EXECUTIVE SUMMARY

With buoyant financial markets and a long-awaited cyclical recovery in manufacturing and trade under way, world growth is projected to rise from 3.1 percent in 2016 to 3.5 percent in 2017 and 3.6 percent in 2018, slightly above the October 2016 World Economic Outlook *(WEO) forecast. But binding structural impediments continue to hold back a stronger recovery, and the balance of risks remains tilted to the downside, especially over the medium term. With persistent structural problems—such as low productivity growth and high income inequality—pressures for inward-looking policies are increasing in advanced economies. These threaten global economic integration and the cooperative global economic order that has served the world economy, especially emerging market and developing economies, well. Against this backdrop, economic policies have an important role to play in staving off downside risks and securing the recovery. On the domestic front, policies should aim to support demand and repair balance sheets where necessary and feasible; boost productivity, labor supply, and investment through structural reforms and supply-friendly fiscal measures; upgrade the public infrastructure; and support those displaced by structural transformations such as technological change and globalization. At the same time, credible strategies are needed in many countries to place public debt on a sustainable path. Adjusting to lower commodity revenues and addressing financial vulnerabilities remain key challenges for many emerging market and developing economies. A renewed multilateral effort is also needed to tackle common challenges in an integrated global economy.*

The world economy gained speed in the fourth quarter of 2016 and the momentum is expected to persist. Global growth is projected to increase from an estimated 3.1 percent in 2016 to 3.5 percent in 2017 and 3.6 percent in 2018.

Activity is projected to pick up markedly in emerging market and developing economies because conditions in commodity exporters experiencing macroeconomic strains are gradually expected to improve, supported by the partial recovery in commodity prices, while growth is projected to remain strong in China and many other commodity importers. In advanced economies, the pickup is primarily driven by higher projected growth in the United States, where activity was held back in 2016 by inventory adjustment and weak investment.

Although changes to the global growth forecast for 2017 and 2018 since the October 2016 WEO are small, there have been meaningful changes to forecasts for country groups and individual countries. In line with stronger-than-expected momentum in the second half of 2016, the forecast envisages a stronger rebound in advanced economies. And while growth is still expected to pick up notably for the emerging market and developing economies group, weaker-than-expected activity in some large countries has led to small downward revisions to the group's growth prospects for 2017.

- For advanced economies, projected growth has been revised upward in the United States, reflecting the assumed fiscal policy easing and an uptick in confidence, especially after the November elections, which, if it persists, will reinforce the cyclical momentum. The outlook has also improved for Europe and Japan based on a cyclical recovery in global manufacturing and trade that started in the second half of 2016.
- The downward revisions to growth forecasts for emerging market and developing economies result from a weaker outlook in several large economies, especially in Latin America and the Middle East, reflecting continued adjustment to the decline in their terms of trade in recent years, oil production cuts, and idiosyncratic factors. The 2017 and 2018 growth forecasts have been marked up for China, reflecting stronger-than-expected policy support, as well as for Russia, where activity appears to have bottomed out and higher oil prices bolster the recovery.

Since the U.S. election, expectations of looser fiscal policy in the United States have contributed to a stronger dollar and higher U.S. Treasury interest rates, pushing up yields elsewhere as well. Market sentiment has generally been strong, with notable gains in equity markets in both advanced and emerging market economies. Stronger activity and expectations of more robust global demand going forward, coupled with agreed restrictions on oil supply, have helped commodity prices recover from their troughs of early 2016.

Headline inflation has been picking up in advanced economies due to higher commodity prices, but core inflation dynamics remain subdued and heterogeneous (consistent with diversity in output gaps). Core inflation has improved little where it had been the weakest (for instance, in Japan and parts of the euro area). Headline inflation has also picked up in many emerging market and developing economies due to higher commodity prices, but in a number of cases it has receded as pass-through from the sharp currency depreciations in 2015 and early 2016 continues to fade.

Risks remain skewed to the downside, however, especially over the medium term, with pervasive uncertainty surrounding policies. Buoyant market sentiment implies that there is now more tangible upside potential for the near term, but in light of the sources of uncertainties discussed below, a sharp increase in risk aversion is possible. Risks to medium-term growth appear more clearly negative, also because policy support in the United States and China will have to be unwound or reversed down the road to avoid unsustainable fiscal dynamics. More generally, downside risks stem from several potential factors:

- An inward shift in policies, including toward protectionism, with lower global growth caused by reduced trade and cross-border investment flows
- A faster-than-expected pace of interest rate hikes in the United States, which could trigger a more rapid tightening in global financial conditions and a sharp dollar appreciation, with adverse repercussions for vulnerable economies
- An aggressive rollback of financial regulation, which could spur excessive risk taking and increase the likelihood of future financial crises
- Financial tightening in emerging market economies, made more likely by mounting vulnerabilities in China's financial system associated with fast credit growth and continued balance sheet weaknesses in other emerging market economies
- Adverse feedback loops among weak demand, low inflation, weak balance sheets, and anemic productivity growth in some advanced economies operating with high levels of excess capacity
- Noneconomic factors, including geopolitical tensions, domestic political discord, risks from weak governance and corruption, extreme weather events, and terrorism and security concerns

These risks are interconnected and can be mutually reinforcing. For example, an inward turn in policies could be associated with increased geopolitical tensions as well as with rising global risk aversion; noneconomic shocks can weigh directly on economic activity as well as harm confidence and market sentiment; and a faster-than-anticipated tightening of global financial conditions or a shift toward protectionism in advanced economies could exacerbate capital outflow pressures in China.

Policy choices will therefore be crucial in shaping the outlook and reducing risks. Priorities for macroeconomic demand management are increasingly differentiated, given the diversity in cyclical positions. In economies with slack and persistently weak core inflation, cyclical demand support remains necessary, including to stave off pernicious hysteresis effects. In economies where output is close to or above potential, fiscal policy should aim at strengthening safety nets and increasing potential output. At the same time, credible strategies are needed in many countries to place public debt on a sustainable path.

Following a lackluster recovery from the global financial crisis, and in the aftermath of the sharp adjustment of global commodity prices, many economies are seeking to enhance growth potential, inclusiveness, and resilience. Actions to bolster potential output are indeed urgent given persistent headwinds from population aging in advanced economies, the ongoing adjustment to lower terms of trade and the need to address financial vulnerabilities in emerging market and developing economies, as well as sluggish total factor productivity growth in both groups. Chapter 2 documents that trade openness, exchange rate flexibility, and strong institutions help emerging market and developing economies enhance the growth impulse from external conditions. Facing ever-present risks of global financial volatility, emerging market economies vulnerable to an adverse turn in external financial conditions would benefit from adopting stronger risk management practices and containing balance sheet mismatches.

Preserving the global economic expansion will also require policymakers to avoid protectionist measures and to do more to ensure that gains from growth are shared more widely. Chapter 3 documents that wages have not kept up with productivity in many economies over much of the past three decades, leading to a decline in labor's share of national income. The chapter's analysis suggests that technological change and trade integration—both of which are drivers of medium- and long-term growth—have likely contributed to the decline. The chapter's findings suggest that technological change has been the dominant driver of the labor share in advanced economies whereas trade integration (and the attendant increase in the capital intensity of production) has been the dominant driver in the case of emerging market economies. These findings highlight the need to make growth more inclusive. Possible policy levers include more progressive taxation; investments in skills, lifelong learning, and high-quality education; and other efforts to enhance the occupational and geographical mobility of workers to ease and hasten labor market adjustments to structural transformations.

Many of the challenges that the global economy confronts call for individual country actions to be supported by multilateral cooperation. Key areas for collective action include preserving an open trading system, safeguarding global financial stability, achieving equitable tax systems, continuing to support low-income countries as they pursue their development goals, and mitigating and adapting to climate change.