Global Economic Prospects

Global Economic Prospects:
Having Fiscal Space and Using It

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Global Economic Prospects: January 2015

Chapter 1: Global Outlook

Chapter 2: Regional Outlooks

Chapter 3: Having Space and Using It: Fiscal Policy Challenges in Developing Countries

Chapter 4: Plunging Oil Prices; Global Trade Slowdown; and Stability of Remittances

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Global Outlook:
Disappointments, Divergences and Expectations

World economy

- *Global recovery:* slow-moving
- *Three drivers:* low commodity prices; easy financial conditions; but weak global trade

Country groups

- *Major Economies:* Upswing in U.S. and U.K.; setbacks in Euro Area and Japan; managed slowdown in China
- *Developing Economies:* New divergences (commodity exporters vs importers); medium-term growth challenges

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Four Questions

1. What is the state of global recovery? *Limping along... Generally helped by low commodity prices and easy financial conditions but held back by weak global trade; divergences and disappointments in country groups*
2. What about the risks? *Downside risks dominate*
3. What are the main policy issues? *Many challenges but also windows of opportunity*
4. Why does it all matter? *Risks to growth and poverty alleviation*

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1. What is the state of global recovery?

Limping along…

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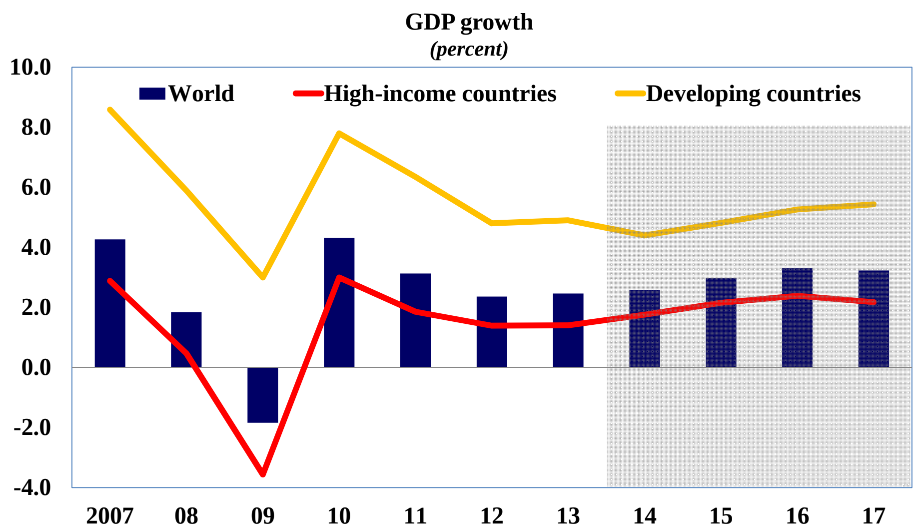
Global Recovery: Limping Along



Source: World Bank.

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Growth Prospects: Headwinds Lifting?

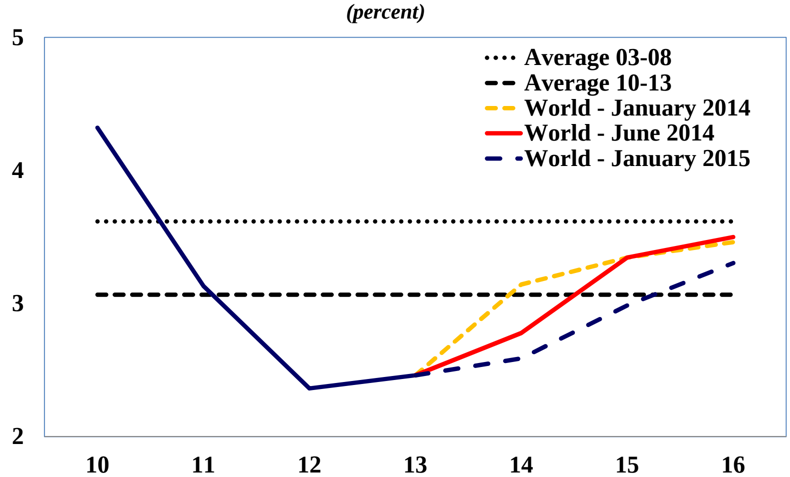
GDP growth
(percent)

	2013	2014	2015	2016-17
World	2.5	2.6	3.0	3.3
High-income countries	1.4	1.8	2.2	2.3
Developing countries	4.9	4.4	4.8	5.3
East Asia and Pacific	7.2	6.9	6.7	6.7
Latin America and Caribbean	2.5	0.8	1.7	3.1
Europe and Central Asia	3.7	2.4	3.0	3.8
South Asia	4.9	5.5	6.1	6.7
Sub-Saharan Africa	4.2	4.5	4.6	5.0
Middle East and North Africa	0.5	1.2	2.5	3.0

Source: World Bank.

But Growth Disappointed Again

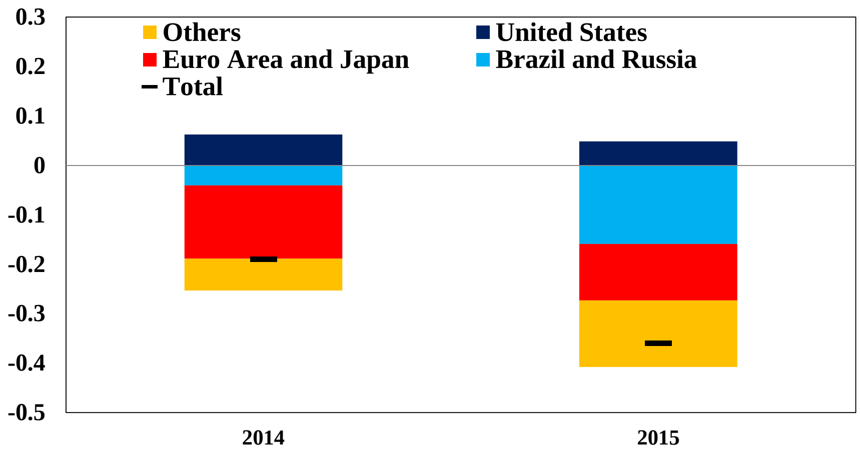
Global growth
(percent)



Source: World Bank.

With Weak Spots

Contribution to Global Growth Revisions since June 2014
(percentage point)



Source: World Bank.
Note: Contribution to global growth revisions from June 2014 to January 2015.

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What are the main drivers of global outlook?

Generally benefiting from low commodity prices
and easy financial conditions
but dampening effects from weak global trade

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Lower Oil Prices: Developments and Implications

What has been happening in oil markets?

- Unusually sharp drop… Reflecting both larger supply and weaker growth prospects…
- Larger than earlier declines in other commodity prices since 2011… Soft prices are expected to continue in 2015-16…

What are the implications?

- Depends on the source and persistence of the shock… Abrupt for exporters… More diffuse for importers…
- Financial market vulnerabilities; Inflation concerns; Large fiscal effects; Significant regional spillovers

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Impact on Global Growth: Net Positive but Many Mitigating Factors

Positive impact on global growth *(simulation results)*

- 30 percent **supply-driven** decline could add **0.5 percent** to global GDP

But mitigating factors *(affecting the growth forecasts)*

- Crisis legacies and weak confidence
- Monetary policy constraint
- Changing relationship between oil and activity
- Reduced investment in new oil exploration or development
- Weak demand

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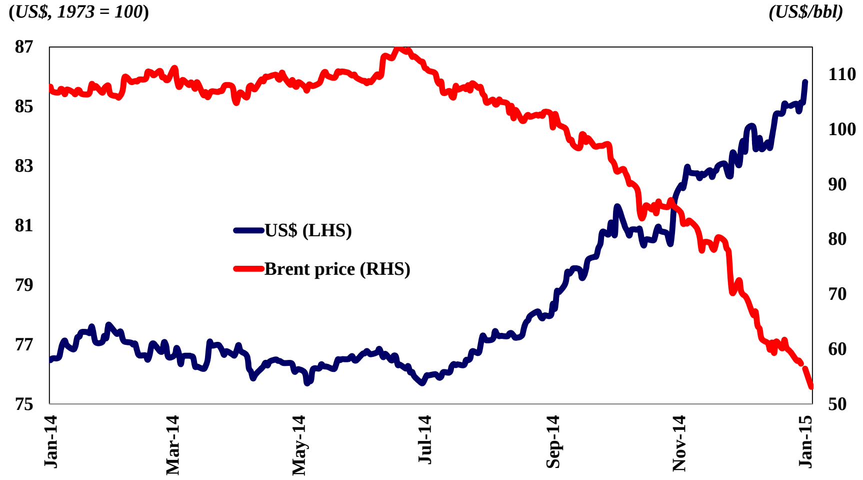
Lower Oil Price and Higher Dollar Coincided

Crude Oil Price and US Dollar



Source: World Bank, Bloomberg, US Federal Reserve

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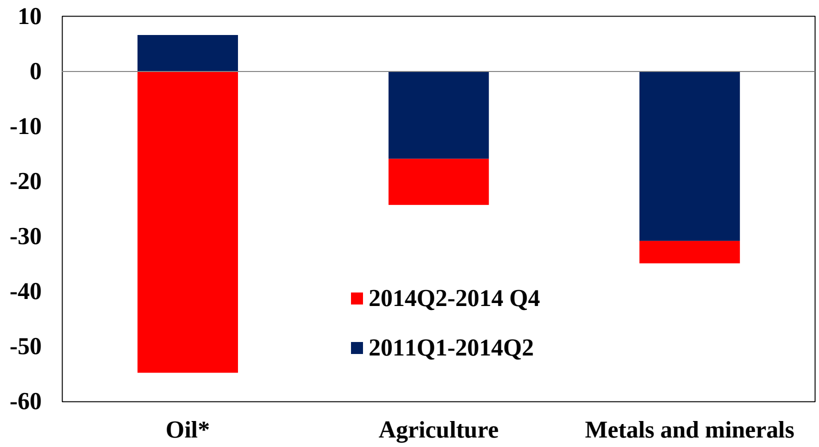
Decline in Oil Price: Surpassing Other Commodities

Cumulative Changes in Commodities Prices
(Percent Change)



Source: World Bank.
Note: Prices are the averages of WTI, Brent, and Dubai oil prices, 21 agricultural goods, and 7 metal and mineral commodities.
*Average price of oil in January 2015 ($48.11) used as the latest data point.

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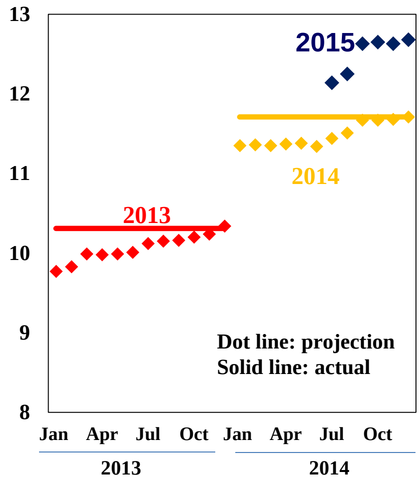
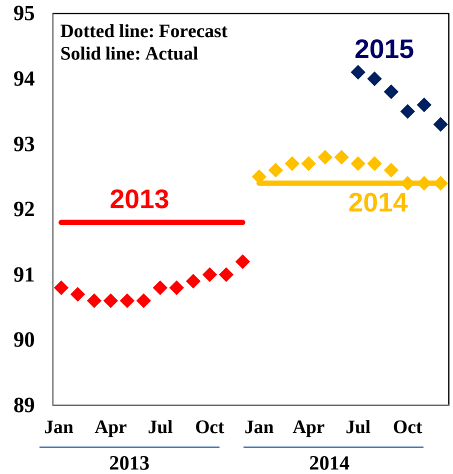
Rising Oil Supply but Weakening Demand Forecasts

U.S Oil Supply
(million barrels per day, monthly)



Global Oil Demand
(million barrels per day, monthly)



Source: World Bank, IEA

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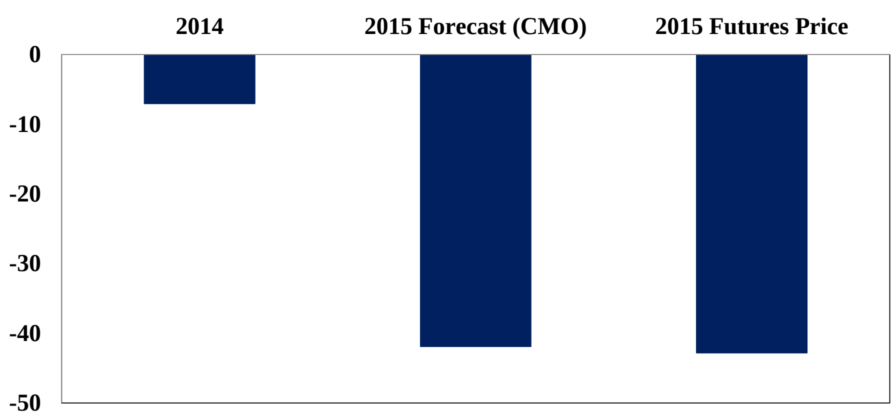
Oil Prices Likely to Stay Weak

Oil Price Forecast
(% change relative to previous year)



Source: World Bank.
Note: Oil price defined as unweighted average of the Dubai, Brent, and WTI prices. The forecast for 2015 is $53/bbl (Commodity Markets Outlook, January 2015). The 2015 future price represents the average of all closing future contracts (11 contracts, Feb-Dec 2015) for the trade index of 5 Trading Days prior to Jan 16, 2015. This price (which is equal to $52.15) represents the average of Dubai, Brent, and WTI future contracts.

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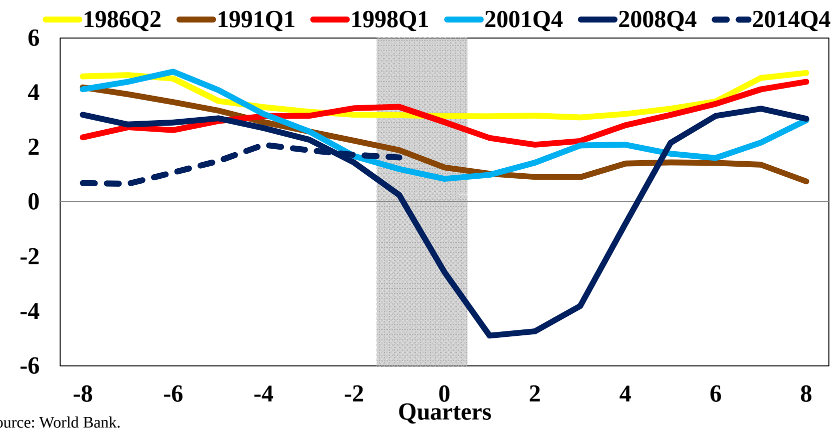
Past Oil Price Drops Followed by Mixed Performance

Global GDP Growth
(year-on-year, in percent)



Source: World Bank.
Note: Global GDP growth computed on the basis of a weighted average (using 2010 USD GDP weights) of countries for which quarterly national account data is available. Time "0" is the quarter of the trough in significant oil price decline episodes. "-8" corresponds to 8 quarters (2years) before that trough and "8" correspond to 8 quarters after.

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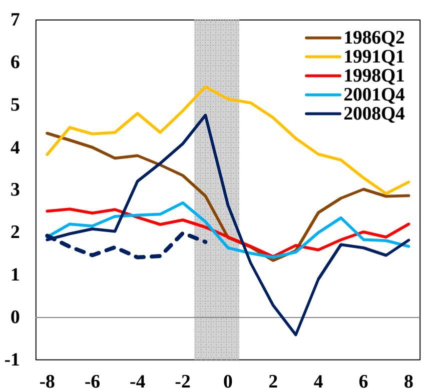
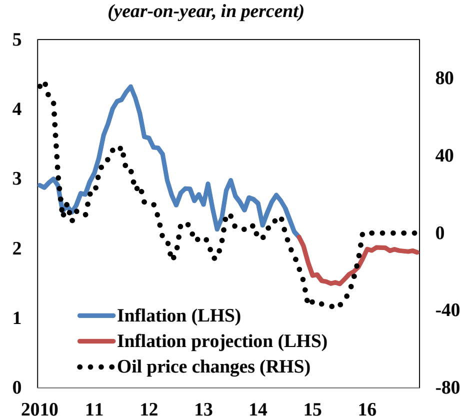
But Past Oil Price Drops Followed by Lower Inflation

Inflation around Drops in Oil Prices
(year-on-year, in percent)



Global Inflation
(year-on-year, in percent)



Source: World Bank.
Note: Left panel: Inflation in high income countries. Time "0" is the quarter of the trough in significant oil price decline episodes. "-8" corresponds to 8 quarters (2years) before that trough and "8" correspond to 8 quarters after. "Inflation" indicates a consumption weighted average of inflation rates of 16 members of the G20. "Inflation projection" is based on country specific VAR models for these 16 countries (including year-on-year growth in consumer prices, producer prices, oil prices (in local currency), the nominal effective exchange rate and the deviation of industrial production from its Hodrick-Prescott-filtered trend)

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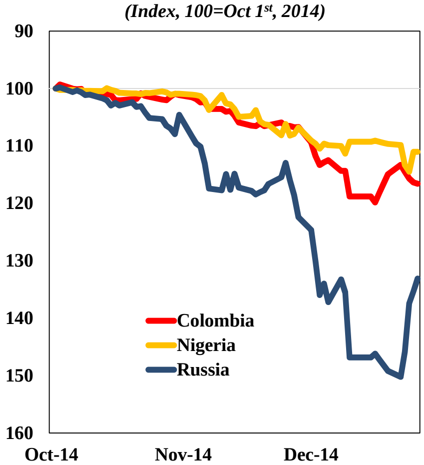
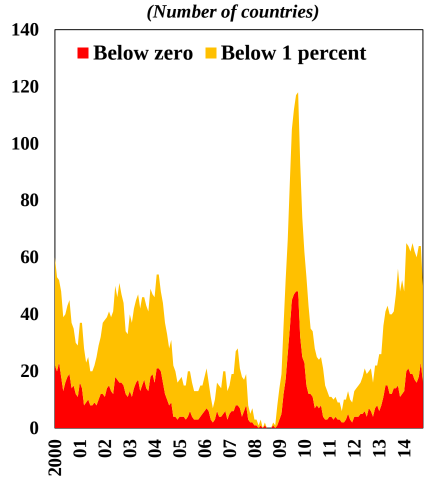
Volatile Exchange Rates and Lower Inflation

Exchange Rates against U.S. dollar
(Index, 100=Oct 1st, 2014)



Countries with Low Inflation
(Number of countries)



Source: Haver Analytics.
Note: Exchange rates are defined as local currency per U.S. dollar, indexed to Oct 2014 as 100. The y-axis is reversed to show local currency's depreciation. Number of countries with year-on-year inflation below 1 percent and below zero. Excludes countries with a population of less than 1 million. Latest data available is October 2014 for most countries.

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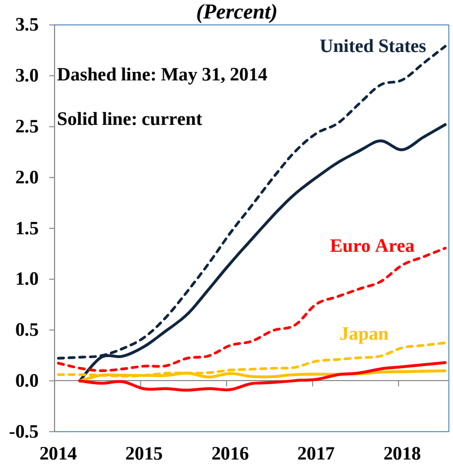
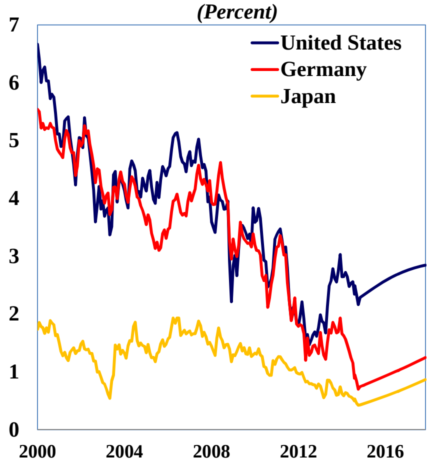
Easy Financing Conditions Here for Now…

Policy Rate Expectations
(Percent)



Government Bond Yields - 10 Year
(Percent)



Source: World Bank, Bloomberg
Note: Policy rate Expectations are based on forward swap rates.
Forecasted 10-years yields are based on implied forward rates from Bloomberg, calculated by using the equation of a continuously compounded forward rate.

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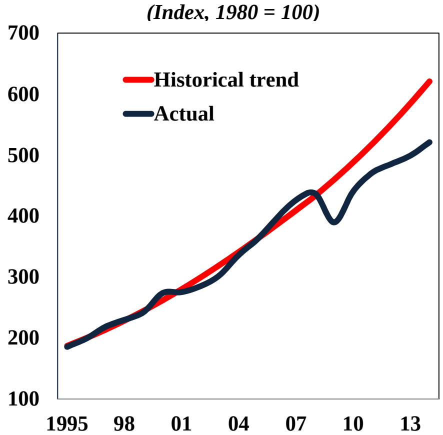
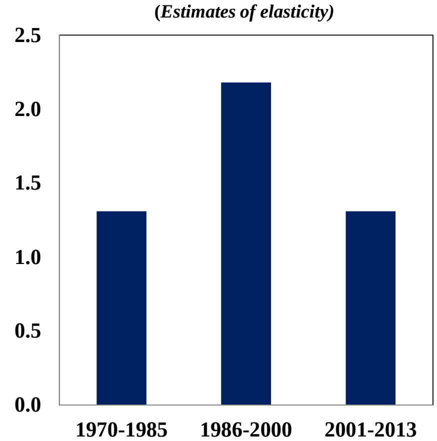
Weak Global Trade: Are We in a New Era?

Actual and Trend Import Volume
(Index, 1980 = 100)



Long-Run Trade Elasticity
(Estimates of elasticity)

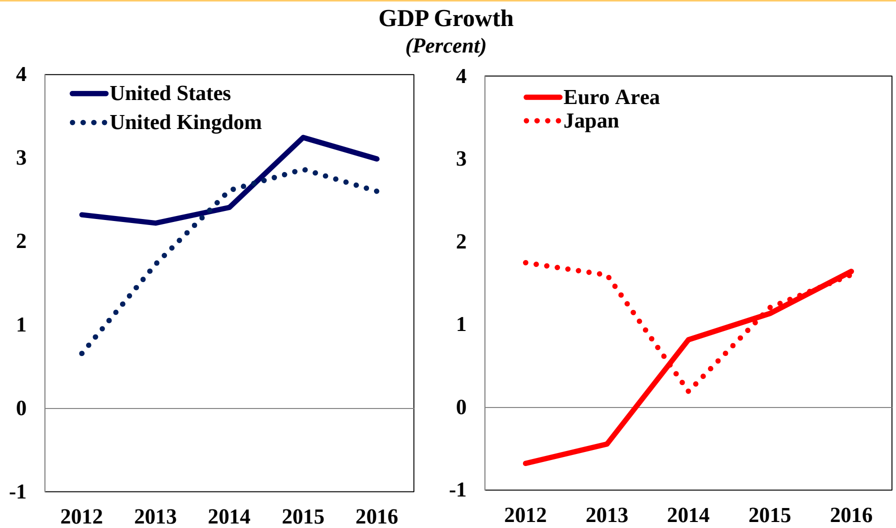


Source: World Bank, Constantinescu, Mattoo and Ruta (2014)
Note: Left panel: The post-crisis trend level growth is assumed to be equivalent to the average growth rate during 1980-2008.Using this, the trend level for 2014 is rebased to 100. Hence, bars below or above 100 show deviations from trends in 2014; Right panel: Each bar represents the long-run elasticity estimated from a cointegration model between imports and GDP

Can High-Income Countries Support Global Growth?

Partly…

High Income Countries: Diverging Growth Performance



Source: World Bank.

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How are Developing Countries Faring?

Mixed outlook and New Divergences

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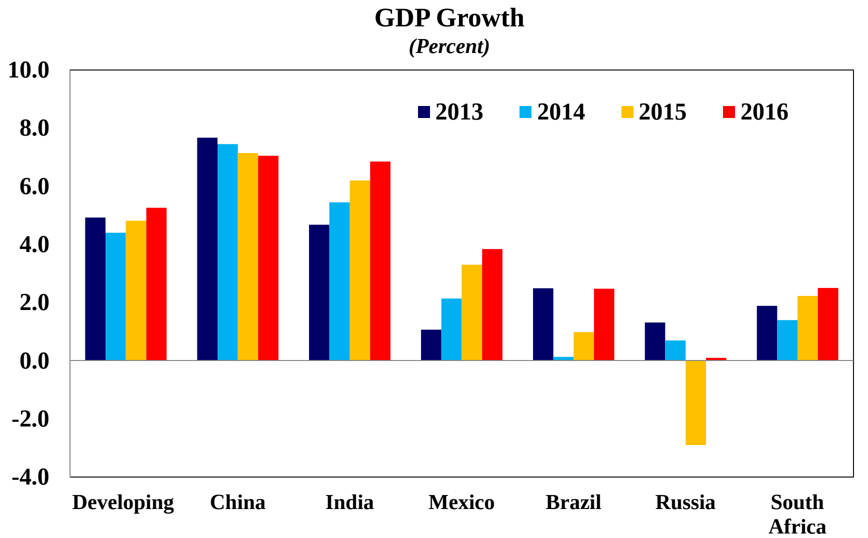
Mixed Outlook: New Divergences



Source: World Bank

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2. What about the risks?

Downside risks dominate…

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Downside Risks Dominate

- Volatility in financial and commodity markets
- Normalization and divergence of monetary policies
- Secular stagnation in the Euro Area
- Geopolitical tensions; Ebola concerns
- Disorderly slowdown in China
- Medium-term slowdown in developing countries

3. What are the main policy issues?

Many policy challenges but also windows of opportunity

Policy Issues: Balance and Opportunity

Monetary Policy

- Weigh growth, inflation and currency stabilization goals *(balance)*
- Help from low oil prices in net-importing countries *(opportunity)*
- Prevent build-up of financial risks

Fiscal Policy

- Need more space to run counter-cyclical policy *(balance)*
- Speed of expanding space depends on country circumstances *(opportunity)*
- Establish well-designed and credible institutions

Structural policy

- Undertake timely subsidy reforms *(opportunity)*
- Improve governance and public infrastructure
- Reduce market distortions and informality; Remove trade restrictions

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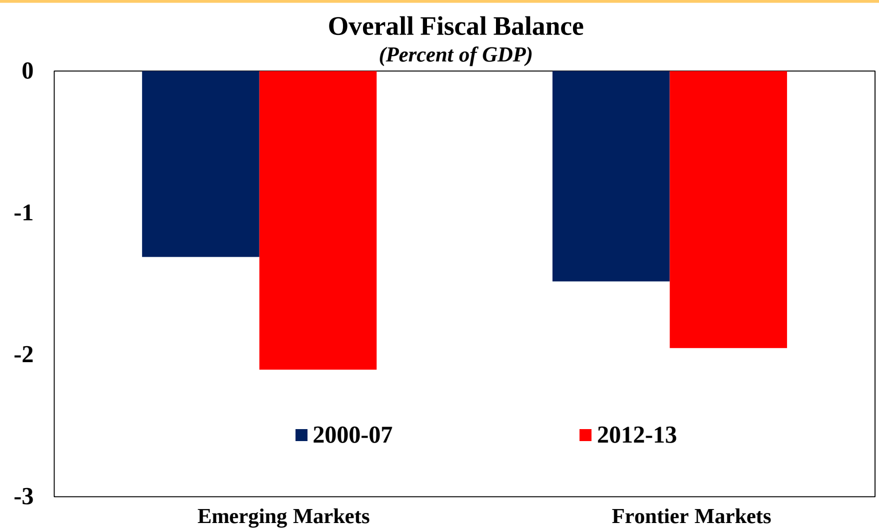
Fiscal Policy: Deficits Larger than in 2000-07



Source: World Bank, IMF
Note: Overall fiscal balance is the general government balance.

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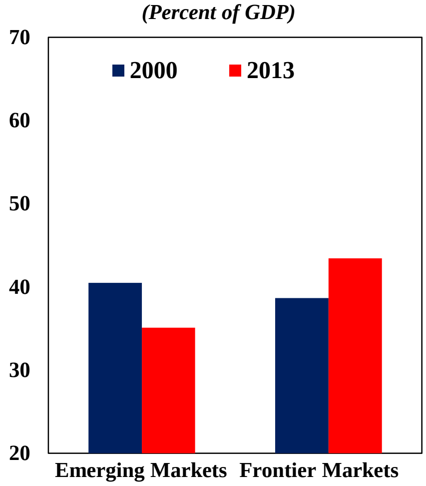
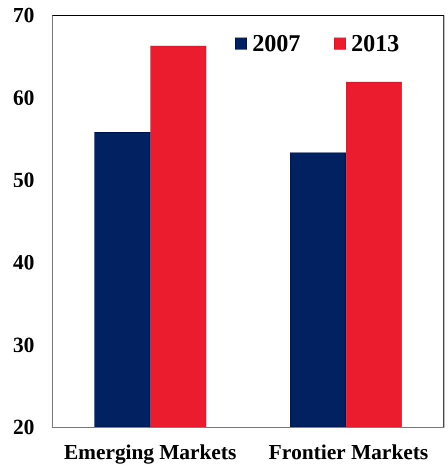
Lower Public Debt *but* Higher Private Sector Debt

Government Debt
(Percent of GDP)



Domestic Credit to Private Sector
(Percent of GDP)



Source: World Bank, IMF

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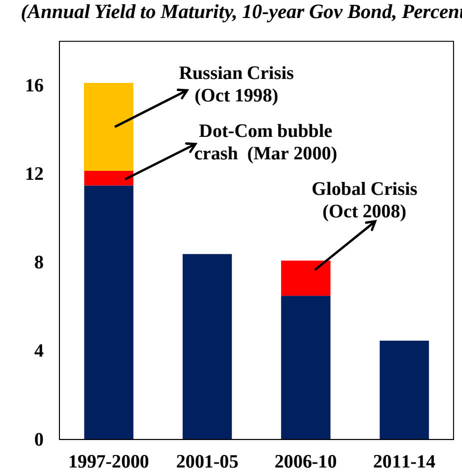
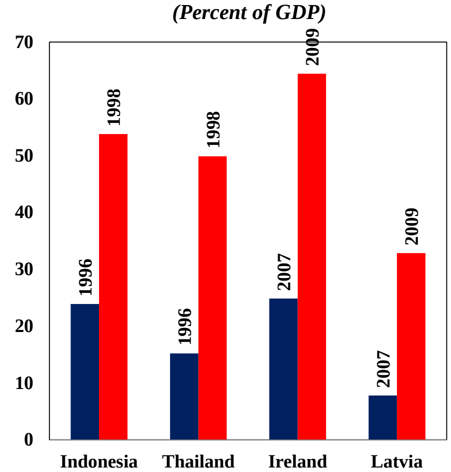
Financing Conditions: Still Favorable but?

Emerging Market Long-term Interest Rates
(Annual Yield to Maturity, 10-year Gov Bond, Percent)



Government Debt in Select Crises
(Percent of GDP)



Source: World Bank
Note: The nominal long-term interest rate is estimated as the sum of 10-year U.S. Treasury yields plus the predicted spreads from a fixed-effect OLS regression of J.P. Morgan's EMBI on the Institutional Investor Rating. For the crisis period, the interest rate refer to the average of daily rate that month. Orange and red bars indicate spiked in long-term interest rates during the relevant months

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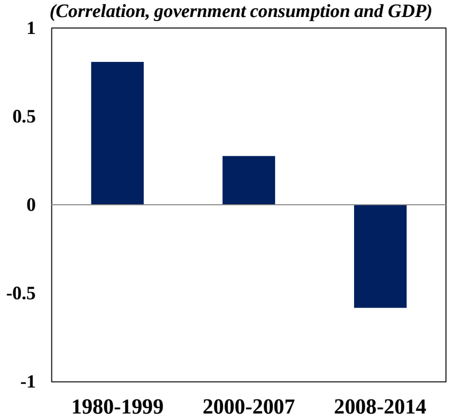
More Fiscal Space, More Room to Adjust

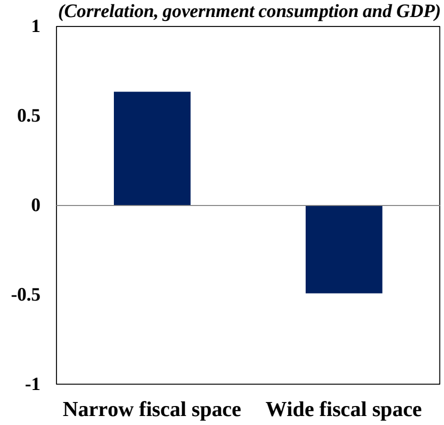
Cycliclality of Fiscal Policy

(Correlation, government consumption and GDP)



Cyclicality of Fiscal Policy and Space

(Correlation, government consumption and GDP)



Source: World Bank staff estimates.
Note: The chart presents correlations between the cyclical components of government consumption and GDP from an unbalanced panel of annual data for 31 EMEs. All correlations are statistically significantly different from zero and differences in correlations across time are also statistically significant. Positive correlations suggest procyclicality, while negative correlations suggest countercyclicality.

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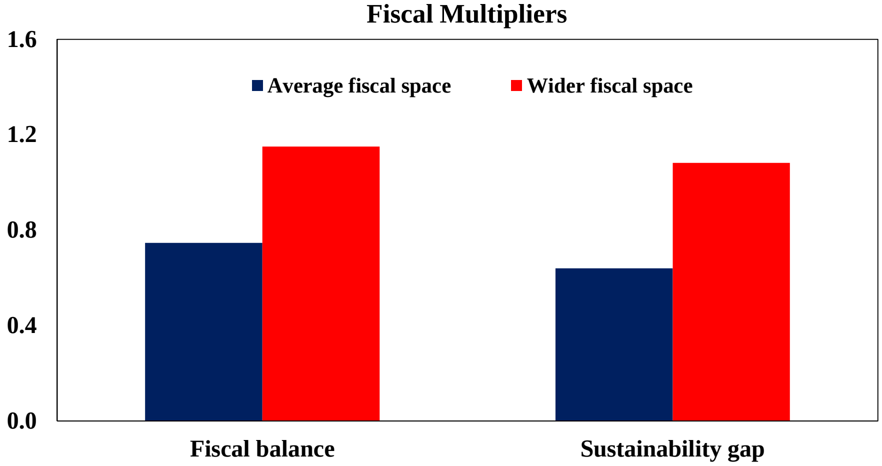
More Fiscal Space, More Effective Policy

Fiscal Multipliers



Source: World Bank staff estimates.
Note: The graph shows the fiscal multipliers at the two-year horizon for an average fiscal space and a (hypothetical) wide fiscal space. The average fiscal space corresponds to the cross-sectional median in 2013 from a sample of EMEs and FMEs while the wide fiscal space corresponds to the 75th percentile. These are based on the estimates from the IPVAR model using the sample of EMEs and FMEs. The results are shown for two alternative measures of fiscal space: fiscal balance as percent of GDP and the sustainability gap. The sustainability gap is the difference between the primary balance and an estimated debt-stabilizing primary balance, which depends on assumptions about interest rates and growth rates.

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Structural Reforms: A Long List…

Subsidy reforms

- Food and energy subsidies: often large and poorly targeted
- Savings can help prioritize investments and social safety nets

Public infrastructure and governance

- Infrastructure constraints widespread, especially in electricity markets
- Benefits conditional on efficiency, better regulation and governance

Employment and informality

•Combine contractual flexibility with adequate social protection
•Reduce informality; manage regional mobility; increase participation

Trade impediments

- Reduce barriers to services liberalization
- Limit congestion at customs
- Reduce logistics obstacles

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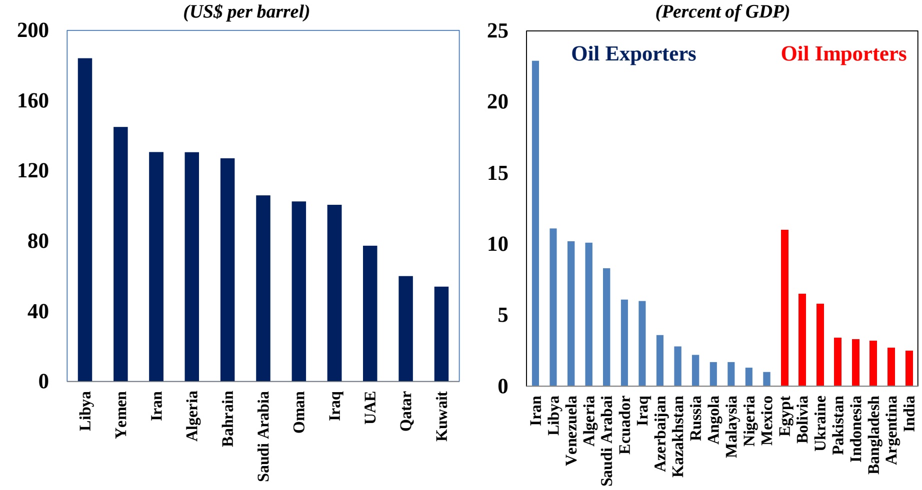
Fiscal Impact of Oil Price: Time for Subsidy Reforms

Fiscal Break-Even Price, 2015
(US$ per barrel)

Fiscal Cost of Fossil Fuel Subsidies, 2013
(Percent of GDP)



Source: IEA Fossil Fuel Subsidy Database, IMF.
Note: Countries where the fiscal cost of fossil fuel subsidies is below 1 percent of GDP are not shown. Fiscal break-even price is the oil price that balances the budget.

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4. Why does it all matter?

Risks to growth and poverty alleviation

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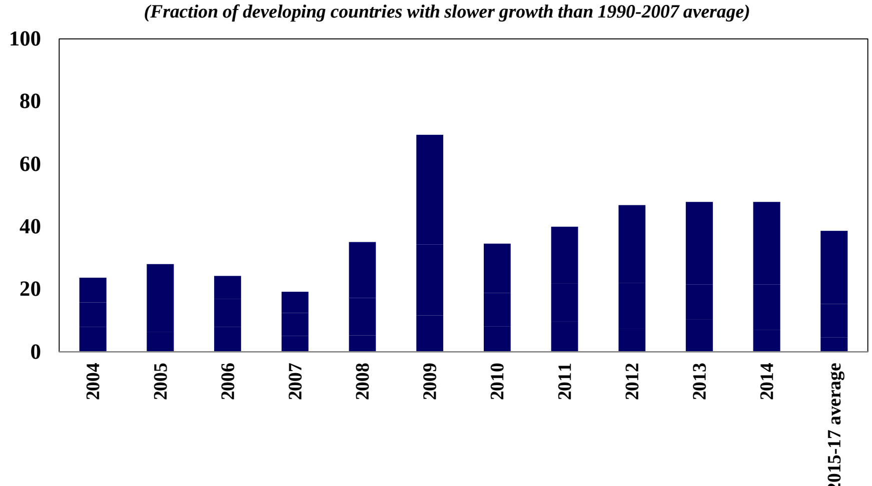
A Serious Risk: Weak Medium-term Growth

Growth Slowdown in Developing Countries

(Fraction of developing countries with slower growth than 1990-2007 average)



Source: World Bank

Note: For each year, number of countries in which growth is slower than in the preceding year.

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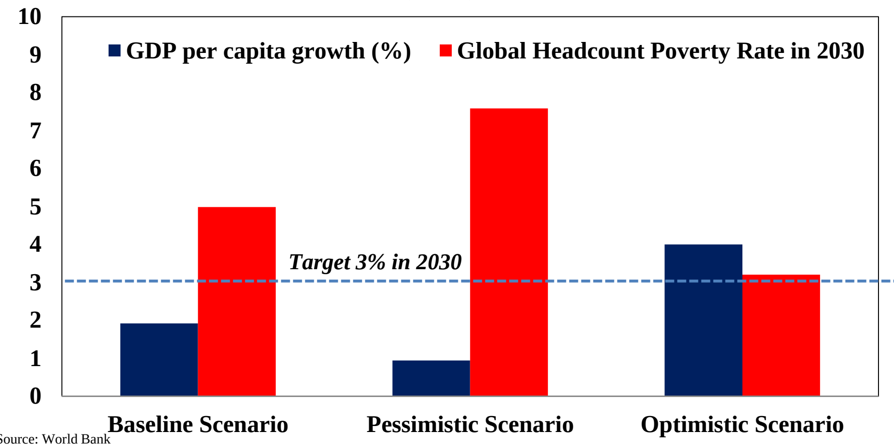
Reaching the Poverty Target: For Higher Growth, Policies and Reforms Necessary

Global Poverty Rate in 2030

(Percent)



Source: World Bank

Note: GDP per capita growth is the aggregate for the developing world. Global poverty estimates in the optimistic scenarios are based on the growth assumptions in World Bank. Poverty estimates for the baseline and pessimistic scenarios are based on the per capita growth of house-hold final consumption expenditure for 2011-2014 in World and per capita GDP growth projections in this report for 2015-2017. Population growth assumptions in all scenarios are based on the UN population growth projections.

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Questions & Comments
Thanks!

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