Executive Summary

Shifts in the global landscape are taking place following disappointing growth in 2016. Momentum picked up in the second half of 2016, and the outlook for advanced economies has improved for 2017–18. Better growth prospects in the United States, Europe, and Japan reflect some rebound in manufacturing and trade, as well as prospects of likely U.S. fiscal stimulus in the wake of the November elections. As it seeks a new policy course, the *United States* should see solid economic growth in the near term with job creation and rising inflation. With a shift in the direction of U.S. policies, market sentiment has strengthened alongside advancing equity markets, a stronger U.S. dollar, and higher U.S. interest rates. Meanwhile, growth prospects marginally worsened for emerging market and developing economies compared to last fall. However, financial conditions have improved here too, though financial risks and market volatility remain elevated. Stronger growth this year and next is projected for these economies, including China, given its stronger-than-expected policy support. On balance, global growth is envisaged to rise modestly in 2017 and 2018 but with widely dispersed risks. Global vulnerabilities include a rising tide of economic nationalism in major advanced economies marked by greater antipathy toward trade, immigration, and globalization.

In this global setting, economies of *Latin America and the Caribbean* are recovering from a recession at the regional level in 2016. In a tale of two adjustments, growth has been held back by weak domestic demand. This reflects both the ongoing external adjustment to earlier terms-of-trade shocks and, in some cases, fiscal adjustment, in addition to other country-specific domestic factors. The regional recession, however, masks divergent outcomes across countries, with relatively robust growth in Central America; deep contractions in a handful of countries such as Argentina, Brazil, Ecuador, and Venezuela; and generally modest growth elsewhere.

Regional activity overall is expected to pick up gradually this year and next, but the outlook is weaker than projected last fall. The projection for medium-term growth remains modest at about 2.6 percent. The outlook is shaped by key shifts in the global economic and policy landscape, including a modest rebound in commodity prices and in partner demand and higher policy uncertainty at the global level. Domestic fundamentals and developments, however, will continue to play a significant role in determining growth in many economies. At the same time, risks to regional growth have widened in a setting of higher global policy uncertainty.

In this challenging external context, countries should aim for completing fiscal and external adjustments to preserve or rebuild policy buffers. Charting a course toward higher, sustainable, and more equitable growth will also require strengthening structural reforms aimed at closing infrastructure gaps; improving the business environment, governance, and education outcomes; and encouraging female labor participation to boost medium-term growth and foster income convergence.

In *South America*, weaker domestic fundamentals combined with a large terms-of-trade shock took a toll on economic performance and led to sharp recessions in some major economies. Despite the improved external outlook, extending external and fiscal adjustment domestically to structurally lower commodity revenues should continue. Continued efforts are also needed to reduce domestic distortions, resolve policy uncertainties, improve governance, and further structural reforms.

The outlook and risks for *Central America* and *Mexico* are influenced by their exposure to the United States through trade, migration, and foreign direct investment linkages. In this context, maintaining macroeconomic stability and market confidence in an environment of heightened uncertainty is crucial. Prospects for the *Caribbean* are improving, but public sector debt remains a major vulnerability.

This issue of the *Regional Economic Outlook* features three analytical chapters that assess the progress in external adjustment to terms-of-trade shifts, analyze drivers of capital flows, and examine migration and remittances in Latin America and the Caribbean. Key findings are:

- Past external adjustment to negative terms-of-trade shocks in Latin America has worked through a compression of domestic demand and imports rather than growth of supply and exports. In the ongoing adjustment, real depreciations have boosted noncommodity exports and lowered imports more than in the past, and demand has shifted toward locally produced goods unlike in past adjustments. This has alleviated the domestic demand compression needed to achieve external adjustment—that is, a lower sacrifice ratio—for countries with flexible currencies. At the same time, the cost of external adjustment has increased for countries with more rigid exchange rate regimes, given increasing use of flexible regimes in trading partners and competitors. Finally, the overall sluggish response of exports to real depreciations masks differences across industries, including a stronger export performance response for manufacturing goods than for commodities.

- Following a decade of strong capital inflows, Latin America and other emerging markets are now facing the prospects of weaker economic growth and financial flows. Overall, capital inflows are strongly influenced by global cyclical factors as well as country-specific structural factors. In particular, good governance and solid institutional and regulatory frameworks play a key role in attracting inflows over periods longer than the usual business cycle. At the same time, having deeper domestic financial markets with a large and stable domestic investor base, as well as allowing for more exchange rate flexibility, are effective ways to reduce the vulnerability of capital flows to external shocks.

- Migration from and remittance flows to Latin America and the Caribbean have major economic and social ramifications for the migrants' home countries. Outward migration in isolation may lower growth in home countries by reducing the labor supply and productivity, but the remittances sent home by migrant workers serve as a mitigating factor. Remittances serve as a large and relatively stable source of external financing, notably in Central America and the Caribbean, and help cushion the impact of economic shocks. However, the region's dependence on remittances primarily from the United States can pose risks, due to both cyclical reasons and to possible changes to immigration-related policies in host countries. Targeted reforms aimed at leveraging the pool of high-skilled and highly educated workers at home can help reduce outward migration and the attendant adverse consequences. Similarly, given the key financing and stabilizing roles played by remittances, policies to reduce transaction costs and promote the use of formal channels of intermediation merit support.