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**GROWTH IN THE POST-CRISIS GLOBAL ECONOMY: POLICY CHALLENGES
FOR DEVELOPING COUNTRIES**

Attached is a document entitled "Growth in the Post-Crisis Global Economy: Policy Challenges for Developing Countries" for the April 12, 2014 Development Committee meeting.

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THE WORLD BANK GROUP

**Growth in the Post-Crisis Global Economy:
Policy Challenges for Developing Countries**

Development Committee Paper
Spring 2014

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*This document has benefited from comments received from IMF staff.

Abbreviations and Acronyms

AMC	Asset Management Company
CCSA	Cross-Cutting Solution Area
CCTs	Conditional Cash Transfers
CPF	Country Partnership Framework
CIF	Climate Investment Fund
DC	Development Committee
EAP	East Asia and Pacific Region
ECA	Europe and Central Asia Region
FCS	Fragile and Conflict-Affected Situations
GDP	Gross Domestic Product
GEP	Global Economic Prospects
GFDR	Global Financial Development Report
GIF	Global Infrastructure Facility
HIC	High-Income Country
IBRD	International Bank for Reconstruction and Development
IDA	International Development Association
ILO	International Labor Organization
IFC	International Finance Corporation
IMF	International Monetary Fund
LCR	Latin America and the Caribbean Region
LIC	Low-Income Country
MCPP	Managed Co-Lending Portfolio Program
MDG	Millennium Development Goal
MENA	Middle-East and North Africa Region
MIC	Middle-Income Country
MIGA	Multilateral Investment Guarantee Agency
QE	Quantitative Easing
R&D	Research and Development
SAR	South Asia Region
SSN	Social Safety Net
SCD	Systematic Country Diagnostic
TFP	Total Factor Productivity
UCT	Unconditional Cash Transfer
UK	United Kingdom
US	United States
VIX	Chicago Board Options Exchange Volatility Index
WBG	World Bank Group
WDR	World Development Report
WTO	World Trade Organization

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Executive Summary

- The post-crisis global economy presents important challenges to growth in developing countries. Unless these challenges are managed well, they can put at risk the achievement of the World Bank Group’s twin goals of ending poverty and boosting shared prosperity.
- Economic recovery in advanced economies has been weak but more recently has shown signs of strengthening, which is a positive development for all. However, the external environment for developing countries continues to be marked by significant risks and uncertainties. As evidenced by the spillover effects of “tapering” the U.S. quantitative easing, the withdrawal of the extraordinary monetary stimulus of the post-crisis period could generate volatility in capital flows and exchange rates in the short run and will over time tighten access to capital and raise its cost. In Europe, despite progress, economic and financial fragilities continue to pose risks to stability and cloud growth prospects.
- Overall, growth in advanced economies in the medium term is likely to be lower than pre-crisis trends. The “new normal” of slower growth in their major export markets means that developing countries will need to rely more on trade among themselves and internal demand to support growth. But growth within developing countries, while still faster than in high-income countries, also has slowed, including in some major economies—notably China—with strong links to other economies.
- While the slowdown in growth in developing countries in part reflects cyclical factors, it also reflects deeper structural bottlenecks that have slowed productivity growth. Important structural shifts are needed in some economies to restore and sustain strong growth.
- Fostering strong and inclusive growth is central to job creation and achieving the goals of ending poverty and boosting shared prosperity. The need to ensure broad participation in economic growth is reinforced by the rise in inequality in many countries. Rising inequality is harmful to economic stability and the sustainability of growth; well-designed policies can reduce inequality without hurting growth.
- Given these challenges, policy makers in developing countries face a two-fold agenda:
 - ***Managing the post-crisis transition.*** Risks emanating from monetary policy normalization in advanced economies call for sound, responsive monetary and exchange rate policies in countries exposed to volatility. At the same time, countries must address underlying macroeconomic vulnerabilities, including reducing large external deficits and reliance on short-term flows, rebuilding macroeconomic buffers, and strengthening prudential management of the financial system. Given today’s interconnected global economy, it is also important for advanced economies to be mindful of the collateral consequences of their policies for developing economies. The transition would be smoother if policy normalization is accompanied by appropriate coordination and communication.
 - ***Boosting longer-term growth with inclusion.*** There is a need to revitalize structural reforms and boost sound investment to strengthen the foundations for strong, inclusive, and sustainable growth. Specific priorities differ across countries but a core element of the agenda is to intensify reforms to improve the enabling environment for private investment and productivity growth and facilitate structural change, including: reinvigorating business environment reforms (regulatory frameworks, tax policies, labor policies, trade and investment openness, governance), boosting quality investment in infrastructure, and improving access to finance. Raising skills and innovation capabilities also are a key element. An open business climate that fosters competition,

and human capital development that is inclusive, are good both for growth and shared prosperity, as are policies that broaden participation of specific groups (women, youth, older workers) and well-targeted social protection programs. Tax and expenditure policies need to be carefully designed, paying attention to both their efficiency and distributional effects. Environmental considerations must be integrated into policymaking: climate-smart policies are necessary for environmental sustainability and building resilience but can also provide important co-benefits for growth and jobs.

- A focus on the twin goals, a new group-wide strategy, and ongoing internal reforms position the World Bank Group well to support developing countries in meeting these challenges, working closely with the IMF and other partners.
 - With the Bank, IFC and MIGA operating as One World Bank Group, synergies across the institution will be better captured to strengthen our ability to engage both the private sector and government to create jobs and promote inclusive and sustainable growth.
 - The new Global Practices and Cross-Cutting Solution Areas will help better develop and deploy knowledge to support policy design and implementation. They will bring new opportunities to enhance technical expertise, share global knowledge, and strengthen external partnerships.
 - An enhanced Country Engagement Model, supported by the Systematic Country Diagnostic and Country Partnership Framework, will help better tailor policies and programs to country-specific needs and priorities. The Global Practices and Cross-Cutting Solution Areas will provide enhanced knowledge capabilities; the new Country Engagement Model will help apply them with more focus, selectivity, and impact at the country level.
 - Innovations in financial instruments and parameters and creative use of balance sheets across the World Bank Group, and initiatives to leverage long-term capital (including the proposed Global Infrastructure Facility), will enhance capacity to meet client financing needs. The record IDA17 replenishment will be instrumental in supporting the needs of the poorest countries and ensuring that no country, including fragile and conflict-affected states, is left behind in the effort to end poverty and boost shared prosperity.

Issues for Discussion

- What do Ministers see as key elements of the policy agenda in developing countries to secure strong, inclusive, and sustainable growth in the post-crisis global economy?
- How do Ministers see the role of a repositioned World Bank Group, working with partners, in supporting that agenda?

A. Introduction

The past decade or so has been a period of historic progress in developing country economic growth and poverty reduction. Growth in GDP per capita far exceeded growth in the high-income countries, and importantly, the superior growth performance spread across most developing regions and many individual countries, including some of the poorest.

Developing countries now face risks to economic growth in the post-crisis global economy that need to be managed to sustain and build on this progress. While prospects for high-income country growth have improved and will strengthen the external demand environment, the consequent normalization of monetary policy in those countries will have an impact on access to and cost of external finance—and could even lead to sharp capital flow reversals. Despite progress in Europe, there remains a substantial reform agenda yet to be undertaken, with consequent risks to stability. Growth in Europe is likely to recover only slowly. In Japan, growth is expected to slow as the initial effects of macroeconomic stimulus wane, unless the recently started structural reform efforts gather momentum. Growth in advanced economies as a whole in the medium term is likely to remain below pre-crisis levels. In addition, some large emerging market economies that have an important impact on global trade and commodity prices are experiencing slower growth than in the pre-crisis period and need to address structural constraints to restore stronger growth. Overall, productivity growth in developing countries has slowed.

The post-crisis global economy contains both short-term risks for developing countries and a “new normal” of slower growth in their major export markets; it also poses challenges of structural reform within developing countries. The new economic context implies the need for developing countries to implement policies to navigate the short-term risks and strengthen the structural foundations for longer-term growth. If adjustments in the external environment are gradual, developing countries should be able to maintain solid growth; however, continued strong growth will rely on revitalizing policy reforms to boost productivity. Rebuilding buffers for macroeconomic policy response would be prudent given the continuing risk of more serious global shocks. Structural reforms take on greater urgency, as developing economies will need to rely more on the strength of their own economies to secure medium-term growth.

The progress in poverty reduction of the last twenty years presents the opportunity to envision a world free of extreme poverty. The extreme poverty rate in the developing world was more than halved between 1990 and 2010, attaining the Millennium Development Goal for that indicator five years ahead of schedule. The 2013 World Bank Group Strategy has established two goals: (i) end extreme poverty—reduce the percentage of people living on less than \$1.25 a day to 3 percent by 2030; and (ii) promote shared prosperity—foster income growth of the bottom 40 percent of the population in every country. As emphasized in the Strategy, “the WBG is committed to supporting countries in reducing poverty and building shared prosperity in a sustainable manner. Environmental, social and economic sustainability require action to secure the future of the planet, ensure social inclusion, and set a solid foundation for the well-being of future generations.” A substantial amount of research is underway on the measurement and policy agenda related to the twin goals.¹

Both goals imply the need for strong, inclusive, and sustainable growth. Changes in the headcount poverty rate can be decomposed into: growth in average household income (i.e., economic growth); and change in income distribution.² The growth of the income of the bottom 40 percent can also be decomposed into two components: growth in the average income of the total population; and change in the share of total income accruing to the bottom 40 percent.³ Cross-country evidence points to the central role played by economic growth over the past few decades in promoting both goals.⁴ Greater progress is achieved in reducing poverty and boosting shared prosperity when growth is “inclusive” and both the

growth and the distributional components improve. To achieve the twin goals, growth needs to be sustainable over the long term and take into account climate change and environmental constraints.

Growth has not always been inclusive. In terms of global trends, the gap between average incomes across countries has declined in the past two decades: faster growth in developing countries compared to rich countries produces this “convergence” of average incomes. On the other hand, within-country inequality has increased in many advanced economies; it has also increased in some large developing countries, such as China and India, especially the former.⁵ The result is that global inequality across individuals in the world has remained persistently and unacceptably high, with a Gini coefficient of around 0.70.⁶ More than two-thirds of the world’s population lives in countries where inequality has increased in the last couple of decades.

The jobs challenge is central to inclusive growth. Crucial to inclusiveness is quality, broad-based job creation, and human development that prepares the poor and middle-class for entering the job market. The translation of economic growth to household incomes of the poor primarily occurs through jobs—whether those workers are engaged in the formal labor market or self-employed in cities or on the farm. The *2013 World Development Report* on jobs confirms the central role of economic growth in sustainable job creation. But it also calls attention to the need for jobs strategies to remove specific barriers to job creation and improve labor force participation, especially of women and youth. Evidence suggests that the aggregate wage bill as a share of global GDP has been shrinking. This may be due, in part, to labor-saving technological progress and globalization. These forces are important drivers of growth but they also imply heightened competition between workers for jobs, which can exert a downward pressure on wages and exacerbate inequality. The risk is the creation of fault lines in the global economy which, if left unattended, can give rise to new economic and political instability. Creative policy thinking is needed to address these challenges. In addition, many economies have very poor data on labor and employment. It is the development community’s collective responsibility to improve data to inform policy solutions.

The risks in the post-crisis global economy to strong, inclusive, and sustainable growth threaten the WBG’s twin goals. Analysis by Bank staff demonstrates that the target of less than 3 percent poor people by 2030 is just that—a target and not a forecast. In other words, “3 by 30” is feasible but we will not get there without special and coordinated efforts. Simulations show that if *all* developing countries grow by at least 4 percent per capita per annum, with no deterioration in inequality, the target can be achieved; however, if each country grows at its country-specific average growth rate of the last decade (assuming no change in inequality), then the target will *not* be achieved.^{7,8} The continuation of the strong growth achieved by many countries in the last decade is not assured, unless the current risks are managed well and reforms are enacted to reinvigorate the drivers of growth. A number of countries with high extreme poverty rates did not perform as well as the developing country growth average. There are 17 countries that are projected to have extreme poverty rates above 30 percent in 2030 if they grow at the rates of the recent past.⁹ Growth performance needs to improve significantly in these countries, while also ensuring that growth is inclusive. No country should be left behind.

B. Growth Challenges in the Post-Crisis Global Economy¹⁰

The post-crisis transition in the global economy poses significant near-term macro-financial risks to developing country growth. At the same time, there is a need to implement deeper reforms to strengthen the foundations for longer-term growth.

I. Managing the post-crisis transition.

Although major tail-risks have subsided, they have not been eliminated. These include fiscal policy uncertainty in the United States, continued financial fragility and protracted economic recovery in the Euro Area, and possible setbacks to growth in China. The U.S. fiscal deficit has declined significantly,

driven by spending cuts imposed by the “sequester” and rising tax revenues as the economy recovers. Less progress has been made on a medium-term plan to bring the debt-to-GDP ratio under control. In the Euro Area, despite progress on restructuring and recapitalization, the banking sector remains fragile and slow progress towards a banking union and a single resolution mechanism hampers capacity to prevent bank defaults from escalating into a larger crisis. Moreover, fiscal reform in many European countries will be a continuing challenge. Not only does fiscal consolidation in advanced economies need to be appropriately calibrated to the stage of economic recovery, attention needs to be paid to how the costs are shared, especially in those economies experiencing rising inequality. In China, rapid credit growth and high levels of debt-financed investment have generated significant risks to the financial sector. The authorities are enacting policies to gradually rebalance the sources of growth away from high levels of investment and exports toward consumption and services. Instability in the financial sector or an abrupt decline in investment could have significant impacts on Chinese GDP. The knock-on effects would extend well beyond the regional economies to developing countries more broadly, including those in Sub-Saharan Africa with which China’s trade and financial links have grown considerably.

After several years of extreme weakness, high-income economies appear to be finally turning the corner. High-income growth is projected to strengthen from only 1.3 percent in 2013 to 2.0 percent this year and 2.4 percent in each of 2015 and 2016. This will contribute to a projected acceleration in global growth from 2.4 percent in 2013 to 3.0 percent this year, 3.4 percent in 2015, and 3.5 percent in 2016 (Table 1).

The continued strengthening of growth in high-income countries represents a transition to a “post-crisis” phase that is accompanied by a gradual normalization of monetary policy. While the recovery of growth in high-income economies will improve the external demand environment for developing economies, the accompanying normalization of monetary policy will raise base rates that will affect the cost of capital for the latter, representing a potential headwind to growth. This normalization is already occurring in the United States. There remains the risk of abrupt market reactions and capital flow reversals, depending upon how the high-income countries manage, coordinate and communicate the normalization of monetary policy, and how markets perceive the strength and resilience of emerging market economies that have been recipients of large inflows.

In developing countries, growth is projected to pick up modestly from 4.8 percent in 2013 to 5.1 percent this year, 5.5 percent in 2015, and 5.7 percent in 2016. Developing-country growth could be 2–2.5 percentage points weaker than it was during the pre-crisis boom period. Two-thirds of the slowdown reflects a decline in the cyclical component of growth but about one-third is due to a decline in potential growth, resulting from slowing productivity growth.

Growth outlook on a regional basis reflects respective progress on recovery from the crisis and shifts in productivity. Growth accelerations are projected to be particularly muted in East Asia and the Pacific and Latin America and the Caribbean, as economies in both of these regions have already recovered from the crisis and are growing at close to potential. Faster growth will depend on reforms to raise productivity. Positive spillovers from a gradual upturn in high-income Europe and a slower pace of household, fiscal, and banking sector consolidation are expected to slowly boost growth in developing Europe and Central Asia. In South Asia, weaker growth in India—following several years of rising inflation and current account deficits—has created both challenges and opportunities. In Sub-Saharan Africa, relatively robust domestic demand, notably resource-sector and infrastructure investments, should help support regional growth in 2015 and 2016.

Table 1: Global Growth Outlook (% p.a.)

	2003- 2007 (avg.)	2008- 2011 (avg.)	2012	2013e	2014f	2015f	2016f
World	4.1	1.8	2.5	2.4	3.0	3.4	3.5
High income	3.0	0.4	1.5	1.3	2.0	2.4	2.4
-OECD countries	2.8	0.2	1.3	1.2	2.0	2.3	2.3
-Euro Area	2.5	-0.3	-0.6	-0.4	1.0	1.5	1.6
-Japan	1.9	-0.6	1.4	1.5	1.0	1.3	1.3
-United States	2.9	0.5	2.7	1.9	2.6	3.0	2.9
-Non-OECD countries	6.5	1.9	3.5	2.4	3.0	3.4	3.8
Developing countries	7.7	5.5	4.8	4.8	5.1	5.5	5.7
-East Asia and Pacific	10.2	8.4	7.4	7.2	7.1	7.1	7.1
-Europe and Central Asia	7.3	2.4	2.0	3.6	2.4	3.8	3.8
-Latin America and Caribbean	5.4	2.8	2.6	2.5	2.9	3.2	3.7
-Middle East and N. Africa	5.6	2.4	1.5	-0.1	2.8	3.3	3.6
-South Asia	8.4	7.3	5.0	4.8	5.3	6.1	6.6
-Sub-Saharan Africa	6.7	4.0	3.5	4.7	5.1	5.3	5.4
<i>Memo item: World (2010 PPP weights)</i>	4.9	2.6	2.9	2.9	3.5	3.9	4.0

Sources: World Bank, *Global Economic Prospects*, January 2014 and World Bank Development Prospects Group Updates.

In the WBG's *Global Economic Prospects*' baseline forecast, the withdrawal of quantitative easing (QE) in the U.S. is assumed to follow a relatively slow, orderly trajectory as the economy improves. The corresponding increase in global interest rates is expected to weigh relatively modestly on investment and growth in developing countries, as capital costs rise and capital flows moderate, in line with a global portfolio rebalancing. In an "orderly" adjustment scenario, tailwinds from strengthening global trade should offset headwinds from tighter global financial conditions. Since the withdrawal of QE is expected to occur in line with improvements in the real economy in the U.S., the negative impact of the policy change would be counterbalanced by the strengthening U.S. economy.

However, if the withdrawal of monetary stimulus is met with deeper and more widespread market turmoil, capital flows to developing countries could weaken sharply, placing much stronger stress on the more vulnerable economies. In a "disorderly" scenario where long-term interest rates rise rapidly by 100 basis points, capital flows to developing countries could decline by as much as 50 percent for several quarters (80 percent in a more acute scenario of a sudden 200 basis point increase). A persistent 10 percent rise in the VIX index, a common measure of market risk aversion, could reduce capital inflows by about 30 percent over a similar horizon.

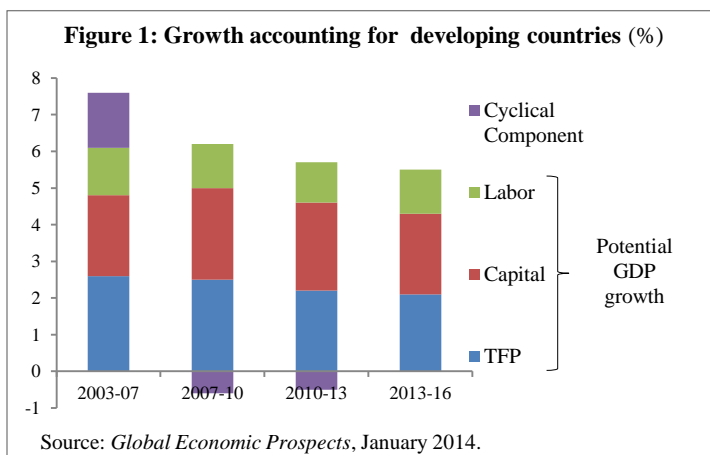
Financial market volatility increased over the past year, especially impacting some emerging market economies. Market response was relatively swift and strong during the spring and summer of 2013 when early indications about the start of QE tapering triggered market uncertainty and speculation about U.S. tapering plans. During that period, many emerging economies, especially large economies closely integrated with global financial markets, experienced currency depreciations and stock market declines. For example, from April to August, there were nominal exchange rate depreciations in Brazil, India, Indonesia, South Africa, and Turkey that ranged from 8–17 percent. Local stock markets in Brazil, Indonesia and Turkey suffered losses of 5, 14, and 15 percent, respectively, over the same period. When the actual tapering started in early January 2014, initial market response was muted. This in part reflected that markets had already factored in the impact and policy adjustments that took place during 2013. However, market volatility has since increased. The more vulnerable emerging economies have experienced greater stress than others, in particular those with large external deficits and financing needs

and those where policy credibility has come into question or where political situations inhibit policy response capacity. These developments and risks heighten the need for countries to reduce their vulnerabilities and take responsive policy actions. With fiscal and current account deficits about 3 percent of GDP higher in most developing countries than before the crisis, policy makers would do well to use available scope to rebuild policy buffers.

II. Boosting longer-term growth

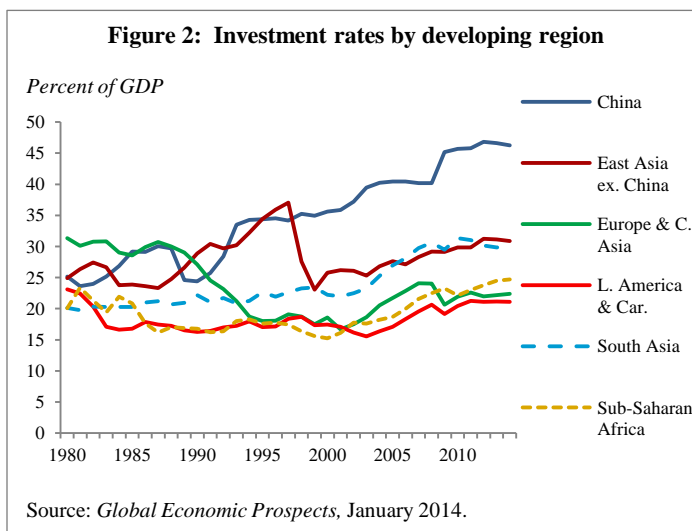
Overall, in the “new normal,” the external environment for developing country growth is likely to be less favorable than during the pre-crisis period. While the recovery is solidifying in high-income countries, these countries will still be growing at a slower pace than during the pre-crisis period. In Europe, in particular, growth is likely to remain substantially below the pre-crisis peak. A number of large emerging market economies, including China and India, are growing at a slower pace as well. This implies that many developing countries that relied on strong growth in export markets and favorable terms of trade will not be able to count on the same degree of external demand stimulus.

For most developing countries, improved growth will need to come from reforms to boost productivity. Internal stimulus measures conducted during the crisis have largely run their course. Both theory and evidence highlight the role of total factor productivity (TFP) in determining the long-run rate of growth. The January 2014 edition of the *Global Economic Prospects* conducted a growth accounting exercise for developing countries. Much of the slowdown in developing country growth has been driven by the cyclical component of GDP (Figure 1), with growth returning from the pre-crisis boom levels to potential.



Part of the slowdown, however, reflects a decline in potential growth on account of a slowing of TFP growth. Restoring stronger growth, in a sustainable manner, will require boosting productivity growth.¹¹

The sources of growth vary across regions and countries, and this highlights the need for reforms that both improve the climate for higher levels of investment and spur productivity growth. More advanced middle-income countries in East Asia, for example, have relatively high rates of investment and the key to long-run growth is to focus on structural reforms and human capital and technological progress that boost productivity (Figure 2). By contrast, many middle-income countries in Latin America could benefit from higher rates of investment, but at the same time need to promote higher productivity growth. More generally, as economies develop to middle-income levels, productivity gains by



reallocating production from agriculture to manufacturing and exploiting technology catch-up become increasingly exhausted, so potential growth has to rely more on within-sector productivity improvements, product transformation and innovation. Structural reforms are central to these shifts to sustain strong growth.

The growth challenges in low-income countries (LICs) are of particular concern, given their high rates of extreme poverty.¹² Many LICs suffer from low investment rates—due to a poor investment climate and a scarcity of domestic or foreign savings, including weak domestic revenue mobilization. A dependence upon natural resource exports is common, leading to risks of “Dutch disease” and price shocks and posing the challenge of what policies can promote export and asset diversification.¹³ To increase wealth, depletion of natural assets needs to be compensated by building up other assets, such as physical or human capital.¹⁴ LICs are also more vulnerable to natural hazards and climate change.¹⁵ As in more developed economies, LICs face a productivity challenge; however, agriculture remains a larger share of GDP, so the particular problems of agricultural productivity are of significance for improving rural incomes, but also for driving structural transformation toward industry. There is also an important gender dimension to improving agricultural productivity.¹⁶ Another issue of particular significance to LICs’ growth performance is governance. Many LICs are classified as fragile or conflict-affected states. The poverty reducing impact of more robust growth in Sub-Saharan Africa, home to most LICs, has been muted by persistently high levels of inequality.¹⁷

As the major middle-income countries, notably China, upgrade from low-wage, labor-intensive manufacturing to more sophisticated products, they will generate important new opportunities for growth and job creation in low-income countries, such as those in Sub-Saharan Africa with young populations. The number of jobs that may be relocated in this process could exceed 100 million.¹⁸ Low-income countries that implement reforms to boost competitiveness and encourage domestic and foreign investment can position themselves to take advantage of this transition.

C. Policies for Strong, Inclusive, and Sustainable Growth

The “post-crisis” transition implies a greater urgency for developing countries to reinvigorate the policy reform agenda. An immediate need is to manage the risks from short-run economic volatility and increases in the cost of capital. Securing stronger, more inclusive and sustainable growth in the longer term will require stepped-up efforts to address deeper, structural constraints—including improving the environment for private investment and productivity growth, building human capital, and promoting climate-smart growth.

The literature on the empirics of macroeconomic growth has now turned to the micro level determinants of firm productivity. This follows on the traditional and more recent theoretical literature that identified and analyzed total factor productivity as a key determinant of long-run growth. Underlying total factor productivity at the macro level is decision-making by individual entrepreneurs and business managers who invest, adopt technologies, and create innovative techniques or new products. Findings from the new research reinforce the importance of structural reforms to remove barriers to private sector productivity growth.¹⁹

There are important synergies between policies that promote economic growth, jobs, inclusion, and environmental sustainability. For example, an open and competitive business environment that provides a level playing field to businesses large and small, and human capital development that is inclusive, are good for growth as well as jobs and shared prosperity (Box 1). Research provides increasing evidence that rising inequality may be harmful to economic stability and the sustainability of growth and that well-designed policies to reduce inequality may not harm growth.²⁰ For example, there are a number of ways in which fiscal policies can be designed to promote equity and growth while ensuring fiscal sustainability, such as introducing/strengthening conditional cash transfer programs; consolidating social

assistance programs and improving targeting; improving access of low-income families to education and health services; and expanding coverage of the personal income tax, ensuring appropriate progressivity, and reducing regressive tax exemptions. Innovative approaches, such as greater use of taxes on property and energy (e.g., carbon taxes), could also be considered.²¹ Policies for environmental sustainability can provide significant co-benefits for growth and employment generation and open new avenues for innovation.

I. Pursuing sound, responsive macroeconomic policies

While long-run growth is determined by productivity and investment fundamentals, history has shown that macroeconomic stability is an overarching precondition for sustained growth. Developing countries need to prepare for possible financial market pressures, reduce vulnerabilities such as large external deficits and heavy reliance on short-term inflows, and rebuild policy buffers. Appropriate policy responses are country specific, but may include a tightening of monetary policy to counter domestic inflationary or currency pressures and retain/attract capital; use of exchange rate flexibility to facilitate adjustment, with currency intervention (for countries with adequate reserves) limited to smoothing excessive exchange rate volatility; and use of carefully targeted macro-prudential policies, with capital controls used as a last resort and not as a substitute for needed policy adjustment. Several developing countries have responded to the Fed tapering with a mix of these instruments. Fiscal adjustment, including revenue mobilization, can help reduce domestic imbalances and enhance policy response capacity. Tax and expenditure measures need to be carefully designed, paying attention to both their efficiency and distributional effects, including the effect on social safety nets. Structural reforms to increase the supply-side growth potential of the economy can also help rebuild the buffers and are key to reducing underlying vulnerabilities and improving competitiveness. Countries with external surpluses and/or adequate buffers can cushion the impact of potential shocks through appropriate countercyclical action.

Complementing macroeconomic management, securing the soundness and resilience of the financial sector is important, especially in economies that have experienced rapid credit growth or are vulnerable to sharp declines in net capital inflows. Precautionary prudential actions can help limit the risks to the financial system from interest rate or currency shocks. Policy makers in vulnerable economies could consider steps to restructure debt holdings toward longer-term issues and require banks to stress-test their loan books and begin provisioning now those loans that might be at risk. Last summer, investors seeking to rebalance their portfolios concentrated on emerging markets with relatively large and liquid financial systems; these were the markets where they could most easily sell without incurring losses and where there was the most scope for portfolio rebalancing.²² These large emerging markets need to be particularly attentive to resolving potential macro-financial vulnerabilities. In many low-income countries, capacities for monetary management and financial supervision need strengthening.

Developing country monetary policy makers face some tough challenges. Globalization has ensured that developing economies are not sheltered from external developments. Their currencies are not reserve currencies, and they are effectively “policy takers” in terms of the supply of liquidity at the global scale. Developing country policy makers face difficult choices in weighing the cost and “self-insurance” benefits of reserve accumulation, as well as how to build reserves while maintaining the principle of a flexible exchange rate, as many countries have moved toward a more flexible regime. These challenges create the need to think of monetary management in innovative ways. Overall, besides sound and responsive monetary and exchange rate and external asset-liability management at the country level, there is a need to ensure the adequacy of financial safety nets at the international level (such as support from international financial institutions, central bank swap arrangements, and regional cooperative arrangements).

II. Intensifying structural reforms for investment, productivity growth, and structural change

The private sector is the main engine of economic growth. Private firms typically generate 9 out of every 10 jobs in an economy. Investment by firms is a key means to innovation, productivity growth, and structural transformation. Governments play an important role by providing a conducive, enabling environment for private sector growth. Firms need efficient regulation that fosters openness and competition in product markets. They need factor markets that facilitate access to finance and employment of productive workers. They need a predictable and open trade regime. They need reliable and affordable infrastructure. And they need good governance.

Box 1: The Jobs Challenge

There are three layers to an effective jobs strategy. At the foundation are fundamentals that drive economic growth: sound macroeconomic management, a conducive private investment climate, and skill development aligned with demand. This is a common agenda for all economies. The second layer covers labor market reform: this is an important issue for those economies with more rigid or distorted labor markets. The third layer consists of specific, selective interventions tailored to country-specific challenges, as they can differ widely across countries, such as between aging societies and those with high youth unemployment or between fast urbanizing economies and those with high informality. Enhancing the participation of women in the labor force is a particularly important issue in some economies. Policy priorities differ across countries and the biggest payoffs require addressing the most critical bottlenecks.

Source: *World Development Report 2013*.

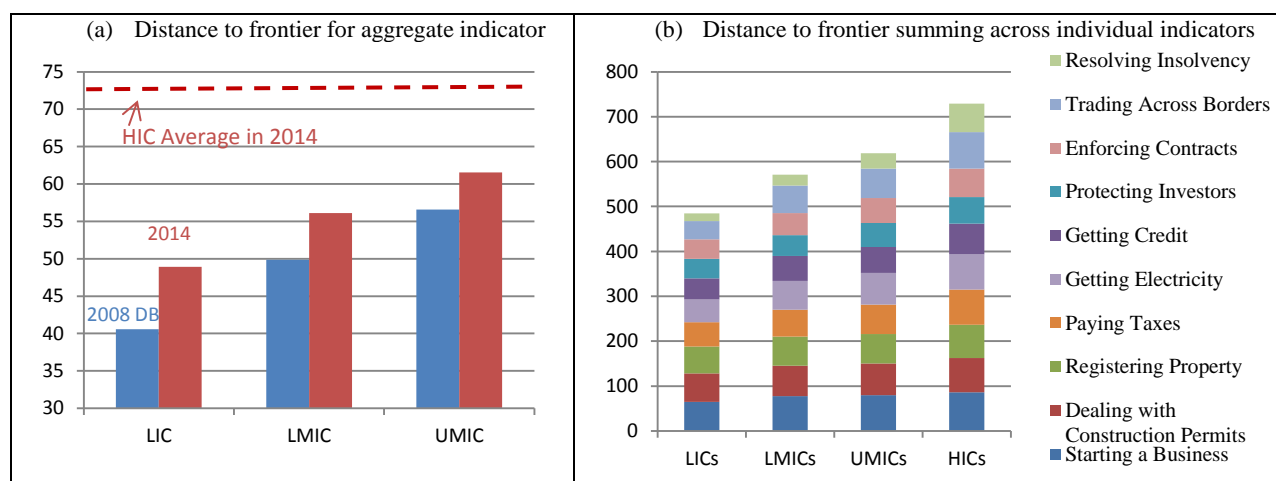
Reform priorities vary across countries.²³ For example, in low-income countries, many “firms” are actually farms and they need basic infrastructure and access to improved farming techniques in order to increase their productivity. Promotion of small and medium enterprises in light manufacturing is another common feature of the agenda in many low-income countries. Policies to facilitate resource allocation toward more productive and higher value-added sectors and spur competition are essential for higher productivity and structural transformation in middle-income countries. As countries move to higher levels of development, skills and technological innovation take on an ever more important role. At a time of rapid technological and structural change and the rise of global value chains, open and competitive business environments are especially at a premium, for the market incentives and pressures they generate and the flexibility they provide.

a. Improving the business environment

In a context of increased market risk aversion and capital flow volatility, the business climate for investment takes on added importance. Longer-term capital flows rely on a positive and stable business climate for investment. Together with appropriate macroeconomic policies, an improved investment climate can enhance countries’ resilience to capital market volatility and also limit the rise in the cost of capital as interest rates normalize by reducing risk premia.

The “distance to frontier” in business climate is narrowing in developing economies but a substantial reform agenda remains. Progress continued in doing business reforms during the recent global crisis. Low-income countries remain farthest from the frontier but have shown the most progress (Figure 3(a)).²⁴ Middle-income countries on average offer better business environments but are still far from the frontier. There is substantial room for further reform even in many high-income countries. It should be noted that the averages for these country classifications hide a high degree of variability across individual countries.

Figure 3(a) and (b): Progress toward “the frontier” in doing business (percentage points)



Note: The distance to frontier measure shows how far an economy is from the highest rating achieved by any economy on the particular *Doing Business* indicator. The measure is normalized between 0 and 100, with 100 representing the frontier. *Doing Business* measures business regulations, with a focus on small- and medium-sized companies.

Source: *Doing Business* database

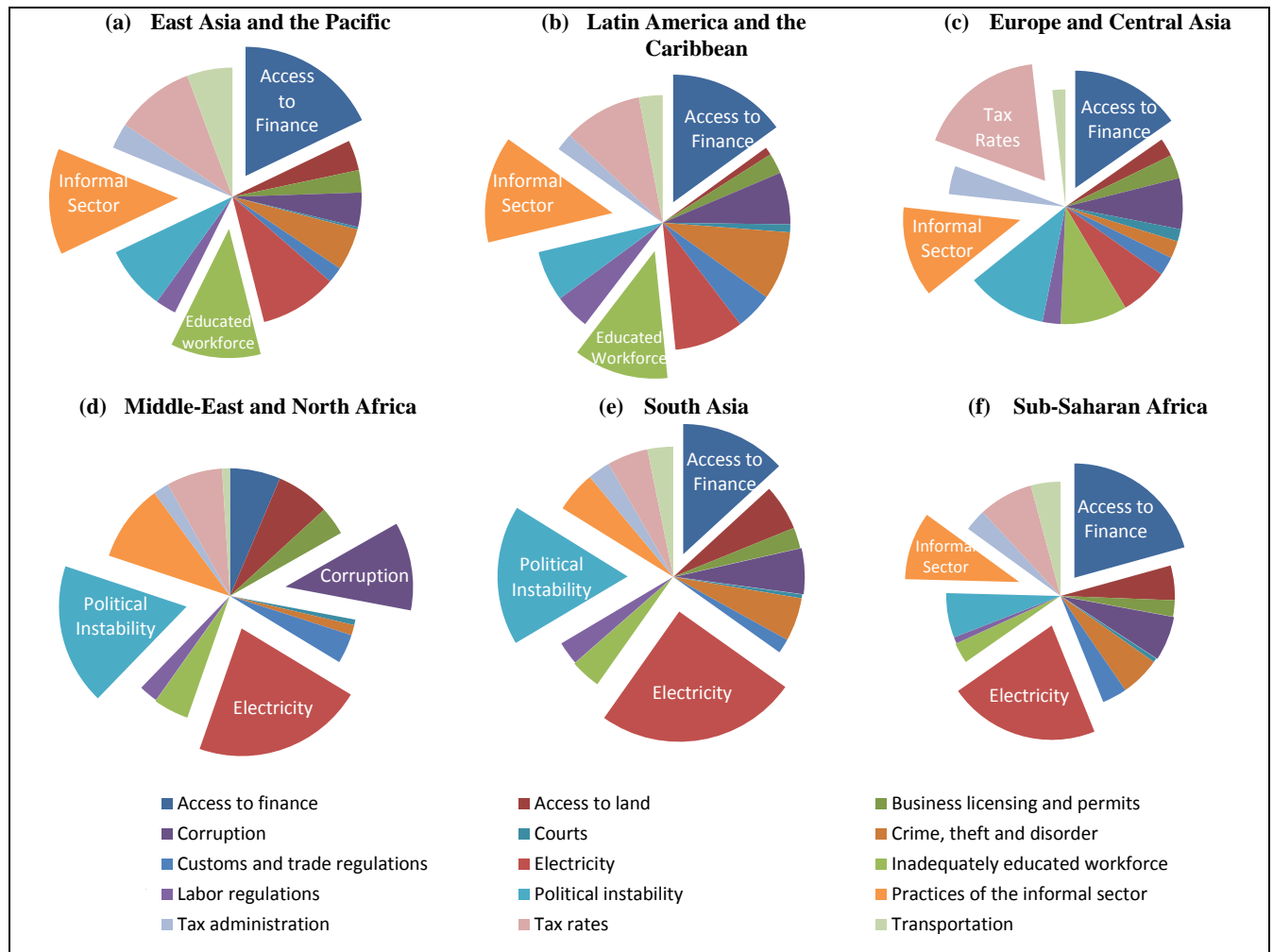
Some policy gaps are larger than others. Typically, especially in lower-income countries, reforms to reduce the cost and complexity of regulatory processes have seen the most progress. Deeper reforms of a more institutional nature—to improve the corporate, financial, and legal institutional framework—have the farthest to go (Figure 3(b)). Also, reforms need to be backed up by effective implementation.

Reforms to improve the business environment should be guided by an assessment of the underlying policy gaps. Besides the *Doing Business* indicators, the WBG *Enterprise Surveys*, which cover a broader set of business environment constraints, provide additional input.²⁵ These surveys point to interesting regional and country differences (Figure 4(a)-(f)). Access to finance appears as an important issue in almost all regions. Electricity is frequently reported as the biggest obstacle in the poorer regions, most notably South Asia and Sub-Saharan Africa, but it also appears strongly in the typically middle-income Middle East and North Africa (MENA). Political instability is reported as a major issue by firms in many countries in MENA, as well as in some countries in South Asia. “Practices of competitors in the informal sector” is another item that appears strongly in several regions. Access to an educated workforce is frequently reported as the biggest obstacle in the typically middle-income regions of East Asia and Latin America.

The incidence of corruption is of particular relevance to businesses in lower-income countries. Enterprise surveys reveal that nearly 40 percent of firms report corruption as a major constraint to investment. While the average is roughly similar across income classifications, low-income country firms report about twice the actual incidence of corruption than do firms in upper-middle income countries.

Recent research points to the complementary roles of policies that establish a broad environment conducive to private activity and policies that address specific binding constraints to the growth of industries where a country may have comparative advantage. Value chain analyses and other diagnostic tools can be quite valuable in identifying specific impediments to growth and job creation in particular sectors. Such investment in the diagnosis of specific binding constraints pays off not only in terms of designing the right policy interventions but also keeping the policy agenda more focused and manageable.²⁶

Figure 4(a)-(f): Key obstacles cited in Enterprise Surveys, by region



Source: WBG Enterprise Surveys database (www.enterprisesurveys.org)

b. More and better infrastructure

Infrastructure investment is a key complement of policy reforms to improve the enabling environment for private sector activity. It is central to delivery of key public services, such as education and health. Getting infrastructure right is also at the heart of green growth. Infrastructure gaps are large in developing countries: for example, the population without access to electricity ranges from one-third of the total in South Asia to two-thirds in Sub-Saharan Africa. Additional investment needed in infrastructure in developing countries exceeds \$1 trillion a year. The increasing role of global value chains in trade, rapid urbanization, and the challenge of climate change are adding to infrastructure needs. Empirical literature confirms the important long-term growth impacts of infrastructure investment. More recent research also finds a positive role for infrastructure in reducing inequality.²⁷ While macro regressions find a positive association between infrastructure development and strong and inclusive growth, micro studies have quantified the importance of infrastructure in driving firm-level productivity.²⁸ The impact depends on project quality and efficiency of implementation and maintenance. As noted, enterprise surveys highlight electricity as a major constraint to firm growth in several regions.

Complementing national-level infrastructure development programs, regional cooperation in infrastructure, such as in the power sector, opens possibilities for projects that can be transformational in

impact. There are already some promising examples of such projects in some regions, including in Sub-Saharan Africa.

Greater attention needs to be given to the quality of infrastructure investment rather than simply increasing the amounts invested. Bank research shows that the growth returns to infrastructure investment vary widely from country to country—even neighboring countries of similar sizes—based largely on the efficiency of investment decisions and operating practices. The current global context, with constrained budgets and tightening financial markets, implies an even greater focus on the efficiency of infrastructure project selection and execution, as well as creative solutions for finance. This includes improving the regulatory and institutional environment for public-private partnerships. Private participation in infrastructure finance and provision is much more sensitive to country risk indicators than foreign direct investment is generally.²⁹

A holistic approach is crucial to promoting efficient and sustainable provision of infrastructure services. Key elements of the agenda include: (i) strengthening capacity for infrastructure planning, prioritization, and project selection; (ii) improving asset management, including more efficient operation and maintenance; (iii) building the institutional capacity, pricing structures, risk-sharing framework, and regulatory environment to develop a strong project pipeline to attract the private sector; (iv) expanding the use of guarantees, risk insurance, and innovative finance to crowd in institutional investors and develop local capital markets; and (v) designing tailored plans, policies, and financing tools to encourage investment in “climate-smart” infrastructure.

c. Finance: promoting access and deepening while maintaining stability

Improving access to finance helps promote stronger and more inclusive growth while improving the soundness of the financial system helps promote the stability and sustainability of growth. The prospect of increased capital flow volatility and rise in the cost of capital reinforces the need to pay attention to the financial sector access and soundness agenda. There is strong country and firm-level evidence that the development of the financial sector, including deepening of the capital market, exerts a significant impact on economic growth and poverty alleviation.³⁰ Research shows that the impact of financial sector development on firm performance and growth is stronger for small and medium-sized enterprises.³¹ However, countries need to develop their financial sectors prudently. Research finds rapid credit growth and unsound financial sector practices as factors in the development of financial crises.³² Vigilance is needed, for example, in monitoring rapid growth in corporate leverage and unhedged foreign currency liabilities.

What should be the role of the state in financial sector development? The WBG’s 2013 *Global Financial Development Report* (GFDR) suggests that the main challenge for financial sector policies is to promote financial development in a sustainable way. The state needs to provide a solid and transparent institutional framework for regulation and supervision. It needs to encourage contestability through healthy entry of well-capitalized institutions and timely exit of insolvent ones. State-owned financial institutions can play a positive role in stabilizing aggregate credit in a recession or crisis; however, government ownership can lead to resource misallocation and deterioration of the quality of intermediation. Policy makers can limit the inefficiencies associated with state bank ownership by paying special attention to the governance of these institutions and to risk management processes.

The fact that as many as 2.5 billion people do not have an account at a formal financial institution underscores the importance of promoting financial inclusion. Financial inclusion is not equivalent to finance for all, no matter the cost. Imprudent expansion and subsidization can have negative consequences and lead to over-indebtedness and financial instability. The focus of public policy needs to be on addressing market failures that constrain the use of financial services; for example, by engendering the right legal and regulatory framework, supporting the information environment, educating and

protecting consumers, facilitating remittances, and promoting the use of new technology such as electronic transactions and mobile telephony. The WBG is actively engaged in supporting this agenda and working with partners in the framework of the Global Partnership for Financial Inclusion.

d. Reinvigorating trade reform

Trade reform holds the potential to provide substantial boost to global growth. Growth benefits from a reduction of trade barriers not only because of the enhanced opportunities for external trade but also the spur to productivity and innovation in the domestic economy from increased competition. Many countries have resorted to trade restrictive measures in the aftermath of the global financial crisis, with a larger share of these measures accounted for by emerging economies (with actions that predominantly impact other emerging economies and therefore restrict South-South trade). Not only is there a need for both advanced and developing economies to refrain from new protectionist measures, but there is also a need to further open up world trade. The agenda spans further reducing trade barriers in the traditional areas of industrial goods and agriculture and advancing services liberalization but also addressing new issues that have an increasingly important impact on trade, including discriminatory behind-the-border measures, domestic regulations and safeguards, and disciplines governing investment.

The success of the WTO's Bali meeting in December 2013 in reaching agreement on some elements of the trade and development agenda, especially trade facilitation, is a welcome step. The trade facilitation agreement will simplify customs procedures, improving their efficiency and lowering transaction costs. Complementary actions to improve transport services and logistics could significantly enhance the gains in trade and GDP growth. Improvements in trade-related infrastructure is especially important for low-income countries, notably in Sub-Saharan Africa, both to capture the potential for increased regional integration and to enter global value chains. Reducing barriers to participation in supply chains can produce high returns.³³ The Bali meeting produced the first agreement on trade negotiations since the establishment of the WTO in 1995. It is important to build on this success and develop a momentum for collective action on trade reform, including ensuring that plurilateral initiatives currently being negotiated among groups of countries support an open multilateral trading system.

III. Building human capital

Capital for growth includes not only physical capital but, importantly, human capital. Macro growth regressions confirm the key role of human capital;³⁴ at the micro level, firm performance is dependent upon the productivity of its workers. Those workers need to have job-specific skills, and they also need to be healthy, in order to be productive. The human capital development agenda is important for growth, job creation, and inclusion.

a. Education and skills development

The premium on skills has been rising. Investment in skills is increasingly important for countries' ability to harness technology and to compete successfully in a progressively knowledge-driven global economy. Across 1,500 subnational regions in 110 countries, education and skills emerge as a critical determinant of knowledge spillovers and entrepreneurship.³⁵ Analyses of international test scores show a strong link with countries' economic performance. Broadening access to quality education also promotes a more inclusive pattern of growth.

Skills training, or retraining, is especially important in the context of structural change. Effective training programs promote productivity growth, as well as facilitate adjustments to shifts in competitiveness and economic shocks, by equipping workers to move between industries and occupations. The skills content of jobs is changing. Rising educational coverage globally is producing

more people with higher levels of paper qualifications but with questionable employability. This has contributed to rising youth unemployment. To address growing skill gaps and mismatches, policies need to pay more attention to aligning supply with changing demand.

Effective investment in the education and skills of youth is key to extracting a “demographic dividend” for economic growth from the youthfulness of developing country populations. Three billion of the world’s seven billion people are below 24 years of age and 90 percent of them live in developing countries. The agenda includes expanding access to education and skills development and improving quality and relevance. Given the progress on basic education enrollments, the demand for post-secondary education is strong, but gaps in access are large. Learning outcomes remain poor in many countries: an estimated 250 million children are unable to read and write, even after three or more years in school.

There are several policy directions that can help developing countries strengthen education and skills development, even during turbulent times. First, protect key education and youth programs from fiscal retrenchment.³⁶ Second, adopt a strategic, integrated approach to investing in education and skills that recognizes and leverages the linkages across multiple policy areas such as labor market reform and active labor market programs, industrial development, science and technology, and R&D and innovation systems. Third, foster partnerships with the private sector and social partners, as governments lack the resources, information, and capacity to act alone. Fourth, orient the education and training system to deliver skills that meet labor market and social needs. This means strengthening the foundational levels of the system to ensure that all children acquire a solid grounding in literacy and numeracy (including strengthening early childhood development programs), and improving post-secondary programs to equip students with skills demanded by prospective employers. Fifth, strengthen technical and vocational education and training as a mechanism for developing and renewing workforce skills. Sixth, encourage and enable lifelong learning. Finally, shift public sector programs from input-based to performance-based financing.

b. Promoting better health and inclusive human development

Health is an investment with positive economic returns—and not simply a drain on scarce resources. The returns in developing countries are especially high on preventive health care—that can save millions of lives lost to communicable diseases such as diarrhea, malaria, and HIV/AIDS—and investments that improve child and maternal health. In many poor countries, vaccination, basic sanitation and hand-washing programs remain key elements of health strategies. Poor health undermines worker productivity. It prevents many poor people from ever participating in economic growth.

An integrated approach to health care delivery value chains and strengthening health systems is important to achieving and sustaining health results.³⁷ Progress toward maternal and child health and nutrition outcomes is particularly slow because these MDGs are dependent on well-functioning health systems. There is a growing realization that countries cannot deliver basic health services through isolated interventions or fragmented or earmarked funding alone. Impact evaluations provide evidence on how careful attention to the design and delivery of health interventions is critical to their quality and effectiveness. A recent Lancet Commission study suggests that with appropriate investments, a “‘grand convergence’ in global health can be achieved within a single generation.”³⁸ One indicator of the current wide divergence is that only one in 150 children in the U.S. and U.K. dies before the age of five versus one in 10 in the poorest countries.

Well-designed social safety nets work to protect people, as a necessary complement to more macroeconomic measures aimed at stabilizing the economy.³⁹ Safety nets linked to school attendance or health care, such as conditional cash transfers (CCTs), not only provide social protection but also contribute to economic growth by promoting human capital accumulation and labor force participation. Yet in many low-income countries, safety net programs are either absent or piecemeal with uncertain

financing and very limited coverage. Many middle-income countries have more effective safety net structures in place, but they too experience financing shortfalls, poor targeting, sub-optimal impacts, and coordination failures.

Recent experience confirms five lessons for policymakers.⁴⁰ First, safety nets can be effective during systemic crises to reduce the toll of human suffering.⁴¹ Second, safety nets must be available on a continuous basis to help build vulnerable people's resilience to shocks and promote equality of opportunity for the poor. They should not be tied to specific jobs because that creates rigidities in the labor market and hurts productivity. Third, it takes time and political will to build good safety nets, so it is important to start early so that these are in place ahead of shocks. Fourth, well-designed safety nets are an affordable investment. Across the world, noncontributory safety nets rarely account for more than 1–2 percent of GDP, even in countries with generous social protection systems. Flagship safety net programs in Mexico or Brazil cost just around 0.5 percent of GDP. Still, affordability could be further improved. Fifth, despite the improvements in safety net development in recent years, countries still have a long way to go. There is the need to build programs where coverage is low; improve targeting; ensure the tax-benefit systems do not create disincentives to formal employment; and improve data to guide policy.

IV. Promoting green growth: converting challenge into opportunity

Ensuring the longer-term sustainability of growth requires reforms to improve the efficiency of use of natural capital and investment in green technologies. The “greening” agenda is essential to ensure sustained growth, but it can also provide more immediate benefits for growth. The poor are especially vulnerable to environmental stresses. For growth to be greener, resources must be allocated in ways that reflect the social costs and benefits of using up scarce natural capital, supported by appropriate accounting of resource use.⁴² Policies and institutions should correct for the overuse of natural capital caused by market failures or policy distortions—for example, through appropriate pricing, taxes, or regulation.

Well-designed green policies improve social welfare, taking into account not only present but future generations. Yet policy makers are also concerned about potential *trade-offs* and costs for near-term growth and employment. Such costs can be kept smaller through well-designed regulations and market-based policies that create incentives for people to seek out the least-cost ways of protecting the environment. The economic costs can be further minimized when environmental damage is taxed and revenues are used to reduce other distorting taxes (or reduce a large fiscal deficit). Poor countries need assistance to manage the up-front costs of investments in climate change mitigation, as well as help with adaptation measures.

There are important win-win opportunities that should be exploited. This includes, for example, the elimination of distortions like large and poorly targeted energy subsidies, thus increasing economic efficiency and equity while generating savings for potential use in other growth-promoting investments, such as green infrastructure, or adaptation to environmental risks. Globally, the cost of environmentally harmful subsidies (in energy, agriculture, water, and fisheries) is on the order of \$2 trillion or more annually.⁴³ As another example, better public transport reduces air pollution, congestion, and harmful health impacts. Also, green policies can act as a spur to innovation and investment in new technologies. Green growth is necessary and is also inclusive. If supported with carefully designed policies, and assistance to poor countries, it is affordable as well.

Many developing countries are interested in the potential to become competitive exporters in expanding markets for environmental goods and services. Maintenance of undistorted trade and foreign investment policies is essential for countries to benefit from mutual gains from trade in environmental products.

D. Role of the World Bank Group

The goals of ending extreme poverty and boosting shared prosperity are under threat in the current global economic conjuncture. Developing countries face a range of external risks and internal challenges to securing strong, inclusive, and sustainable growth. They need to navigate the post-crisis transition in the global economy and strengthen the foundations for longer-term growth. Unless the risks and challenges are managed well, there is the potential of a “new normal” of slow growth, rising inequality, and diminished prospects for reaching the WBG’s twin goals.

The WBG has been undertaking some major changes to improve its ability to marshal the best expertise from around the world to help countries confront challenges in making progress toward the twin goals. The assessment in the preceding sections highlighted challenges of economic management to deal with near-term risks to economic stability and structural reforms and investments to bolster longer-term growth and shared prosperity. The latter agenda spans areas such as promoting growth with inclusion, creating jobs, investing in people, improving the private investment climate, strengthening infrastructure, managing urbanization, boosting agricultural productivity, and addressing the threat of climate change. These are also key themes of the emerging post-2015 agenda. The ongoing change process will help the Group better support clients in responding to these challenges. The new Global Practices and Cross-Cutting Solution Areas will help better deploy knowledge and global best practice to support policy design and implementation. They will bring new opportunities to sharpen technical expertise, consolidate and share global knowledge, and strengthen external partnerships. The new Country Engagement Model, including the Systematic Country Diagnostic and Country Policy Framework, will help better tailor policies and programs to country needs and priorities and provide the basis to establish higher-impact, transformational WBG country engagements. With the Bank, IFC, and MIGA operating as one WBG, synergies across the institution will be better captured to engage both the private sector and government to promote job creation and inclusive and sustainable growth.

The first WBG-wide strategic budget exercise has helped sharpen the client focus. In alignment with suggestions from many chairs on the Board, the Senior Management Team decided to prioritize regions with the highest incidence of extreme poverty—South Asia and Sub-Saharan Africa. At the same time, in line with the goal to boost shared prosperity, middle-income countries will be supported in adapting to new opportunities and challenges. Promoting shared prosperity in every country also positions the WBG to work with high-income countries. The review of client demand highlighted the need to build flexibility in Global Practices and CCSAs; for example, some global practices, such as energy, are expected to be in higher demand than currently resourced.

The World Bank Group is prepared for a potential increase in demand for lending and other forms of financial support, such as guarantees. The WBG Strategy was a starting point, setting the stage for coordinated Group-wide efforts to take advantage of the strengths of the balance sheet of each institution within the group and their variety of instruments and diverse client base. The record \$52 billion IDA17 replenishment will support progress toward the goals of ending extreme poverty and boosting shared prosperity in the world’s poorest countries—home to nearly one billion people living on less than \$1.25 per day. IDA17 will see an increased focus on the most challenging frontier areas, including helping fragile countries get on a path of sustainable growth, greater private sector mobilization and stronger, more targeted investments in climate change and gender equality—with a strong commitment to inclusive growth underpinning these efforts. Proposals approved by the Board in February 2014 established a number of important changes to improve financial margins for maneuver, including adjusting IBRD financial parameters (target equity/loan ratio and single borrower limit), establishing more maturity differentiation on IBRD lending, and reinstating the IBRD commitment fee. These measures, along with actions to nurture IFC and MIGA revenue growth and to implement Group-wide reductions in administrative expenditures of \$400 million (in line with the goals discussed with Development Committee Ministers at the 2013 Annual Meetings), will create additional financial capacity to respond to

future increases in demand for financial services from the WBG. Innovative exposure exchanges to manage exposure concentration will allow both MIGA and IBRD to improve the diversification of their portfolios. In addition to financing, the WBG's broader menu of financial products and services will help strengthen countries' capacity on debt, asset, and risk management.

I. Managing the post-crisis transition

Drawing on the experience of past crises, the WBG is supporting countries through policy advice in strengthening resilience to future shocks and restoring policy buffers. If global economic volatility leads to demands for increased fast-disbursing support, the WBG stands ready to work closely with the IMF in developing multilateral packages of financial support. During the 2008–10 period, the WBG substantially increased financial support for developing countries. The WBG is positioned to respond with a similar level of financial support should the need arise. As an illustration, in a scenario where long-term interest rates increase rapidly by 200 basis points and a disruption in capital markets drives up demand for fast-disbursing IBRD financing, the IBRD would have the capacity to scale up FY15–17 lending to about \$100 billion while still being able to lend at about \$20 billion per year thereafter, without changing current terms. Also, based on experience of past crises, IFC has several relevant programs that can be scaled-up if conditions warrant, such as the trade and commodity finance programs.

Macro-financial linkages arose as a key issue during the last crisis. The WBG will be able to work across the group to provide both advisory services and financial instruments to strengthen countries' financial systems and help them endure market volatility. With the new global practice model, the WBG's macroeconomic, fiscal, and financial sector expertise and knowledge can be better deployed globally to where it is needed most, working in collaboration with the IMF and other partners. Also, the WBG will work with countries, and partners such as the IMF, to develop new macroeconomic policy tools and guidance for policy coordination between high, middle- and low-income countries in today's globalized world.

Improving country preparedness to crises and shocks requires steady country dialogue and support for building social safety nets. During the 2008–09 crisis, increased demand from clients and substantial resources deployed by the Bank saw a sharp expansion of Bank engagement with countries on social safety nets. One of the strongest developments in the IBRD-IDA portfolio has been the growing investment in cash transfer programs. At the start of the crisis (FY07–08), there were a total of 8 conditional cash transfer (CCT) and 9 unconditional cash transfer (UCT) programs worldwide supported by the Bank. During the crisis period (FY09–10), the number more than doubled for CCTs to 17 and nearly tripled for UCTs to 25. In FY10–12, the Bank supported 24 CCT programs in 16 countries and 50 UCT programs in 32 countries. Other crisis-response programs supported by the Bank include public works, training, food and nutrition programs, and provision of other public services.

The response will vary across countries. Many low-income countries have limited access to global financial markets and weak fiscal and external financial room to maneuver; if trade or commodity prices drop, they may need extraordinary financial support. Some more advanced middle-income countries have built up stronger macroeconomic buffers; however, they may need policy support for addressing macro-financial vulnerabilities, enhancing resilience, and strengthening social safety nets. Some countries in this group, those with larger financing gaps, may also need financial support in the event of a financial market shock.

II. Boosting strong, inclusive and sustainable growth

The WBG's change process positions the institution better to support longer-term growth in developing countries. With a focus on the twin goals and a group-wide strategy, the WBG can more effectively support the policies and financing needs that can promote private sector-led growth and job

creation that are central to achieving the goals. The new Global Practices will enhance technical expertise and knowledge sharing across regions in fourteen specialized areas ranging from macroeconomics and finance to infrastructure and human development that span the agenda for strong, inclusive, and sustainable growth. The analysis of the growth agenda in this paper has underscored the need to improve the environment for private entrepreneurship, increase productivity, and enhance inclusion. Sound policy advice on needed structural reforms and investments in infrastructure and human capital will be crucial, as will learning from what works and what doesn't in ensuring development effectiveness and impact. In a context of tight budget constraints, analysis and advice on spending priorities and efficiency and effectiveness of implementation and service delivery take on added importance. The rapid rise of global value chains increases the demand for support on trade policy reform, trade facilitation, and other policies to improve competitiveness. The opportunities and challenges countries face are increasingly differentiated, requiring tailored advice. There is a growing demand for knowledge on global best practice. The Global Practices will help better respond to this agenda for knowledge on growth and development, also tapping synergies across the WBG.

The Cross-Cutting Solution Areas will address development challenges that require integration across areas of specialization. The Jobs CCSA should help country teams work on linking economic growth to the jobs that generate inclusive growth. The Gender CCSA will help country teams work with clients on enhancing women's participation in the labor force and economic activity. The Climate Change CCSA will help teams work on integrating environmental sustainability into the growth agenda. The Fragility, Conflict, and Violence CCSA will help teams in addressing development agendas in the most difficult contexts so that no country is left behind in the effort to end extreme poverty and promote shared prosperity. The CCSA for public-private partnerships can help promote creative development solutions, especially in addressing the large infrastructure needs. Many of the challenges countries face cut across sectors and the WBG's sectoral depth and breadth, as well as the capacity to connect macro and micro aspects, position it well to help countries address those challenges.

The jobs agenda is of particular importance in securing inclusive growth. As noted in the 2013 WDR, in some countries, labor market reforms are essential to unleashing the potential for job creation. In many cases, reforms that increase private firms' demand for labor, along with investing in people to improve the supply of skills, are the winning combination. The jobs issue has increasing prominence in World Bank country policy dialogue and assistance strategies. Also, the IFC is working increasingly to approach its operations with a jobs lens, focusing on key constraints to job creation by the private sector. The Human Development and Finance and Private Sector Development Networks have launched a joint program with a focus on issues related to the self-employed, including training and financial inclusion. The Bank is involved in the Global Coalition on Youth Employment Solutions—a partnership with other multilateral organizations and practitioners to support pilot programs that connect youth to wage-earning jobs or self-employment. The Bank has also launched an initiative, in collaboration with the ILO, to develop guidelines to inform the design/reform of core labor regulations. The Bank is actively participating in and supporting the work of the G20 Task Force on Employment.

The jobs agenda varies across countries. For example, in many low income countries, the majority of the poor still earn their living on the farm. Raising agricultural productivity is a priority for increasing gainful employment and incomes in these countries. The WBG's Agricultural Action Plan is giving more emphasis to: promoting climate-smart agriculture, including support for climate change mitigation and adaptation; facilitating private sector response, including increasing IFC's agribusiness investments; improving agricultural risk management; promoting gender mainstreaming; tapping complementarities between agriculture, water, forestry, and biodiversity; and addressing governance constraints to improving agricultural performance.⁴⁴

Another key innovation is growth-focused (or "productive") safety nets. Safety net programs should be devised to complement graduation strategies and connect to human development services and

programs. International experience suggests that efforts to link beneficiaries to other complementary services can be an effective way to lift people permanently out of poverty (for example, Ethiopia's safety net program, Jamaica's Program for Advancement through Health and Education, and Ecuador's *Bono de Desarrollo Humano*). Some programs include workfare elements (as in the income generation programs in Bulgaria and Romania). Most of the innovation in safety nets originated in the South (with landmark programs such as Brazil's *Bolsa Familia* and Mexico's *Oportunidades*), so facilitating South-South knowledge exchange is especially important in propagating best practice in this area. In many middle-income countries, knowledge exchange may be the key transformational support that leads to policy change; in weaker institutional environments, more continuous technical assistance and financial support may be needed.

Environmental hazards and natural disasters impose a major risk to both short-term welfare and future growth, and low-income countries are especially vulnerable.⁴⁵ There are substantial "win-win" opportunities for improving both growth prospects and environmental sustainability. This includes moving from costlier and more environmentally harmful means of electricity generation to cheaper and environmentally friendlier processes. Poor countries need financial support to meet the up-front costs of investments in climate change mitigation and adaptation. The WBG is expanding successful Group-wide approaches: for example, in Sub-Saharan Africa, a blend of IDA guarantees, IFC investments, and MIGA products are being used to expand electricity capacity in ways that favor the environment. The electricity sector is also an important area where the WBG is supporting innovative and transformational multi-country projects.

Strengthening partnerships is a key element of the WBG strategy. Partnerships can leverage funding from the private sector and mobilize bilateral and multilateral funding for key global public goods—for example, the Climate Investment Fund (CIF). A central part of IFC's strategy is to mobilize capital from third parties to meet clients' needs and increase impact, and efforts are underway to expand these mobilization efforts through new approaches such as the Asset Management Company (AMC) and the Managed Co-Lending Portfolio Program (MCP). MIGA is growing its guarantee portfolio in support of private sector investment in infrastructure, including through expanded product offerings. The Lancet Commission called for enhanced cooperation among the development community to increase support for health, and the WBG can play an important role in that effort. The WBG is engaged in several other sectoral partnerships as well that leverage finance and knowledge.

Partnership approaches and innovation are especially important in infrastructure, where investment needs are large and WBG resources small. Also, the post-crisis period has witnessed a retrenchment of traditional commercial financing for infrastructure. Consultations in 2013 for a Global Infrastructure Facility (GIF) indicated that there is strong interest from both public and private stakeholders for the WBG to play a greater role in meeting infrastructure needs, in particular in catalyzing more private sector resources and attracting new sources of financing such as institutional investors. The GIF design is a work in progress, but it is likely to include both upstream and downstream platforms; the former would strengthen the regulatory framework and project preparation and the latter would focus on arranging and mobilizing financing and credit enhancements.

At the country level, the new Systematic Country Diagnostic (SCD) is designed to strengthen the focus on the twin goals. The objective is to develop stronger and more systematic analysis of the key constraints and opportunities for accelerating progress on poverty reduction and shared prosperity in a sustainable manner. The SCD will help better inform and tailor policy responses to the specific challenges countries face in promoting strong, inclusive, and sustainable growth. It will draw upon the best available analysis and evidence for a country in and outside the Bank, including work by partner institutions such as the IMF, government, and independent researchers. While being a WBG-led exercise, it will seek to involve country partners in preparation and be informed by citizens' input and feedback. The analytics of

the SCD will in turn be a key input into the new Country Partnership Framework (CPF) for WBG engagement at the country level, as set out in the WBG Strategy.

The structure of the SCD will help the WBG engage country policy makers on more detailed and nuanced aspects of the country's policy agenda. The diagnostic will investigate the agenda for economic growth, the inclusiveness of growth, and the sustainability of growth. It will look at the constraints to private investment, productivity, entrepreneurship, and job creation. To identify barriers to inclusiveness, the SCD will analyze equality of opportunity and access to basic services and discuss institutional factors that impact inclusion of women and other social groups. For sustainability concerns, the SCD will assess and highlight acute environmental issues or vulnerabilities, as well as risks to macro-fiscal-financial and socio-political stability. The analysis will address linkages between factors affecting growth, inclusion and sustainability, including cross-cutting issues such as governance, gender, and conflict and fragility.

Based on its analyses, the SCD will identify the most critical constraints and opportunities that, if addressed, would accelerate the country's progress toward the development goals. It will confront the policy trade-offs and prioritization that countries face around the world. The SCD will provide a narrative of what development path a country might ideally follow to accelerate progress toward its development goals that are consistent with the WBG goals of ending poverty and boosting shared prosperity in a sustainable manner. The SCD and the CPF will provide a stronger framework for focus and selectivity in WBG country engagement, responsive to country priorities and aligned with the WBG's comparative advantage. It will also support a more concerted One-WBG approach.

In support of a sharper focus on priorities in the policy agenda to achieve the WBG's twin goals, and to better monitor progress toward the goals, work on data and research on poverty and shared prosperity is being substantially strengthened. A Data for Goals Initiative aims to significantly improve the availability of data on poverty and shared prosperity. Research on the drivers of shared prosperity, including the links between growth, inequality, and sustainability, has been stepped up.

Endnotes

¹ For example, a paper “Improving the Lives of the Poor” is being prepared for release during the Spring Meetings. The Global Monitoring Report for the Annual Meetings will establish regular monitoring of the twin goals. A Policy Research Report on the twin goals is being prepared for release this fall.

² Different techniques can be used depending upon which measure of inequality is used. A classic reference is Datt, Gaurav, and Martin Ravallion, 1992 “Growth and Redistribution Components of Changes in Poverty Measures: A Decomposition with Applications to Brazil and India in the 1980s,” *Journal of Development Economics*, 38:275–295. Note that the appropriate empirical measure for growth would be the growth of average consumption (or income) per capita from household surveys, which does not necessarily match with national accounts growth rates.

³ See Rosenblatt, David, and Tamara McGavock, 2013, “A Note on the Simple Algebra of Shared Prosperity Indicator,” World Bank Policy Research Working Paper 6645.

⁴ See Dollar, David, and Aart Kraay, 2002, “Growth is Good for the Poor,” *Journal of Economic Growth*, Vol. 7, and Dollar, David, et al., 2013, “Growth Still is Good for the Poor,” World Bank Policy Research Working Paper 6568.

⁵ See Lakner, Christoph, and Branko Milanovic, 2013, “Global Income Distribution: From the Fall of the Berlin Wall to the Great Recession,” World Bank Policy Research Working Paper 6719.

⁶ As estimated by Lakner and Milanovic (2013). They report other estimates in the literature which range from 0.66 to 0.72. All plausible estimates imply an extremely high level of inequality on a global scale, higher than almost any individual country.

⁷ See Ravallion, Martin, 2013, “How Long Will it Take to Lift One Billion People Out of Poverty,” World Bank Policy Research Working Paper 6325. It is somewhat more complicated than what is stated in the text in that Ravallion is using average household per capita consumption growth and a global distribution of income.

⁸ See Basu, Kaushik, 2013, “Shared Prosperity and the Mitigation of Poverty,” World Bank Policy Research Working Paper 6700. Growth rates from national accounts data were used in this exercise.

⁹ Basu (2013), cited above. Also see Chen, Shaohua, Lanjouw, P., Kleineberg, T. and Kraay, A., 2013, “The World Bank’s Poverty Target of 3% in 2030: Assessing the Realism of this Goal and Exploring Some Country Level Implications,” mimeo, DEC Research Group, The World Bank.

¹⁰ This section draws heavily on World Bank, 2014, *Global Economic Prospects*, January.

¹¹ See also, OECD, *Going for Growth 2014: Avoiding the Low-Growth Trap*.

¹² See World Bank, 2006, *The Challenges of African Growth*. Over two-thirds of countries currently classified as LICs are in the Sub-Saharan Africa region.

¹³ See World Bank, 2014, *Diversified Development: Making the Most of Natural Resources in Eurasia*; and IMF, 2014, *Sustaining Long-Run Growth and Macroeconomic Stability in LICs: The Role of Structural Transformation and Diversification*.

¹⁴ See World Bank, 2011, *The Changing Wealth of Nations: Measuring Sustainable Development in the New Millennium*.

¹⁵ See World Bank, 2013, *World Development Report 2014: Risk and Opportunity—Managing Risk for Development*. See also World Bank, GFDRR, and Government of Japan, 2012, *The Sendai Report: Managing Disaster Risks for a Resilient Future*.

¹⁶ See FAO, 2011, *The State of Food and Agriculture 2010–2011: Women in Agriculture: Closing the Gender Gap for Development*.

¹⁷ See, for example, World Bank, 2013, *Africa’s Pulse*, Volume 8, October.

¹⁸ See Stiglitz, Joseph E., Justin Yifu Lin et al., *The Industrial Policy Revolution*, Volumes I & II, Palgrave MacMillan, 2013..

¹⁹ A few stylized facts emerge from the recent empirical literature using firm-level data. First, underlying low aggregate productivity, there is substantial resource misallocation across firms in low-income countries. (See, for example, Hsieh, Chan-Tai and Peter Klenow, 2009, “Misallocation and Manufacturing TFP in China and India”, *The Quarterly Journal of Economics*.) This misallocation may be caused by frictions in moving resources across firms so that, for example, talented entrepreneurs with high productivity activities might not secure the capital or labor they need to expand to an optimal scale. A second firm-level fact about under-development relates to the size distribution of firms: a typical low-income country exhibits a size distribution in which small firms account for a much larger share of total employment than large firms, compared to advanced economies. Lastly, firms in developing countries also exhibit marked differences with developed economies in terms of the dynamics of productivity and employment over the life cycle; that is, they grow at a much slower pace from start-up to maturity.

(See, for example, Hsieh, Chan-Tai and Peter Klenow, 2012, “The Life-Cycle of Plants in India and Mexico”, *Chicago Booth Working Paper No. 11-38*).

²⁰ See, for example: World Bank, *World Development Report 2006: Equity and Development*; Stiglitz, Joseph E., *The Price of Inequality: How Today’s Divided Society Endangers Our Future*, Norton, 2012; and Ostry, Jonathan, Andrew Berg and Charalambos Tsangarides, *Redistribution, Inequality, and Growth*, IMF, February 2014.

²¹ See, for example, IMF, *Fiscal Policy and Income Inequality*, IMF Policy Paper, January 2014.

²² See Eichengreen, Barry and Gupta, Poonam, 2014, “Tapering Talk: The Impact of Expectations of Reduced Federal Reserve Security Purchases on Emerging Markets,” World Bank Policy Research Paper 6754.

²³ See Dabla-Norris, Era, et al., 2013, “Anchoring Growth: The Importance of Productivity-Enhancing Reforms in Emerging Market and Developing Economies,” IMF Staff Discussion Note SDN/13/08.

²⁴ This excludes the relatively new access to electricity indicator that did not exist in 2008. There is no individual country at 100 percent, since it would have to be the world leader in each individual indicator that contributes to the aggregate doing business indicator.

²⁵ All data are compiled and organized for easy access and analysis at <http://www.enterprisesurveys.org/>, a website set up by the World Bank Group.

²⁶ A recent World Bank research project developed this approach to analyze specific constraints to growth of manufacturing in a sample of Sub-Saharan African countries – Ethiopia, Tanzania, and Zambia (with comparator analyses of China and Vietnam). See, for example, Hinh T. Dinh et al., *Light Manufacturing in Africa: Targeted Policies to Enhance Private Investment and Create Jobs*, World Bank, 2012. See also Stiglitz, Joseph E. and Justin Yifu Lin (op cit).

²⁷ See, for example, Estache, Antonio, and Marianne Fay, 2007, *Current Debates on Infrastructure Policy*. World Bank Policy Research Working Paper 4410; McKinsey Global Institute, 2013, *Infrastructure Productivity: How to Save \$1 Trillion A Year*; Calderon, Cesar, Enrique Moral-Benito and Luis Servén, “Is Infrastructure Capital Productive? A Dynamic Heterogeneous Approach,” *Journal of Applied Econometrics* 2014; and Calderon, Cesar and Luis Servén, The Effects of Infrastructure Development on Growth and Income Distribution, *Annals of Economics and Finance*, 2014 (forthcoming).

²⁸ See, for example, Escribano, Alvaro, et al., (2009), “Assessing the Impact of Infrastructure Quality on Firm Productivity in Africa: Cross-Country Comparisons Based on Investment Climate Surveys from 1999 to 2005,” Universidad Carlos III de Madrid Economic Series Working Paper 09-86, November.

²⁹ See Araya Gonzalo, et al., 2013, “The Effects of Country Risk and Conflict on Infrastructure PPPs,” World Bank Policy Research Working Paper 6569.

³⁰ Levine, Ross, 2005, “Finance and Growth: Theory and Evidence,” In *Handbook of Economic Growth*, ed. Aghion, Philippe and Steven N. Durlauf, 865–934. Amsterdam: Elsevier.

³¹ Beck, Thorsten, Asli Demirgüç-Kunt, and Vojislav Maksimovic. 2005. “Financial and Legal Constraints to Firm Growth: Does Size Matter?” *Journal of Finance* 60: 137–177. Beck, Thorsten, Asli Demirgüç-Kunt, and Vojislav Maksimovic. 2008. “Financing Patterns around the World: Are Small Firms Different?” *Journal of Financial Economics* 89: 467–487.

³² Demirgüç-Kunt, Asli, and Enrica Detragiache 1998. “The Determinants of Banking Crises in Developing and Developed Countries,” *IMF Staff Papers*. Kaminsky, Graciela, and Carmen Reinhart, 1999, “The Twin Crises: The Causes of Banking and Balance-of-Payments Problems,” *American Economic Review*, 89(3): 473–500.

³³ Reducing supply chain barriers to trade, through improving border administration and trade-related infrastructure, could increase GDP by 5 percent and trade by 15 percent (see World Economic Forum and World Bank, 2013, *Enabling Trade: Valuing Growth Opportunities*).

³⁴ For example, see Jamison, Eliot A. et al., 2007, “The effects of education quality on income growth and mortality decline,” *Economics of Education Review*, Vol. 7; Bloom, David E. et al., 2003, “The Effect of Health on Economic Growth: A Production Function Approach,” *World Development*, 32(1); Weil, David N., 2007, “Accounting for the Effect of Health on Economic Growth,” *Quarterly Journal of Economics*.

³⁵ Gennaioli, Nicola, et al., 2011, “Human Capital and Regional Development,” National Bureau of Economic Research Working Paper 17158.

³⁶ For example, see Friedman, Jed and Jennifer Sturdy, 2011, “The Influence of Economic Crisis on Early Childhood Development: A Review of Pathways and Measured Impact,” in *No Small Matter: The Impact of Poverty, Shocks, and Human Capital Investments in Early Childhood Development*.

³⁷ See Kim, Jim Yong, Paul Farmer and Michael Porter, 2013, “Redefining Global Health-Care Delivery,” *The Lancet*, September 2013.

³⁸ See “Global Health 2013: A World Converging within a Generation” *The Lancet*, December, 2013.

³⁹ See World Bank, 2012, “Safety Nets Work: During Crisis and Prosperity,” paper prepared for the Development Committee meeting of April 2012. This section draws on that paper.

⁴⁰ Also see *Resilience, Equity and Opportunity: The World Bank’s Social Protection and Labor Strategy, 2012–2022*.

⁴¹ For example, public works programs protected families from starvation in Ethiopia; school feeding programs let poor families keep their children in school in Nicaragua; and cash transfers prevented child malnutrition in El Salvador.

⁴² See World Bank, 2011, *The Changing Wealth of Nations: Measuring Sustainable Development in the New Millennium*, op. cit.

⁴³ See World Bank, 2012, *Inclusive Green Growth: The Pathways to Sustainable Development*. See also International Monetary Fund, 2013, *Energy Subsidy Reform: Lessons and Implications*.

⁴⁴ *Implementing Agriculture for Development: World Bank Group Agriculture Action Plan: 2013-2015*.

⁴⁵ See World Bank, 2014, *Progress Report on Mainstreaming Disaster Risk Management in World Bank Group Operations*, DC 2004-0003.