CHAPTER 1

GLOBAL OUTLOOK

Darkening Skies
Moderating activity and heightened risks are clouding global economic prospects. International trade and investment have softened, trade tensions remain elevated, and some large emerging market and developing economies (EMDEs) have experienced substantial financial market pressures. Against this challenging backdrop, EMDE growth has stalled, with a sharply weaker-than-expected recovery in commodity exporters accompanied by a deceleration in commodity importers. Downside risks have become more acute. Disorderly financial market developments could disrupt activity in the affected economies and lead to contagion effects. Trade disputes could escalate or become more widespread, denting activity in the economies involved and leading to negative global spillovers. To confront this increasingly difficult environment, the most urgent priority is for EMDE policymakers to prepare for possible bouts of financial market stress and rebuild macroeconomic policy buffers as appropriate. Equally critically, policymakers need to foster stronger potential growth by boosting human capital, removing barriers to investments, and promoting trade integration within a rules-based multilateral system. Such efforts would also help address the challenges associated with informality.

Summary

Global growth is moderating as the recovery in trade and manufacturing activity loses steam (Figure 1.1). Despite ongoing negotiations, trade tensions among major economies remain elevated. These tensions, combined with concerns about softening global growth prospects, have weighed on investor sentiment and contributed to declines in global equity prices. Borrowing costs for emerging market and developing economies (EMDEs) have increased, in part as major advanced-economy central banks continue to withdraw policy accommodation in varying degrees. A strengthening U.S. dollar, heightened financial market volatility, and rising risk premiums have intensified capital outflow and currency pressures in some large EMDEs, with some vulnerable countries experiencing substantial financial stress. Energy prices have fluctuated markedly, mainly due to supply factors, with sharp falls toward the end of 2018. Other commodity prices—particularly metals—have also weakened, posing renewed headwinds for commodity exporters.

Economic activity in advanced economies has been diverging of late. Growth in the United States has remained solid, bolstered by fiscal stimulus. In contrast, activity in the Euro Area has been somewhat weaker than previously expected, owing to slowing net exports. While growth in advanced economies is estimated to have slightly decelerated to 2.2 percent last year, it is still above potential and in line with previous forecasts.

EMDE growth edged down to an estimated 4.2 percent in 2018—0.3 percentage point slower than previously projected—as a number of countries with elevated current account deficits experienced substantial financial market pressures and appreciable slowdowns in activity. More generally, as suggested by recent high-frequency indicators, the recovery among commodity exporters has lost momentum significantly, largely owing to country-specific challenges within this group. Activity in commodity importers, while still robust, has slowed somewhat, reflecting capacity constraints and decelerating export growth. In low-income countries (LICs), growth is firming as infrastructure investment continues and easing drought conditions support a rebound in agricultural output. However, LIC metals exporters are struggling partly reflecting softer metals prices. Central banks in many EMDEs have tightened policy to varying degrees to confront currency and inflation pressures.

In all, global growth is projected to moderate from a downwardly revised 3 percent in 2018 to 2.9 percent in 2019 and 2.8 percent in 2020-21, as economic slack dissipates, monetary policy accommodation in advanced economies is removed, and global trade gradually slows. Growth in the United States will continue to be supported by fiscal stimulus in the near term,
### TABLE 1.1 Real GDP

(Percent change from previous year)

<table>
<thead>
<tr>
<th></th>
<th>2016</th>
<th>2017</th>
<th>2018e</th>
<th>2019f</th>
<th>2020f</th>
<th>2021f</th>
<th>Percentage point differences from June 2018 projections</th>
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<td>2.8</td>
<td>-3.5 0.7 0.2</td>
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**Memorandum items:**

**Real GDP**

<table>
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<tr>
<th></th>
<th>2016</th>
<th>2017</th>
<th>2018e</th>
<th>2019f</th>
<th>2020f</th>
<th>2021f</th>
<th>Percentage point differences from June 2018 projections</th>
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<td>High-income countries</td>
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<td>-0.1 -0.2 -0.1</td>
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<td>3.5</td>
<td>3.6</td>
<td>3.6</td>
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<td>3.6</td>
<td>3.5</td>
<td>3.4</td>
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**Commodity prices**

<table>
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<tr>
<th></th>
<th>2016</th>
<th>2017</th>
<th>2018e</th>
<th>2019f</th>
<th>2020f</th>
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<th>Percentage point differences from June 2018 projections</th>
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<tbody>
<tr>
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<td>1.2</td>
<td>1.2</td>
<td>-3.4 0.8 0.7</td>
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</tbody>
</table>

**Source:** World Bank.

*Note: PPP = purchasing power parity; e = estimate; f = forecast. World Bank forecasts are frequently updated based on new information. Consequently, projections presented here may differ from those contained in other World Bank documents, even if basic assessments of countries’ prospects do not differ at any given moment in time. Country classifications and lists of emerging market and developing economies (EMDEs) are presented in Table 1.2. BRICS includes Brazil, Russia, India, China, and South Africa.


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

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

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

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

Click here to download data.
which will likely lead to larger and more persistent fiscal deficits. Advanced-economy growth will gradually decelerate toward potential, falling to 1.5 percent by the end of the forecast horizon, as monetary policy is normalized and capacity constraints become increasingly binding.

Softening global trade and tighter financing conditions will result in a more challenging external environment for EMDE economic activity. EMDE growth is expected to stall at 4.2 percent in 2019—0.5 percentage point below previous forecasts, partly reflecting the lingering effects of recent financial stress in some large economies (e.g., Argentina, Turkey), with a sharply weaker-than-expected pickup in commodity exporters accompanied by a deceleration in commodity importers. EMDE growth is projected to plateau at an average of 4.6 percent in 2020-21, as the recovery in commodity exporters levels off. Per capita growth will remain anemic in several EMDE regions—most notably, in those with a large number of commodity exporters—likely impeding further poverty alleviation.

The projected gradual deceleration of global economic activity over the forecast horizon could be more severe than currently expected given the predominance of substantial downside risks (Figure 1.2). A sharper-than-expected tightening of global financing conditions, or a renewed rapid appreciation of the U.S. dollar, could exert further downward pressure on activity in EMDEs, including in those with large current account deficits financed by portfolio and bank flows. Government and/or private sector debt has also risen in a majority of EMDEs over the last few years, including in many LICs, reducing the fiscal room to respond to shocks and heightening the exposure to shifts in market sentiment and rising borrowing costs.

Escalating trade tensions are another major downside risk to the global outlook. If all tariffs currently under consideration were implemented, they would affect about 5 percent of global trade flows and could dampen growth in the economies involved, leading to negative global spillovers. While some countries could benefit from trade

### FIGURE 1.1 Summary – Global prospects

Global growth is moderating, as industrial activity and trade decelerate, negatively impacting investor sentiment and equity prices. The recovery in EMDEs has stalled, owing to softening external demand, tighter external financing conditions, and heightened policy uncertainties. Many EMDE central banks have raised interest rates to fend off currency pressures. Per capita growth will remain anemic in several EMDE regions—most notably in those with a large number of commodity exporters.

**A. Global growth**

**B. Global industrial production and new export orders**

**C. Global and EMDE equity prices**

**D. Growth in EMDEs**

**E. EMDE policy interest rates, by extent of currency depreciation against the U.S. dollar**

**F. Per capita growth, by region**

Source: Bloomberg, Haver Analytics, World Bank.

**Note:**

- B. New export orders measured by Purchasing Managers’ Index (PMI). PMI readings above 50 indicate expansion in economic activity; readings below 50 indicate contraction. Last observation is November 2018 for new export orders and October 2018 for industrial production.
- C. Figure shows MSCI Global and Emerging Markets Indexes. Last observation is December 19, 2018.
- E. The aggregate policy interest rates are calculated using constant 2010 U.S. dollar GDP weights. The above average and below average currency depreciation groups are defined by countries above or below the sample average of the year-to-date percent change in the bilateral exchange rate against the U.S. dollar. The sample average is -9.3 percent and includes 27 EMDEs, of which 12 are above and 15 are below average. Last observation is November 2018.
- F. EAP = East Asia and Pacific, ECA = Europe and Central Asia, LAC = Latin America and the Caribbean, MNA = Middle East and North Africa, SAR = South Asia, and SSA = Sub-Saharan Africa.
diversion in the short run, rising trade protectionism would stifle investment and severely disrupt global value chains, contributing to higher prices and lower productivity. Other downside risks—such as heightened political uncertainty, escalating geopolitical tensions, and conflict—further cloud the outlook.

Even though the probability of a recession in the United States is still low, and the slowdown in China is projected to be gradual, markedly weaker-than-expected activity in the world’s two largest economies could have a severe impact on global economic prospects. Stimulus measures have bolstered the near-term outlook in these two countries but could contribute to a more abrupt slowdown later on. A simultaneous occurrence of a severe U.S. downturn and a sharper-than-expected deceleration in China would significantly increase the probability of an abrupt global slowdown and thus negatively impact the outlook of other EMDEs through trade, financial, and commodity market channels. A global downturn would be particularly detrimental for those EMDEs with reduced policy space to respond to shocks.

The softening outlook and heightened downside risks exacerbate various challenges faced by policymakers around the world. Advanced economies should use this period of above-potential growth to rebuild macroeconomic policy buffers and lay the foundation for stronger growth with reforms that bolster potential output. Care should be taken to avoid shifts in trade and immigration policies that could negatively affect longer-term growth prospects, both domestically and abroad. A renewed commitment to a rules-based international trading system would also help bolster confidence, investment, and trade.

In a context of limited policy buffers, EMDE policymakers need to bolster the capacity to cope with possible bouts of financial market volatility, including sharp exchange rate movements—while undertaking measures to sustain the ongoing period of historically stable inflation (Box 1.1). This immediate priority will require a credible commitment to price stability from central banks, underpinned by strong institutional
independence, as well as efforts by regulators and prudential authorities to reduce persistent financial fragilities. EMDEs also face substantial fiscal challenges and the risk of worsening debt dynamics as global financing conditions tighten. For many EMDEs, it will be imperative to restore fiscal space given cyclical conditions, as well as address the vulnerabilities associated with elevated foreign-currency-denominated debt.

Equally critically, amid a projected deceleration in potential growth, EMDEs face the pressing challenge of ensuring sustained improvements in living standards. This will require investments in human capital and skills development to raise productivity and take full advantage of technological changes. In the current environment of limited fiscal resources, the urgency of these investments highlights the critical need to prioritize effective public spending and increase public sector efficiency.

Moreover, facilitating the expansion of small- and medium-sized enterprises, including by improving their access to international markets and finance, would also spur productivity and stimulate growth-enhancing investments. For many EMDEs, there is scope to further liberalize trade and improve the extent to which they are integrated into global value chains, which would foster a more efficient allocation of resources, job creation, and export diversification. Policies that help improve outcomes in these areas would also contribute to address the challenges associated with informality, thus reinforcing the basis for future productivity growth.

**Major economies: Recent developments and outlook**

_Growth has moderated in most advanced economies, with the notable exception of the United States, where fiscal stimulus is boosting activity. Over the forecast horizon, growth in all major advanced economies is projected to slow toward potential as capacity constraints become increasingly binding and monetary accommodation is withdrawn. In China, activity remains robust, but headwinds are increasing in a context of heightened trade tensions._

**FIGURE 1.3 Advanced economies**

Activity has softened but still points to above-potential growth in major advanced economies. Growth is expected to continue to moderate over the forecast period. Fiscal policy will boost U.S. activity in 2019 but will become a drag thereafter.

Incoming data in advanced economies have softened but still point to above-potential growth. Unemployment rates have continued to decline, and for many countries are below levels seen prior to the global financial crisis. After slightly decelerating from 2.3 percent in 2017 to an estimated 2.2 percent last year, advanced-economy growth is expected to continue slowing over the forecast period, with a notable slowdown in investment and the eventual shift of U.S. fiscal policy from stimulative to contractionary (Figure 1.3).

**United States**

U.S. growth in 2018 is estimated to have picked up to 2.9 percent, up 0.2 percentage point from previous projections, mostly reflecting stronger-than-expected domestic demand (Figure 1.4). Activity is being bolstered by procyclical fiscal stimulus and still-accommodative monetary policy.

The labor market remains robust, bolstering consumption. The unemployment rate has fallen to an almost 50-year low, despite an influx of new workers—a bout three-quarters of the approximately 200,000 jobs being added every month are being filled by new entrants. Labor productivity is showing signs of picking up.
Evolution of EMDE inflation: A remarkable conquest

Disinflation. EMDEs have witnessed a significant decline in inflation since the mid-1970s, with median annual national consumer price inflation down from a peak of 17.3 percent in 1974 to about 3.5 percent in 2018. Disinflation over recent decades has been broad-based across regions and country groups. For example, disinflation occurred across all EMDE regions, including those with a history of persistently high inflation, such as Latin America and Sub-Saharan Africa (Figure 1.1.2). Even among low-income countries (LICs), inflation fell by two-thirds between the mid-1970s and 2017, to 5 percent.

EMDE disinflation was set against the backdrop of sharper disinflation among advanced economies, where median inflation dropped from its highest (15 percent in 1974) to its lowest level (0.3 percent in 2015) in more than 60 years. Since then, it has risen somewhat to just over 1.5 percent in 2018 but remains below the median inflation target of advanced-economy central banks. After 2008, below-target inflation and, in some cases, deflation became pervasive across advanced economies: for example, in 2015, inflation was negative in more than half of advanced economies. Some advanced-economy central banks have struggled to lift inflation back to their inflation targets over the past decade.

Drivers of low inflation. While the global financial crisis played a major role in pushing inflation down around the
world over the past decade, the longer-term trend of disinflation has been supported by a wide range of structural changes. The most significant of these have been the wide-spread adoption of more effective and more transparent monetary, exchange rate, and fiscal policy frameworks as well as globalization (Figure 1.1.2).  

- **Macroeconomic policies.** In the second half of the 1980s and during the 1990s, many EMDEs implemented macroeconomic stabilization programs and structural reforms, and gave their central banks clear mandates to control inflation. The adoption of resilient policy frameworks has facilitated more effective control of inflation (Taylor 2014; Fischer 2015). Twenty-four EMDEs have introduced inflation targeting monetary policy frameworks since the late 1990s and, in the median EMDE, the index of central bank independence and transparency rose more than one-and-a-half-fold between 1990 and 2014. Inflation tends to be lower in countries that employ an inflation targeting framework and that have more independent and transparent central banks. Changes in fiscal policy frameworks have also contributed: fiscal rules have been adopted in 88 countries, including 49 EMDEs. Other reforms, including labor market and product market liberalization, and the removal or easing of foreign exchange market controls, also assisted the disinflation process.

- **Trade and financial integration.** Trade integration has contributed to lower prices, as higher shares of imports in consumption and production result in competitive pressures from foreign producers (Figure 1.1.4). Financial integration has helped discipline macroeconomic policies since more financially integrated economies are more likely to implement monetary policies targeting low and stable inflation (Kose et al. 2010). In the median EMDE, as in the median advanced economy, the ratio of trade to GDP increased by half between 1970 and 2017, to 75 percent of GDP, and international assets and liabilities tripled (although they remain only half the level of advanced economies). Inflation tends to be lower in economies that are more open to trade and financial flows.

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*Other structural changes have also been important (Ha, Ivanova et al. 2019). For example, technological advances, including the digitalization of services and automation of manufacturing have also transformed production processes, attenuating inflation pressures. Population aging may also have contributed.*
analyze its importance, a dynamic factor model is estimated for annual consumer price inflation rates in 25 advanced economies and 74 EMDEs during 1970-2017 (Ha, Kose et al. 2019). The model includes a common global factor as well as group factors specific to advanced economies and EMDEs. The presence of group factors allows the model to account for the large differences in country characteristics between advanced economies and EMDEs.

Global inflation factor. Inflation has become increasingly globally synchronized (Figure 1.1.3). The contribution of the global factor to inflation variation has grown over time; since 2001, it has almost doubled, and now accounts for 22 percent of inflation variation (Ha, Kose et al. 2019). It has explained about one-fifth and one-quarter of EMDE and advanced economy inflation variation, respectively, since 2001. Over the past four decades, an EMDE-specific factor has also become more prominent. The rising importance of these global and group-specific factors indicates that inflation synchronization has become more broad-based over time.

Global inflation versus global business cycle. Inflation synchronization is sizable by comparison with global business cycle synchronization. The international business


BOX 1.1 The great disinflation (continued)

cycle literature has established the presence of a well-defined global business cycle (Kose, Otrok, and Prasad 2012). In the sample used here, the global business cycle, as captured by a common global factor in output growth, has accounted for 5 percent of national output growth fluctuations since 1970—less than half the degree of inflation synchronization.

Tradables versus non-tradables. The role of the global factor has been more prominent in price baskets with a larger tradables content. The global factor’s contribution to inflation variation was largest for import prices (54 percent in the median country) and smallest for core CPI inflation (5 percent). Between these two extremes, the global factor’s contribution to variation in PPI inflation was 42 percent and that for GDP deflator growth was 13 percent and comparable to that for headline CPI inflation.

Maintaining low inflation: A greater challenge

The achievement of low inflation cannot be taken for granted (Rogoff 2014; Draghi 2016; Carstens 2018). If cyclical and structural forces become less disinflationary over the next decade than they have been over the past five decades, inflation could rise globally. Through the strengthening global inflation cycle, this may put upward pressure on EMDE inflation. More importantly, structural and policy related factors that have helped lower inflation over the past several decades may lose momentum or be rolled back amid mounting populist sentiment.

- **Slowing globalization.** The rising protectionist sentiment of recent years may slow or even reverse the pace of globalization. New tariffs and import restrictions have been put in place in advanced economies and EMDEs since 2017. The possibility of further escalation in trade restrictions involving major economies remains elevated.

- **Weakening monetary policy frameworks.** A shift from a strong mandate of inflation control, to objectives related to the financing of government, would undermine the credibility of monetary policy frameworks and raise inflation expectations. Among EMDEs, a decline in central bank independence and transparency has been associated with significantly less well-anchored inflation expectations and greater pass-through of exchange rate movements to inflation.

- **Weakening fiscal policy frameworks.** Growing populist sentiment could lead to a move away from rule-based fiscal policies. Fiscal rules can become ineffective once commitment to them falters (Wyplosz 2012). Mounting public and private debt in EMDEs could also weaken commitment to strong fiscal and monetary policy frameworks. Government and/or private sector debt has risen in more than half of EMDEs since 2012, including in many LICs (World Bank 2018a). EMDE sovereign credit ratings have continued to deteriorate, with some falling below investment grade, reflecting concerns about rising debt and deteriorating growth prospects.

If unwanted inflation makes a comeback, policy frameworks may be tested in EMDEs: their inflation expectations are less well-anchored, and the absence of strong monetary policy frameworks in many of these economies means that inflation is sensitive to exchange rate movements (Kose et al. 2019; Ha, Stocker and Yılmazkuday 2019). Growing inflation synchronization also increases the risk of policy errors when the appropriate response differs depending on the origin of the underlying inflation shock (IMF 2018a). EMDE central banks may struggle to contain inflationary pressures and may not receive adequate support from fiscal policy in stabilizing the business cycle. For some EMDEs, a significant increase in inflation could set back poverty reduction efforts.

The demise of previous periods of sustained low inflation is a reminder that low EMDE inflation is by no means guaranteed. Inflation has been low and stable before: during the Bretton Woods fixed exchange rate system of the post-war period up to 1971 and during the Gold Standard of the early 1900s (Figure 1.1.4). Yet directly following the low inflation period that ended in the early 1970s, the sharp increase in oil prices in 1973-74 led to a rapid acceleration in global inflation and sharp declines in growth in many countries (Kose and Terrones 2015). Global inflationary pressures also led to a significant increase in domestic inflation in developing economies, including those that experienced relatively low and stable inflation in the late 1960s and early 1970s (Cline 1981). All three episodes of sustained low inflation are characterized by inflation below 5 percent for an extended period. It is notable, however, that the two earlier episodes were followed by sharply rising inflation. This illustrates

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5 Major advanced-economy central banks have also acknowledged the need to consider the global environment in setting monetary policy in light of the highly synchronized nature of global inflation (Bernanke 2007; Draghi 2015; Carney 2015).
that maintaining low inflation can be as great a challenge as achieving low inflation.

EMDE policymakers need to recognize the increasing role of the global inflation cycle in driving domestic inflation. Options to help insulate economies from the impact of global shocks include strengthening institutions, including central bank independence, and establishing fiscal frameworks that can both assure long-run debt sustainability and provide room for effective counter-cyclical policies. Low inflation in EMDEs in the past two decades is no guarantee of low inflation in the future.
Nominal wage gains have been outpacing inflation, resulting in modest real wage growth. Long-term inflation expectations have edged up but remain contained.

During 2018, the U.S. administration raised tariffs on about $300 billion worth of imports, mostly from China; other countries have retaliated with tariffs on about $150 billion worth of U.S. exports. In all, new tariffs have been imposed on about 12 percent of U.S. goods imports and may expand further, resulting in higher prices and elevated policy uncertainty (Kutlina-Dimitrova and Lakatos 2017; Lindé and Pescatori 2017).

During the forecast horizon, growth is expected to decelerate as monetary policy accommodation is removed, and as fiscal stimulus fades and subsequently begins to drag on growth. Higher trade tariffs are expected to further weigh on activity, especially exports and investment. In all, U.S. growth is projected to slow to 2.5 percent in 2019 and to an average of 1.7 in 2020-21—roughly consistent with potential.

**Euro Area**

Euro Area growth slowed notably in 2018 to an estimated 1.9 percent, 0.2 percentage point below previous projections. In particular, exports have softened, reflecting the earlier appreciation of the euro and slowing external demand (Figure 1.5).

While unemployment has declined, inflation remains stubbornly low. Headline inflation has risen to target, but largely due to a temporary acceleration in energy prices. Core inflation remains around 1 percent, while long-term inflation expectations continue to hover around 1.6 percent, as in the past three years. The European Central Bank has stopped adding to its balance sheet, although it is expected to maintain its negative interest rate policy until at least mid-2019. Financial system lending and profitability have continued to increase, though some European banks may be exposed to financial stress in some EMDEs.

Across the Euro Area, the stance of fiscal policy is expected to be mildly expansionary. Increased German expenditures are envisioned to lead to smaller surpluses, while deficits in France and Italy are likely to rise amid public pressures for additional spending and tax relief. Italy’s borrowing costs have increased and remain volatile, reflecting uncertainties about the outlook for the country’s debt load.

In all, Euro Area growth is projected to further decelerate toward potential over the forecast horizon, to 1.6 percent in 2019 and an average of 1.4 percent in 2020-21, as monetary stimulus is withdrawn and global trade growth moderates.

**Japan**

Japanese growth slowed to an estimated 0.8 percent in 2018, reflecting contractions in the first...
A slowdown in exports has been the primary driver of cooling Euro Area activity. While headline inflation has risen to target, it is largely due to a temporary acceleration in energy prices.

FIGURE 1.5 Euro Area

A. Export contribution to growth
B. Inflation

The economy is still growing above potential, as solid growth in employment offsets subdued productivity. The Bank of Japan is providing exceptionally supportive monetary policy by keeping long-term rates near zero and expanding its balance sheet, while the fiscal deficit is narrowing.

FIGURE 1.6 Japan

A. Employment and productivity growth
B. Gross government debt and long-term bond yields

Growth is estimated to have slowed to a still robust 6.5 percent in 2018, supported by resilient consumption (Figure 1.7). A rebound in private fixed investment helped offset a decline in public infrastructure and other state spending. However, industrial production and export growth have decelerated, reflecting easing global manufacturing activity. Import growth continued to outpace export growth, contributing to a shrinking current account surplus. Net capital outflows have resumed, and international reserves have been edging down. Stock prices and the renminbi have experienced continued downward pressures, and sovereign bond spreads have risen amid ongoing trade tensions and concerns about the growth outlook.

New regulations on commercial bank exposures to shadow financing, together with stricter provisions for off-budget borrowing by local governments, have slowed credit growth to the non-financial sector. However, in mid- and late 2018, the authorities reiterated their intention to pursue looser macroeconomic policies to counter the potential economic impact of trade disputes with the United States. Prices of newly constructed residential buildings have rebounded, including in Tier 1 cities, following several years of correction. Consumer price inflation has generally moved up since mid-2018, partly reflecting currency depreciation and higher energy and food prices in most of last year, but it remains below target.

Growth is projected to decelerate to 6.2 percent in 2019, slightly below previous projections as a result of weaker exports, and to further moderate and third quarters due to bad weather and natural disasters. Nevertheless, the labor market has been robust, with the unemployment rate at 2.4 percent, rising earnings, and the participation rate standing above 79 percent—up 1.5 percentage points since the beginning of last year. Rising labor force inputs, however, have been offset by weak productivity (Figure 1.6).

The Bank of Japan continues to provide stimulus by keeping long-term rates near zero and adding to its balance sheet. It now holds about 40 percent of government debt. The government continues to run a primary deficit, and it has announced a temporary stimulus package to offset the short-term impact of a VAT hike in late 2019.
to 6 percent by the end of the forecast horizon, broadly in line with its potential pace. Domestic demand is projected to remain robust aided by policies to boost consumption. Supportive fiscal and monetary policies undertaken or announced so far are expected to largely offset the negative impact of higher tariffs; however, additional stimulus may have the undesirable effect of slowing the deleveraging and de-risking process (World Bank 2018b).

**Global trends**

In 2018, global trade slowed more rapidly than expected, alongside softening industrial activity. Trade policy uncertainty remains elevated, dampening global investment and trade. Borrowing costs have generally tightened in EMDEs following a broad-based appreciation of the U.S. dollar, bouts of investor risk aversion, and increased focus on country-specific vulnerabilities. External financing conditions are expected to continue deteriorating in 2019, as monetary policy accommodation in advanced economies is unwound. Oil prices were markedly volatile in the second half of 2018, mainly due to supply factors, with sharp falls toward the end of the year. Most other commodity prices—particularly metals—also weakened, reflecting heightened trade tensions.

**Global trade**

Following strong momentum in 2017, growth in global goods trade markedly slowed during the first half of 2018 and has only partially recovered since then. The deceleration was more pronounced than previously expected, as reflected in decelerating export orders and global manufacturing activity (Figure 1.8).

In particular, global capital goods production, which is highly trade-intensive, has slowed notably in Europe and developing Asia, two tightly interconnected global manufacturing hubs (Raschen and Rehbock 2016). Nearly a third of European exports and more than half of German exports to developing Asia are of machinery and vehicles, while capital goods and electronics account for a third of exports from developing Asia to Europe.

**FIGURE 1.7 China**

Growth in China remains robust, in part reflecting resilient consumption. However, industrial production and new export orders have moderated, asset prices have experienced downward pressures, and sovereign bond spreads have risen amid trade tensions. Prices of newly constructed residential buildings have rebounded, including in Tier 1 cities following a period of correction.

The softening of global goods trade comes against the backdrop of ongoing trade tensions involving major economies. New tariffs introduced since the beginning of last year have affected about 12 percent of U.S. goods imports, 6.5 percent of China’s goods imports, and about 2.5 percent of global goods trade. In the United States, tariff increases were implemented citing national security concerns and unfair trade practices. Import restrictions and tariff increases were also put in place in some EMDEs, as retaliatory actions or as measures aimed at reducing current account vulnerabilities in the face of intensifying capital
outflow pressures (e.g., Arab Republic of Egypt, Indonesia, Islamic Republic of Iran, Pakistan, Sri Lanka, Turkey).

Combined with the rising prevalence of temporary trade barriers (such as anti-dumping and countervailing duties and safeguards), recent protectionist measures have disproportionately affected trade in parts and components, with negative repercussions for international value chains (Baldwin 2018; Bown 2018; Johnson and Noguera 2017). Increased tariffs on certain goods, including on U.S. steel imports, is associated with an especially large negative effect on producers in poorer and smaller EMDEs (Bown, Jung, and Zhang 2018). In contrast, some EMDEs may be benefiting in the short term from trade diversion, as rising tariffs increase the cost of targeted goods in the United States and China.

The temporary pause in tariff hikes agreed by the United States and China during the G20 meeting in early December 2018 and the successful negotiations of the new United States-Mexico-Canada Agreement have somewhat tempered trade policy uncertainties. However, the possibility of escalating trade restrictions involving major economies remains elevated. This uncertainty is likely to weigh on firms’ willingness to invest, export, and engage in international value chains, with negative effects on the global trade outlook (Feng, Li, and Swenson 2017; Handley and Limão 2015; Osnago, Piermartini, and Rocha 2018). In addition, rising interest rates in advanced economies and economic rebalancing in China is expected to contribute to slower global investment and trade growth, with the latter projected to decelerate from 3.8 percent in 2018 to 3.4 percent by the end of the forecast horizon (Ahuja and Nabar 2012; Kose, Ohnsorge et al. 2017). Global trade is still projected to grow somewhat faster than global GDP, but at a much weaker pace than previously envisaged, reflecting a deterioration in growth prospects in several large EMDEs and in the Euro Area, as well as trade policy uncertainties.

Structural factors continue to weigh on the medium-term outlook for global trade, including maturing international value chains (Constantinescu et al. 2018; ECB 2016; Hoekman 2015). However, technological change and progress in liberalization efforts under the Trade in Services Agreement (TiSA) should continue to increase the relative importance of services in global trade flows (Lodefalk 2014; Miroudot and Cadestin 2017).
Financial markets

Borrowing costs in advanced economies crept up during most of 2018, as inflation moved closer to central bank targets and monetary policy accommodation continued to be withdrawn. After notable fluctuations, U.S. long-term yields ended the year at 2.7 percent, up around 30 basis points from the start of 2018 (Figure 1.9). Notwithstanding a scaling back of central bank asset purchases in the Euro Area and Japan, negative interest rate policies in these economies have continued to keep a lid on global bond yields, with more than $7.5 trillion of outstanding debt still trading at negative interest rates (15 percent of all bonds). Investor concerns about softening growth prospects and a search for higher-yielding safe assets have led to a further compression of the U.S. yield curve, despite higher inflation and ballooning U.S. government deficits driven by fiscal stimulus measures. Global equity markets dropped in the final quarter of 2018, partly reflecting a deterioration in market sentiment regarding global activity and trade policy shifts.

Divergent monetary policy among major economies also contributed to a significant appreciation of the U.S. dollar in 2018. This, together with increased investor risk aversion and renewed attention to external vulnerabilities, contributed to significant capital outflows in many EMDEs. Since the U.S. dollar started strengthening in April 2018, EMDE currencies fell by an average of about 10 percent—the most significant episode of sustained depreciation since early 2016. Cumulative portfolio outflows from EMDEs also surpassed those seen after the 2013 Taper Tantrum, reflecting a broad-based sell-off in both equity and bond funds.

While financial market stress was most pronounced in Turkey and Argentina, many other EMDEs also suffered from deteriorating market sentiment. Countries with current account deficits financed by volatile capital flows, as well as countries with high short-term external debt, were most severely impacted, pointing to heightened investor focus on external vulnerabilities. Elevated domestic debt, above-target inflation, and idiosyncratic factors such as policy uncertainty

FIGURE 1.9 Global finance

Borrowing costs increased in the United States, as monetary policy accommodation continued to be withdrawn, while softening global growth prospects weighed on equity markets. Tighter external financing conditions contributed to significant capital outflows and more significant currency pressures in more vulnerable EMDEs. International bond issuances slowed markedly in some regions, with yields increasing at their fastest pace since 2013.

A. U.S. sovereign bond yields

B. Global and EMDE equity prices

C. EMDE portfolio flows during recent stress episodes

D. EMDE currency movements since April 2018, by current account balance ex. FDI

E. EMDE new bond issuance, by region

F. Largest annual changes in EMDE bond yields since 2000


A. Sovereign yields reflect the yield on U.S. Treasury bonds. Last observation is December 19, 2018.

B. Figure shows MSCI Global and Emerging Markets Indexes. Last observation is December 19, 2018.

C. Cumulative flows to major EMDEs, excluding China, for the 250 days following the start of the stress episode. The start dates for the stress episodes are: Taper Tantrum: May 23, 2013; China concerns: June 12, 2015; Latest episode: April 15, 2018. Orange lines indicate interquartile ranges. Last observation is December 19, 2018.

D. FDI = foreign direct investment. Figure shows the median of cumulative changes in exchange rates since April 15, 2018. Orange lines indicate interquartile ranges. Last observation is December 19, 2018.

E. EAP = East Asia and Pacific, ECA = Europe and Central Asia, LAC = Latin America and the Caribbean, MNA = Middle East and North Africa, SAR = South Asia, and SSA = Sub-Saharan Africa. Figure shows the total new bond issuance from January to November for each year. Last observation is December 19, 2018.

F. EMDE bond yields are calculated as the sum of the J.P. Morgan Emerging Market Bond Index (EMBI) spread and the 10-year U.S. Treasury yield. Last observation is December 19, 2018.

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played a role as well. As in previous episodes, EMDEs with more liquid currency and equity markets were particularly affected by shifting market sentiment and contagion effects (Ahmed, Coulibaly, and Zlate 2015; Eichengreen and Gupta 2014).

Bond issuance has slowed markedly since mid-2018, particularly in Latin America and the Caribbean and Eastern Europe and Central Asia, amid worsening external financing conditions. EMDE sovereign credit ratings have continued to deteriorate, with some falling below investment grade, reflecting concerns about rising debt and deteriorating growth prospects. Yields on EMDE debt issued in international bond markets rose by 140 basis points in 2018—the third largest increase over the last two decades. Demand for cross-border bank loans has also weakened, with the appreciation of the U.S. dollar putting upward pressure on dollar funding costs. Various EMDE central banks have responded to currency and capital outflow pressures with interest rate hikes, leading to tighter domestic borrowing conditions and, in some cases, slower credit and domestic demand growth.

In contrast to the deceleration in portfolio and bank flows, foreign direct investment (FDI) into EMDE is estimated to have stabilized in 2018, while remittance flows continued to increase (World Bank 2018c). Outward FDI from China remained robust, boosted by the Belt and Road Initiative.

Looking forward, global interest rates are likely to rise at a slower pace than previously expected, reflecting increased headwinds to global growth. Nevertheless, external financing conditions are expected to tighten further in EMDEs, and capital flows to remain moderate, particularly among more vulnerable economies.

Commodities

Energy prices fluctuated markedly in the second half of 2018, mainly reflecting supply factors, with sharp falls toward the end of the year. Prices of most metals and, to a lesser extent, agricultural commodities also weakened, largely due to concerns about the effects of tariffs on global growth and trade. Prices of the three commodity groups are expected to generally stabilize in 2019 (Figure 1.10).
Oil prices averaged $68 per barrel (bbl) in 2018, a touch lower than June forecasts but about 30 percent higher than in 2017. While robust global oil consumption contributed to this increase, supply-side factors were the main drivers of price movements through the year. Continuing declines in production in Venezuela and market concern about the impact of U.S. sanctions on Iran contributed to rising Brent crude oil prices, which peaked at $86/bbl in early October. However, prices fell sharply in November after the United States announced temporary waivers to the sanctions on Iran for eight countries, including China and India. The decline in prices also reflected continued rapid growth in oil production in the United States, as well as a substantial increase in supply by the Organization of the Petroleum Exporting Countries (OPEC) and the Russian Federation.

Oil prices are expected to average $67/bbl in 2019 and 2020, $2/bbl lower than June projections; however, uncertainty around the forecast is high. While growth in oil demand is expected to remain robust in 2019, the expected loss in momentum across EMDEs could have a greater impact on oil demand than expected. The outlook for supply is uncertain and depends to a large extent on production decisions by OPEC and its non-OPEC partners. While these producers have agreed to cut output by 1.2mb/d for six months starting January 2019, few details have been forthcoming about the distribution of the cuts, and they may prove insufficient to reduce the oversupply of oil. Considerable uncertainty remains about the full impact of Iranian sanctions once the waivers end, as well as the outlook for Venezuelan production. Meanwhile, crude oil output in the United States is expected to rise by a further 1mb/d in 2019, with capacity constraints envisioned to ease in the second half of the year as new pipelines come onstream.

Metals prices rose 6 percent, on average, in 2018, less than previously expected. After increasing in the first half of last year, prices fell sharply in the second half following the imposition of broad-based tariffs by the United States on China’s imports (World Bank 2018d). Heightened trade tensions involving these economies have raised market concerns about global trade and investment prospects; as a result, they have clouded the outlook for demand for commodities. Industrial metals have been particularly responsive to these concerns given their many uses in the manufacture of tradable goods, with some metals such as nickel falling more than 20 percent. In contrast, the price of steel and aluminum in the United States rose following the announcement of specific tariffs on imports of those metals from a wide range of countries. Metals prices are expected to stabilize in 2019 and 2020.

While agricultural prices were roughly flat in 2018 as a whole, they declined appreciably in the second half of the year, with developments varying by commodity. Soybean prices in the United States fell substantially following the announcement of tariffs by China on imports of U.S. soybeans, while prices were higher in other countries, particularly in Brazil. The imposition of tariffs has led to trade diversion, with China’s imports of soybeans from the United States 25 percent lower in 2018 relative to 2017, while those from Brazil have risen 22 percent. More recently, the gap in prices has closed, as China has resumed purchases of U.S. soybeans. Wheat prices were slightly higher in 2018, as bad weather in Europe led to smaller harvests. Estimates for the 2018-19 crop forecast have been revised up for most commodities, and high stock-to-use ratios for rice and wheat reduce the likelihood of a food price spike. In all, agricultural prices are projected to remain broadly stable in 2019 and 2020.

Emerging market and developing economies: Recent developments and outlook

EMDE growth is expected to stall at 4.2 percent in 2019, markedly below previous expectations. The forecast reflects the lingering effects of recent financial market pressure in some large economies, with a substantially weaker-than-expected pickup in commodity exporters accompanied by a deceleration in commodity importers. Growth is projected to plateau at 4.6 percent toward the end of the forecast horizon, as the recovery in commodity exporters levels
renewed market attention to country-specific vulnerabilities and financial stress in some large economies with persistent macroeconomic fragilities—most notably, Argentina and Turkey. More generally, the weakness in activity was most pronounced in EMDEs that suffered financial market pressures in a context of elevated current account deficits and high exposure to portfolio and bank inflows (Figure 1.11). Many of these economies faced sizable currency depreciation, equity market declines, or foreign reserve losses (e.g., Angola, Argentina, Turkey, South Africa).

Domestic demand across EMDEs has generally moderated, reflecting tighter domestic borrowing conditions, softer confidence, and policy tightening in some large economies to ward off domestic price and capital outflow pressures. A rebound in EMDE gross capital formation that began in 2015 has slowed, and investor sentiment has deteriorated. On the external front, import growth has softened, partly due to sharp currency depreciations in some large economies, while export growth has also moderated, reflecting weaker external demand—notably, moderating global investment. Recent high-frequency indicators confirm the weaker momentum among EMDEs, particularly in those that have sizable current account deficits and rely heavily on portfolio and bank flows.

Commodity-exporting EMDEs

The pace of recovery in commodity exporters has weakened significantly, and activity across the group has become more heterogeneous. Investor confidence has generally worsened, especially toward economies with external vulnerabilities and fragile domestic conditions (e.g., Angola, Argentina, Nigeria, South Africa). Recent declines in oil and other commodity prices have posited additional headwinds to activity.

Long-standing challenges in several large economies have resurfaced. In a number of countries, capital flows have softened, and asset prices and currencies have come under significant pressure amid weaker global trade, rising trade restrictions, and renewed investor attention to country-specific factors including sizable current account and fiscal deficits and elevated debt. As a consequence, the rebound in domestic demand

off. In over 35 percent of EMDEs, per capita growth will be too low to avoid widening income gaps with advanced economies.

Recent developments

The recovery in EMDE activity has stagnated. Aggregate growth in EMDEs edged down to an estimated 4.2 percent in 2018—0.3 percentage point below previous projections—against the backdrop of a substantial strengthening of the U.S. dollar, weakening capital flows, heightened trade tensions, and moderating global manufacturing and trade. This more challenging international environment was accompanied by

FIGURE 1.11 Activity in EMDEs

EMDE activity has stalled, in part reflecting the effect of financial stress in some large economies with sizable current account deficits and high exposure to volatile capital flows. Domestic demand across EMDEs has generally moderated, and trade flows have softened. High-frequency indicators suggest that the weakness continues, particularly in more vulnerable economies.

A. Growth

B. Contribution to GDP growth

C. Import growth, volumes

D. Manufacturing PMIs

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

A. Aggregate growth rates calculated using constant 2010 U.S. dollar GDP weights. Data for 2018 are estimates. Data for 2015-16 are simple averages.

A-D. High CA def. ex. FDI = high current account deficit excluding foreign direct investment, which refers to countries with zero or negative values of current account balances net of foreign direct investment. Others refers to countries with positive values of current account balances net of foreign direct investment.


B. Domestic demand includes government consumption, private consumption, and gross capital formation, which includes the change in inventories. Net exports are calculated as the volume of exports minus imports.

C. Figure shows imports of goods and services.

D. Figure shows average Purchasing Managers’ Index (PMI) for manufacturing output for country groups. Readings above 50 indicate expansion in economic activity; readings below 50 indicate contraction.

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has slowed and the recovery in investment has stalled (e.g., Argentina, Iran, South Africa). Private consumption growth has also cooled following several years of continued recovery, partly reflecting the dampening impact of higher inflation and tighter lending conditions.

Among the largest commodity exporters, growth in Argentina plummeted following acute financial market stress that resulted in sharp currency depreciation and monetary policy tightening. In South Africa, activity contracted in the first half of 2018 and, despite a recovery in the second half, it remains subdued, reflecting challenges in mining production, low business confidence, and policy uncertainty. Growth in Brazil was lackluster in 2018, reflecting a truckers’ strike mid-year and heightened policy uncertainty. In Russia, growth has been resilient, supported by private consumption and exports; however, momentum has slowed, reflecting policy uncertainty, recent oil price declines, and renewed pressures on currency and asset prices. Output has contracted in a number of other commodity exporters that experienced declines in commodity production (e.g., Angola, Equatorial Guinea); social tensions (e.g., Nicaragua), or other idiosyncratic factors (e.g., sanctions in Iran).

In contrast, activity has firmed further in several oil-exporting economies where oil production rebounded in 2018 (e.g., Kuwait, United Arab Emirates). Recoveries have also continued, to varying degrees, in some large energy exporters where significant adjustments were introduced in response to the 2014-16 oil price plunge (e.g., Azerbaijan, Colombia, Saudi Arabia; World Bank 2018e, 2018f). Despite recent declines in industrial metals prices, growth among some large metals exporters has continued to show resilience (e.g., Chile, Mongolia, Peru). In addition, activity in a number of countries has been supported by infrastructure spending and foreign direct investment flows (e.g., Benin, Côte d’Ivoire, Ethiopia, Lao People’s Democratic Republic, Morocco, Senegal, Uganda; World Bank 2018g).

**Commodity-importing EMDEs**

Growth in commodity importers has decelerated, reflecting capacity constraints, moderating export growth, and deteriorated conditions in some large economies with elevated vulnerabilities and heightened policy uncertainty. Inflation has generally moved up, partly in response to higher energy prices in most of 2018 and closed or positive output gaps. Price pressures, widening fiscal and current account deficits, or in some cases currency and financial market volatility have prompted a shift to less accommodative monetary policy in some countries in this group (e.g., India, Mexico, Pakistan, the Philippines, Romania).

The moderation in activity is most evident among commodity importers with increasing capacity constraint, high current account deficits, or sizable public debt. The slowdown in Turkey—which faced a substantial deterioration in foreign investor confidence—has been especially severe. Activity is also slowing, and financial conditions have tightened, in a number of other commodity importers that have experienced financial market stress or continue to face widening fiscal and current account deficits (e.g., Pakistan, the Philippines, Romania).

Slowing Euro Area growth has diminished the positive trade and financial spillovers that had previously supported activity in several countries in Europe and Central Asia (e.g., Bulgaria, Croatia, Montenegro). However, in some economies, moderate inflation and low interest rates have supported a pickup in growth (e.g., Hungary, Poland, Serbia). Growth in Mexico remains moderate, partly owing to tighter financing conditions and domestic policy-related uncertainty.

Although activity continues to be generally more solid in Asia, external headwinds have increased. In India, growth has accelerated, driven by an upswing in consumption, and investment growth has firmed as the effects of temporary factors wane. However, rising interest rates and currency volatility are weighing on activity (World Bank 2018h). Other Asian economies (e.g., Bhutan, Cambodia, Vietnam) continue to benefit from pan-Asian infrastructure investment projects, including the China-led Belt and Road Initiative (World Bank 2018b).
BOX 1.2 Low-income countries: Recent developments and outlook

Growth in low-income countries increased only slightly in 2018, to 5.6 percent, but is expected to rise to 5.9 percent in 2019 and average about 6.3 in 2020-21. Oil producers are benefitting from higher oil prices and output, while softer metals prices are weighing on growth in the metals exporters. Higher agricultural production and continued infrastructure spending has supported growth in non-resource-intensive countries. However, progress on poverty reduction across all low-income countries will remain slow. Downside risks to the outlook include the possibility that commodity prices will soften as a result of trade disputes, global financing conditions will tighten abruptly, fiscal policies will slip, or extreme weather-related or health crises will emerge.

Recent developments

Economic growth is gradually improving in most low-income countries (LICs), even though the external environment is becoming less favorable (Figure 1.2.1). Robust growth in several non-resource-intensive countries has been supported by agricultural production (e.g., Rwanda, Uganda) and services (e.g., Nepal, Uganda) on the production side, and household consumption (e.g., Togo, Tajikistan) and public investment (e.g., Benin, The Gambia, Nepal, Tajikistan) on the demand side. However, in Ethiopia—the largest LIC—growth lost momentum as weaker activity in the construction and manufacturing sectors was aggravated by foreign exchange shortages. Among exporters of industrial commodities, Chad emerged from two years of recession partly due to the recovery in oil prices from their 2016 trough, as well as increased oil production. In contrast, the growth performance of metals exporters was more subdued, reflecting weaker metals prices and external demand, as well as mine closures (e.g., Sierra Leone), and heightened political uncertainty (e.g., Democratic Republic of Congo).

Progress on poverty reduction in LICs continues to be disappointing, with more than 40 per cent of the population in these countries living in extreme poverty—i.e., earning below $1.90 per day. And while this ratio has remained broadly unchanged in recent years, insufficient per capita GDP growth, especially in economies affected by fragility, conflict, and violence, means that the poverty headcount is rising.

Current account deficits are estimated to have widened in several countries in 2018. Among non-resource-intensive economies, as well as metals exporters, external balances have deteriorated as exports declined in response to weaker external demand and moderating metals prices and the effect of rising fuel prices on import bills. In contrast, oil exporters, such as Chad, recorded smaller deficits, helped by higher oil export earnings.

The financing of current account deficits has become more challenging amid a less supportive external environment, as foreign direct investment (FDI) inflows slowed in almost 40 percent of countries (e.g., Mozambique, Tanzania, Zimbabwe; UNCTAD 2018). FDI inflows, in particular to LICs, are more vulnerable to fluctuations in international financial conditions (Burger and Ianchovichina 2017). However, in some countries, reduced political uncertainty and improved investor sentiment have supported stronger FDI inflows (e.g., Benin, The Gambia). In addition, remittance flows have recovered in several countries as growth in selected advanced economies improved in recent years (e.g., Benin, Guinea-Bissau, Haiti; World Bank 2018). Nevertheless, for many LICs, the accumulation of sufficient international reserves remains difficult, leaving them below the three-months-of-imports benchmark and highly vulnerable to negative shocks.

Fiscal deficits generally widened among the LICs, with the median deficit increasing from 3.3 percent of GDP in 2017 to an estimated 3.5 percent in 2018. The deterioration reflected rising fiscal deficits among several industrial-commodity-exporting LICs as moderating metals prices dampened revenues. However, in oil-exporting countries (e.g., Chad), higher oil revenues combined with improved non-oil revenue collection yielded a fiscal surplus, and in some non-resource-intensive countries, fiscal consolidation delivered narrower fiscal deficits (e.g., Benin, The Gambia).

Debt levels remain elevated in many countries and continue to rise. In Liberia and Sierra Leone, the debt-to-GDP ratio has increased more than twofold over the last five years, driven by a significant slowdown in growth and continually weak revenue collection (Liberia) and a deprecating exchange rate coupled with new borrowings (Sierra Leone). In addition to the rise in debt ratios, changes in the composition of debt have made some countries more vulnerable to shifts in international financing conditions (Chapter 4). As countries have gained

Note: This box was prepared by Rudi Steinbach. Research assistance was provided by Hazel Macadangdang.
access to international capital markets and non-resident participation in domestic debt markets expanded, non-concessional debt has increased, reaching more than 30 percent of total public debt in several LICs (e.g., Ethiopia, Mozambique, Senegal) and over half of total public debt in Zimbabwe.

As a result, debt sustainability has deteriorated in several LICs. By late 2018, The Gambia, Mozambique, South Sudan, and Zimbabwe were classified as in debt distress under the IMF–World Bank debt sustainability framework. In addition, Ethiopia was downgraded during the year from a moderate-risk to high-risk rating.

**Outlook**

Growth in LICs is expected to improve, rising to 5.9 percent in 2019 and an average of about 6.3 percent in 2020-21 (Figure 1.2.2). While the growth recovery among the metals exporters is expected to be sluggish, as lower revenues constrain fiscal spending, growth among oil exporters is expected to be spurred by higher oil
BOX 1.2 Low-income countries: Recent developments and outlook

**FIGURE 1.2.2 Outlook**

Growth among the LICs is expected to improve. In non-resource-intensive economies, growth will be supported by stronger agriculture production and continued infrastructure investment, while oil exporters should benefit from higher oil production. However, weaker metals prices and subdued external demand imply a sluggish recovery in metals exporters. Moreover, progress on poverty reduction in LICs is expected to be slow, as per capita income growth still remains modest, especially among fragility, conflict, and violence-affected economies.

**A. GDP growth forecasts**

![GDP growth forecasts chart]

**B. Per capita GDP growth**

![Per capita GDP growth chart]

Per capita GDP growth in LICs is expected to increase only modestly from 2.7 percent in 2018 to 3.1 percent in 2019, and to an average of 3.5 percent in 2020-21. Moreover, among LICs affected by fragility, conflict, and violence, growth in per capita GDP is expected to be significantly lower—increasing from 0.5 percent in 2018 to an average of 1.6 percent in 2020-21. In all, these rates are not sufficient to generate a marked reduction in poverty rates, and the number of people in LICs living below the international poverty line of $1.90 per day is expected to remain elevated.

**Risks**

The economic outlook is dominated by downside risks. On the external front, slower-than-projected growth in major world economies—such as the United States, Euro Area, or China—would adversely affect export demand and investment in several LICs, specifically countries that are heavily dependent on these large economies for trade and investment flows. Moreover, escalating trade tensions involving major economies (e.g., rising tariffs between the United States and China) would be detrimental to LICs that depend on extractive industries—specifically metals producers, as metals prices are likely to fall faster than other commodity prices in response (World Bank 2018j). Furthermore, an unexpected deterioration in international financial conditions could disrupt capital inflows (IMF 2018b), fuel disorderly exchange rate depreciations, and raise financing costs, especially in LICs with weaker macroeconomic fundamentals or higher political risks. Sharp increases in debt-servicing costs, specifically foreign-currency-denominated debt, would undermine much-needed fiscal consolidation efforts and crowd out poverty-reducing expenditures.

Risks to debt sustainability are high, as several countries are either already in debt distress or facing high risk thereof, according to the IMF–World Bank debt sustainability framework for LICs (Chapter 4). The recent increased reliance on foreign currency borrowing has
BOX 1.2 Low-income countries: Recent developments and outlook (continued)

TABLE 1.2.1 Low-income country forecastsa
(Real GDP growth at market prices in percent, unless indicated otherwise)

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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, Somalia, Syria, and Yemen are not forecast due to data limitations.
b. GDP at market prices and expenditure components are measured in constant 2010 U.S. dollars.
c. GDP growth based on fiscal year data. For Nepal, the year 2017 refers to FY2016/17.
d. Due to changes in the official list of countries classified as low income by the World Bank, the sample of LICs in this table is not comparable to June 2018. However, an identical sample is used for the comparison of the aggregate LIC GDP projection.
To download this data, please visit www.worldbank.org/gep.

Click here to download data.

increased the extent to which debt sustainability is vulnerable to sharp currency depreciations.

Weather-related shocks, such as flooding or severe and prolonged drought episodes remain an important risk for many LICs. A return of the drought conditions experienced in recent years would undermine the ongoing recovery in agricultural production. In addition, lower agricultural output, and the food price spikes that are likely to follow, could adversely affect poverty rates in many LICs, especially countries where agricultural activity accounts for a dominant share of domestic value added (e.g., Chad, Sierra Leone), or is the prevailing source of employment (e.g., Burkina Faso, Burundi; Chapter 4).

Health crises are a continuous concern. The recent Ebola outbreak in the Democratic Republic of Congo could have a detrimental impact on economic activity in the country and the sub-region should it spread to major urban centers and to neighboring countries.
**Box 1.3 Regional Perspectives: Recent Developments and Outlook**

The cyclical upswing in regions with many commodity exporters (such as Latin America and the Caribbean, and the Middle East and North Africa) is proceeding at a more moderate pace than previously anticipated, partly reflecting a substantial slowdown in some large economies, and is expected to plateau toward the end of the forecast horizon. Growth in regions with large numbers of commodity importers (such as South Asia and East Asia and the Pacific) is projected to remain solid at around 6-7 percent. For all regions, risks to the outlook are increasingly tilted to the downside.

**East Asia and Pacific.** Growth is projected to moderate to a still-robust pace of about 6 percent in 2019 and remain near that level over the forecast period, in line with earlier projections. In China, policies aimed at rebalancing the economy and countering the impact of higher U.S. tariffs will continue to tilt activity toward consumption and away from exports. Excluding China, regional growth is expected to remain steady at 5.2 percent over the forecast horizon. Risks to regional growth are to the downside and have intensified. They include a further escalation of trade restrictions and a faster-than-expected tightening of global financing conditions. Highly leveraged economies and countries with sizable external financing needs are particularly vulnerable to disruptions in real and financial activity.

**Europe and Central Asia:** Growth fell to an estimated 3.1 percent in 2018, driven by a slowdown in Turkey and in Central European economies. Turkish growth for this year has been revised sharply down due to substantial financial market stress and the associated economic effects, contributing to a deceleration in regional growth in 2019 to 2.3 percent. Growth in the region is expected to pick up to 2.7 percent in 2020, as a rebound in Turkey offsets a moderation in activity among other commodity importers. Risks are tilted to the downside and growing. They include the possibility of renewed stress in Turkey alongside larger-than-expected spillovers to the rest of the region, and unexpected shifts in policy.

**Latin America and the Caribbean.** Growth stalled at 0.6 percent in 2018, held back by a currency crisis and drought in Argentina, a truckers’ strike in Brazil, and worsening conditions in Venezuela. Although regional growth is projected to strengthen over the forecast horizon, the improvement will be weaker than previously expected, partly owing to the effects of financial market tightening and trade policy uncertainty. However, firming momentum in Brazil and Colombia, together with gradual improvements in Argentina, will push regional growth to 1.7 percent in 2019 and 2.4 percent in 2020. Downside risks dominate, including the possibility of an abrupt further tightening of external financial conditions, a further escalation of domestic or international trade policy uncertainty, adverse market responses to fiscal conditions, and disruptions from natural disasters.

**Middle East and North Africa.** Growth in the region is expected to pick up slightly to 1.9 percent in 2019, but prospects are uneven across countries. Accelerating activity in Saudi Arabia and Egypt is expected to be offset by a sharp contraction in Iran following the imposition of U.S. sanctions. Increased oil production and fiscal easing are supporting the recovery in some oil exporters, while oil importers continue to benefit from policy reforms. Regional growth is projected to rise to 2.7 percent in 2020-21, as domestic demand among both oil importers and exporters shows a broad-based pickup, supported by reforms and diversification policies. Key downside risks include the possibility of intensified geopolitical tensions, renewed volatility in oil prices, rising global trade restrictions, an abrupt tightening of global financing conditions, and delays in reform implementation.

**South Asia.** Growth is projected to accelerate to 7.1 percent in 2019. This mainly reflects strengthening domestic demand in India, as the benefits of structural reforms such as GST harmonization and bank recapitalization take effect. Elsewhere in the region, the forecast is for a moderation in activity, notably in Bangladesh and Pakistan. Over the medium term, growth is expected to remain at 7.1 percent, underpinned by robust domestic demand in the region. External vulnerabilities are rising, reflected in mounting external debt, widening current account deficits, and eroding foreign reserves. Risks to the outlook are to the downside. On the domestic front, vulnerabilities are being exacerbated by fiscal slippages and rising inflation, and there is a risk of delays in structural reforms to address balance sheet issues in the banking and non-financial corporate sectors. Key external risks include a further deterioration in current accounts and a faster-than-expected global financial tightening.

**Sub-Saharan Africa.** Regional growth reached an estimated 2.7 percent in 2018—a downward revision from previous projections, reflecting a sluggish expansion in the

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Note: This box was prepared by Patrick Kirby, with contributions from Yoki Okawa, Rudi Steinbach, Temel Taskin, Ekaterine Vashakmadze, Dana Vorisek, and Lei Ye. Research assistance was provided by Hazel Macadangdang.
Low-income countries

Economic activity has continued to strengthen in most low-income countries (LICs; Box 1.2). Increased agricultural production in the wake of easing drought conditions is supporting robust growth in several non-resource-intensive countries (e.g., Rwanda, Uganda), as well as infrastructure investment related to reforms (e.g., Benin, Senegal). However, in Ethiopia—the largest LIC—growth lost momentum as weaker activity in the construction and manufacturing sectors was aggravated by foreign exchange shortages. Among region’s largest economies amid moderate trade growth, tightening financial conditions, and weak prices for key metals and agricultural commodities. Regional growth is expected to pick up, reaching 3.4 percent in 2019 and an average of 3.7 in 2020-21, predicated on diminished policy uncertainty and improved investment in large economies, together with continued robust growth in non-resource-intensive countries. Per capita income growth is predicted to remain well below its long-term average in many countries, yielding little progress in poverty reduction. Downside risks include the possibility of slower-than-projected growth in China and the Euro Area, further declines in commodity prices, a sharp tightening of global financing conditions, fiscal slippage, stalled structural reforms, and conflict.
as fiscal deficits remain elevated due to commodity-related declines in revenue, as well as governance challenges in some countries (Chapter 4).

**EMDE growth outlook**

EMDE growth is expected to stall at 4.2 percent in 2019—down 0.5 percentage point relative to previous projections. This reflects the lingering effects of recent financial market stress on several large economies, a lackluster and notably softer-than-envisioned cyclical recovery in commodity exporters, and a further deceleration in commodity importers (Figure 1.12). Growth across EMDEs in 2019 is expected to be close to the upper bound of estimates of its potential pace—particularly among commodity importers, where slack has largely been exhausted.

Growth in EMDEs is foreseen to increase to 4.5 percent in 2020, with a large part of this acceleration reflecting the projected dissipation of severe headwinds in a few large economies (e.g., Argentina, Iran, Turkey). In 2021, EMDE growth is expected to plateau at 4.6 percent as the recovery in commodity exporters matures. Throughout the forecast horizon, the international context is expected to be increasingly less favorable, in light of a projected slowdown in advanced-economy growth, weakening trade and investment, tighter financing conditions, and trade policy uncertainty. These factors will impede further acceleration in EMDE activity.

Growth in commodity exporters is projected to pick up to 2.3 percent in 2019—sharply below previous expectations—and plateau at 2.9 percent in both 2020 and 2021. Some large economies that experienced sizable contractions in activity in 2018 are expected to gradually recover over the forecast horizon (e.g., Angola, Argentina, Iran). The outlook for commodity exporters is uneven, however, partly owing to renewed market attention to country-specific vulnerabilities. Projections for about half of commodity exporters have been downgraded for 2019. Downward revisions reflect, to varying degrees, more adverse financial conditions and the resulting policy adjustment, softening confidence, lingering effects of strikes and political uncertainty, and weaker commodity prices and mining bottlenecks. These downward revisions are also reflected in forecasts for EMDE regions with a substantial number of commodity exporters (Box 1.3; Chapter 2).

Growth in commodity importers is expected to moderate to 5.5 percent in 2019 and remain steady at 5.6 percent in both 2020 and 2021—broadly in line with its potential rate. A structural...
slowdown in China is expected to be partly offset by a moderate pickup in other large economies in this group. In commodity importers excluding China, a downgrade to growth projections of 0.4 percentage point this year partly reflects the worsened outlook for Turkey as a result of the effects of recent financial market stress, and, to a lesser degree, in some other large economies (e.g., Pakistan, Romania).

Growth in LICs is expected to improve, rising to 5.9 percent in 2019 and 6.3 percent in 2020-21. However, for metals exporters, growth will be more sluggish than previously envisioned, with lower revenues constraining fiscal spending. In contrast, oil exporters should benefit from higher oil prices and improving domestic demand. Economic activity is expected to remain robust in non-resource-intensive LICs. In fast-growing countries (e.g., Rwanda, Tanzania), the expansion will be supported by public investment in infrastructure and strong agricultural growth. Similarly, infrastructure investment related to structural reforms should sustain Senegal’s growth recovery. While growth in Ethiopia is expected to remain strong, it will be weighed down by a tighter fiscal stance, as the government aims to stabilize public debt.

In the longer run, the underlying potential growth of EMDEs has fallen considerably over the past decade, reflecting softening productivity growth and, to a lesser degree, slowing capital accumulation and less favorable demographic trends (Vorisek et al. forthcoming; World Bank 2018k). Potential growth in EMDEs is expected to further decline, as its fundamental drivers continue to weaken. Moreover, tightening global financing conditions, higher borrowing costs, moderating capital flows, and lingering policy uncertainty are likely to hamper investment growth in coming years, further constraining potential growth.

**Outlook for per capita income and poverty**

Per capita income growth in EMDEs is expected to stabilize at 3 percent in 2019—insufficient to narrow income gaps with advanced economies in over 35 percent of countries (Figure 1.13). The share will be even greater among commodity exporters (41 percent) and in countries affected by fragility, conflict, and violence (nearly 60 percent).

Although the extreme poverty rate—defined at a threshold of $1.90 per day—has fallen below 3 percent in more than half of the world’s economies in recent years, nearly one-fifth of countries faced rates above 30 percent in 2015, with the average for LICs standing above 40 percent. Poverty rates remain the highest among LICs, but the majority of extreme poor currently reside in large lower-middle-income countries, including India and Nigeria. Current growth
projections suggest that the number of extreme poor should continue to fall rapidly in India, but remain broadly unchanged in some other countries, including Nigeria. While extreme poverty has declined notably, progress in alleviating poverty at higher income levels has been slower, with nearly a quarter of the world’s population still living with less than $3.20 per day.

Worryingly, per capita income growth in Sub-Saharan Africa is expected to average only 0.9 percent in 2019-21—insufficient to drive significant progress toward poverty alleviation. Indeed, if recent growth trends persist, the fraction of the global poor residing in Sub-Saharan Africa could be as large as 87 percent by 2030 (World Bank 2018).

Risks to the outlook

The balance of risks is more firmly on the downside. The risk of disorderly financial market developments has increased and could spread through EMDEs, amplified by elevated vulnerabilities in many countries. A marked intensification of trade restrictions remains possible, and its realization could be highly disruptive in the presence of complex value chains. Policy uncertainty and geopolitical risks remain elevated and could negatively impact confidence and investment both in the affected countries and globally. Although unlikely in the near term, the simultaneous occurrence of a severe U.S. downturn and a sharper-than-expected deceleration in China would trigger a marked slowdown in global activity.

Global growth is projected to gradually slow over the forecast horizon as economic slack dissipates, major central banks remove policy accommodation, and the recovery in commodity exporters matures. This moderation is somewhat more pronounced than previously expected, amid softer-than-expected global trade and industrial activity and heightened financial market pressures in some EMDEs. While an abrupt slowdown is only expected in countries that faced severe financial stress in 2018, the global outlook has become more uncertain, with downside risks becoming more predominant.

A faster-than-expected tightening of global financing conditions, or disorderly exchange rate movements, could have large adverse effects on activity, particularly among more vulnerable EMDEs. Escalating trade tensions represent another key risk to the global outlook, as they could significantly hamper cross-border trade and investment, with the impact amplified by complex regional and global value chains. Loss of confidence in international trading rules could inflict long-lasting damage, lowering opportunities for future growth in EMDEs. Rising political uncertainty and polarization, geopolitical risks, and conflict could also depress sentiment and investment in the affected countries and globally.
The materialization of one or several of these downside risks would result in a more abrupt slowdown in global growth than currently envisioned. In particular, a simultaneous occurrence of a severe U.S. downturn and a sharper-than-expected deceleration in China would significantly increase the likelihood of an abrupt global slowdown. Past experience illustrates that global slowdowns and recessions often come unexpectedly after spells of highly synchronized growth and rapid debt build-ups (Figure 1.14; Kose and Terrones 2015).

On the upside, a resolution of trade tensions between major economies could lift sentiment and support global investment and trade. Furthermore, the ongoing cyclical recovery in global productivity growth could prove more durable than expected, especially if the pickup in intangible investments in recent years leads to a broader diffusion of productivity-enhancing technologies. If so, this would help counter the dampening effect of population aging on potential growth in the longer term.

A quantification of possible global growth outcomes around the baseline provides additional evidence of elevated forecast uncertainty and the predominance of downside risks. At current market conditions, the probability of global growth being more than 1 percentage point below baseline in 2020 is estimated at 21 percent, while that of growth being more than 1 percentage point above baseline is 17 percent. This reflects uncertainty embedded in the distribution of key risk factors, including equity price futures.

Disorderly financial market developments

Risks of disorderly financial market developments have intensified substantially, reflecting the possibility of a faster-than-expected tightening of global financing conditions, sharp movements in major currencies, and contagion from financial stress in some EMDEs.

Despite bouts of volatility in bond and equity markets, as well as ongoing uncertainty about growth and inflation prospects, U.S. term premiums are still negative, raising the risks of sudden upward adjustments (Crump, Eusepi, and Moench 2018; Kopp and Williams 2018). While investors appear to foresee an end to the tightening cycle in U.S. policy interest rates, the Federal Reserve continues to signal additional hikes, implying risks of disorderly market reassessments (FOMC 2018). In this context, a sharper-than-expected rise in U.S. borrowing costs remains possible. This could be triggered, for instance, by concerns about swelling fiscal deficits, intensifying wage pressures, or slowing foreign demand for U.S. government debt (Andolfatto and Spewak 2018; Kopp and Williams 2018). Following a decade of exceptionally low U.S. interest rates and growing debt levels, the effects of a sudden rise in borrowing costs could be amplified by increased investor risk aversion and sudden stops in capital flows to EMDEs (Arteta et al. 2015; Buttiglione et al. 2014; Dobbs et al. 2015; Mai 2018). The dampening effect could be particularly severe on cross-border bank loans to EMDEs (Bräuning and Ivashina 2018).

A further appreciation of the U.S. dollar, possibly triggered by diverging monetary policy and growth prospects among major economies, could also impact the outlook for EMDEs. Periods of dollar strength have been associated in the past with an increased frequency of disorderly currency depreciations in EMDEs. If currency crises were to materialize, they would be associated with slowing growth or outright contractions. In the past, a large proportion of crises were accompanied by a recession in the same year (Figure 1.15). When currency crises are accompanied by banking crises, as is sometimes the case, the likelihood of large output losses rises substantially (Laeven and Valencia 2018). These “twin” crises can occur in the presence of elevated foreign-currency-denominated debt or on the back of an abrupt end to capital inflows and credit booms leading to rising corporate defaults and large asset price corrections (Bordo and Meissner 2016; Caballero 2014).

Financial stress could spread through contagion effects. Excluding China and a few large regional economies (e.g., Brazil, Russia), direct trade and financial sector spillovers from most other EMDEs are limited (World Bank 2016). However, contagion across countries can result from heightened investor risk aversion and shifts in portfolio allocations between broad asset classes,
amplifying the effects of shocks (Gelos 2012). Historically, the correlation across EMDE assets has been high and tends to increase during stress episodes (Eichengreen and Gupta 2016; Park and Mercado 2014). These risks are particularly salient in the current context of persistent domestic and external vulnerabilities in EMDEs, as these can both amplify the impact of financial shocks and limit policy options in response to financial stress. On the domestic front, many countries have sizable government debt and primary fiscal deficits, elevated or rising private debt, and high non-performing loans. Corporate borrowers have increasingly relied on bond markets to finance rising debt levels, and now face significant refinancing needs amid rising interest rates (Lund et al. 2018). This could result in sudden increases in corporate default rates and have a sustained negative effect on investment and financial stability (Borensztein and Ye 2018). On the external side, many EMDEs are faced with the challenge of financing large current account deficits and rely heavily on volatile capital inflows. Coupled with high levels of short-term external debt and low foreign currency reserves, this leaves them exposed to shifts in external financing conditions, which could exert further downward pressure on activity.

In low-income countries (LICs), public debt burdens and vulnerabilities associated with a greater reliance on non-concessional financing are rising (Chapter 4). About 40 percent of LICs are in debt distress or at high risk of debt distress—roughly twice the share in 2015 (IMF 2018; World Bank 2018). Most LICs also suffer from a lack of transparency in public sector accounts, further exacerbating vulnerabilities.

Escalating trade restrictions

The risk of rising trade protectionism remains high. New U.S. tariffs and the retaliatory response of trading partners now affect close to $430 billion of global imports—around 2.5 percent of global goods trade (Figure 1.16). Despite a temporary pause in tariff hikes agreed by the United States and China in early December, unsuccessful negotiations could lead to a renewed escalation in trade restrictions. These, along with previous measures, would affect close to all goods trade between the two countries. Additional tariffs on U.S. imports of motor vehicles and parts are also under consideration, which could cause serious adverse effects given tightly integrated global automotive value chains.

If all proposed tariffs increases were to be implemented, the average U.S. tariff rate would more than quadruple, rising to levels not seen since the late 1960s. These new tariffs, and the associated retaliatory actions, could substantially depress bilateral U.S.-China trade, increase demand for costlier substitutes, and lead to lower

FIGURE 1.15 Financial stress

More than a third of currency crises in EMDEs are associated with negative growth in the same year. Currency crises are sometimes accompanied by banking crises, and their simultaneous occurrence can be particularly damaging. Financial stress can be amplified by persistent external vulnerabilities, potentially leading to further forecast downgrades for more exposed countries.

A. Currency crises and growth in EMDEs

B. EMDE banking and sovereign debt crises around currency crises

C. Share of EMDEs with negative growth around currency crises

D. Growth forecast revisions and current account position, 2019

A. Currency crises with negative or positive GDP growth during the year of the crisis. Currency crises are defined as nominal depreciation of the currency vis-à-vis the U.S. dollar of at least 30 percent that is also at least 10-percentage-points higher than the rate of depreciation in the year before.
B. The percent of EMDE currency crisis episodes that were preceded by, coincided with, or followed by a banking or sovereign debt crisis, with t denoting the start of the currency crisis. Crises episodes are as defined in Laeven and Valencia (2018).
C. Share of countries that experienced negative growth in the current or next year following a currency crisis, a currency and banking crisis, or a currency, banking, and sovereign debt crisis between 1975-2017.
growth in both the United States and China. It is also likely to affect investment strategies by multinational companies and lead to changes in some value chains. While some countries could benefit from trade diversion in the short run, including those with comparative advantages in close substitutes to the goods subject to U.S. or China tariffs, adverse effects from weakening growth and rising policy uncertainty involving the world’s two largest economies would have predominantly negative repercussions. In this context, a further escalation of trade frictions between the United States and China, coupled with possible negative effects on confidence, could reduce global exports by up to 3 percent and global income by 1.7 percent over the medium term (Freund et al. 2018).

More generally, a proliferation of trade barriers across both advanced economies and EMDEs could inflict lasting damage to the global economy. In particular, if all WTO members were to increase tariffs up to legally-allowed bound rates, this could translate into a decline in global trade flows of about 9 percent, similar to the drop seen during the global financial crisis in 2008-09 (Kutlina-Dimitrova and Lakatos 2017). In the presence of regional and global value chains, costs associated with increasing tariffs or other barriers to trade would cumulate through different stages of production (Koopman, Wang, and Wei 2014; World Bank et al. 2017). This amplification effect of vertical specialization would be particularly important for EMDEs, as the share of domestic value added in manufactured exports is usually lower and trade costs higher than in advanced economies. In the automotive sector, participation of EMDEs in global value chains has proliferated in the past decade, intensifying risks in the event of sudden pullbacks (Van Biesebroeck and Sturgeon 2011).

Intensifying trade disputes could eventually threaten the stability of the rules-based global trading system and undo the beneficial effects of trade liberalization and global integration achieved during decades of multilateral cooperation. Uncertainty about future trade rules could compound the negative effect of trade barriers on investment and activity (IMF 2018d; Kose, Ohnsorge et al. 2017).

Policy uncertainty and geopolitical tensions

Global policy uncertainty has increased since mid-2018, reflecting heightened trade tensions and geopolitical risks, as well as idiosyncratic developments in a number of large advanced economies and EMDEs. Elevated policy uncertainty tends to encourage investors to require higher risk premiums to hedge against negative outcomes. Financial market volatility remained exceptionally low in 2018, implying the risk of...
disorderly repricing of policy-related risks (Figure 1.17). A further escalation of policy uncertainty could lead companies to delay or reconsider capital spending, contributing to a more rapid deceleration of global growth than currently projected.

Political uncertainty is generally associated with lower growth in both advanced economies and EMDEs (Aisen and Veiga 2013). It has increased or remained elevated in a number of European countries—including in Italy where fiscal slippages have led to a market reassessment of country risk, and in the United Kingdom as it transitions out of the European Union (EU). In the absence of an approved withdrawal agreement, the exit of the United Kingdom from the EU could be accompanied by significant disruptions to activity in the short term and lasting economic losses over the medium term (Bank of England 2018; H.M. Treasury 2018). A sustained period of financial market stress and interruptions in cross-border financial flows associated with a disorderly exit process could cause significant adverse spillover effects and become a source of financial stability risks in systematically large economies (ECB 2018; FSOC 2018). Electoral outcomes in a number of EMDEs and advanced economies could result in further polarization and political fragmentation, making it harder to govern and formulate policies. A backlash against trade and immigration could also spur more inward-looking and populist policies (Aksoy, Guriev, and Treisman 2018; Moriconi, Peri, and Turati 2018).

Geopolitical risks intensified again in the Middle East, and persist in Central Asia, East Asia, and Africa. An intensification of these risks could impact growth in the affected regions, and their main trading partners. In the case of the Middle East, disruptions to global oil supplies could result in higher-than-expected oil prices, with negative impacts on aggregate demand and trade balances in major oil importers (Baffes et al. 2015; Stocker et al. 2018).

The number of armed conflicts also remains above historical averages. In particular, security conditions remain challenging in many countries in Sub-Saharan Africa, the Middle East, and North Africa. In the past, countries in conflict or in fragile situations suffered from below average growth in income per capita, delaying or derailing their catchup with advanced economy levels (UN and World Bank 2018). Beyond adverse short-term effects on growth, conflict can also substantially set back efforts to reduce poverty and child mortality, and can hamper access to education, implying longer lasting negative repercussions on development (Gates et al. 2012).
Region-specific downside risks

These global risks are compounded by multiple region-specific risks (Box 1.2; Chapter 2). Most regions are vulnerable to sudden shifts in policy, which could result in fiscal slippage, reduced investment due to policy uncertainty, and weaker potential growth resulting from insufficient structural reforms. Security-related risks remain present, in varying degrees, in Europe and Central Asia, the Middle East and North Africa, South Asia, and East Asia, and could rise in the face of renewed geopolitical tensions. A flare-up in violence would disrupt activity in various ways, weigh on potential output, and drive up refugee flows. A fall in the price of specific commodities could disrupt activity in large regional commodity exporters, with possible broader spillovers.

Severe weather events appear to be becoming more frequent, with particularly serious consequences for vulnerable countries, such as island nations in the Caribbean and East Asia and the Pacific. Adverse weather patterns are also problematic for countries with large agricultural sectors dependent on rainfall, including many in Sub-Saharan Africa and South Asia. In those countries, large food price increases could severely impact poverty (Chapter 4). For instance, the spike in food prices in 2010-11 is estimated to have increased extreme poverty by 8.3 million people. Other natural disasters, such as earthquakes and hurricanes, can inflict severe damage in the affected countries. These events are unpredictable and often force countries to overly rely on aid for reconstruction, even though recent progress in disaster risk finance has created opportunities for preventive actions (Végh et al. 2018).

Simultaneous slowdown in the two largest economies

Fiscal measures undertaken in the United States and China are supporting their near-term growth prospects; however, they could exacerbate imbalances and amplify risks of a more abrupt downturn later on. A sharper-than-expected and simultaneous slowdown in these two economies could have severe consequences for the global economy.
The policy mix in the United States will shift from expansionary to contractionary during the forecast horizon, with monetary, fiscal, and trade policies all expected to become a drag on activity within the next couple of years. In this context, relatively small negative shocks have the potential to abruptly end the current expansion, which is on track to be the longest in more than century (Figure 1.18). Although the probability of a U.S. recession in the short term is still low, at about half its level prior to previous recessions, it has increased throughout 2018.

Economic expansions do not end and give way to recessions only because they have lasted long (Castro 2013; Diebold and Rudebusch 1999; Rudebusch 2016). Instead, they tend to end as a reflection of corrections from imbalances accumulated over the business cycle. In particular, recessions often follow periods of rapid increase in debt levels and excessive asset price valuations (Claessens, Kose, and Terrones 2012; Mendoza and Terrones 2012). These imbalances tend to suddenly unwind, often during or shortly after the end of a monetary policy tightening cycle (Bernanke and Gertler 1995; Sims and Tao 2006). In the United States, three of the last four tightening cycles were indeed followed by a recession within a year and a half, with the most severe contractions following unsustainable housing market booms (Berkovec, Chang, and McManus 2012; Gelain, Lansing, and Navvik 2018; Mian and Sufi 2009). The only exception was the productivity-driven growth revival around mid-1990, which continued uninterrupted despite interest rate hikes in 1994-95.

At the present juncture, the rise in U.S. private debt is smaller than prior to past recessions, mostly because of household and bank deleveraging since the global financial crisis. U.S. corporate debt is starting to accumulate, however, raising the risk that corporate bond defaults could amplify the next downturn (FSOC 2018). On balance, the U.S. economy has some of the characteristics that have preceded relatively mild recessions, but some corporate and non-bank financial sector risks are a source of concern (IMF 2018e).

In China, risks to the outlook are increasingly tilted to the downside. Fiscal and monetary policy stimulus measures could offset the adverse effect of trade tensions with the United States but may delay efforts to contain credit growth and limit the buildup of balance sheet vulnerabilities of corporates, local governments, and financial institutions (IMF 2017; World Bank 2018a, 2018k). Both the level and growth rate of private debt stocks are well above those observed during previous credit booms in other EMDEs—two thirds of which ended in significant growth slowdowns and more than a third in financial crises (Acharya et al. 2015; Alter and Elekdag 2016). In the case of China, risks are somewhat tempered by still low central government debt, extensive capital controls, large foreign reserves, and a low reliance on external financing. That said, if financial stress were to materialize, it would likely translate into a significantly sharper-than-expected slowdown in activity (Beltran, Garud, and Rosenblum 2017; Bernadini and Forni 2017; Maliszewski et al. 2016).

The simultaneous occurrence of a severe downturn in the United States and a sharper-than-expected deceleration in China, although still unlikely in the near term, would substantially increase the risk of an abrupt global slowdown. These two economies are, together with the Euro Area, the most important source of global spillovers, and can impact the outlook for EMDEs through trade, confidence, financial-market, and commodity-market channels (World Bank 2016).

In all, a 1-percentage-point decline in U.S. growth is estimated to translate after one year into a decline in other advanced economy and EMDE growth of 0.6 percentage point for both groups. The impact of slower growth in China is around half that of a U.S. slowdown for other advanced economies (-0.3 percentage point), but it is comparable for other EMDEs (-0.6 percentage point)—and, among them, significantly larger for commodity exporters (-1.2 percentage points). Slower growth in China tends to dampen commodity prices, as this country is a primary driver of global demand for industrial commodities, especially of metals (World Bank 2018d). Critically, a combined 1-percent negative growth shock in China and the United States would have severe consequences for global growth, reducing it by almost 1 percentage point after one
year. Should such a risk materialize in the second half of 2019, global per capita growth would drop to around 1 percent in 2020, bringing the global economy somewhat closer to a global recession.\(^1\)

The probability of a global recession tends to increase noticeably when one or several systemically large economies decelerate (Kose and Terrones 2015). For instance, a recession in the United States increases the probability of a global recession from 7 percent on an average year to 50 percent. The risk of a sharp global downturn could be magnified as policymakers’ ability to respond is constrained by a lack of fiscal and monetary space and by a reduced appetite for coordinated policy responses among major economies. High levels of private and public debt also make EMDEs particularly vulnerable to adverse shocks (World Bank 2018k). The materialization of a global downturn could set back efforts to alleviate extreme poverty—including in Sub-Saharan Africa, where progress has been slow in recent years.

**Possible productivity revival**

Although global downside risks predominate, a sustained revival in productivity growth following cyclical improvements in 2017-18 could lead to stronger-than-expected global activity in coming years (Figure 1.19). An acceleration in patent applications and growing investments in intangible assets could be tentative signs of such a revival. Greater connectivity, falling computing costs, and open software architectures could also facilitate the adoption of digital technologies and enable less productive firms to catch up with the technological frontier (Andrews, Criscuolo, and Gal 2016; OECD 2018). Over the medium term, breakthroughs in data processing, artificial intelligence, and manufacturing could drive additional productivity-enhancing innovations (Brynjolfsson and McAfee 2014; Diamandis and Kotler 2012).

Economies experiencing faster productivity growth would benefit from additional policy room, as the recovery could continue without generating overheating pressures. This could allow for a more gradual pace of monetary policy tightening than currently envisioned and facilitate the necessary restoration of fiscal buffers given higher revenues. A sustained pickup in productivity could also spur additional investments and trigger a virtuous cycle between capital deepening and growth.

**Policy challenges**

**Challenges in advanced economies**

Advanced-economy monetary policy is expected to be less stimulative, especially in the United States, where tightening is proceeding more quickly than elsewhere partly in response to pro-cyclical fiscal easing. Advanced economies should use this period of above-potential growth to create the room to respond to future cyclical shocks. Longer-term prospects remain subdued and could be further eroded by major shifts in trade and immigration policies.

**Monetary and financial policies**

The U.S. Federal Reserve is gradually removing stimulus in response to low unemployment and near-target inflation amid pro-cyclical fiscal stimulus. In contrast, the European Central Bank...
suggests that the Federal Reserve has significantly less room to cut rates before reaching the zero lower bound should a new downturn occur—in the last three downturns, the Federal Reserve cut its policy rate by about 5 percentage points. To varying degrees, central banks in other advanced economies currently have even less policy space. While unconventional monetary policies could again be deployed, their effectiveness in returning inflation to target and supporting growth is subject to debate (Bernanke 2017a; Engen, Laubach, and Reifschneider 2015; Greenlaw et al. 2018). This lack of monetary space highlights the importance of avoiding a policy-driven downturn in activity, combined with research into alternative methods of providing monetary policy stimulus (Bernanke 2017b; Williams 2017).

Fiscal policy

In many advanced economies, government debt-to-GDP ratios have reached unprecedented levels, with government debt becoming the largest component of total debt. This limits the capacity of countries to provide counter-cyclical fiscal stimulus in response to economic slowdowns (Huidrom et al. 2016). The United States has enacted significant fiscal stimulus even though the economy is already at or above full employment. This stimulus is expected to result in persistent deficits equivalent to about 5 percent for most of the next decade (CBO 2018). In these circumstances, the consequence of pro-cyclical stimulus is likely to be inflation pressures, higher domestic interest rates, a crowding out of private sector activity, and a widening of the U.S. current account deficit.

Structural policies

Potential growth remains subdued in advanced economies and is likely to slow further in coming years, partly due to aging populations and declining birth rates (Figure 1.21; World Bank 2018k). An increasing number of countries are raising barriers to immigration, which might hasten this deceleration. Immigration is an important reason for rising labor forces in many advanced economies and may also contribute to and the Bank of Japan have signaled that they will be holding policy rates at current levels in the near term.
productivity growth; immigrants skew younger than host populations, and younger populations have been associated with faster labor productivity growth for various industries and occupations (Maestas, Mullen, and Powell 2016; World Bank 2018m). Heightened restrictions on immigration could also worsen fiscal positions, by dampening growth and the net contribution that immigrants typically provide to the government budget (Clements et al. 2015).

Recent trade disputes represent a critical headwind to longer-term prospects. Rising tariffs may already be contributing to weaker productivity by increasing costs, disrupting global supply chains, stranding productive assets, and relocating activity away from the most efficient locations (Melitz 2003). Lack of policy clarity also risks causing firms to delay investment because of uncertainty over market access. This highlights the critical importance of a continued commitment to a rules-based international trading system.

Increasing restrictions to trade and immigration could therefore result in weaker growth and lower productivity. While international trade and immigration can impose costs on some sectors of the economy or vulnerable groups of workers, a better course is to adopt policies that mitigate these costs and redistribute more equitably the benefits of globalization.

Challenges in emerging market and developing economies

Recent financial market stress in some EMDEs highlights the pressing need to strengthen buffers against the risk of less favorable global financial conditions. Fiscal positions remain fragile, underscoring the urgency to improve domestic revenue mobilization and to commit to or deepen fiscal reforms aimed at controlling expenditures. In the longer term, steps to enhance human capital, encourage regional economic integration, and lower barriers to investment for small- and medium-sized enterprises would boost potential growth and help tackle challenges associated with high informality. China’s key policy challenge is to foster the transition to more sustainable growth while dealing with trade-related headwinds without overstimulating the economy and delaying the deleveraging process.

**FIGURE 1.21 Structural policies in advanced economies**

Potential growth is expected to decelerate in advanced economies, partly due to demographic factors. This deceleration is likely to be more severe if government policies lead to heightened restrictions on immigration, as immigrants tend to be younger than the native population.

![Potential growth in advanced economies](chart)

**A.** Potential growth in advanced economies

<table>
<thead>
<tr>
<th>Year</th>
<th>TFP Growth</th>
<th>HPC Growth</th>
<th>MFP Growth</th>
<th>Potential Growth (TFP)</th>
</tr>
</thead>
<tbody>
<tr>
<td>2006-07</td>
<td>1.5%</td>
<td>2.0%</td>
<td>0.5%</td>
<td>3.0%</td>
</tr>
<tr>
<td>2013-17</td>
<td>2.0%</td>
<td>2.5%</td>
<td>0.5%</td>
<td>3.0%</td>
</tr>
<tr>
<td>2018-22</td>
<td>2.5%</td>
<td>3.0%</td>
<td>0.5%</td>
<td>4.0%</td>
</tr>
</tbody>
</table>

**B.** Immigrant versus native population age distribution to OECD destinations


**Policy challenges in China**

Authorities in China have shifted to looser monetary and fiscal policies in response to a more challenging external environment, including heightened trade tensions. They have cut reserve requirements, introduced new tax breaks for financial institutions lending to small firms, and encouraged banks to buy more local government bonds. They have also reduced taxes and fees, increased export tax rebates, and accelerated issuance of special purpose local government bonds to bolster infrastructure spending. In addition, the authorities have stepped up their structural reform efforts to improve the business environment, including for foreign firms, have strengthened intellectual property protection, and have lowered tariffs on imports—with the exception of some tariffs on U.S. imports in retaliation to U.S. tariffs on China’s goods. The authorities’ commitment to growth stability and structural reforms was reaffirmed in late December (CEWC 2018).

The trade disputes with the United States, as well as the ongoing moderation of global trade,
highlight China’s key policy challenge to foster the transition to more sustainable growth while dealing with trade-related headwinds without overstimulating the economy and delaying the deleveraging process (World Bank 2018b). This will require continued reforms to reduce financial vulnerabilities, including those associated with the accumulation of non-financial enterprise debt. Additional efforts to enhance market competition, encourage a shift of capital and labor toward more productive firms and sectors, and bolster household consumption would also be needed (World Bank 2018n). Advancing reforms that boost innovation, including through stronger intellectual property rights, would also help alleviate trade frictions while enhancing China’s competitiveness in the medium term. In addition, productivity-enhancing investments in health, education, and research and development would encourage a shift from growth that is dependent on physical capital and help offset the impact of adverse demographic trends.

**EMDE monetary and financial policies**

Policy challenges across many EMDEs have been compounded by recent financial market pressures that have been associated with sizable currency depreciations and capital outflows. Among some key EMDEs, currency and financial market pressures were substantial (e.g., Argentina, Turkey), leading to significant policy tightening and markedly clouding the near-term macroeconomic and financial outlook. More generally, monetary policy became less accommodative in EMDEs that faced above-average currency depreciation, or that used up reserves to stem it (Figure 1.22). Weaker exchange rates have pushed up inflation across many EMDEs, particularly in some key commodity exporters, highlighting the role of the exchange rate pass-through to domestic prices (e.g., Argentina, Brazil, South Africa; World Bank 2018p). Among commodity importers, price pressures also reflect their cyclical positions, as suggested by their positive output gaps. Higher energy prices in most of 2018 also pushed up inflation in a number of net oil importers (e.g., Egypt, Kenya, Mexico).

The ongoing normalization of advanced-economy monetary policy will continue to pose challenges for EMDEs (Arteta et al. 2015; Obstfeld 2015; Sobrun and Turner 2015). In particular, U.S. tightening cycles spillover to EMDEs mainly through the availability of foreign credit, especially through portfolio bond flows (Bräuning and Ivashina 2018; Koepke 2018). Moreover, the

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**FIGURE 1.22 EMDE monetary policy**

Monetary and financial policy challenges have been compounded by recent financial market pressures. Policy interest rates and inflation ticked up in EMDEs facing above-average currency depreciation against the U.S. dollar in 2018. The share of EMDEs hiking policy rates during U.S. tightening cycles is markedly higher than the share of EMDEs cutting rates during U.S. easing periods, suggesting that ongoing U.S. normalization may constrain the room of maneuvering for many EMDE central banks. Higher borrowing costs contributed to an increase in sovereign bond spreads, especially in EMDEs with large current account deficits.

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**A. Policy interest rates, by extent of currency depreciation against the U.S. dollar**

**B. Inflation, by extent of currency depreciation against the U.S. dollar**

**C. Share of policy interest rate changes following U.S. policy rate hikes or cuts**

**D. Change in sovereign bond spreads, by extent of current account deficit in 2018**

Source: Haver Analytics, International Monetary Fund, J.P. Morgan, Shambaugh (2004), World Bank. A. The aggregate policy interest rates are calculated using constant 2010 U.S. dollar GDP weights. B. Median consumer price inflation for each group. C. Pegged exchange rates are defined based on a de facto classification, as exchange rates fluctuating within a +/-2 percent band or, at most, a one-time devaluation over the preceding 11-month period relative to a country-specific reference currency. Refer to Shambaugh (2004) for details. Unbalanced sample includes 108 non-LIC EMDEs and considers policy rate actions from 1970 onwards. Last observation is November 2018. D. The above average and below average current account deficit groups are defined by countries above or below the 2018 sample average of the current account balance. The sovereign bond spread is measured by J.P. Morgan Emerging Market Bond Index (EMBI). Sample includes 38 EMDEs. Last observation is December 19, 2018. Click here to download data and charts.
share of EMDEs hiking policy rates during U.S. tightening cycles is markedly higher than the share of EMDEs cutting rates during U.S. easing periods, suggesting that ongoing U.S. normalization may constrain the room of maneuvering for many EMDE central banks. These challenges will be greater for those countries with large external vulnerabilities, such as sizable current account imbalances, weak foreign reserves, and high inflation or external debt (Iacoviello and Navarro 2018). In addition, higher borrowing costs may cause balance sheet, debt service, and rollover difficulties for some EMDE sovereigns and corporates, which could undermine financial stability (Borensztein and Ye 2018; World Bank 2018a). These may be particularly acute in economies facing currency mismatches on corporate and household balance sheets (Davies et al. 2014).

To confront these challenges, EMDE authorities need to urgently address persistent vulnerabilities that render their countries more susceptible to tighter financing conditions, capital flow reversals, and financial market shocks. This includes shoring up the financing of current account deficits to reduce the effects of net portfolio flow reversals, improving public and corporate balance sheet management, and implementing macroprudential frameworks that bolster banking and corporate sector resilience, such as countercyclical capital buffers and stricter reserve ratio or leverage ratio requirements (Cerutti, Claessens, and Laeven 2015; Forbes 2018). In addition, reducing exposures to foreign currency borrowing and currency mismatches, as appropriate, can help contain the financial system’s vulnerability to dislocating exchange rate movements (Ahnert et al. 2018). For EMDEs that have made progress on macroprudential reforms, enhancing financial deepening and improving governance could further boost resilience to shocks (Sahay et al. 2015).

EMDE policymakers also need to uphold a credible commitment to medium-term price stability—one that is supported by macroeconomic frameworks that set attainable inflation targets where appropriate, as well as maintain strong institutional independence and transparency. This will be especially critical if the ongoing period of low and stable global inflation comes to an end, perhaps driven by a slowdown or rollback of the structural factors that have held inflation at bay in recent decades—in particular, trade and financial integration—or an erosion of central bank independence. The reversals of these long-term trends could coincide with cyclical upward pressures on prices in some EMDEs, reigniting inflation (Box 1.1).

FIGURE 1.23 EMDE fiscal policy

For the first time in several years, fiscal deficits are projected to be wider in commodity importers than in commodity exporters. Government debt is rising among EMDEs with high foreign-currency-denominated debt or persistent current account deficits. In low-income countries, the cost of servicing debt has risen as the composition has moved from concessionary to market financing. Greater government effectiveness is associated with stronger tax revenue collection.

A. Fiscal deficits

B. Fiscal sustainability gaps, by extent of reliance on foreign-currency-denominated debt

C. Interest rate payments on debt in LICs

D. Tax revenues, by extent of government effectiveness

Source: Haver Analytics; International Monetary Fund; Kose, Kufat et al. (2017); World Bank. A.C.D. Figures show medians across groups.

A. Shaded area indicates forecasts. Sample includes 151 EMDEs.

B. FC debt = foreign-currency-denominated debt. The sustainability gap is measured as the difference between the primary balance and the debt-stabilizing primary balance, assuming historical median (1990-2016) interest rates and growth rates. A negative gap indicates government debt is rising along an accelerated trajectory. The aggregates are calculated using constant 2010 U.S. dollar GDP weights. The sample includes 27 EMDEs. The above (below) average foreign-currency-denominated debt groups are defined by countries above (below) the sample average of external debt in foreign currency as a share of total external debt in 2017. The sample average is 86.9 percent of GDP.

C. Interest rate payments include those made on government debt to domestic and foreign residents. Solid line represents median and area between the dashed lines represents the interquartile range. The sample includes 30 low-income countries and excludes Somalia, South Sudan, and Syria due to data restrictions.

D. Government effectiveness measured by the Worldwide Governance Indicators. Higher government effectiveness are EMDEs with 2000-17 averages above 0 (stronger governance); lower are EMDEs with 2000-17 average government effectiveness below 0 (weaker governance). Unbalanced sample includes 150 EMDEs. Click here to download data and charts.
**EMDE fiscal policy**

Regaining policy buffers is a key priority to be able to use countercyclical fiscal policy to stabilize growth (World Bank 2015). Efforts to build fiscal space could include implementing credible medium-term expenditure or deficit targets, better managing contingent liabilities to contain fiscal risks, stabilizing debt, and reforming the tax system to improve domestic resource mobilization and the investment climate—e.g., adjusting statutory rates, broadening bases, eliminating loopholes and exemptions, and improving tax administration and compliance. Managing the composition of debt can also help address public-sector balance sheet vulnerabilities. For EMDEs with elevated foreign-currency-denominated debt, bolstering domestic-currency bond markets, if feasible, could help stem rollover and currency risks.

To complement these efforts, improving government effectiveness and strengthening institutions would support tax revenue collection (Ajaz and Ahmad 2010; Prichard 2010). If fiscal adjustment remains necessary to ensure long-term fiscal sustainability, policymakers need to evaluate the efficacy of public expenditures, prioritizing spending on quality investment and safeguarding poverty-reducing social transfers, while reining in programs that are unproductive or inefficient (World Bank 2018k, 2018p). EMDE fiscal policymakers also need to confront the longer-term challenges posed by high informality, as its prevalence in some regions reduces government revenues through tax base erosion (Chapter 3).

**EMDE structural policies**

EMDEs also face substantial longer-term challenges to ensure sustained improvements in incomes and living standards amid rapid technological and demographic changes. Meeting these challenges will require, among other actions, effective investments in human capital, efforts to accelerate regional and global integration, and measures to free up a large untapped potential for growth and productivity gains among small- and medium-sized enterprises. Progress in these areas would also help bring people and companies out of informality.
Improving human capital

Under-investment in human capital has left large parts of the workforce in EMDEs unprepared for rapid technological changes and future skill requirements (Flabbi and Gatti 2018). This represents a significant bottleneck to growth in many countries. Moreover, continued divergences in the demand for high- and low-skilled labor could exacerbate income inequality over time. How education systems adapt to skills needs will be a key determinant of the productivity and distributional effects of technological change (Barro and Lee 2015).

Improving student learning is particularly important, starting with an effective measurement of the performance of education systems. Measures that capture both the quantity and quality of learning, such as learning-adjusted years of schooling, reflect relevant dimensions of success and are better predictors of subsequent growth across EMDEs (Figure 1.24; Filmer et al. 2018). A focus on both schooling participation and learning results can more properly inform policy actions and support effective investments in human capital (World Bank forthcoming).

Beyond a heightened focus on learning outcomes, a comprehensive approach to human capital improvements in EMDEs should also address other dimensions, including malnutrition and health throughout the life cycle. In this context, a human capital index has recently been developed to assess productivity gains that could be achieved by matching education and health outcomes to best practices (Kraay 2018). This benchmarking exercise helps to identify areas of intervention to improve public spending and governance in education and health systems—and to raise awareness of the costs of inaction (World Bank 2018q).

The urgency to bolster human capital comes in a period of constrained public-sector resources and elevated debt levels, creating a notable policy challenge. Accordingly, more effective spending in education and health will need to be accompanied by renewed efforts to prioritize government spending, improve efficiency of public administrations and revenue mobilization, and encourage private sector participation.
Boosting regional and international integration

If faced with growing protectionist measures, policymakers in EMDEs may be tempted to resort to retaliatory action or unilateral increases in barriers to trade. While such measures could help recapture some of their terms-of-trade losses, an increase in trade barriers would likely lead to significant distortional effects and efficiency losses for EMDEs (Devarajan et al. 2018). Instead, continued commitment to regional and international integration through trade liberalization, properly designed free trade agreements, and participation in global value chains (GVCs) within an open and rules-based multilateral trading system could yield significant, previously untapped benefits for EMDEs. The call of G20 members to consider additional reform of the World Trade Organization could be a chance to maximize development opportunities for EMDEs.

International integration enables firms of all sizes to increase their participation in international trade. In particular, participation in GVCs helps companies specialize in tasks closely aligned with their comparative advantage and can contribute to a more efficient allocation of resources, job creation, and export diversification. In turn, increased trade openness and GVC integration boost productivity growth and helps the diffusion of technologies (Criscuolo and Timmis 2017; Elms and Low 2013).

Many EMDEs and LICs, however, still face important challenges in fostering an environment conducive to greater GVC integration. Although their participation has increased during the last two decades, LICs still have little presence in GVCs. Participation is hindered by domestic capacity constraints and restrictive trade and investment regimes. Tariffs and other barriers to trade increase costs for firms, reduce their ability to access foreign inputs, and can impede the development of downstream industries (Miroudot, Rouzet, and Spinelli 2013). Reducing these barriers remains a key priority to support GVC participation, and to increase trade gains for many EMDEs (Kowalski at al. 2015). Closer physical integration of transport networks and other regional infrastructure can also help reduce the cost of trade and support increased openness (Donaldson 2018).

That said, increased international integration and participation in GVCs does not guarantee positive and sustainable development outcomes for EMDEs. Targeted policies that encourage the upgrading of domestic production are crucial in ensuring that the social and development impacts of GVC activities are optimized (Feser and Morris 2018; Taglioni and Winkler 2016).

Untapping SME growth potential

Supported with appropriate frameworks, small- and medium-sized enterprises (SMEs) can be key drivers of growth and job creation in EMDEs (Ayyagari, Demirgüç-Kunt, and Maksimovic 2017). They can play a central role in industrial development and restructuring, support larger firms with inputs and services, and allow increased sectoral specialization. However, their growth potential continues to be hindered by many factors, including insufficient access to finance; tax and regulatory burdens; skills mismatch; limited access to infrastructure, particularly electricity; and corruption (Wang 2016). Alleviating those obstacles could lead to significant growth windfalls for EMDEs, given that SMEs have the largest untapped potential for productivity catch-up with advanced economies (Cusolito, Safadi, and Taglioni 2017). Supporting SME development could also help reduce high informality in some regions, which is most prevalent among micro-enterprises.

Limited access to finance is most often cited as a key obstacle to SME growth in EMDEs, forcing these companies to rely on retained earnings to fund investment. This leads to sub-optimal capital spending and an unrealized potential for expansion and job creation. Key obstacles include the lack of reliable credit information, the absence of suitable collateral, and weak legal institutions. Increasing SME access to finance could help boost their average size and support innovation and job creation (Ayyagari, Demirgüç-Kunt, and Maksimovic 2017; Ayyagari et al. 2016). Improved access to finance for women
entrepreneurs could also lead to more investment, while access to savings account for female-headed households could result in additional spending on education (Demirgüç-Kunt et al. 2018; Sahay and Cihak 2018). Bankruptcy protection laws also lag international best practices in many EMDEs. Historical experience suggests that strengthening bankruptcy protection can boost investment activity and facilitate responsible corporate risk-taking, helping to relieve the costs of debt overhang (Gopalan, Mukherjee, and Singh 2016; World Bank 2014).

Beyond basic education, technological know-how, managerial capabilities, and tolerance for risk are also key factors underlying successful entrepreneurship and vibrant firm dynamics (Cusolito and Maloney 2018). Conditions that encourage experimentation and do not penalize failure are crucial to support the upgrading of firm capabilities and diffusion of technological progress. Tax, registration, and other administrative simplifications can also be successful tools to facilitate SME creation and expansion (Bruhn 2011). Finally, restrained access to infrastructure, particularly electricity, is often mentioned as a major barrier to the development of SMEs and start-up companies in many EMDEs, especially in Sub-Saharan Africa. Improvements in both traditional power line supplies and off-grid solutions such as solar energy and micro grids need to be achieved in tandem, supported by proper policy incentives and effective regulations (World Bank 2017).

**Growing out of informality**

Informality remains widespread in many EMDEs (Chapter 3). It is particularly prevalent in less developed regions, with South Asia and Sub-Saharan Africa accounting for nearly 60 percent of all informal workers in EMDEs. It is also elevated in regions with weak institutions and high levels of fiscal and regulatory burdens, such as Latin America and the Caribbean and Europe and Central Asia.

While the informal economy provides an important safety net to workers, particularly during downturns, it can dampen growth by weighing on physical and human capital formation (Docquier, Müller, and Naval 2017; Oviedo, Komas, and Karakurum-Ozdemir 2009). In particular, firms operating in the informal economy tend to limit their size to avoid detection and use less advanced production technologies (Dabla-Norris et al. 2018). Their lack of compliance with regulations and taxes may help them stay in business despite low productivity (La Porta and Shleifer 2014; Schneider and Enste 2000; Box 3.4).

High informality can also limit fiscal revenues and thus can constrain the ability of governments to provide public services, conduct counter-cyclical policies, and implement effective redistributive measures (Besley and Persson 2014; Ordóñez 2014). Both government revenues and expenditures are lower in EMDEs where informality is widespread. High informality is often associated with lack of development, limited access to finance, low human capital, poor governance, and heavy regulatory burdens. If properly designed, policies that help improve outcomes in those areas would bolster growth prospects and encourage workers to participate in the formal economy, thus helping reduce informality and its associated challenges.

Policies that are implemented with other purposes in mind also need to take into consideration the unintended consequences on informality. For example, changes in labor market regulation accompanying the decentralization of minimum-wage-setting responsibilities or the liberalization of trade have resulted in higher informality in some countries (Artanzio, Goldberg, and Pavcnik 2004; Goldberg and Pavcnik 2003; Chapter 3; Box 3.4). These experiences are a reminder of the need to design comprehensive reform packages that are calibrated to country circumstances.
### TABLE 1.2 List of emerging market and developing economies

<table>
<thead>
<tr>
<th>Commodity exporters&lt;sup&gt;1&lt;/sup&gt;</th>
<th>Commodity importers&lt;sup&gt;2&lt;/sup&gt;</th>
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<td>Equatorial Guinea*</td>
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<td>Guyana</td>
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<td>Kuwait*</td>
<td>West Bank and Gaza</td>
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<td>Kyrgyz Republic</td>
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<td>Lao PDR</td>
<td>Zimbabwe</td>
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<td>Liberia</td>
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</table>

<sup>1</sup> Energy exporters.

<sup>2</sup> Emerging market and developing economies (EMDEs) include all those that are not classified as advanced economies. Dependent territories are excluded. Advanced economies include Australia; Austria; Belgium; Canada; Cyprus; the Czech Republic; Denmark; Estonia; Finland; France; Germany; Greece; Hong Kong SAR, China; Iceland; Ireland; Israel; Italy; Japan; the Republic of Korea; Latvia; Lithuania; Luxembourg; Malta; Netherlands; New Zealand; Norway; Portugal; Singapore; the Slovak Republic; Slovenia; Spain; Sweden; Switzerland; the United Kingdom; and the United States.

<sup>3</sup> 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).

<sup>4</sup> Commodity importers are all EMDEs that are not classified as commodity exporters.
References


