3 Shrinking Spaces

Key messages

- The growth prospects of middle-income countries are becoming more problematic because of an increasingly fragmented global economy, rapidly changing demographic trends, multiple crises, populist pressures, rising government debt, and climate change pressures.
- Previous episodes of growth acceleration have been accompanied by trade integration, but rising geopolitical tensions have affected trade policy, and further protectionism can potentially worsen the diffusion of knowledge to low- and middle-income countries.
- Many middle-income countries are severely indebted in the aftermath of the COVID-19 pandemic, and monetary tightening in high-income countries risks compounding the burden of high debt.
- Middle-income countries will need significant resources to scale up reliable low-carbon energy. But many face the rising cost of borrowing, high up-front infrastructure requirements, and high capital costs, all of which could increase the cost of low-carbon technologies and delay the diffusion of low-carbon energy.

Introduction

Growing past middle-income status has never been easy—slowing growth (chapter 1) and structural stasis (chapter 2) dampen growth prospects. This chapter asks whether growth in middle-income countries is becoming harder. The answer: it is.

Two decades into the twenty-first century, the world is at a historic crossroads. Foreign trade and investment are in danger of becoming constricted by geopolitical tensions, and the room for governments to act is shrinking because of rising populism and public debt. As a result, economic growth in the remainder of this decade will likely be weaker than it was in the last two.¹

For middle-income countries, this prospect means they are growing into shrinking spaces with the retrenchment of globalization (a force that has spurred infusion and innovation), difficulties in servicing debt obligations, and the additional economic and financial costs of climate change and climate action. On the latter, middle-income countries will need to build resilience to the shocks arising from a changing climate, as well as accelerate their energy transitions. Such challenges will have to be confronted against the backdrop of a rapidly aging world population and therefore waning demographic dividends (box 3.1). At the same time, middle-income countries need to ensure macroeconomic stability since it is essential for high and sustainable rates of growth. Macroeconomic instability will increase the cost of borrowing and keep both domestic and foreign investors away.
Box 3.1 Graying growth

Historically, demographic dividends have fostered economic growth in many countries. An increase in the working-age population and a consequent decrease in dependency ratios free up resources to be spent on education, health care, employment, and social protection schemes. However, the world is aging rapidly and fertility rates are declining rapidly, which will especially affect middle-income countries projected to face labor crunches in the coming decades. In fact, today’s middle-income countries are aging more rapidly than high-income countries did in the past. Transitioning from an aging society to an aged society took about 61 years in today’s high-income countries and as long as 69 years in the United States and 115 years in France. By contrast, transitioning from an aging society to an aged society is estimated to take about 26 years for today’s middle-income countries (figure B3.1.1).

Figure B3.1.1 Today’s middle-income countries are aging more rapidly than high-income countries did in the past


Note: The bars indicate beginning and end years for transitioning from 7 percent (aging) to 14 percent (aged) of the population age 65 and older. The number corresponding to each bar shows total number of years to transition from aging to aged. Aging and aged thresholds are based on definitions by the Population Division of the United Nations Department of Economic and Social Affairs (UN DESA). Bars for income groups represent the averages of countries included in the corresponding income group. The dashed vertical line indicates the year 2023.

(Box continues next page)
Box 3.1 Graying growth (continued)

Working-age populations are already declining in middle-income countries in East Asia. Latin America will retain a large workforce until the early 2040s, while the Middle East and North Africa and South and Central Asia regions will begin to lose working-age persons by 2045. As a result, middle-income countries can no longer rely on increasing employment as a primary source of output growth. This prospect of “growing old before becoming rich” makes escaping the middle-income trap more challenging and more urgent, including among the largest middle-income countries such as Brazil, China, Mexico, and Türkiye.

The demographic challenge has implications for public policy. Investments will be needed in infrastructure and technologies to support the elderly, in addition to expanding fiscal transfers for older persons. These measures will, in turn, necessitate policies that support savings among the working-age population. Meanwhile, countries will need to invest in upgrading skills of their workforce and ensuring that everyone’s talent is used appropriately and efficiently. Furthermore, automation and other productivity-enhancing technologies to compensate for a shrinking workforce will have to be deployed and have been prioritized by aging countries such as Japan. The path from imitative to innovative growth is the key for middle-income countries to address the needs of their aging populations.

Finally, the booming populations in low-income countries and lower-middle-income countries in Sub-Saharan Africa and elsewhere will need to be integrated into graying societies’ labor markets (especially those in middle-income countries). Canada has successfully relied on immigration as a strategy to manage its low fertility rates and labor shortages. World Development Report 2023: Migrants, Refugees, and Societies argues that if managed effectively, migration could unlock further growth for destination countries. And this migration need not be a brain drain imposed on lower-income countries with high population growth rates. For example, professional links established between expat scientists and those they leave behind may generate knowledge spillovers in their countries of origin.

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a. UN DESA (2022). *Dependency ratios* refer to the number of children (ages 0–14) and older persons (age 65 and over) to the working-age population (ages 15–64).
b. Lee and Mason (2006); UN DESA (2022).
c. Aging society and aged society thresholds are based on the definition of the Population Division of the United Nations Department of Economic and Social Affairs (UN DESA). According to the definition, the share of people age 65 and older exceeds 7 percent of the population in an aging society, and a country qualifies as an aged society if this share exceeds 14 percent.
d. UN DESA (2022).
e. Moss (2017).
g. Green (2023).
h. World Bank (2023b).
i. Prato (2023).
Fragmenting international trade

Episodes of growth acceleration have been accompanied by trade integration. The Republic of Korea’s economic metamorphosis was underpinned by a licensing regime to import frontier technologies, followed by a shift toward promotion of research and development. The Korean story suggests that catching up and eventually leading the pack requires trade liberalization to buy foreign technology and to sell a country’s own inventions. More broadly, globalization has increased incentives to adopt foreign technologies by enhancing international competition.

But the international trade architecture that allowed countries such as Korea to ascend is facing challenges. First, declining potential global output threatens trade flows, compounding the blows dealt by the global financial crisis and the COVID-19 pandemic. Second, rising geopolitical tensions have affected trade policy, and further protectionism could worsen the diffusion of knowledge to low- and middle-income countries. Although there is limited evidence of widespread “friend-shoring” or realignment of trade along geopolitical lines beyond the United States–China decoupling, this situation could change in the near future if trade tensions continue to rise. Many industries that use technology and innovation intensively will face extensive costs and risks if critical global links are reduced because these links are at the heart of technology-intensive industries such as information and communication technology (ICT) and smartphones. Globally, since 2019 the number of harmful trade policies has exceeded the number of helpful trade policies, and the pace of their enactment is increasing: the number of new harmful trade measures enacted per year doubled over the last decade (figure 3.1).

Figure 3.1 Globally, harmful trade policies outnumber helpful trade policies

Source: WDR 2024 team using the GTA (Global Trade Alert) database, St. Gallen Endowment for Prosperity through Trade, University of St. Gallen, St. Gallen, Switzerland, https://www.globaltradealert.org/data_extraction.

Note: Measuring trade policies is fraught with challenges, and the GTA database may overrepresent countries that issue a relatively high quantity of legislative documents or those with greater regulatory transparency. The plotted lines indicate global trade policies that were introduced in the corresponding year. Helpful trade policies include interventions that liberalize on a nondiscriminatory basis or improve the transparency of a relevant policy. Harmful trade policies include interventions that discriminate against foreign commercial interests. See Harmonized System (dashboard), World Customs Organization, Brussels, https://www.wcotradetools.org/en/harmonized-system.
Moreover, most high-income and large middle-income countries are now increasingly resorting to industrial policy and trade-related measures that may result in restrictions to trade flows. For example, some of the largest trading nations have adopted a “friend-shoring” approach that concentrates their supply chain network among allies and friendly countries in response to rising tensions with the Russian Federation and China. In addition, the costs associated with technological fragmentation are estimated to be as high as 5 percent of the gross domestic product (GDP) for many economies. Compounding that are the high risks associated with disrupting critical industries and global supply chains. In a deglobalized scenario, some critical industries may be unable to function, or it would take decades for those industries to catch up their current levels of functionality because of their massively modular industrial organization. Unfortunately, harmful interventions to block the trade of critical technologies have more than tripled since 2019 (figure 3.2).

**Elevated debt**

Global debt relative to GDP has remained stubbornly high in the aftermath of the COVID-19 pandemic (figure 3.3). Indeed, many middle-income countries are more severely indebted than ever before. Postpandemic fiscal deficits in response to spikes in food and energy costs...
have kept public debt levels elevated. Meanwhile, monetary tightening in high-income countries risks compounding the burden of high debt-to-GDP ratios for middle-income countries. About three-quarters of countries tightened both fiscal and monetary policy in 2022. As interest rates have surged, government budgets have been squeezed. This squeeze has increased sovereign spreads and borrowing costs for many emerging and frontier markets. The resulting loss of market access for some of these countries and the lack of access to these avenues of relief are likely to result in a wave of uncoordinated defaults in middle-income countries over the medium term. Unfortunately, there is no sign of relief because high-income countries are likely to sustain high interest rates for the foreseeable future (figure 3.4). Many low- and middle-income countries now spend more on debt service payments than they do on health, education, and infrastructure. Because fiscal space is eroding due to costlier borrowing in low- and middle-income countries, new investment needs—including in the green transition, education, the capacity to innovate, and infrastructure—are likely to be put on hold.

Encouraging growth in low- and middle-income countries under the current circumstances will not be easy. Reducing debt vulnerabilities and reversing long-term debt trends should be at the core of these countries’ agendas. In particular, the governments of middle-income countries urgently need to take steps to alleviate debt distress in the medium term. More broadly, reforms to improve debt transparency and strengthen debt management policies and frameworks are key to reducing the risks of debt distress. These reforms could also foster economic growth if they are coupled with reforms in labor markets and product markets. In addition, reducing debt burdens is crucial to creating the fiscal space for investments in health, education, and infrastructure. Middle-income countries can make quick progress in transitioning to higher-income status only if they achieve strong and sustained investment growth.
**Figure 3.4** Debt service payments in emerging markets and middle-income countries may skyrocket as the cost of borrowing soars

![Graph showing debt service payments](image)

Source: WDR 2024 team using data from Fiscal Monitor (dashboard), International Monetary Fund, Washington, DC, [https://data.imf.org/?sk=4be0c9cb-272a-4667-8892-34b582b21ba6](https://data.imf.org/?sk=4be0c9cb-272a-4667-8892-34b582b21ba6).

Note: GDP = gross domestic product.

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**Climate action**

Fossil fuels—coal, oil, and natural gas—are the major contributors to global climate change, accounting for over three-fourths of total greenhouse gas emissions and about 90 percent of carbon dioxide (CO\(_2\)) emissions.\(^{16}\) The International Energy Agency has announced that achieving net zero emissions by 2050 will require reducing between 2020 and 2050 the global demand for coal by 90 percent, oil by 75 percent, and natural gas by 55 percent.\(^{17}\) Therefore, climate action—measures to mitigate climate change—requires changing the way energy is produced and consumed.

Because middle-income countries presently account for about two-thirds of global CO\(_2\) emissions, their decarbonization is material to the world’s ability to meet its climate goals. Today, both energy intensity and carbon intensity are quite high in middle-income countries (figure 3.5). Energy intensity (panel a) in middle-income countries is about double that in high-income countries, and the carbon intensity of their energy consumption (panel b) is also relatively inefficient.

At the same time, reliable cheap energy is critical to supporting industrial activities and powering businesses. It is also correlated with higher living standards. But over 300 million people in middle-income countries still lack access to electricity. Moreover, blackouts and brownouts are common in middle-income countries. As energy demand rises with income, expanding access to reliable energy will be as critical as transitioning to lower-carbon energy.\(^{18}\)

Today, energy transition technologies constitute the largest investment gap. Significant resources are needed to scale up reliable, low-carbon energy. Low-carbon energy technologies

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\(^{18}\) The International Energy Agency has announced that achieving net zero emissions by 2050 will require reducing between 2020 and 2050 the global demand for coal by 90 percent, oil by 75 percent, and natural gas by 55 percent.
Figure 3.5 In middle-income countries, the energy intensity and carbon intensity of energy consumption are quite high

![Chart showing energy intensity and carbon intensity of energy consumption for LMICs, UMICs, and HICs.](chart)


Note: Data for low-income countries are not available. GtCO₂ = gigatons of carbon dioxide; HICs = high-income countries; LMICs = lower-middle-income countries; UMICs = upper-middle-income countries.

require considerable up-front capital despite lower operating expenses. Thus middle-income countries need access to low-cost capital to increase the affordability of low-carbon energy transitions because considerable improvement of capital-intensive clean energy assets—such as wind power, solar photovoltaic (PV), electric vehicles, and hydrogen electrolysers—is required. The cost of capital is key because the weighted average cost of capital can account for 20–50 percent of the levelized cost of electricity from utility-scale solar PV projects. And yet the cost of capital for utility-scale solar power projects in middle-income countries is significantly higher than that in the United States and Europe (figure 3.6). High up-front infrastructure requirements and capital costs could potentially increase the cost of low-carbon technologies.

High borrowing costs make it more challenging for middle-income countries to finance green energy investments and to diffuse low-carbon energy. In addition, developing countries are currently spending more on interest payments than on climate investments even though they need to more than triple climate investments to meet the Paris Agreement targets.

Meanwhile, middle-income countries are more exposed to risks from climate change than high-income countries and have less capacity to adapt to such risks (figure 3.7). They also face overwhelmingly high costs to finance climate adaptation. In 2030, annual adaptation costs are estimated to exceed 1 percent of GDP per year for some middle-income countries, while annual global adaptation needs will reach about 0.25 percent of global GDP.

The room for governments to act in middle-income countries is shrinking because of rising debt and interest rates, and their feeble growth prospects stem from a weakening foreign trade and investment outlook. In addition, international
pressures and domestic pledges for climate action will require these countries to allocate substantial investment to adaptation and mitigation. With many middle-income economies facing high debt and higher borrowing costs, a policy dilemma arises between achieving ambitious climate actions that pay off in the longer term and averting short-term macroeconomic imbalances.

The constraints facing middle-income countries and the extensive and frenetic pace of change required for them to transition to high-income status make policy making more challenging than at the low- or high-income stage. The chapters that follow focus on feasible steps that could aid this transition.
Figure 3.7 Low- and middle-income countries are exposed to similar levels of risk from climate change, and they have less adaptive capacity.

Source: WDR 2024 team using data from ND-GAIN Country Index (University of Notre Dame Global Adaptation Index) (dashboard), University of Notre Dame, Notre Dame, IN, https://gain.nd.edu/our-work/country-index/.

Note: The solid lines show the linear relationship for each country group.

Notes
1. World Bank (2023a).
3. Choi and Shim (2024).
5. Goldberg and Reed (2023); Kose and Ohnsorge (2024).
6. Góes and Bekkers (2022); Goldberg and Reed (2023).
15. IMF (2023a).
17. IEA (2021b).
20. IEA (2021a).
22. UNCTAD (2024).

References
Aligishiev, Zamid, Matthieu Bellon, and Emanuele Massetti. 2022. “Macro-Fiscal Implications of Adaptation to Climate Change.” IMF Staff Climate Note 2022/002 (March), International Monetary Fund, Washington, DC.


