A World Bank Group
Flagship Report

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Global Economic Prospects

Heightened Tensions, Subdued Investment

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Foreword

Global growth has continued to weaken and momentum remains fragile. As this edition of the *Global Economic Prospects* report documents, investment is sluggish. Downside risks to growth predominate, including rising trade barriers, a build-up of government debt, and deeper-than-expected slowdowns in several major economies.

Substantial challenges are clouding the global economic outlook in both the near and long term. For emerging market and developing economies (EMDEs), lackluster investment is particularly concerning. Investment growth in these economies is expected to remain weak and below historical averages, held back by sluggish global growth; limited fiscal space; and structural constraints that misallocate or discourage investment such as poor business environments, labor and product market controls, and weak governance. Subdued investment weakens the foundations for the sustained growth that is needed to alleviate extreme poverty and advance shared prosperity.

In an era of low interest rates, government borrowing might appear to be an attractive option to finance growth-enhancing investment projects. Debt is often an important tool for development and poverty reduction, and sustainable borrowing can help countries finance investments in infrastructure, health, education, and other essential areas. To be additive to growth, however, debt has to be transparent and well managed. Otherwise, it becomes more of a burden than a benefit by increasing vulnerability to crises, eroding the effectiveness of macroeconomic policy, and weighing on investment and growth.

Unsustainable debt levels have become increasingly troublesome in the last few years, with incentives often working against transparency. As this report highlights, EMDE government debt is higher than before the global financial crisis by an average of 15 percentage points of GDP. The bottom line is that EMDEs need to strike a careful balance between acquiring debt to promote investment growth and avoiding risks associated with excessive levels and hidden forms of debt.

This report also details the difficulties low-income countries face in the effort to improve living standards. A number of these countries achieved middle-income status between 2000 and 2018, but current low-income countries face a steeper road to deliver the same progress. Relative to countries that made the earlier leap to middle-income ranks, many of today's low-income countries are poorer, more fragile, constrained geographically, and heavily reliant on subsistence agriculture. It will take comprehensive policy changes to tackle these difficulties.

Policymakers have a wide range of options to bolster investment and growth. In light of the formidable challenges, big policy adjustments are urgently needed, including decisive action to undertake structural reforms for growth that will lead to stronger development outcomes for countries.

David Malpass
President
The World Bank Group

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Executive Summary

Global growth has continued to soften this year. Momentum remains weak and policy space is limited. A subdued recovery in investment growth in emerging market and developing economies (EMDEs) dampens potential growth prospects and hampers progress toward achieving the Sustainable Development Goals. Risks remain firmly on the downside, including the possibility of escalating trade tensions, sharper-than-expected slowdowns in major economies, and renewed financial stress in EMDEs. Meanwhile, rising debt constrains the ability of EMDE governments to support economic activity in the event of adverse developments, as well as finance growth-enhancing investments. This highlights the need for policy actions to undertake reforms to boost private investment and productivity growth. These reforms are particularly urgent in low-income countries, which face more significant challenges today than they did in the early 2000s.

Global Outlook. Global growth in 2019 has been downgraded to 2.6 percent, 0.3 percentage point below previous forecasts, reflecting weaker-than-expected international trade and investment at the start of the year. Growth is projected to gradually rise to 2.8 percent by 2021, predicated on continued benign global financing conditions, as well as a modest recovery in emerging market and developing economies (EMDEs) previously affected by financial market pressure. However, EMDE growth remains constrained by subdued investment, which is dampening prospects and impeding progress toward achieving development goals. Risks are also firmly on the downside, in part reflecting the possibility of destabilizing policy developments, including a further escalation of trade tensions between major economies; renewed financial turmoil in EMDEs; and sharper-than-expected slowdowns in major economies. It is therefore urgent for EMDEs to reinforce policy buffers and build resilience to possible negative shocks, and to implement reforms that promote private investment and improve public sector efficiency. Efforts to strengthen access to markets and technology while boosting the quality of infrastructure and governance should be prioritized and be implemented through cost-effective and private-sector-led solutions. Structural reforms aimed at improving the business climate would also boost growth prospects. Well-designed social safety nets and active labor market policies are key to managing risks and protecting vulnerable groups.

This edition of *Global Economic Prospects* includes analytical essays on the benefits and risks of government borrowing, recent investment weakness in EMDEs, the pass-through of currency depreciations to inflation, and the evolution of growth in low-income countries (LICs).

Debt: No Free Lunch. Government debt has risen substantially in EMDEs, by an average of 15 percentage points of GDP since 2007 to 51 percent of GDP in 2018. The current environment of low global interest rates and weak growth may appear to mitigate concerns about elevated debt levels. Considering currently subdued investment additional government borrowing might also appear to be an attractive option for financing growth-enhancing initiatives such as investment in human and physical capital. However, history suggests caution: the cost of rolling over debt can increase sharply during periods of financial stress and result in financial crises; high debt levels can limit the ability of governments to provide fiscal stimulus during downturns; and high debt can weigh on investment and long-term growth, especially at a time when investment momentum is already weak. Hence, EMDEs need to strike a careful balance between taking advantage of low interest rates and avoiding the potentially adverse consequences of excessive debt accumulation. This is particularly critical at present given the set of risks facing the global economy, which will require EMDEs to have adequate fiscal policy space and build resilience to financial market disruptions.

Investment: Subdued Prospects, Strong Needs. Investment growth in EMDEs over the next three years is expected to be subdued and below historical averages. This continues a prolonged, broad-based slowdown after the global financial crisis, notwithstanding a modest recovery between 2016 and 2018. During the forecast period, EMDE investment growth is expected to be held back by weak global growth, limited fiscal space against the backdrop of elevated debt, and the presence of several structural constraints. Weak investment is a concern because it will further dampen potential growth, and make achieving the Sustainable Development Goals more difficult. Depending on country circumstances, the use of appropriate fiscal and structural reforms could generate upside potential for investment in the medium and long term. For EMDEs with limited fiscal space, institutional reforms to improve business conditions could help attract private investment. In light of elevated debt levels, policymakers should also ensure resources are allocated to high quality investment projects and improve the transparency and efficiency of public investment management systems where necessary.

Currency Depreciations, Inflation and Central Bank Independence. Financial market turbulence in 2018 illustrated, once again, that EMDEs continue to face the risk of destabilizing exchange rate movements. These stress episodes often compel central banks to tighten policy to lessen currency pressures and fend off inflationary pressures despite slowing growth. To design appropriate policies it is important to quantify the exchange rate pass-through to inflation associated with different shocks and with different country characteristics. The pass-through to inflation tends to be largest when currency movements are triggered or amplified by monetary policy action. In contrast, the pass-through is significantly smaller when central banks pursue a credible inflation target, operate in a flexible exchange rate regime, and are independent from fiscal authorities. This highlights the critical importance of central bank credibility, given the self-reinforcing feedback loop between credibility, the exchange rate and price stability. These episodes also serve as a reminder of the risks posed by excessive levels of foreign currency debt, and EMDEs can foster resilience to periods of financial stress by issuing debt contracted at longer maturities, at fixed interest rates, and denominated in local currency, where possible.

Growth in Low-Income Countries: Evolution, Prospects and Policies. There are currently 34 countries classified as low-income, about half the number in 2001. Rapid growth in low-income countries from 2001-18 allowed many to progress to middle-income status, supported by a pre-crisis commodity price boom, the MDRI and HIPC debt relief initiatives, increased investment in human and physical capital, improved economic policy frameworks, and recoveries from the deep recessions in transition economies during the 1990s. However, the prospects for today's LICs appear much more challenging. Compared to the LICs in 2001 that became middle-income countries, today's LICs are further below the middle-income threshold and more often fragile than were LICs in 2001. Their heavy reliance on agriculture makes them vulnerable to climate change and extreme weather events, and their scope to boost external trade is limited by geography. Coordinated and multi-pronged policy efforts are required to address these challenges.

Abbreviations

ACP	African, Caribbean and Pacific Group of States
AE	advanced economy
CDS	credit default swap
CPTPP	Comprehensive and Progressive Agreement for Trans-Pacific Partnership
DR-CAFTA	Central America-Dominican Republic Free Trade Agreement
EAP	East Asia and Pacific
ECA	Europe and Central Asia
ECB	European Central Bank
ECI	Economic Complexity Index
EMBI	Emerging Market Bond Index
EMDE	emerging market and developing economies
ERPTR	exchange rate pass-through ratio
EU	European Union
FAVAR	Bayesian factor-augmented vector autoregression
FCV	fragility, conflict, and violence
FDI	foreign direct investment
GCC	Gulf Cooperation Council
GDP	gross domestic product
GEP	*Global Economic Prospects*
GMM	generalized methods of moments
GNFS	goods and nonfactor services
GNI	gross national income
GST	goods and services tax
GVCs	global value chains
HIPC	Heavily Indebted Poor Countries
ICE	Intercontinental Exchange
ICRG	International Country Risk Guide
IMF	International Monetary Fund
IT	inflation targeting
LAC	Latin America and the Caribbean
LFPR	Labor force participation rate
LIC	low-income country
LSAP	Large-Scale Asset Purchase
MDRI	Multilateral Debt Relief Initiative
MENA	Middle East and North Africa
MEP	Maturity Extension Program
MIC	middle-income country

NEER	nominal effective exchange rate
NPL	nonperforming loan
ONI	Oceanic Niño Index
OPEC	Organization of the Petroleum Exporting Countries
PMI	Purchasing Managers' Index
PPP	purchasing power parity
REER	Real Effective Exchange Rate
RHS	right-hand side (in figures)
RMB	renminbi
SAR	South Asia Region
SSA	Sub-Saharan Africa
SSE	Shanghai Stock Exchange
TFP	total factor productivity
TiVA	Trade in Value Added
USMCA	United States-Mexico-Canada Agreement
VAT	Value-added tax
WAEMU	West African Economic and Monetary Union
WGI	World Governance Indicators
WTO	World Trade Organization