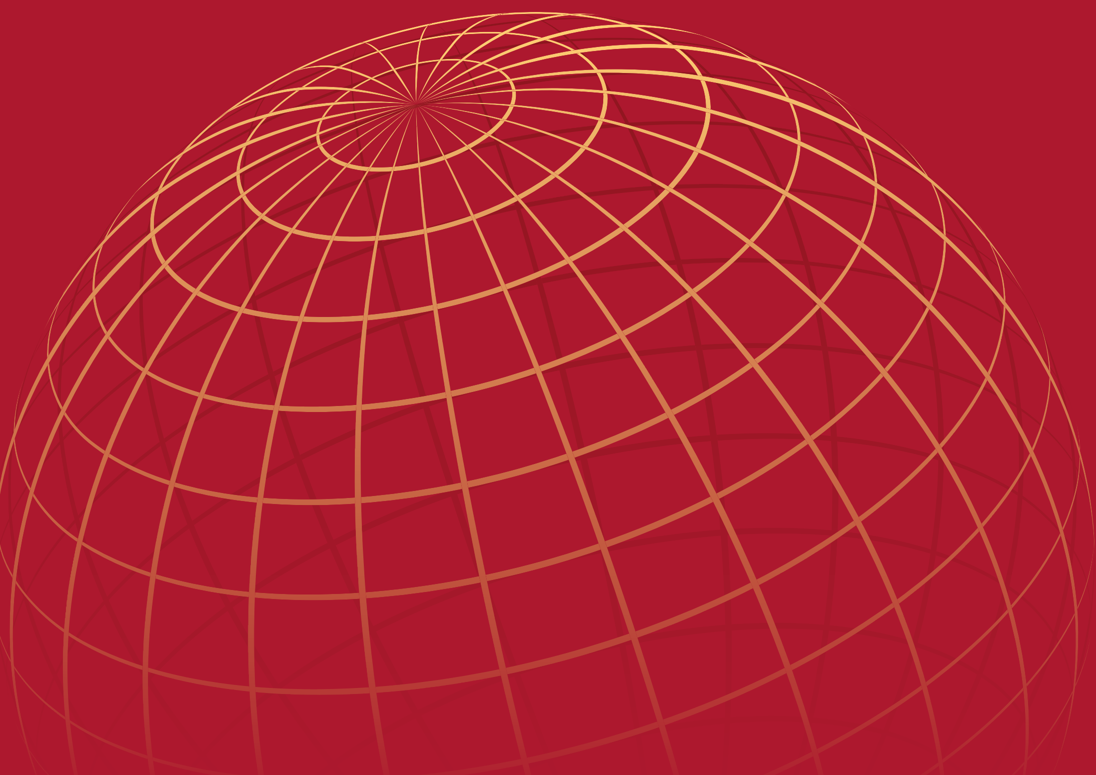
A World Bank Group
Flagship Report

JANUARY 2016

Global Economic Prospects

Spillovers amid Weak Growth



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Foreword

Emerging market economies have been an engine of global growth during the 2000s, especially after the 2007-08 global financial crisis. However, times are changing. Growth rates in several emerging market economies have been declining since 2010. The global economy will need to adapt to a new period of more modest growth in large emerging markets, characterized by lower commodity prices and diminished flows of trade and capital. This is the message that underlies this issue of the World Bank Group's *Global Economic Prospects*.

The report offers a detailed outlook for the global economy and each of the world's emerging market regions. It analyzes themes vital to policy makers in emerging markets and elsewhere. These include how the slowdown in major emerging markets affects the rest of the world, including their regions and their neighbors; the potentially far-ranging macro-economic implications of the Trans-Pacific Partnership trade accord; and risks and opportunities offered by low commodity prices for low-income countries with recent discoveries of natural gas, oil, metals, and other natural resources. The report also examines capital controls and other strategies that countries with different exchange rate regimes can use to better shield themselves from financial turmoil.

Looking ahead, global growth is poised to recover modestly, by 2.9 percent in 2016, after (once again) falling short of expectations at 2.4 percent in 2015, held back by weak capital flows to emerging and developing countries, weak trade and low commodity prices. Under the baseline scenario, it is expected that China will steer its economy to a more consumption- and services-led growth and the monetary policy tightening cycle in the United States will proceed without undue turbulence; as a consequence, global growth will see a modest upturn.

This outlook is expected to be buttressed by recovery in major high-income economies, stabilizing commodity prices, and a continuation of low interest rates. All this does not rule out the fact that there is a low-probability risk of disorderly slowdown in major emerging markets, as U.S. interest rates rise after a long break and the US dollar strengthens, and as a result of geopolitical concerns.

The simultaneous slowing of four of the largest emerging markets—Brazil, Russia, China, and South Africa—poses the risk of spillover effects for the rest of the world economy. Global ripples from China's slowdown are expected to be greatest but weak growth in Russia sets back activity in other countries in the region. Disappointing growth again in the largest emerging markets, if combined with new financial stress, could sharply reduce global growth in 2016.

Meanwhile, the Trans-Pacific Partnership could potentially provide a boost to growth and trade in its member countries. The detrimental effects on non-members as trade is diverted could be mitigated by beneficial effects from greater regulatory harmonization, streamlining and transparency.

In the current environment, developing countries need to brace for possible shocks by building resilience to risks to growth. Where they are able to boost government spending or lower interest rates, they can provide support to economic activity. They can further encourage investor confidence with reforms to governance, labor market functioning, and business environments. Measures to absorb young workers or to increase workforce participation will relieve demographic pressures in many countries.

Kaushik Basu

Chief Economist and Senior Vice President

The World Bank

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Executive Summary

Global growth again fell short of expectations in 2015. Growth is projected to edge up in 2016-18 but the forecast is subject to substantial downside risks. In addition to discussing global and regional economic developments and outlook, this edition of the Global Economic Prospects also includes analysis of key challenges and opportunities currently confronting emerging and developing countries: spillovers from a slowdown in major emerging markets; the potential macroeconomic implications of the Trans-Pacific Partnership; and the links between exchange rate regimes and capital controls in emerging and developing countries. It also includes a study on vulnerabilities accumulating between commodity discovery and production in low-income countries.

Global Outlook: Disappointments, Risks, and Spillovers. Global growth again fell short of expectations in 2015, decelerating to 2.4 percent from 2.6 percent in 2014 (Chapter 1). The disappointing performance mainly reflected a continued growth deceleration in emerging and developing economies amid post-crisis lows in commodity prices, weaker capital flows and subdued global trade. Global growth is projected to edge up in the coming years, but at a slower pace than envisioned in June 2015, reaching 2.9 percent in 2016 and 3.1 percent in 2017-18. This pickup is predicated on continued gains in major high-income countries, a gradual tightening of financing conditions, a stabilization of commodity prices, and a gradual rebalancing in China. The forecast is subject to substantial downside risks, including a disorderly slowdown in major emerging market economies, financial market turmoil arising from sudden shifts in borrowing costs amid deteriorating fundamentals, lingering vulnerabilities in some countries, and heightened geopolitical tensions. Weakening growth and sharply lower commodity prices have narrowed the room for policy makers to respond, especially in commodity-exporting countries, should risks materialize.

Who Catches a Cold When Emerging Markets Sneeze? Given the size and global economic integration of the largest emerging markets—Brazil, the Russian Federation, India, China, and South Africa (BRICS)—the simultaneous slowdown underway in all but one of them could have significant spillovers to the rest of the world (Chapter 3). Specifically, a 1 percentage point decline in growth in BRICS is associated with a reduction in growth over the following two years by 0.8 percentage points in other emerging markets, 1.5 percentage points in frontier markets, and 0.4 percentage points in the global economy. Spillovers could be considerably larger if the growth slowdown in BRICS were combined with financial market turbulence.

Within-Region Spillovers. Within-region spillovers from BRICS and other major emerging markets are discussed in Boxes 2.1-2.6 of Chapter 2. Since most BRICS are the largest and most integrated economies in their respective regions, they tend to generate larger spillovers than other major emerging markets. Strong within-region trade and remittance links are reflected in sizeable spillovers in Europe and Central Asia from a growth decline in Russia, and in East Asia and Pacific from a growth decline in China (Boxes 2.1 and 2.2). In other regions, measured within-region spillovers are typically small (Boxes 2.3-2.6), partly reflecting the lesser openness of major regional emerging markets or the prevalence of integration with major advanced economies. Many emerging market and developing countries are still most susceptible to growth spillovers from major advanced markets.

Potential Macroeconomic Implications of the Trans-Pacific Partnership. On October 4, 12 Pacific Rim countries concluded negotiations on the Trans-Pacific Partnership. The first essay in Chapter 4 shows that, if ratified by all, the agreement could raise GDP in member countries by an average of 1.1 percent by 2030. It could also increase member countries' trade by 11 percent by 2030. A common regulatory approach could buoy trade provided it is not associated with excessively restrictive requirements on rules of origin and standards. As long as regulatory reforms benefit non-members, the detrimental effects of the agreement due to trade diversion and preference erosion on non-members would be limited.

Peg and Control? The Links between Exchange Rate Regimes and Capital Account Policies. As emerging and developing countries prepare to shield themselves from risks to the global outlook, they need to consider policy responses to adjust to external shocks. Among these, some countries might rely on exchange rate flexibility as a buffer, some might aim to minimize currency fluctuations, and some might consider measures to limit capital flows as they seek to keep some degree of monetary policy control. The second essay in Chapter 4 explores how emerging markets and developing countries manage these competing pressures. The results suggest that developing countries with fixed exchange rate regimes appear to be more likely to have capital flow restrictions. This effect is particularly pronounced for lower-income countries.

From Commodity Discovery to Production: Vulnerabilities and Policies in Low-Income Countries. Major natural resource discoveries have transformed growth prospects for many low-income countries (LICs), though the sharp post-crisis downturn in commodity prices may delay development of these discoveries into production. During the pre-production period, macroeconomic vulnerabilities in these economies may rise as a result of large-scale investment needs. This heightens the importance of reducing lead times between discovery and production. The Special Focus finds that such lead times can be shortened by several years through improvements in business environments that benefit resource and non-resource sectors alike. Separately, while growth in LICs eased in 2015, it continued to be robust at about 5 percent, sustained by investment (both public and private, including in mining) and rising farm output. For 2016-17, strengthening import demand in advanced economies should help support activity in these countries.

Abbreviations

ASEAN	Association of Southeast Asian Nations
bbl	barrel
BRICS	Brazil, Russian Federation, India, China, and South Africa
BVAR	Bayesian Vector Autoregression
CFM	capital flow measures
DEV	developing countries
EAP	East Asia and Pacific
ECA	Europe and Central Asia
ECB	European Central Bank
EM	emerging market economies
EMBI	Emerging Markets Bond Index
ERR	exchange rate regime
EU	European Union
FDI	foreign direct investment
FM	frontier markets
FTA	free trade agreements
FY	fiscal year
GCC	Gulf Cooperation Council
GDP	gross domestic product
GEP	Global Economic Prospects
HIC	high-income country
HIY	high-income country
IMF	International Monetary Fund
LAC	Latin America and Caribbean
LDC	least developed country
LIC	low-income country
MNA	Middle East and North Africa
MIMT	Mexico, Indonesia, Malaysia, and Turkey
MRTA	mega-regional trade agreements
NAFTA	North America Free Trade Agreement
NTM	non-tariff measures
ODA	official development assistance
OECD	Organisation for Economic Co-operation and Development
OPEC	Organization of the Petroleum Exporting Countries
PPP	purchasing power parity
REER	real effective exchange rate
RHS	right-hand side (in figures)

RTA	Regional Trade Agreements
SAR	South Asia region
SSA	Sub-Saharan Africa
TFP	total factor productivity
TPP	Trans-Pacific Partnership
T-TIP	Transatlantic Trade and Investment Partnership
VAR	vector autoregression
VAT	value-added tax
WDI	World Development Indicators
WEO	World Economic Outlook
WTO	World Trade Organization