook in the United States. The resilience of the U.S. shale oil industry presents a considerable downside risk for oil prices. Metals prices, which are largely influenced by fluctuations in demand from China, are projected to rise 16 percent in 2017. Agricultural prices are expected to remain stable, with global stocks of the three key grains at 15-year highs.*




Sources: Baker Hughes, Bloomberg, Rystad Energy, U.S. Department of Agriculture, World Bank, World Bureau of Metal Statistics.

A. Last observation is May 19, 2017 for rig count and May 24, 2017 for WTI.

C. 2016 data are estimates.

D. Stock-to-use ratios denote the ratio of ending stocks to domestic consumption and represent a measure of how well supplied the market is. The data reflect the April 2017 U.S. Department of Agriculture update.

prices rose on supply constraints, including wage negotiations in large copper mines in Chile, planned shutdowns of nickel mines in the Philippines, and aluminum capacity reductions in China. Exhaustion of zinc deposits in Australia and Canada also played a role. Average annual metals and mineral prices, which declined 6 percent in 2016, are projected to rise 16 percent in 2017 and decline marginally in 2018 as some of the temporary supply constraints are resolved. Price forecasts have been lifted from January projections due to stronger-than-expected demand in China and some unexpected supply constraints.

Agricultural prices are projected to remain broadly stable in 2017 and 2018. Improved growing conditions have pushed stocks-to-use ratios of key grains to 15-year highs. Fears of supply disruptions in the Southern Hemisphere, which boosted soybean prices earlier in the 2016-17 crop year, have diminished. Since agricultural production is energy intensive, lower energy prices (compared to pre-2015 levels) continue to dampen grain and oilseed prices. In addition, lower energy prices reduce the incentive to divert land use away from food to biofuel commodities. Indeed, biofuel production has changed very little in the past two years and is forecast to increase 5 percent in 2017, compared with an annual average rate of expansion of 15 percent during the preceding 10 years (World Bank 2017c).

# Emerging market and developing economies: Recent developments and outlook

*From a post-crisis low in 2016, growth is strengthening in EMDEs. A recovery in commodity exporters is being led by some large economies where adjustment to the earlier decline in commodity prices is well advanced. However, some other economies still face longer-than-expected adjustment needs, suggesting that this recovery will be somewhat softer than previously envisioned. In commodity importers, growth is projected to remain solid, as stronger exports offset the impact of diminishing policy support. Despite an easing of short-term macroeconomic pressures in many EMDEs, the longer-term EMDE outlook is constrained by structural headwinds to world trade and slowing productivity growth.*

## Recent developments

Growth in EMDEs reached a post-crisis low of 3.5 percent in 2016, as commodity exporters continued to stagnate and idiosyncratic factors held back growth in some large commodity-importing EMDEs (e.g., India, Turkey). Activity firmed toward the end of 2016 and into 2017 (Figure 1.11), reflecting a recovery in commodity exporters, where the contraction in investment is easing and import growth is bottoming out. This trend was broad-based across energy, metals, and agricultural commodity exporters. Some large commodity exporters are beginning to emerge from recession (e.g., Argentina, Brazil, Nigeria, Russia), while growth in commodity importers continues to generally be robust.

Industrial production and manufacturing purchasing managers' indexes have increased in 2017. This increase has been most pronounced among commodity exporters, where PMIs reached their highest levels since early 2015. In commodity importers, industrial production remains robust, with PMIs well into expansionary territory.

Domestic demand is leading the upturn in 2017, amid improving confidence and, in a number of commodity exporters, diminishing drag from earlier policy tightening. This is mirrored in rising import demand, which bottomed out in late 2016. Stronger external demand is also supporting the recent improvement in EMDE conditions, albeit unevenly.

### *Commodity-exporting EMDEs*

Growth appears to be bottoming out, to varying degrees, in many of the large commodity exporters that were in recession or stagnation in 2016 (e.g., Angola, Argentina, Brazil, Kazakhstan, Nigeria, Russia). Activity remains solid in a number of diversified, or non-resource-intensive, economies (e.g., Costa Rica, Ethiopia, Indonesia, Malaysia, Rwanda, Senegal, Sri Lanka, Tanzania). However, remaining adjustment needs, particularly related to fiscal sustainability, are holding back economic activity in some economies, especially in those that have significant domestic vulnerabilities and political challenges (IMF 2017a).

In general, currencies in commodity exporters have strengthened and inflation has retreated as commodity prices have stabilized, allowing monetary policy to be eased in some countries (e.g., Brazil, Chile, Colombia, Ghana, Kazakhstan, Russia, Ukraine). Fiscal policy adjustment to low commodity prices is easing in countries where such adjustment started early and is well advanced (e.g., Honduras, Indonesia, Malaysia). Confidence is generally improving, although it remains fragile (e.g., Argentina, Brazil, Kazakhstan, Nigeria, Russia, Ukraine). While private consumption growth appears to have bottomed out, impaired household balance sheets continue to weigh on consumption in some countries (e.g., Brazil, Kazakhstan, Russia, Ukraine). In resource sectors, corporate profits have picked up and companies have made progress in repairing their balance sheets.

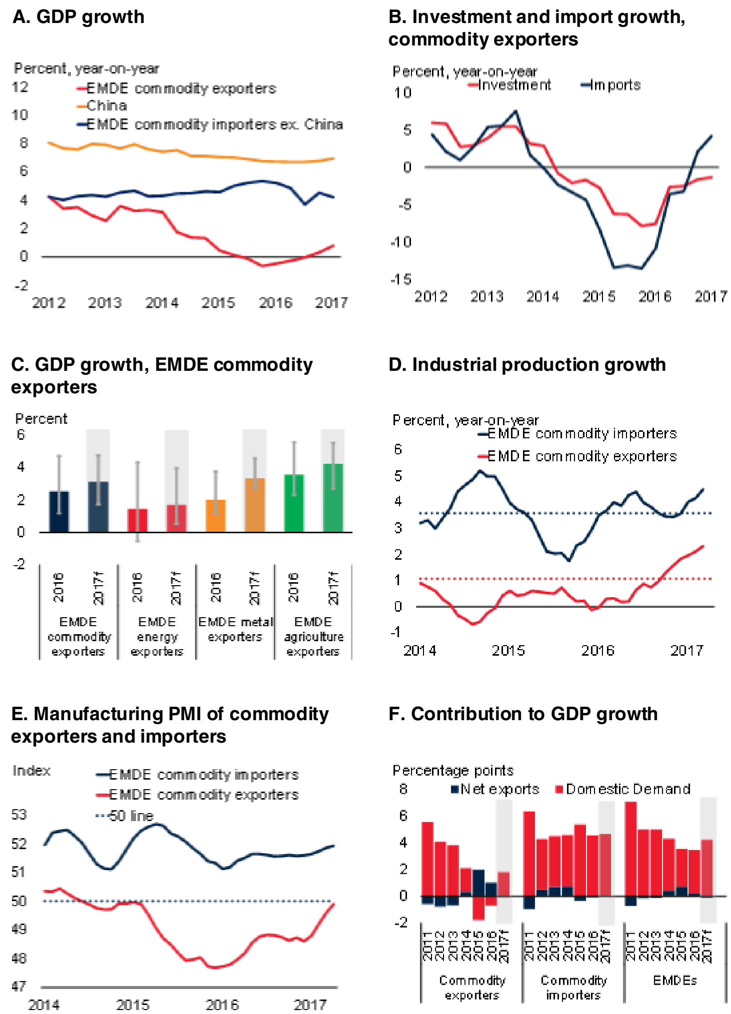
Russia is emerging from recession, with a diminishing contraction of consumer demand amid increasing price and currency stability, and a positive contribution from exports (World Bank 2017d). Growth in other large commodity exporters is firming, supported by higher commodity prices and gradual monetary policy easing (e.g., Indonesia, Kazakhstan), as well as improved confidence (e.g., Malaysia, Ukraine). In Nigeria, recent indicators point to a recovery in the manufacturing and non-manufacturing sectors. Brazil is expected to slowly emerge from recession in 2017 (Banco Central do Brasil 2017). Activity indicators have improved, including a resumption of industrial output growth and a pickup in export growth, as well as gains in confidence and manufacturing. However, the country continues to struggle with rising unemployment and still sizable fiscal adjustment needs.

In general, growth in energy exporters lags that of metal and agriculture exporters. Energy exporters face more recent, and deeper, adjustment needs. In addition, they have enacted policy measures later than other exporters. Oil production cuts and protracted fiscal consolidation has weighed on growth of Gulf Cooperation Council (GCC) countries and other affected energy exporters (e.g., Algeria, Angola, Ecuador, Iraq, Kuwait, Qatar, Saudi Arabia, United Arab Emirates). Real exchange rate appreciation in economies pegged to the U.S. dollar has curtailed current account improvements (Werner, Adler, and Magud 2017).

In contrast to the generally improving trend across EMDE commodity exporters, activity was weak in early 2017 in some countries in Sub-Saharan Africa (e.g., Burundi, Chad, Equatorial Guinea), Latin America and the Caribbean (e.g., Ecuador, República Bolivariana de Venezuela), Europe and Central Asia (e.g., Azerbaijan), and East Asia and Pacific (e.g., Mongolia, Papua New Guinea). This generally reflects sizable and protracted policy adjustment to low commodity prices. Country-specific domestic challenges have added to the difficulties, including domestic and external imbalances, exchange rate misalignments, social tensions, political challenges, security issues, and droughts. Recent activity in some metals exporters

**FIGURE 1.11 EMDE activity**

*EMDE growth is strengthening, led by commodity exporters, where the contraction of investment is easing and imports are bottoming out. The recovery is broad-based among energy, metals, and agricultural commodity exporters. Industrial production and manufacturing PMIs are rising. EMDE domestic demand is firming, amid improved confidence.*




Sources: Haver Analytics, World Bank.

A. B. Aggregate growth rates calculated using constant 2010 U.S. dollars weights. Last observation is 2017Q1.

C. Simple average of GDP growth. EMDE commodity exporter groups exclude BRICS countries. Gray line indicates interquartile ranges of growth in each group. Shaded areas indicate forecasts.

D. 6-month moving average of year-on-year industrial production growth. EMDE commodity importers excludes China. Last observation is March 2017. Dotted lines indicate median values from 2012-16.

E. 6-month moving average of country sample. Index values above 50 indicate expansion. EMDE commodity importers excludes China. Sample includes 5 EMDE commodity exporters (Brazil, Russia, Indonesia, Malaysia, South Africa) and 7 EMDE commodity importers ex. China (India, Poland, Philippines, Thailand, Vietnam, Mexico, Turkey). Last observation is April 2017.

F. Shaded areas indicate forecasts. Commodity importers excludes China.

has been held back by special factors, including production bottlenecks (e.g., Papua New Guinea), policy uncertainty (e.g., Armenia, South Africa), and mining sector disruptions and natural disasters (e.g., Chile, Peru).

### *Commodity-importing EMDEs*

Growth in commodity importers remains generally robust. In East Asia and Pacific and in South Asia, solid domestic demand, strong infrastructure spending, FDI-led investment into highly competitive manufacturing sectors and services, and rising global demand are benefiting many countries (e.g., Bangladesh, Cambodia, India, the Philippines, Vietnam; World Bank 2017b). Asian EMDE economies are also helped by increased intra-regional trade and investment flows, which may receive a further boost from China's "One Belt, One Road" initiative (World Bank 2016b).

Robust domestic demand and stronger imports from the Euro Area has favored commodity importers in Europe and Central Asia (e.g., Bulgaria, Romania, Serbia). Accelerated implementation of EU-funded projects is lifting other regional economies (e.g., Hungary, Poland), while adverse spillovers from recession in Russia and Ukraine are fading, benefiting neighboring countries (e.g., Belarus, Georgia, Moldova) (World Bank 2017e). Activity in commodity importers in the Middle East and North Africa is improving as reforms are implemented, as political conditions normalize, and as harvest conditions recover (e.g., Jordan, Lebanon, Tunisia).

Despite an overall solid performance among commodity importers, special factors are weighing on growth in some large economies. In Mexico, uncertainty about U.S. trade policy appears to be discouraging investment. In Turkey, lingering effects from the failed coup last year and high inflation stemming from a substantial currency depreciation have hurt confidence. Growth in Thailand remains below its long-term trend, as policy uncertainty and competitiveness challenges are dampening investment and exports.

### *Low-income countries*

Growth in low-income countries is rebounding after a slowdown in 2016, supported by both global and domestic factors (Box 1.1). Improving metals prices are stimulating production in metals exporters (e.g., Democratic Republic of Congo, Guinea). In many non-resource-intensive low-income countries, solid growth achieved in 2016 is continuing, driven by infrastructure investment. In countries hit by drought in 2016, above-average rainfalls are boosting agricultural production. Elsewhere, reconstruction efforts following natural disasters (e.g., the earthquake in Nepal) are picking up pace. However, some low-income countries remain under significant economic stress due to declining oil production (e.g., Chad), conflict (e.g., South Sudan), drought (e.g., South Sudan), security threats (e.g., Afghanistan), or political instability (e.g., Burundi).

## Outlook

EMDE growth is projected to strengthen from 3.5 percent in 2016 to 4.1 percent in 2017 and reach an average of 4.6 percent in 2018-19, reflecting a recovery in commodity exporters and steady growth in commodity importers (Figure 1.12). Commodity prices are expected to rise moderately from low 2016 levels, although oil prices are projected to rise slightly less than forecast in January. A rebound in global trade is expected to offset the negative effects associated with a gradual tightening of global financing conditions.

Growth in commodity exporters is expected to pick up from 0.4 percent in 2016 to 1.8 percent in 2017, and to reach 2.8 percent on average in 2018-19. The improvement is expected to be broad-based, with an acceleration of activity predicted in the majority of commodity exporters both in 2017 and in 2018. Aggregate growth in commodity exporters will be supported by improved confidence and rising commodity prices, and will solidify as the adjustment to the earlier terms-of-trade shock runs its course, as exports rebound and domestic demand firms.

Nevertheless, the expected recovery in commodity exporters is weaker than envisioned in January, mainly reflecting longer-than-expected adjustment to low commodity prices in some countries and, to a lesser degree, weaker energy price prospects. Special factors contributing to downward revisions include slowing oil sector growth in the Islamic

## BOX 1.1 Low-income countries: Recent developments and outlook

*Growth in low-income countries slowed to 4.4 percent in 2016 but is projected to pick up to 5.4 percent in 2017. Output in oil and metals-exporting countries will recover gradually, reflecting improvements in commodity prices and global trade, and reforms to remove constraints to growth. Average growth in non-resource-intensive countries is expected to remain solid, supported by domestic demand and, in particular, public investment. The main downside risks to the outlook include a weaker-than-expected recovery in commodity prices, a delay in necessary fiscal adjustments, and a deterioration in security and political conditions.*

**Growth rebound.** Growth in low-income countries is rebounding in 2017 from the 2016 slowdown.[1] The increase in metals prices is stimulating production in metals exporters (e.g., Democratic Republic of Congo, Niger). In many non-resource-intensive countries, including in the West African Economic and Monetary Union (WAEMU), the rebound is led by infrastructure investment (IMF 2017b).[2] Investor risk appetite for low-income countries' assets has improved. In May, Senegal tapped the Eurobond market to finance its investment projects. In countries that were hit by an El Niño-related drought in 2016 (e.g., Malawi, Mozambique), above average rainfalls are boosting agricultural production. Elsewhere, reconstruction efforts following natural disasters (e.g., the earthquake in Nepal) are picking up pace. However, a number of low-income countries remain under significant economic stress on account of declining oil production (e.g., Chad), conflict (e.g., South Sudan), drought (e.g., Somalia, South Sudan), security threats (e.g., Afghanistan), or political instability (e.g., Burundi).

**Elevated current account deficits.** Current account positions remain weak across low-income countries (Figure 1.1.1). Although current account deficits in oil and metals exporters are declining, they are still elevated. For oil exporters, the improvement mainly reflects the recent increase in the price of oil and a decline in imports resulting from cuts in public investment. In metals exporters, exports are gradually increasing as production expands from existing and new mining projects. Among non-resource-intensive countries (e.g., Rwanda, Uganda), rising fuel prices and large public investment programs are keeping current account deficits high. Foreign reserves remain under pressure in many countries, reflecting continued weakness of current account balances and lower-than-expected external financing. Reserve levels were less than two months of imports of goods and services in several countries at end-2016 (e.g., Chad, Democratic Republic of Congo, South Sudan) (IMF 2016a).

**Stabilizing exchange rates, high inflation.** The currencies of commodity exporters are stabilizing, following sharp depreciations in 2016, although they continue to weaken in some cases (e.g., Democratic Republic of Congo). Large exchange rate depreciations, compounded by the impact of drought on food prices, contributed to a rapid increase in inflation in some metals exporters. Inflation in Mozambique exceeded 20 percent in the first quarter of 2017. In non-resource-intensive countries, inflationary pressures are intensifying across East Africa, where a drought has reduced agricultural production, causing a spike in food prices (e.g., Ethiopia, Rwanda). Other cases of high inflation reflect domestic supply disruptions from natural disasters (e.g., Haiti). In Chad and WAEMU low-income countries, inflation has remained generally low, reflecting the stable peg to the euro. In some countries where inflation has stabilized, central banks have reduced policy rates (e.g., Tanzania, Uganda).

**Improving fiscal positions.** Fiscal positions have improved somewhat across low-income countries, reflecting fiscal consolidation efforts. Large drops in oil revenues have forced sharp spending cuts in Chad. Some metals exporters (e.g., Mozambique, Sierra Leone) have revised their spending plans to stabilize their economies. However, in others (e.g., Liberia, Niger), fiscal balances remain under pressure, reflecting delayed fiscal consolidation. Fiscal deficits widened in several non-resource-intensive countries (e.g., Togo, Uganda) due to the continued expansion in public infrastructure. As a result, government debt ratios in low-income countries have continued to rise (e.g.,

Note: This box was prepared by Gerard Kambou and Boaz Nandwa. Research assistance was provided by Trang Thi Thy Nguyen and Xinghao Gong.

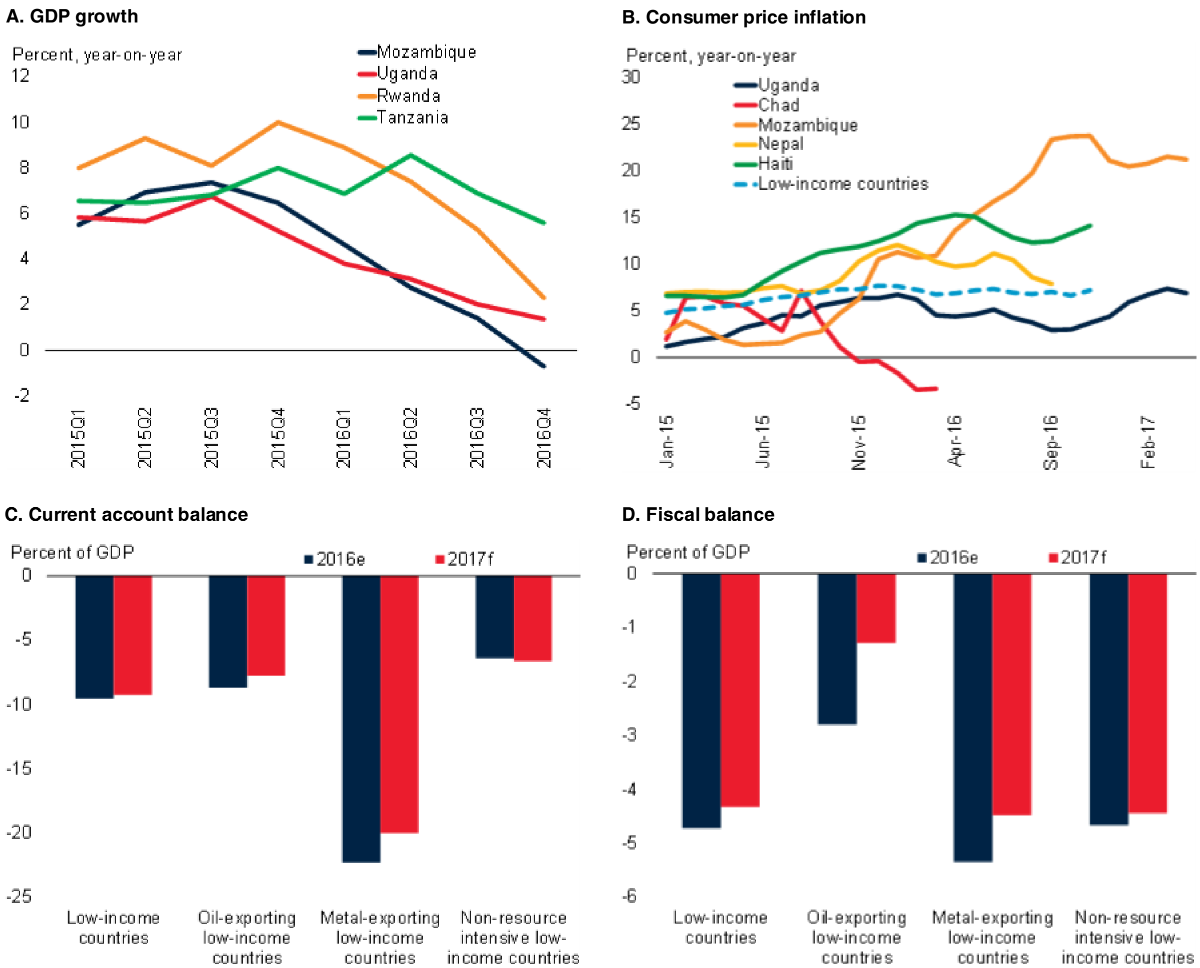
[1] For the 2017 fiscal year, low-income countries are defined as those with a gross national income (GNI) per capita, calculated using the World Bank Atlas method, of $1,025 or less.

[2] The WAEMU low-income countries are Benin, Burkina Faso, Guinea-Bissau, Mali, Niger, Senegal, and Togo.

## **BOX 1.1** Low-income countries: Recent developments and outlook *(continued)*

### **FIGURE 1.1.1** Recent developments

*Growth slowed markedly in several low-income countries toward the end of 2016. The impact of low commodity prices was the dominant factor, although drought and conflict also played a role. Inflationary pressures increased at the start of the year, reflecting large currency depreciations and the effect of drought on food prices in some countries. While current account and fiscal deficits remain elevated across low-income countries, they are narrowing in oil and metals exporters as commodity prices improve.*




Sources: Haver Analytics, International Monetary Fund, Tanzania Bureau of Statistics, World Bank.

A. Last observation is 2016Q4.

B. Last observation is March 2016 for Chad, September 2016 for Nepal, November 2016 for Haiti and low-income countries, and April 2017 for Mozambique and Uganda.

C.D. Non-resource-intensive countries include agricultural-based economies and commodity importers.

Ethiopia, Liberia, Togo), or stayed elevated (e.g., Mozambique, Senegal), exceeding in most cases 50 percent of GDP at end-2016. The rising government debt levels indicate a need for low-income countries to improve debt management capacity to manage rollover risks (World Bank 2017f).

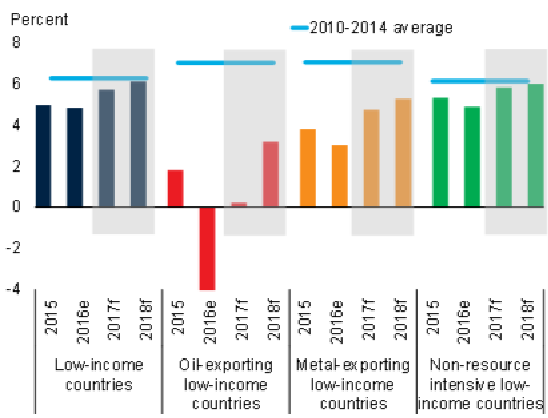
**Weaker-than-expected growth outlook.** Growth in low-income countries is projected to reach 5.4 percent in 2017 and strengthen to 5.8 percent by 2019 (Figure 1.1.2). The turnaround is predicated on a continued recovery of commodity prices, as well as on policy actions to reduce macroeconomic imbalances. These

**BOX 1.1 Low-income countries: Recent developments and outlook *(continued)***

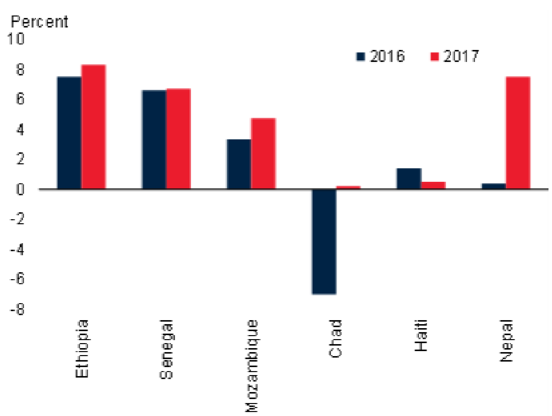
**FIGURE 1.1.2 Outlook**

*GDP growth in low-income countries is projected to recover to 5.4 percent in 2017 and to 5.8 percent in 2018-19. This reflects a moderate recovery in oil and metals exporters toward their long term average growth. Growth in non-resource-intensive countries is projected to remain robust.*

**A. GDP growth: Low-income country groups**




**B. GDP growth: Selected countries**




Source: World Bank.

forecasts are slightly weaker than those in January, with a more moderate recovery among oil and metals exporters, where growth will remain well below its 2010-2014 average. The factors underlying the modest recovery vary. Maturing oil fields (e.g., Chad) or conflict (e.g., South Sudan) will dampen the growth of oil production. Among metals exporters, inflation and fiscal tightening will be a greater drag on growth than expected.

In non-resource-intensive countries, growth should remain robust. Large low-income countries in Sub-Saharan Africa (e.g., Ethiopia, Tanzania) will expand at a rapid pace, helped by buoyant service sectors, infrastructure investment, and a rebound in agriculture. However, with elevated debt levels, these countries will need to increase public savings, contain debt accumulation, and rebuild policy buffers. Fragile states (e.g., Burundi, Haiti, Zimbabwe) will continue to expand at a slower pace.

**Risks tilted to the downside.** External risks include the possibility of weaker-than-expected growth in advanced economies. This could reduce demand for low-income countries' exports, depress commodity prices, and curtail foreign direct investment in mining and infrastructure. Low-income countries in SSA are particularly vulnerable to this risk because of their dependence on commodity exports. Other major risks are a sharp reduction in foreign aid, particularly in view of the cuts proposed by the U.S. administration; larger declines in remittances due to stricter immigration policies (e.g., Haiti); and border closures (e.g., Afghanistan). The materialization of these risks would dampen investment, consumption, and regional trade in many low-income countries.

There are also a number of domestic downside risks. Failure to implement appropriate macroeconomic policies, especially in countries where large fiscal adjustments are needed, would further weaken macroeconomic stability. Adjustment needs are particularly large in several low-income countries in SSA, including Chad and Mozambique. In addition, rising security threats (e.g., Afghanistan), heightened political uncertainty (e.g., Democratic Republic of Congo, Burundi), intensification of conflict (e.g., South Sudan), and worsening drought conditions (e.g., Somalia, South Sudan) would severely affect economic conditions in fragile countries.

## BOX 1.1 Low-income countries: Recent developments and outlook *(continued)*

### TABLE 1.1.1 Low-income country forecasts[a]

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

| | 2014 | 2015 | 2016 | 2017 | 2018 | 2019 | 2016 | 2017 | 2018 | 2019 |
|---|---|---|---|---|---|---|---|---|---|---|
| | | | Estimates | Projections | | | Percentage point differences from January 2017 projections | | | |
| **Low Income Country, GDP[b]** | **6.3** | **4.7** | **4.4** | **5.4** | **5.8** | **5.8** | **-0.3** | **-0.2** | **-0.2** | **-0.3** |
| Afghanistan | 1.3 | 1.1 | 2.2 | 2.6 | 3.4 | 3.1 | 1.0 | 0.8 | 0.4 | -0.5 |
| Benin | 6.4 | 2.1 | 4.0 | 5.5 | 6.0 | 6.3 | -0.6 | 0.3 | 0.7 | 1.0 |
| Burkina Faso | 4.0 | 4.0 | 5.4 | 6.1 | 6.3 | 6.3 | 0.2 | 0.6 | 0.3 | 0.3 |
| Burundi | 4.7 | -3.9 | -0.6 | 1.5 | 2.0 | 2.6 | -0.1 | -1.0 | -1.5 | -0.9 |
| Chad | 6.9 | 1.8 | -7.0 | 0.2 | 3.2 | 3.1 | -3.5 | 0.5 | -1.5 | -3.2 |
| Comoros | 2.1 | 1.0 | 2.2 | 3.3 | 4.0 | 4.0 | 0.2 | 0.8 | 1.0 | 1.0 |
| Congo, Dem. Rep. | 9.0 | 6.9 | 2.2 | 4.7 | 4.9 | 4.9 | -0.5 | 0.0 | -0.1 | -0.1 |
| Ethiopia[c] | 10.3 | 9.6 | 7.5 | 8.3 | 8.0 | 7.9 | -0.9 | -0.6 | -0.6 | -0.7 |
| Gambia, The | 0.9 | 4.1 | 2.1 | 2.5 | 3.8 | 4.0 | 1.6 | 1.7 | 1.2 | 1.4 |
| Guinea | 0.4 | 0.1 | 4.6 | 4.4 | 4.6 | 4.6 | -0.6 | -0.2 | 0.0 | 0.0 |
| Guinea-Bissau | 2.5 | 4.8 | 4.9 | 5.1 | 5.1 | 5.1 | 0.0 | 0.0 | 0.0 | 0.0 |
| Haiti[c] | 2.8 | 1.2 | 1.4 | 0.5 | 1.7 | 2.3 | 0.2 | 1.1 | 0.2 | 0.3 |
| Liberia | 0.7 | 0.0 | -1.2 | 3.0 | 5.3 | 5.7 | -3.7 | -2.8 | 0.0 | 0.4 |
| Madagascar | 3.3 | 3.8 | 4.4 | 3.5 | 6.4 | 4.7 | 0.3 | -1.0 | 1.6 | -0.1 |
| Malawi | 5.7 | 2.8 | 2.5 | 4.4 | 4.9 | 5.3 | 0.0 | 0.2 | 0.4 | 0.8 |
| Mali | 7.0 | 6.0 | 5.6 | 5.3 | 5.2 | 5.1 | 0.0 | 0.2 | 0.2 | 0.1 |
| Mozambique | 7.4 | 6.6 | 3.3 | 4.8 | 6.1 | 6.7 | -0.3 | -0.4 | -0.5 | 0.1 |
| Nepal[c] | 6.0 | 3.3 | 0.4 | 7.5 | 5.5 | 4.5 | -0.2 | 2.5 | 0.7 | -0.2 |
| Niger | 7.0 | 3.6 | 4.7 | 5.2 | 5.5 | 5.5 | -0.3 | -0.1 | -0.5 | -0.5 |
| Rwanda | 7.0 | 6.9 | 5.9 | 6.0 | 6.8 | 7.0 | -0.1 | 0.0 | -0.2 | 0.0 |
| Senegal | 4.3 | 6.5 | 6.6 | 6.7 | 6.9 | 7.0 | 0.0 | -0.1 | -0.1 | 0.0 |
| Sierra Leone | 4.6 | -20.6 | 5.0 | 5.4 | 5.6 | 5.9 | 1.1 | -1.5 | -0.3 | 0.0 |
| Tanzania | 7.0 | 7.0 | 6.9 | 7.2 | 7.2 | 7.4 | 0.0 | 0.1 | 0.1 | 0.3 |
| Togo | 5.9 | 5.4 | 5.0 | 4.6 | 5.5 | 5.5 | -0.4 | -0.4 | 0.0 | 0.0 |
| Uganda[c] | 5.6 | 5.6 | 4.8 | 4.6 | 5.2 | 5.6 | 0.2 | -1.0 | -0.8 | -0.4 |
| Zimbabwe | 3.8 | 0.5 | 0.7 | 2.3 | 1.8 | 1.7 | 0.3 | -1.5 | -1.6 | -1.7 |

Source: World Bank.
World Bank forecasts are frequently updated based on new information and changing (global) circumstances. Consequently, projections presented here may differ from those contained in other Bank documents, even if basic assessments of countries' prospects do not significantly differ at any given moment in time.
a. Central African Republic, Democratic People's Republic of Korea, 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. For Nepal, the year 2017 refers to FY2016/17, which runs from July 16 to July 15 of the following year.
For additional information, please see www.worldbank.org/gep.

Republic of Iran, the protracted effects of restricted access to international financial markets in Russia, deeper-than-expected oil production cuts in Saudi Arabia, and a deterioration of investor confidence in South Africa amid two recent sovereign rating downgrades to sub-investment grade. More generally, the subdued long-term outlook for commodity prices is expected to keep investment rates in commodity exporters well below the high rates achieved during the pre-2014 commodity boom. In this context, growth in regions with large numbers of commodity exporters will strengthen in 2017, but at a slower-than-expected pace (Box 1.2).

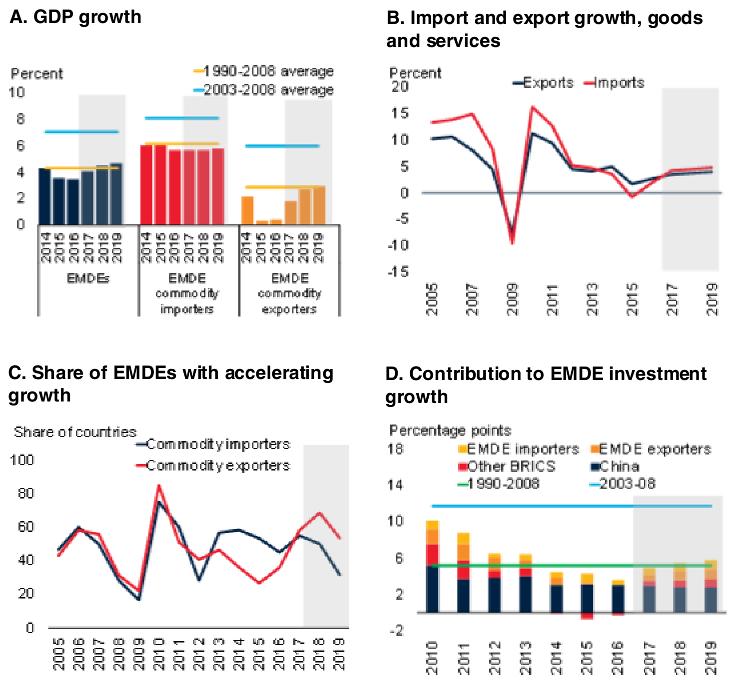
Growth in commodity importers is projected to remain broadly stable, at around 5.7 percent on average in 2017-19. In general, stronger exports are expected to offset the impact of diminishing policy support and waning windfalls from earlier commodity price declines. A gradual slowdown in China will be partly offset by a modest pickup in the rest of the group. Excluding China, growth in commodity importers will accelerate from 4.6 percent in 2017 to an average of 5.0 percent in 2018-19, partly reflecting the diminishing role of idiosyncratic factors holding back activity in some large economies (e.g., Mexico, Turkey). Relative to January projections, the outlook for commodity importers is little changed. In particular, a downgrade to India's fast pace of expansion, mainly reflecting a softer-than-expected recovery in private investment, is accompanied by an upward revision to Turkey, partly due to signs of less severe effects of last year's failed coup and a reassessment of potential growth.

In low-income countries, growth is projected to rebound to 5.4 percent in 2017, helped by a pickup in metals exporters, and strengthen to 5.8 percent in 2018-19, as activity improves in oil exporters. This turnaround is predicated on policy actions to tackle macroeconomic imbalances, as well as on moderately rising commodity prices. These forecasts are slightly lower than in January. In oil exporters, oil production will increase at a slower pace than previously projected due to maturing oil fields (Chad) or conflict (South Sudan). In metals exporters, high inflation and tight fiscal policy will be a greater drag on activity than previously thought in several countries. Growth should remain robust in non-resource-intensive countries as they continue to benefit from infrastructure investment (e.g., Ethiopia, Senegal) and buoyant services sectors (e.g., Tanzania).

While the easing of macroeconomic pressures is a positive development in the short term for many EMDEs, structural obstacles continue to impede the longer-term outlook. These include structural headwinds to world trade, such as slower trade liberalization and value chain integration; persistently low commodity prices; worsening demographics in most developing regions; slowing productivity growth; and governance and institutional challenges. In addition, many economies have experienced trend slowdowns in investment growth in recent years (World Bank

**FIGURE 1.12 EMDE growth outlook**

*EMDE growth is projected to pick up to 4.1 percent in 2017 and accelerate further in 2018-19. Amid strengthening global trade, EMDE exports and imports are expected to firm. The strengthening EMDE outlook mainly reflects a recovery in commodity exporters, while growth in commodity importers is projected to remain robust. However, EMDE investment is likely to remain subdued, with investment recoveries concentrated in a few large EMDEs.*




Source: World Bank.
A.-D. Shaded areas indicate forecasts.
A. Aggregate growth rates calculated using constant 2010 U.S. dollars GDP weights.
B. Export and import volumes include goods and non-factor services.
C. Share of countries in EMDE commodity exporters and importers whose GDP growth is at least 0.1 percentage point higher than the previous year. Sample includes 60 commodity importers and 86 commodity exporters.
D. Averages for 1990-2008 and 2003-08 include all EMDEs.

2017a). Even if the expected modest recovery in investment materializes, the slower rate of capital accumulation in previous years, and the associated loss of embodied technological progress, may have already set back potential output growth. Moreover, the overall EMDE investment recovery is expected to be concentrated in a few large economies.

## Risks to the outlook

*Despite the possibility of more expansionary fiscal policies than currently assumed in major economies, the balance of risks remains titled to the downside, although slightly less so than at the start of the year.*

## BOX 1.2 Regional perspectives: Recent developments and outlook

*Growth in most EMDE regions with a substantial number of commodity exporters is projected to strengthen in 2017, amid modestly rising commodity prices and growing trade. However, this acceleration is weaker than previously envisioned, mainly due to longer-than-expected adjustment to the weak commodity price outlook and, to a lesser degree, a minor downward revision to oil price forecasts. EMDE regions with large numbers of commodity importers are expected to continue to experience solid growth.*

**East Asia and Pacific.** Regional growth is projected to inch down from 6.2 percent in 2017 to 6.1 percent on average in 2018-19, in line with previous forecasts (Figure 1.2.1). A gradual slowdown in China will be partly offset by a modest pickup in the rest of the region. Domestic demand is projected to remain robust. Firming exports are expected to offset the negative impact of gradual policy tightening. Downside risks include heightened policy uncertainty, increased protectionism in key advanced economies, and an abrupt tightening of financing conditions. A sharper-than-expected slowdown in China could have adverse consequences for the rest of the region and continues to be a low-probability risk.

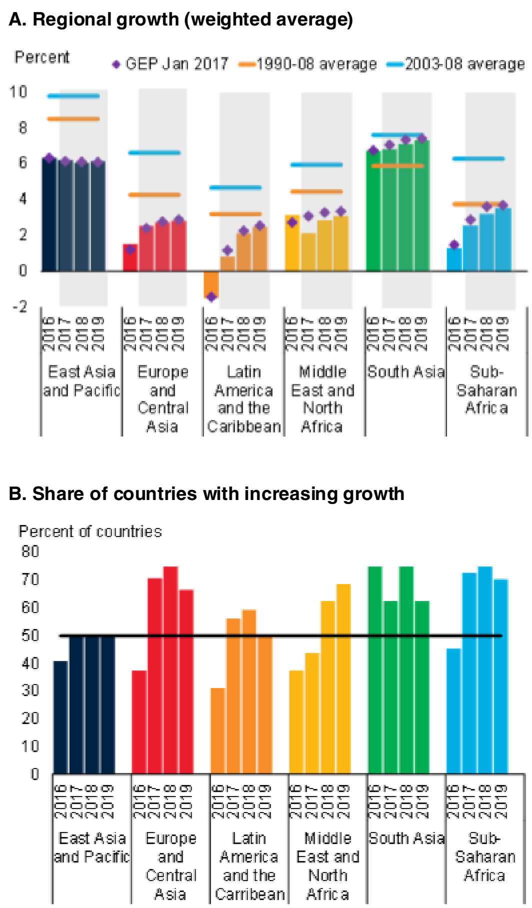
**Europe and Central Asia.** Regional activity has picked up since the end of 2016, and the 2017 growth forecast of 2.5 percent is in line with January projections. Both commodity exporters and importers are recovering. The region is benefiting from modestly rising oil prices, benign global financing conditions, and solid growth in the Euro Area. Regional growth is expected to edge up to an average of 2.8 percent in 2018-19, as activity in Russia and other commodity exporters firms and growth in Turkey recovers. The main downside risks include renewed declines in oil and other commodity prices, policy uncertainty and geopolitical risks, and international financial market disruptions. Domestic banking system weaknesses are a vulnerability and could amplify internal and external shocks.

**Latin America and the Caribbean.** Regional output contracted 1.4 percent in 2016, pulled down by recessions in Argentina, Brazil, and República Bolivariana de Venezuela. Although recent data suggest that the regional economy is stabilizing after two years of contraction, the recovery is expected to be subdued in the short term. Growth is projected to reach 0.8

Note: This box was prepared by Carlos Arteta with contributions from Gerard Kambou, Lei Ye, Boaz Nandwa, Yoki Okawa, Temel Taskin, Ekaterine Vashakmadze, and Dana Vorisek. Research assistance was provided by Trang Thi Thy Nguyen.

### FIGURE 1.2.1 Regional growth

*Growth in most EMDE regions with a substantial number of commodity exporters is projected to pick up in 2017; however, this acceleration is weaker than previously envisioned. EMDE regions with large numbers of commodity importers are expected to continue to experience solid growth.*




Source: World Bank.

A.B. Average for 1990-08 is constructed depending on data availability. For ECA, data for 1995-2008 are used to exclude the immediate aftermath of the collapse of the Soviet Union.

A. Bars denote latest forecast; diamonds denote previous forecasts. Since the largest economies of each region account for almost 50 percent of regional GDP in some regions, weighted average predominantly reflects the development in the largest economies in each region.

B. Share of countries that GDP growth exceeds that of the previous year out of total countries in the region. Horizontal black line denotes 50 percent.

**BOX 1.2 Regional perspectives: Recent developments and outlook *(continued)***

percent in 2017, supported by strengthening private consumption and an easing contraction in investment, despite a slowdown in Mexico as uncertainty about U.S. economic policy dents confidence. Regional growth is expected to accelerate to an average of 2.3 percent in 2018-19, as the recoveries in Brazil and other commodity exporters advance. The main downside risks to the outlook arise from domestic political and policy uncertainty and from possible policy changes in the United States.

**Middle East and North Africa.** Regional growth is projected to decline from 3.2 percent in 2016 to 2.1 percent in 2017. The deceleration reflects slowdowns in oil-exporting economies, resulting from OPEC-led oil production cuts agreed in November 2016. In oil importers, growth is expected to improve this year, aided by reforms and supply-side factors such as weather-induced recoveries in agricultural output. Regional growth is expected to pick up to an average of 3 percent in 2018-19, amid modestly rising oil prices. The need for additional fiscal consolidation by both oil exporters and importers remains an important headwind over the medium term. Key risks include a weaker-than-expected rise in oil prices, continued geopolitical conflicts, and social tensions that may delay implementation of key structural reforms.

**South Asia.** Regional growth is projected to remain strong, at 6.8 percent in 2017. India is recovering from the temporary adverse effects of the end-2016 withdrawal of large-denomination currency notes. Elsewhere in the region, growth in Pakistan is accelerating this year, largely driven by robust domestic demand and improved foreign direct investment, while activity in Bangladesh is moderating, reflecting a pullback in domestic demand and in industrial production. Regional growth is expected to firm in 2018-19, reaching an average of 7.2 percent, supported by robust domestic demand, an uptick in exports, and strong foreign direct investment. The regional outlook has been slightly revised down from January, reflecting a more protracted recovery in private investment in India than previously expected. Risks to the outlook are tilted to the downside and include reforms setbacks, geopolitical tensions, and policy uncertainty.

**Sub-Saharan Africa.** Regional growth is projected to recover in 2017 to 2.6 percent, reflecting a modest rise in commodity prices, strengthening external demand, and the end of drought in several countries. The recovery is proceeding at a slightly more moderate pace than anticipated in January, reflecting in part the longer-than-expected adjustment among some large commodity exporters to low commodity price prospects, as well as heightened political uncertainty in South Africa. Solid growth in non-resource-intensive countries is continuing into 2017, as expected. However, in some countries, drought continues to weigh on agricultural production. Growth is projected to pick up to 3.4 percent in 2018-19. Downside risks to the outlook include insufficient adjustment to low commodity prices, weaker improvements in commodity prices, stronger-than-expected tightening of global financing conditions, and political uncertainty.

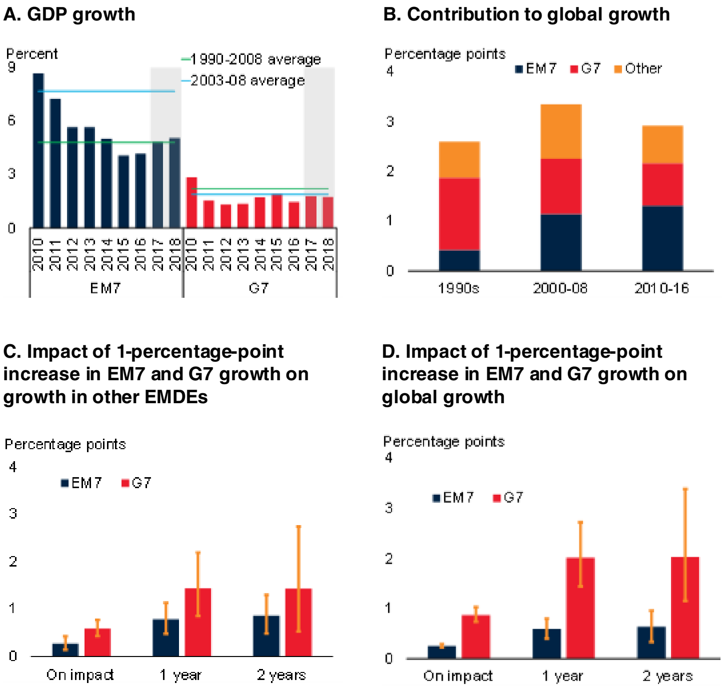
*Increased protectionism, persistent policy uncertainty, geopolitical risks, or renewed financial market turbulence could derail an incipient recovery. Financial market stress could be amplified by vulnerabilities in some EMDEs. Over the longer term, a protracted slowdown in productivity and investment growth could further deteriorate the growth potential of advanced economies and EMDEs.*

Baseline forecasts point to strengthening momentum throughout 2017, with global growth reaching 2.7 percent in 2017, helped by a moderate investment-led recovery in advanced economies and diminishing headwinds among commodity-exporting EMDEs. In 2018 and 2019, global growth is predicted to average 2.9 percent, as recoveries in commodity-exporting EMDEs gain traction.

In particular, aggregate growth in the largest seven EMDEs (Brazil, China, India, Indonesia, Mexico, the Russian Federation, and Turkey) is expected to pick up throughout the forecast horizon, surpassing its long-term average by 2018 (Figure 1.13). Over time, this group has come to play an

**FIGURE 1.13 Role of the largest EMDEs in the global outlook**

*Aggregate growth in the largest seven EMDEs is expected to pick up throughout the forecast horizon. Over time, this group has come to play an increasingly important role in the global economy. Recovering activity in the largest EMDEs should have notable positive effects for growth in other EMDEs as well as globally.*




Source: World Bank.
A.-D. EM7 includes Brazil, China, India, Indonesia, Mexico, the Russian Federation, and Turkey. G7 includes Canada, France, Germany, Italy, Japan, the United Kingdom, and the United States.
A. Aggregate growth rates calculated using constant 2010 U.S. dollars GDP weights. Shaded areas denote forecasts.
C. Cumulative impulse responses of a 1-percentage-point increase in EM7 and G7 growth on growth in other EMDEs. Solid bars represent medians, and error bars represent 16-84 percent confidence intervals.
D. Cumulative impulse responses of a 1-percentage-point increase in EM7 and G7 growth on global growth. The impact is the GDP-weighted average of the responses of EM7, other EMDEs, and G7 countries. Solid bars represent medians, and error bars represent 16-84 percent confidence intervals.

increasingly important role in the global economy. Accordingly, recovering activity in the largest EMDEs should have notable positive effects for growth in other EMDEs as well as globally—even if the largest advanced economies continue to be the main source of global spillovers (Huidrom, Kose, and Ohnsorge 2017).

The benign global outlook is little changed since January 2017, after a sequence of forecast downgrades in previous years (Figure 1.14). While a more expansionary fiscal stance in advanced economies—particularly the United States—could lead to stronger-than-expected growth, downside risks continue to dominate. Policy uncertainty is likely to remain high in 2017, and there is a risk that financial market volatility could increase from current low levels. This could be triggered by unexpected changes in monetary, trade, or other policies in major economies; heightened financial sector concerns; electoral outcomes; or rising geopolitical risks. Over the longer term, a more prolonged slowdown in investment could further erode the growth potential and resilience of both advanced economies and EMDEs.

Against this backdrop, downside risks remain above historical averages. This implies a continued downward skew in the distribution of possible forecast errors. At present, the estimated 50-percent probability range for global growth in 2018 is 2.2-3.6 percent. The probability that global growth could be more than 1 percentage point below baseline over the next year is currently estimated at 17 percent. The probability of global growth being more than 1 percentage point above the baseline next year is estimated at 15 percent.

## Upside risk: fiscal stimulus in advanced economies

While the baseline forecast assumes that fiscal policy in major advanced economies will be broadly neutral to growth, a more expansionary fiscal stance could eventually materialize over the forecast period, particularly in the United States. Fiscal stimulus could provide a boost to U.S. growth, depending on the nature of the measures (World Bank 2017a). Although this would have positive effects on global growth, its benefits for trading partners could be dampened by countervailing forces—in particular, changes in U.S. trade policy.

The proposed tax cuts and measures to boost U.S. infrastructure spending are not included in baseline projections due to insufficient details and the unclear timeframe. Suggested tax reforms include a reduction in marginal tax rates for corporations and individuals, a simplification of the tax code, and measures to improve international tax competitiveness. Large cuts to corporate and personal income taxes could have a positive short-term effect on growth, but could also lead to a substantial increase in fiscal deficits.[2] Immediate expensing of business investments could provide particularly strong support to capital expenditures, and help spur U.S. growth above current projections (Auerbach et al. 2017). Infrastructure investment programs could also lead to stronger-than-expected U.S. growth in the short-term, and increase potential output over the medium term (Bivens 2014; Whalen and Reichling 2015). However, the U.S. economy is already close to full employment, which could limit the short-term lift from fiscal stimulus, and lead to earlier, and ultimately larger, policy interest rate increases (Auerbach and Gorodnichenko 2012; Christiano, Eichenbaum, and Rebelo 2011).

In the Euro Area, fiscal stimulus could boost growth in view of still-high unemployment and low equilibrium interest rates (European Commission 2016). Given the high trade intensity of Euro Area activity, positive spillovers of Euro Area stimulus for the rest of the world, and for EMDEs in particular, could be substantial (World Bank 2017a). In Japan, additional stimulus measures in the short term, and further delays in planned consolidation measures over the medium term, could lead to a slightly higher growth trajectory in coming years.

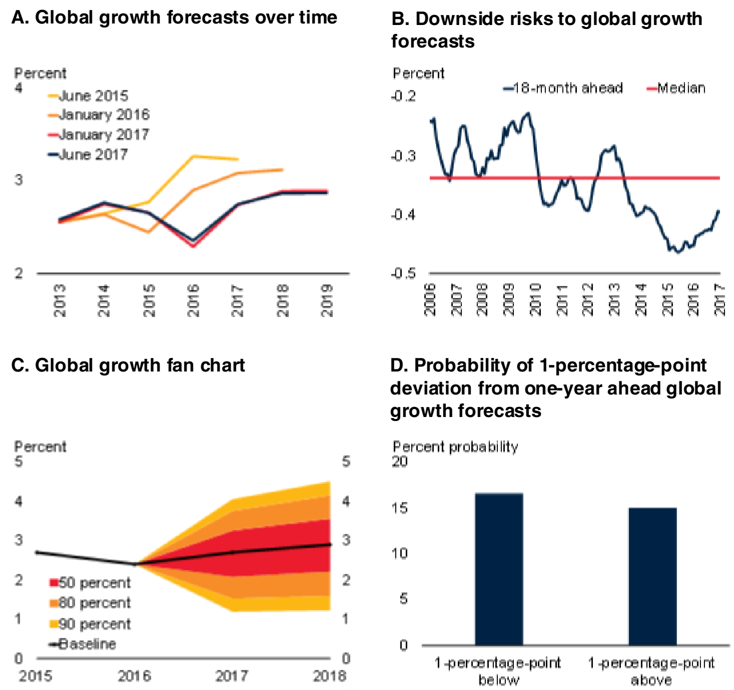
## Downside risk: increased protectionism and trade retaliation

Despite the recent improvement in world trade, the possibility of rising trade protectionism has become a major source of concern (Figure 1.15). Over the medium term, additional erosion of the multilateral rules-based system that has been built since the mid-1940s could put downward pressure on economic integration, and ultimately on growth and job creation.

While the widespread imposition of trade barriers remains a tail risk in the short term, unilateral restrictions may be met with retaliatory measures.

### FIGURE 1.14 Global risks

*Global growth forecasts have stabilized following sequential downgrades in previous years. However, downside risks remain above historical averages. The probability that global growth could be more than 1 percentage point below the baseline next year is currently estimated at 17 percent. The probability of global growth being more than 1 percentage point above the baseline next year is 15 percent.*




Sources: Bloomberg, Consensus Economics, World Bank.

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

B. Downside risks measured as the time-varying skewness of global growth forecasts, computed from the forecast distribution of the three underlying risk factors (oil price futures, the S&P 500 equity price futures, and term spread forecasts). Each of the three risk factors' weight is estimated using the variance decomposition of global growth forecasts derived from the vector autoregression model described in Ohnsorge, Stocker, and Some (2016).

C.D. The fan chart and the corresponding probabilities are constructed based on the recovered standard deviation and skewness, assuming a two-piece normal distribution. Values for 2017 are computed from the forecast distribution of 6-month ahead oil price futures, S&P500 equity price futures, and term spread forecasts. Values for 2018 are based on 18-month ahead forecast distributions. Last observation is April 2017.

A non-cooperative rise in trade restrictions could result in retaliatory measures, eventually leading to substantial increases in tariffs worldwide (Ossa 2014; Tabakis and Zanardi 2016). This could result in large income losses for all countries involved (Broda, Limao, and Weinstein 2008; Perroni and Whalley 2000).

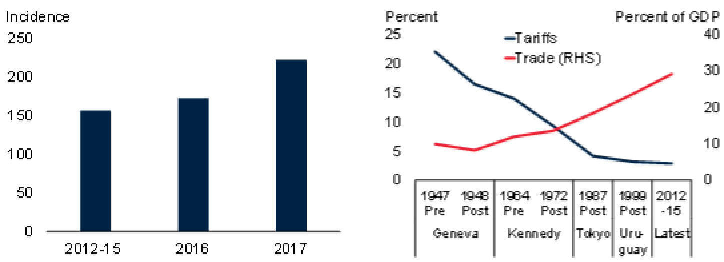
An upward spiral in beggar-thy-neighbor protectionist measures would put into reverse the process of trade liberalization that has been a major contributor to deepening trade in past decades. For example, new preferential trade agreements, and a rising number of WTO

[2]Simulations suggest that a reduction in the statutory corporate tax rate from 35 percent to 15 percent, along with a reduction in marginal personal income tax rates by an average of 2.5 percentage points, could increase GDP by about 1.2 to 1.9 percent above baseline after 2 years, but also widen fiscal deficits by 1.9 to 2.4 percent of GDP over the same period (World Bank 2017a).

**FIGURE 1.15 Risk of protectionism**

*Protectionism has become an important source of concern. A spiral of retaliatory trade restrictions could undo gains from past trade liberalization.*

**A. Discussion of protectionism** **B. Global trade and tariffs**




Sources: Bown and Irwin (2015), Google Trends, World Bank.
A. Weekly average Google Trend search for "protectionism," "trade restrictions," "trade war," and "import tariffs." 2017 average is year-to-date. Latest observation is May 21, 2017.
B. Global trade is defined as the average of exports and imports in percent of global GDP. Applied tariff rates based on the weighted mean for all products.

members, appear to have increased global trade growth by an average of more than 1 percentage point per year (Mattoo, Mulabdic, and Ruta 2017). The unwinding of such agreements would likely put downward pressure on trade prospects and jeopardize the effectiveness and viability of the multilateral trading system. Past experiences with protectionist policies warn of considerable unintended damage.

In turn, rising protectionism and declining trade integration would harm growth. Trade—particularly vertical specialization—tends to boost productivity, and hence activity (Constantinescu, Mattoo, and Ruta 2017). In the presence of complex value chain integration, tariffs and other barriers to trade are cumulative, as intermediate goods cross borders multiple times through the stages of production. An increase in barriers to trade may result in cascading trade costs along the supply chain (Diakantoni et al. 2017; Rouzet and Mirodout 2013). Consumers would ultimately bear these costs, resulting in widespread welfare losses. Deteriorating trade relationships between major economies could also increase the risk of geopolitical tensions and conflict (Copeland 2014).

## Downside risk: policy uncertainty and geopolitical risks

Global economic policy uncertainty has been particularly elevated since mid-2016. If this uncertainty persists, it could weigh on confidence and derail the ongoing recovery in global growth. Increased uncertainty about policy direction can delay investment and hiring decisions (Fernández-Villaverde et al. 2011; Born and Pfeifer 2014; Kose et al. 2017b). Policy uncertainty can also constrain the supply of credit to the economy, which can prolong or amplify economic downturns (Bordo, Duca, and Koch 2016; Karnizova and Li 2014). The threat of increased trade tariffs, even in the absence of actual changes in trade policies, could negatively impact investment and trade as well (Crowley, Song, and Meng 2016). Elevated policy uncertainty is negatively associated with firms' entry into foreign markets, and the decision to undertake costly and irreversible investments associated with exporting. Overall, a 10-percent increase in global policy uncertainty is associated with a 0.2 percentage-point reduction in trade growth (Constantinescu, Mattoo, and Ruta 2017).

The potential sources of economic policy uncertainty are extensive. In the United States, the new administration has suggested major shifts in fiscal, trade, and immigration policies. These changes could affect investment and hiring decisions by companies, as well as capital and remittance flows to EMDEs. Even without concrete changes, uncertainty about the direction and scope of U.S. policies could affect prospects for the U.S. economy and its main trading partners (Kose et al. 2017a; World Bank 2017a). These effects could be exacerbated by political uncertainty. In Europe, the rising influence of populist parties could impact policies and affect economic integration in the European Union. Negotiation around the exit of the United Kingdom from the European Union also carries risks.

Geopolitical risks have also steadily increased, and fragile security conditions could set back activity in a number of regions. The risk of large-scale conflict in the Middle East continues, reflecting persistent unrest in Iraq, the Syrian Arab Republic, and the Republic of Yemen, as well as sectarian divisions in the region. A flare-up of geopolitical risks in the Middle East could lead to disruptions in global oil supplies and a resurgence of refugee flows, posing additional challenges for host countries (Adhikari 2013). Water scarcity and food insecurity could also contribute to instability in the Middle East and Sub-Saharan Africa. Droughts and conflict have already led to intensifying risks of famine in Nigeria, Somalia, South Sudan, and the Republic of Yemen and contributed to further unrest in Syria. Finally, the threat of conflict in the Korean peninsula represents a significant source of regional and global risk.

## Downside risk: financial market stress

A disorderly tightening of financing conditions or a sharp increase in financial market volatility from current low levels represent significant risks. These could be triggered by a number of factors.

### *Repricing of policy-related risks*

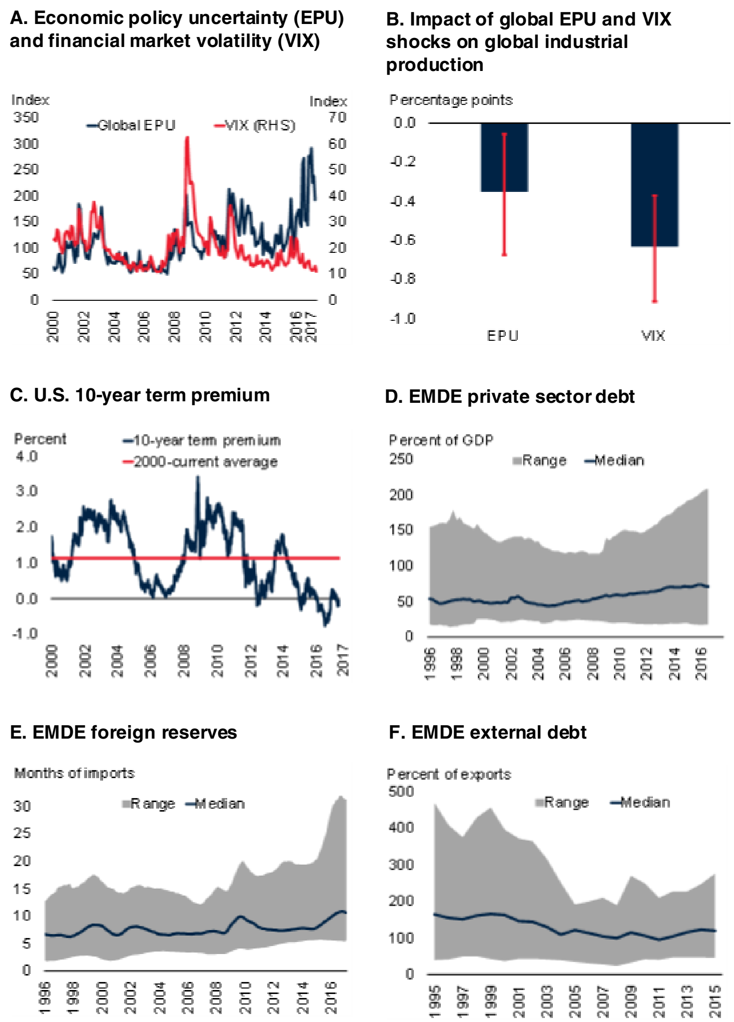
Since the start of 2017, financial market volatility has been low, despite elevated policy uncertainty. This divergence is unusual (Figure 1.16). A sudden reassessment of policy-related risks could lead to abrupt adjustments in asset prices and safe-haven flows, with adverse consequences for higher-yielding assets, including those from EMDEs. In general, high policy uncertainty is associated with higher risk premiums as investors seek to hedge against negative outcomes (Brogaard and Detzel 2015; Pastor and Veronesi 2013). Economic policy uncertainty is generally a weak predictor of financial market volatility. However, specific events, such as the U.S. debt ceiling negotiations in 2011, have provoked bouts of volatility and sudden repricing of risks on international markets (Hamilton 2017). In turn, both volatility and policy uncertainty shocks can lead to adverse short-term effects on activity, with the former generally having a larger impact (Alexopoulos and Cohen 2015; Baker, Bloom, and Davis 2015; Jurado, Ludvigson, and Ng 2015). Countries with large exposures to international financial markets could be particularly susceptible to these negative effects (Adrian, Stackman, and Vogt 2016).

### *Sudden increase in borrowing costs*

Changes in monetary policy expectations, including a faster-than-expected normalization in U.S. policy, or signals of an earlier-than-anticipated exit from exceptional easing measures

**FIGURE 1.16 Financial market risks**

*A sudden reassessment of policy-related risks could trigger financial market volatility and set back global activity. An uptick in the U.S. term premium from current low levels could raise long-term yields, and worsen financing conditions for EMDEs. Given elevated private sector debt, some countries remain vulnerable to a sharp increase in borrowing costs. Some countries also remain vulnerable to risks associated with further U.S. dollar appreciation, but foreign reserves are ample and external debt is manageable in most cases.*




Sources: Baker, Bloom, and Davis (2015); Board of Governors of the Federal Reserve System; Bloomberg; Bank for International Settlements; Federal Reserve Bank of New York; Haver Analytics; World Bank.

A. VIX is the implied volatility of option prices on the U.S. S&P 500. EPU is the Economic Policy Uncertainty index computed by Baker, Bloom, and Davis (2015). Last observation is April 2017 for EPU and May 24, 2017 for VIX.

B. Cumulative impulse response of global industrial production growth after 12-months to a one-standard-deviation shock in global Economic Policy Uncertainty (EPU) and VIX. Data are in deviation from mean and scaled by the standard deviation. Estimation based on a Bayesian vector autoregression of global EPU, VIX, and global industrial production growth rate. Blue bars denote median responses and lines denote 16th-84th percentile confidence intervals. The sample period is 2000M1-2017M2.

C. Term premium estimates from the model in Adrian, Crump, and Moench (2013). Last observation is May 24, 2017.

D.-F. Range indicates minimum to maximum of country sample.

D. Country sample includes Argentina, Brazil, Chile, China, Colombia, Czech Republic, Hungary, India, Indonesia, Malaysia, Mexico, Russia, Saudi Arabia, South Africa, Thailand, and Turkey. Last observation is 2016Q3.

E. F. Country sample includes Brazil, Bulgaria, China, Colombia, Mexico, Peru, India, Indonesia, Malaysia, Philippines, Thailand, Romania, South Africa, and Turkey. Last observation is April 2017 for foreign reserves and 2015 for external debt.

in the Euro Area and Japan, could trigger a sudden increase in borrowing costs. A build-up of inflation fears or the perception of increased macroeconomic risks could lead to an uptick in term premiums from current exceptionally low levels. Such events could trigger an abrupt deterioration in financing conditions for EMDEs and a slowing of capital inflows—particularly if higher yields do not reflect improved advanced-economy prospects (Arteta et al. 2015). Sizable external financing needs, limited levels of foreign reserves, and elevated domestic debt expose various EMDEs to a sudden rise in borrowing costs. Rapid deleveraging could potentially intensify slowdowns—including in China, where private indebtedness and financial sector vulnerabilities remain elevated (Bernardini and Forni 2017; World Bank 2016a; World Bank 2017b). While vulnerabilities have somewhat diminished in EMDEs in recent years, the dispersion of vulnerabilities across countries widened in 2016 as commodity exporters faced continued challenges.

### *Further U.S. dollar appreciation*

Diverging monetary policies, with the U.S. Federal Reserve raising policy rates well ahead of other major central banks, has already contributed to a significant U.S. dollar appreciation. Fiscal stimulus measures in the United States could intensify this trend. Safe-haven flows triggered by increased investor risk aversion, or unexpected changes in trade or fiscal policies in the United States, could also push up the value of the U.S. currency. Broad-based U.S. dollar appreciation has been associated historically with tighter global financing conditions and balance sheet pressures for countries with large U.S. dollar debt exposure (Bruno and Shin 2015). Debt levels in foreign currency have increased in recent years, particularly among EMDE corporates. A sudden strengthening of the U.S. dollar could contribute to rollover and currency risks for companies with unhedged foreign exchange exposures. For companies in commodity-related sectors, such pressures can be amplified by the negative correlation between the U.S. dollar and commodity prices (Baffes et al. 2015).

However, there are several mitigating factors. The bulk of EMDE credit growth over the last decade has been in domestic currency. The number of countries with currency pegs to the U.S. dollar has declined. The ratio of external debt to exports remains in most cases markedly lower than in the early 2000s, despite some recent increases, and foreign reserves are generally ample. High vulnerability to currency risks is confined to those countries that still have elevated short-term foreign-currency-denominated debt (Chow et al. 2015; Chui, Kuruk, and Turner 2016).

## Downside risk: impact of renewed sharp slide in oil prices on oil exporters

A faster-than-expected rise in unconventional oil supplies, such as U.S. shale production, or faltering commitment of OPEC and non-OPEC producers to additional cuts in output, could keep oil markets oversupplied. This could lead to an abrupt slide in oil prices.

For many oil-exporting EMDEs, a renewed sharp decline in oil prices, after two years of difficult adjustments to the previous plunge, could substantially weigh on growth prospects. Financially constrained exporters with depleted fiscal buffers could be forced into additional consolidation measures, while deteriorating current account positions could increase external financing pressures. This could lead to renewed currency depreciation and trigger a re-pricing of credit and sovereign risks (Baffes et al. 2015). As highlighted by the early-2016 oil price drop, which heightened concerns about default risks in oil and gas companies, an abrupt decline in oil prices could also intensify corporate balance sheet pressures among energy companies, which are among the most leveraged in EMDEs (IMF 2016b, Bank for International Settlements 2016, World Bank 2016a). Although banking systems in most oil-exporting EMDEs have become more resilient to oil price changes, financial strains could intensify in the face of persistently depressed prices.

In principle, these negative effects on oil producers would be accompanied by real income gains for oil importers, offsetting the overall impact on global growth. This offsetting effect is most likely when oil price declines are due to abundant supply, as opposed to weakening demand (Cashin, Mohaddin, and Raissi 2014; Cerdeiro and Plotnikov 2017). However, renewed weakness and financial stress in large oil-exporting EMDEs could have adverse contagion effects on other economies through trade, financial market, and remittance flows (Huidrom, Kose, and Ohnsorge 2017; World Bank 2016c). Moreover, oil price movements could have asymmetric effects—with declines having a smaller positive effect on oil importers than increases having a negative one—due, for instance, to frictions associated with the relocation of activity across sectors (Engemann, Kliesen, and Owyang 2011; Hamilton 2011; Jo 2014).

### Downside risk: slowdown in potential output growth

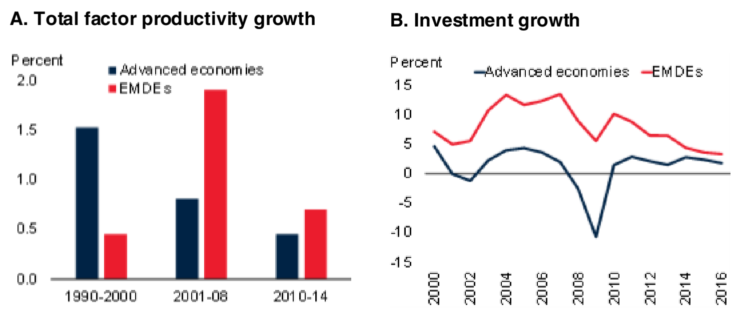
Potential output growth has softened appreciably in both advanced economies and EMDEs in recent years, reflecting the combined deceleration in productivity and investment growth, albeit to different degrees. While baseline projections for both advanced economies and EMDEs assume some cyclical recovery in productivity and investment, risks to long-term growth remain predominantly on the downside.

The trend deceleration in total factor productivity growth largely predated the global financial crisis, and it has been particularly pronounced in EMDEs since 2010 (Figure 1.17). This pattern has been broad-based and is seen in more than 60 percent of EMDEs. Weak productivity trends could be associated with a slower rate of innovation among companies and countries operating at the technological frontier, and a slower pace of diffusion to companies and countries operating below that frontier (Buera and Oberfield 2016; Andrews, Criscuolo, and Gal 2015; Gordon 2014).

The anticipation of lower future growth may lead to a decrease in current investment, depressing aggregate demand in the short term and slowing capital accumulation over the longer term (Blanchard, L'Huillier, and Lorenzoni 2013).

**FIGURE 1.17 Risks linked to weak productivity and investment growth**

*A key factor behind the slower growth potential in both advanced economies and EMDEs has been a deceleration in total factor productivity. Investment growth slowed considerably in EMDEs, reducing the contribution of capital accumulation to growth.*




Sources: Penn World Table, World Bank.
A. TFP growth measured at constant national prices and aggregated using 2011 U.S. dollars GDP weights. Sample includes 28 advanced economies and 68 EMDEs.
B. Aggregate growth rates calculated using constant 2010 U.S. dollars gross fixed investment weights.

Demographic pressures in advanced economies, and in some large EMDEs, could also contribute to a lower rate of return on capital (Baker, De Long, and Krugman 2005; Rachel and Smith 2015). Over time, capital deepening, which has been an important engine of growth in EMDEs over the last two decades, could further decelerate, adding downward pressure to productivity and potential output growth.

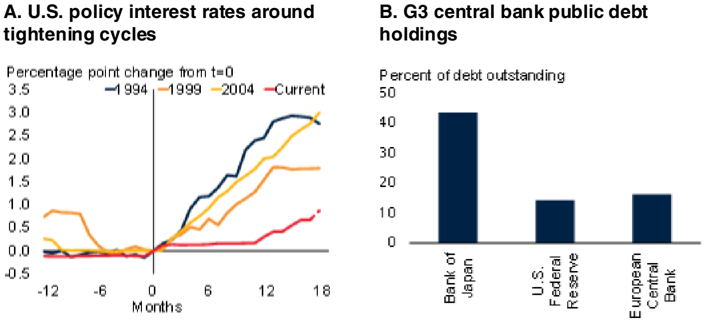
## Policy challenges

### Challenges in major economies

*Advanced economies have begun to shift away from a mix of exceptionally supportive monetary policy and restrictive fiscal policy. Central banks in major advanced economies face the challenge of normalizing monetary policy without disrupting a fragile recovery or triggering financing market disruptions. Expansionary fiscal policy would be appropriate in a number of economies, provided it is complemented with measures to bolster medium-term fiscal sustainability. Globalization and technological progress have changed the demand for jobs and skills; accordingly, there is a need to support the adjustment process for workers that are adversely affected. In China, avoiding a sharp slowdown and a disorderly unwinding of financial vulnerabilities will require a careful balancing of policy objectives.*

**FIGURE 1.18 Monetary policy challenges in advanced economies**

*U.S. monetary policy normalization has been significantly slower than in past tightening episodes. Large central bank balance sheets might constrain monetary policy actions in the case of a renewed downturn.*




Sources: Bank of Japan, Bloomberg, European Commission, Federal Reserve Bank of St. Louis, Federal Reserve Board, Haver Analytics, World Bank.

A. t=0 refers to the start of U.S. monetary policy tightening cycles. Percentage point change from t=0 in monthly effective federal funds rates. Previous tightening cycles refer to those beginning in January 1994, June 1999, and June 2004, with the current cycle having begun in December 2015. Dashed lines show market implied changes in the given rates over the next four months. Last observation is May 24, 2017.

B. Public debt held by the European Central Bank is calculated as the ratio of the Eurosystem's holdings of general government debt to general government debt outstanding. The Federal Reserve's debt holding is in percent of publicly held U.S. Treasury securities. Data as of December 31, 2016.

## *Monetary policy in advanced economies*

A gradual pickup in inflation across advanced economies has raised the prospects of less accommodative monetary policy. In the United States, inflation and employment are already near central bank objectives, justifying continued policy normalization (Yellen 2017). A more expansionary fiscal policy stance could accelerate the pace of interest rate increases, but the materialization of downside risks to growth, due to policy changes or other factors, could have the opposite effect. Historically low equilibrium interest rates will likely result in a lower terminal point for policy rates during this tightening cycle compared with previous episodes (Figure 1.18). Over the longer term, this could increase the frequency and duration of periods when nominal policy interest rates are constrained by the zero lower bound (Kiley and Roberts 2017). Such constraints have led to calls for higher central bank inflation targets, which would create additional space for interest rate cuts in the future (Ball 2014; Ball et al. 2016).

In the Euro Area and Japan, large-scale unconventional policies continue to be in operation and are helping to maintain supportive borrowing conditions. In the Euro Area, quantitative easing is expected to be gradually unwound, as economic slack narrows and inflation moves toward policy objectives. However, a prolonged period of low inflation has made expectations more susceptible to negative shocks, encouraging the ECB to maintain a highly accommodative stance over a sustained period of time (Ciccarelli et al. 2017). The Bank of Japan has so far been successful in stabilizing long-term interest rates around zero, but this policy may only deliver a slow increase in inflation (Cecchetti and Schoenholtz 2016). Looking forward, the exceptionally large balance sheets and elevated government bond holdings of major central banks might constrain their ability to undertake further unconventional policies in case of a renewed downturn. Fiscal policy would need to stand ready to implement counter-cyclical measures in the event of future growth setbacks.

## *Fiscal policy in advanced economies*

Fiscal policy in advanced economies stopped being a drag on growth in 2016, for the first time since 2010 (Figure 1.19). This shift was visible in the United States, Euro Area, and Japan, and it is expected to continue to a lesser degree in 2017. In the United States, where fiscal stimulus is under consideration, a priority could be infrastructure spending in view of large unmet needs and of the elevated fiscal multipliers of such spending (Bivens 2014). Improving public sector efficiency, regulation, and private sector participation could also increase economic returns from infrastructure investment. As the U.S. economy is already operating close to full capacity, growth windfalls from fiscal stimulus measures could be short lived and might be offset over time by pressures associated with deteriorating public finances. Under unchanged policies, public debt is already expected to significantly increase over the next decade (CBO 2017). Unfunded tax cuts could add to the upward trajectory (Page 2017). In contrast, tax and spending reforms that enhance productivity and are consistent with medium-term fiscal sustainability could deliver lasting benefits.

In the Euro Area, a more expansionary fiscal policy stance to absorb remaining slack would be appropriate for the region as a whole (European

Commission 2016). However, countries with fiscal space are generally not those in the greatest need of stimulus. The absence of a more centralized fiscal capacity and strong coordination makes it more difficult to implement supportive fiscal policies in a monetary union (Eyraud, Gaspar, and Poghosyan 2017; European Commission 2014; Bańkowski et al. 2017). In Japan, the government is debating whether fiscal consolidation should be implemented before the inflation target is reached, with some arguing that fiscal policy should help complement monetary policy in stabilizing inflation (Sims 2016).

### *Structural policy in advanced economies*

In advanced economies, rising income inequality and stagnant median wages have fueled the political debate on the benefits of globalization and trade liberalization, amid a trend decline in the share of manufacturing jobs. This has led to calls for unwinding past trade liberalization efforts, and for increased protection for domestic industry.

The last three decades have seen a decline of manufacturing employment across most advanced economies (Wood 2017). For instance, the share of manufacturing jobs in total private employment in the United States, Germany, and Japan has fallen by 10 percentage points since 1985 (Figure 1.20). Over that period, the United States accumulated large goods trade deficits, but Japan and especially Germany registered substantial trade surpluses. Since 2000, the drop in manufacturing jobs has accelerated, particularly in the United States, but productivity gains have more than offset the decline, leading to a continued rise in output. These common trends highlight complex interactions between technological change and globalization. Automation, shifts in production patterns, and trade policies all played a role in driving labor market outcomes (Wood 2017; De Long 2017; Felipe and Mehta 2016; Autor, Dorn, and Hanson 2016).

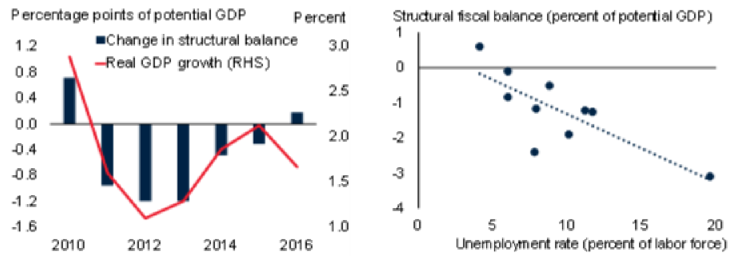
Measures to support workers directly affected by sectoral shifts in employment, and to more widely spread the benefits of technological progress and globalization, should be reinforced. This includes vocational training, life-long learning, better employment services, and effective social protection systems.

**FIGURE 1.19 Fiscal policy challenges in advanced economies**

*Fiscal policy in advanced economies was no longer a drag on growth in 2016, a first since 2010. A more expansionary fiscal stance in the Euro Area would be warranted, but countries with fiscal space are generally not those in most need of stimulus.*

**A. Change in structural fiscal balance and growth in advanced economies**

**B. Structural fiscal balance and unemployment across Euro Area countries**



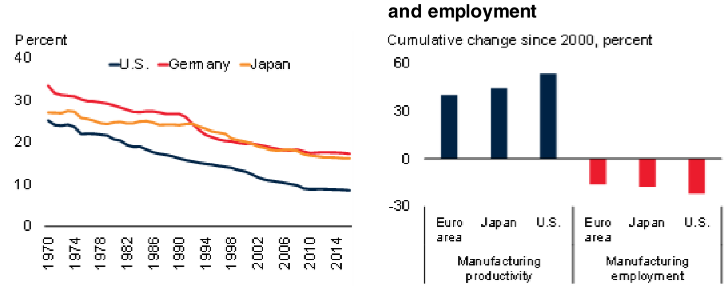

Sources: Eurostat, International Monetary Fund WEO, World Bank.
A. Structural fiscal balance is the cyclically-adjusted primary balance in percent of potential GDP.
B. Last observation is 2016.

**FIGURE 1.20 Structural policy challenges in advanced economies**

*The last three decades have seen a decline in the share of manufacturing employment across major advanced economies. Since 2000, this decline has accelerated, particularly in the United States. Productivity gains, nevertheless, resulted in rising manufacturing output.*

**A. Manufacturing as a share of total employment**

**B. Advanced economies manufacturing productivity and employment**



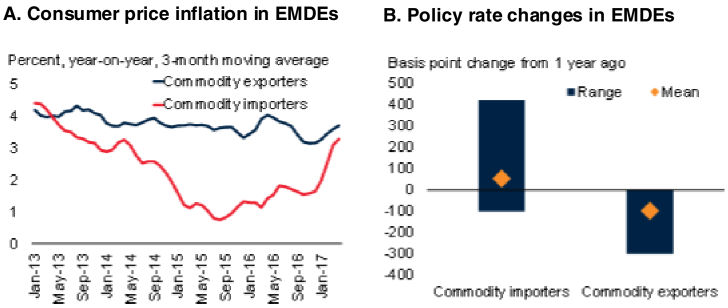

Sources: Federal Reserve Bank of St. Louis, Haver Analytics, Organisation for Economic Co-operation and Development, U.S. Bureau of Labor Statistics.
A. U.S. data measures total employment on nonfarm payrolls. Last observation is 2016.
B. Cumulative changes from 2000 to 2015. Manufacturing productivity is the gross value added per person employed.

### *Challenges in China*

The key policy challenge for China remains to manage a gradual deceleration to a sustainable growth rate in the medium term. Avoiding a sharp slowdown and a disorderly unwinding of financial

**FIGURE 1.21 EMDE monetary policy**

*Inflation rates in commodity exporters and importers are converging. Declining inflation has enabled some central banks in commodity-exporting EMDEs to reduce policy rates.*




Sources: Haver Analytics, National central banks, World Bank.
A. Sample includes 75 commodity-exporting and 54 commodity-importing EMDEs and shows median in each respective group. Last observation is April 2017.
B. Commodity importers include China, Hungary, India, Mexico, Philippines, Poland, Romania, Thailand, and Turkey. Commodity exporters include Brazil, Chile, Colombia, Indonesia, Malaysia, Peru, Russia, and South Africa. Last observation is April 2017.

vulnerabilities accumulated during years of rapid credit growth will require a careful balancing of policy objectives.

China has initiated a wide range of reforms in recent years. Efforts have focused on excess capacity reduction and re-employment of affected workers. Measures to improve the viability of state-owned enterprises include the promotion of stronger participation of the private sector, more market discipline, and competition. In the oil and gas sector, these efforts are being accompanied by a reorganization of the industry to separate functions in the value chains. Considerable progress has been made in household registration reforms. Fiscal reform initiatives have focused on addressing imbalances in revenue and expenditure responsibilities across different levels of government, the conversion of business taxes to value-added tax (VAT), tax cuts for small and high-tech firms, and reform of the personal income tax system. In addition, measures to improve local-government debt management have been implemented, such as revisions of the budget law, market-based conversion of debt to bonds, and more effective monitoring and classification of local government debt. Financial regulation has been tightened to contain financial sector vulnerabilities, including through broader regulatory oversight of off-balance sheet items such as wealth management products. Exchange rate flexibility has been enhanced, with the use of a basket of currencies rather than the U.S. dollar to determine the reference rate. The relaxation of foreign institutional investor rules and the opening of the bond and currency derivatives market should help promote foreign participation (IMF 2016c).

Despite considerable progress, there is a need to further contain financial and fiscal vulnerabilities, including rapid credit growth and high levels of debt. Financial and corporate sector reforms, including appropriate budget constraints on state-owned enterprises, could improve the allocation of capital. They would also help reallocate factors of production toward more productive sectors and away from stagnating sectors with excess capacity, which would spur productivity.

Additional structural reforms could help China shift its growth model from manufacturing to services, from investment to consumption, and from exports to domestic spending. China has significant potential for rapid urban development and technological transformation. Land and hukou (labor market) reforms could significantly lift urban growth and employment. Productivity in rural areas could be bolstered by reorienting subsidy and price support programs toward the development of more efficient and sustainable agricultural production systems. During the reform period, counter-cyclical fiscal measures to support consumption and private investment could smooth the transition, as long as they are consistent with medium-term fiscal sustainability. The economic and social dislocations that might arise from enterprise restructuring could be addressed by targeted temporary income support and by robust social protection programs.

## Challenges in emerging and developing economies

*Inflation rates in commodity exporters and importers are converging. Easing inflation is allowing policymakers in some commodity exporters to adopt a more accommodative policy stance. Although the impact of the drop in commodity prices on government revenues in commodity exporters is* *beginning to wane, fiscal space remains generally constrained across EMDEs. Policies that improve the business climate and support investment are critical to boost long-term growth. In addition, policies that promote trade integration and address structural impediments to trade will help counteract the negative effects of trade policy uncertainty and rising protectionism.*

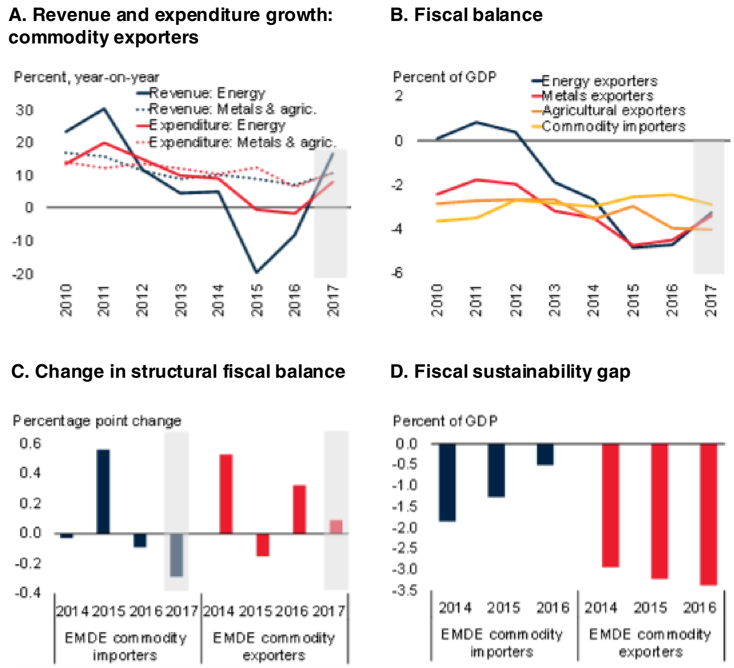
### *Monetary and financial policies*

Headline inflation in commodity exporters and importers is converging (Figure 1.21). Stabilizing or appreciating exchange rates account for much of the decline in inflation in commodity exporters since mid-2016, and inflation is already within the target bands in some countries (e.g., Brazil, Indonesia, Russia). In commodity importers, the more recent increase in inflation reflects the lagged impact of rising energy prices in 2016. Easing inflation and subdued growth have led monetary policymakers in several major commodity exporters to cut policy rates (e.g., Brazil, Colombia, Kazakhstan), despite rising interest rates in the United States (IMF 2017c). Meanwhile, some commodity importers facing currency pressures have tightened policy amid rising inflation (e.g., Mexico, Turkey).

Market concerns about financial stability in EMDEs have receded relative to late 2016, when a tightening of global financing conditions led to market volatility. This highlights the need to shore up buffers of liquidity and capital to mitigate future encounters with financial stress. In the event of bouts of financial market stress, depending on country-specific circumstances, appropriate policy actions could include providing liquidity support to markets or implementing macro-prudential measures (e.g., Israel in August 2013; the Republic of Korea in July 2014; IMF 2014a). In conjunction with other appropriate monetary and financial policies, there could be a role in some countries for the temporary and targeted use of capital controls (e.g., Colombia's unremunerated reserve requirements during 2007-08), if needed and transparently implemented (Baba and Kokenyne 2011; Baffes et al. 2015; IMF 2014b).

**FIGURE 1.22 EMDE fiscal policy**

*The impact of the sharp drop in commodity prices on government revenues in commodity-exporting EMDEs is beginning to fade. But with fiscal space still constrained across EMDEs, consolidation will need to continue to set debt on a sustainable path, particularly in commodity exporters.*



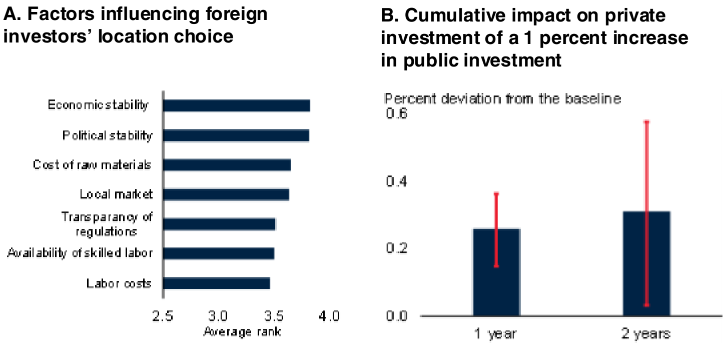

Sources: International Monetary Fund, World Bank.
A. Figure shows median in each country group. Sample includes 35 energy exporters and 56 metal and agricultural product exporters. Shaded areas indicate forecasts.
B. Figure shows median in each country group. Sample includes 35 energy exporters, 34 agricultural product exporters, 20 metals exporters, and 62 commodity importers.
C. Structural balance is the fiscal balance adjusted for the economic cycle and for one-off effects. Figure shows median in each country group. Sample includes 17 commodity exporters and 22 commodity importers. Shaded areas indicate forecasts.
D. Sustainability gap is measured as the difference between the primary balance and the debt-stabilizing primary balance, assuming historical average (1990–2016) interest rates and growth rates. A negative gap indicates that government debt is on a rising trajectory; a positive gap indicates government debt is on a falling trajectory. Figure shows median in each country group. Sample includes 44 commodity-exporting and 28 commodity-importing EMDEs.

### *Fiscal policy*

Fiscal consolidation continues in commodity-exporting EMDEs. Revenue losses from the sharp drop in commodity prices since 2014 deepened already large deficits in some countries (e.g., Mongolia, República Bolivariana de Venezuela) and turned large surpluses into large deficits in others (e.g., Oman, Saudi Arabia). More generally, many commodity exporters still face substantial consolidation needs to ensure fiscal sustainability in the medium term (Figure 1.22). In energy exporters, slowing expenditure growth and strengthening oil revenues in the second half of 2016 have helped stabilize deficits (e.g., Algeria,

**FIGURE 1.23 EMDE structural domestic policy challenges**

*Policies directed at improving the overall business environment are critical to boosting investment, productivity, and long-term growth of output and employment. Well-managed public investment raises aggregate investment directly and can crowd-in private investment.*




Sources: UNIDO (2011), World Bank.
A. Average rankings according to a business survey of 7,000 companies in 19 Sub-Saharan African countries conducted from 2010-2011.
B. Cumulative impulse responses of private investment to a positive shock to public investment, based on a sample of 8 EMDEs for the period 1998Q1-2016Q2. The model includes, in this order, real public investment, real GDP, real private investment, current account balance, and real effective exchange rate. The shock size is such that public investment increases by 1 percent from the baseline on impact. Blue bars represent median values and red error bars 16-84 percent confidence intervals.

Azerbaijan, Iraq, Kazakhstan). Among commodity-importing EMDEs, slowing revenue growth in 2016 contributed to a modest worsening of fiscal balances (e.g., China, Dominican Republic, Egypt, Turkey).

With average oil and metals prices expected to rise in 2017, and amid ongoing fiscal consolidation, deficits in most commodity exporters are expected to narrow this year. Structural budget balances in this group are projected to improve only marginally. With deficits predominating across EMDEs, and debt on a rising path, especially in commodity exporters, fiscal space remains constrained (Special Focus 1). In such an environment, careful consideration of revenue and expenditure reforms needed to support both activity and long-term fiscal sustainability is key (Cordes et al. 2015). In particular, reallocating spending toward investment would help reduce the trade-off between the need for fiscal consolidation and the goal of boosting growth. EMDE policymakers could also take advantage of still benign financing conditions to lengthen the maturity and duration of public debt as a precaution against a further tightening of borrowing conditions. Countries with elevated foreign-currency debt could consider shifting to domestic currency financing, if feasible, to reduce the risks from currency depreciation.

Building credibility—for instance, by setting achievable fiscal targets and implementing them consistently, or establishing fiscal councils—will continue to be a policy priority (Debrun and Kinda, forthcoming). Replenishing or establishing stabilization funds, and improving tax administration, will help rebuild fiscal space and increase resilience to shocks (World Bank 2015a).

## *Structural policy*

Despite signs of pickup in EMDE activity in the near term, these economies continue to face various structural challenges to boost growth over the longer run. On the domestic front, potential output growth in EMDEs is likely to further decline as a result of weak productivity growth and demographic pressures (IMF 2015). As the current global context illustrates, notable structural challenges to trade growth and growing protectionist pressures are likely to weigh on the recovery in global trade flows. This highlights the importance of efforts to further promote trade integration.

### Domestic policy challenges

Modest growth rates in advanced economies, structural impediments to trade, and increasing protectionist sentiment suggest that EMDEs may need to become less reliant on external demand. Addressing domestic bottlenecks would help boost growth prospects in EMDEs. Policy measures that improve infrastructure, encourage innovation, promote labor market and education reform, and deepen within-country integration will foster potential growth (OECD and World Bank 2017; World Bank 2017g). EMDEs can reap substantial benefits from upgrading institutions and improving the overall business environment through more efficient regulations.

In light of the sharp investment growth slowdown in recent years across EMDEs, structural policies to boost fixed capital formation are crucial. Policies that reduce economic and political uncertainty, improve the transparency of regulations through the elimination of bureaucratic obstacles, streamline regulatory practices, and increase the availability of skilled labor are critical to enhance a country's attractiveness for investors (Figure 1.23). Measures directed at enhancing the overall business environment through improved access to credit, fewer obstacles to start a business, and enhanced contract enforcement would encourage greater market entry for new firms, job creation, and investment (World Bank 2017h; Dabla-Norris, Ho, and Kyobe 2016). In addition, reforms that help level the playing field between private and state-owned enterprises and promote the participation of private investors in public-private partnerships can play an important role in fostering capital formation (G20 2015).

Under the right circumstances—including the presence of economic slack and a strong institutional and legal environment—well-managed public investment directly raises aggregate investment and also crowds-in private investment. This effect can be boosted by accommodative financial conditions, as well as reforms that reduce barriers to trade and foreign investment and strengthen property rights (World Bank 2017a; Bruno, Campos, and Estrin 2017).

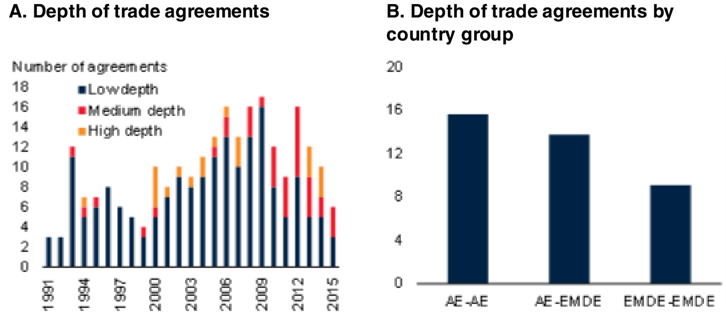
### Trade policy challenges

Trade has been a catalyst for economic growth and stability. It boosts aggregate demand, enhances productivity, and fosters job creation. However, rising protectionist pressures, coupled with economic and trade policy uncertainty and various structural factors, are weighing on the outlook for trade growth (Constantinescu, Mattoo, and Ruta 2017).

Economic policy uncertainty is negatively associated with trade growth as it impacts exporters' entry into foreign markets and the decision to undertake costly investments associated with exporting (Special Focus 2). Exporting firms in EMDEs—in particular, low-income countries—are likely to be disproportionately affected, as they rely more on imports of capital equipment and intermediate goods, and their costs associated with exporting account for a larger share of total costs.

**FIGURE 1.24 EMDE structural trade policy challenges**

*Deep trade agreements—those that contain substantial provisions beyond the mere liberalization of border measures—have become more common in recent years, although they still lag behind in EMDEs.*




Sources: Hofman, Osnago, and Ruta (2017); World Bank.

A. Includes provisions outside the mandate of the WTO. Low depth refers to free trade agreements (FTAs) with less than 10 provisions. Medium depth refers to FTAs with between 10 and 20 provisions. High depth refers to FTAs with more than 20 provisions.

B. Depth of trade agreements measured by average number of enforceable provisions for FTAs in 1958-2015. "AE" denotes advanced economies.

Policy measures aimed at removing domestic trade bottlenecks and improving the availability of credit for exporters, along with increased trade facilitation efforts, may help counteract the negative effects on EMDEs of trade policy uncertainty. In addition, measures to address the adverse distributional consequences of trade liberalization could counteract rising protectionist sentiments.

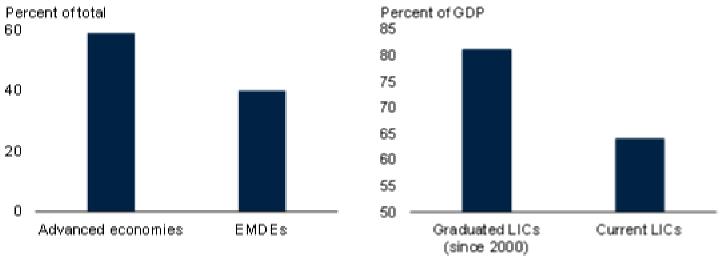
The withdrawal from existing trade agreements or unilateral increases in protectionist measures by some major economies could spiral into widespread trade retaliation involving many countries, including EMDEs. This in turn could result in substantial income losses (Ossa 2014; Perroni and Whalley 2000), as well as reverse the gains from the last seven decades of trade liberalization (Figure 1.24). Such protectionist measures would likely hurt countries that rely heavily on trade, including the poorest EMDEs.

In the current environment, a renewed commitment by EMDE policymakers to trade liberalization through bilateral and regional trade agreements, coupled with commitments under the WTO system, could act as a first line of defense against a potential uptick in protectionism (IMF, World Bank, and WTO 2017; Bown et al. 2017). The temptation for governments to resort to unilateral increases in tariffs to improve their

**FIGURE 1.25 Poverty and trade**

*Protectionist measures could hurt EMDEs in general, and low-income countries (LICs) in particular, especially if they emanate from major economies, which are the main destination of their exports. Countries that graduated from low to middle income status generally had a higher degree of trade openness.*

**A. Destination of EMDE exports** **B. Trade-to-GDP ratio in low-income countries, 2000-15**




Sources: IMF Direction of Trade Statistics; World Development Indicators, World Bank.
A. Data reflect 2012-16 averages.
B. Simple averages. Graduated LICs include 31 countries. Current LICs include 29 countries.

terms of trade can be reduced by an efficient and rule-based trading system and trade agreements that promote inclusive and sustained growth.

Deep trade agreements—i.e., those that include substantial provisions beyond the mere liberalization of border measures, such as the removal of tariffs—are becoming more common in EMDEs, although they still lag those in advanced economies. They cover an extensive set of provisions, including those that regulate competition and investment policy, consumer protection, worker and environmental standards, and the protection of intellectual property rights. Recent agreements concluded by the European Union and some EMDE trading partners (such as Georgia, Ukraine, and Central America) have a very comprehensive set of provisions—above 30, compared to the average of 20 for advanced economies.

Deep trade agreements are associated with more trade than shallow trade accords. The harmonization or mutual recognition of standards, improved competition policy, and streamlined labor and capital market regulations can boost the regional and global integration of EMDEs (Hofmann, Osnago, and Ruta 2017). Provisions that improve the contractibility of inputs provided by suppliers are associated with increased FDI (Ahcar and Siroën 2014; Osnago, Rocha, and Ruta 2015). By addressing a number of dimensions that are crucial for well-functioning supply chains—such as investment policy, services, standards, and customs procedures—deep trade agreements have had a positive impact on the formation of global value chains.

### *Poverty and trade*

The poorest EMDEs rely heavily on trade for economic growth. Many are highly dependent on imports of capital goods. In addition, advanced economies are important export destinations for poor EMDEs (Figure 1.25). Protectionist trade policies could impact the most vulnerable populations in EMDEs and would curtail efforts to reduce global poverty.

Greater trade openness has been associated with lower poverty and inequality in EMDEs—with the important proviso that appropriate supporting policies accompany it. Trade expansion appears to have been an important factor in the transition of countries out of low-income status. Declines in tariffs have been estimated to lead, on average, to proportionate increases in incomes of the poor (Dollar and Kraay 2004; Sachs and Warner 1995). Income inequality fell in many EMDEs after the extensive trade liberalization of the 1990s (World Bank 2017i).

Measures that promote trade openness need to be accompanied by other policies to be effective in addressing associated adjustment costs and improving the welfare of the population (Goldberg and Pavckik 2004; Winters, McCulloch, and McKay 2004). These include measures to encourage savings and investment in human and physical capital, as well as reforms to improve governance and alleviate intra-national frictions associated with market imperfections and transport costs (Bartley Johns et al. 2015). Without these accompanying policies, increased trade openness might have an adverse impact on poverty and inequality (World Bank 2015b; Le Goff and Singh 2013). This suggests the need for a multi-pronged agenda to pair trade liberalization with improved human capital development and institutional reforms to ensure that the gains from increased trade contribute effectively to poverty reduction and the promotion of shared prosperity.

**TABLE 1.2 List of emerging market and developing economies**[1]

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

[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; 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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