

EXECUTIVE SUMMARY

The global upswing in economic activity is strengthening. Global growth, which in 2016 was the weakest since the global financial crisis at 3.2 percent, is projected to rise to 3.6 percent in 2017 and to 3.7 percent in 2018. The growth forecasts for both 2017 and 2018 are 0.1 percentage point stronger compared with the April 2017 World Economic Outlook (WEO) forecast. Broad-based upward revisions in the euro area, Japan, emerging Asia, emerging Europe, and Russia—where growth outcomes in the first half of 2017 were better than expected—more than offset downward revisions for the United States and the United Kingdom.

But the recovery is not complete: while the baseline outlook is strengthening, growth remains weak in many countries, and inflation is below target in most advanced economies. Commodity exporters, especially of fuel, are particularly hard hit as their adjustment to a sharp stepdown in foreign earnings continues. And while short-term risks are broadly balanced, medium-term risks are still tilted to the downside. The welcome cyclical pickup in global activity thus provides an ideal window of opportunity to tackle the key policy challenges—namely to boost potential output while ensuring its benefits are broadly shared, and to build resilience against downside risks. A renewed multilateral effort is also needed to tackle the common challenges of an integrated global economy.

The global pickup in activity that started in the second half of 2016 gained further momentum in the first half of 2017. Growth is projected to rise over this year and next in emerging market and developing economies, supported by improved external factors—a benign global financial environment and a recovery in advanced economies. Growth in China and other parts of emerging Asia remains strong, and the still-difficult conditions faced by several commodity exporters in Latin America, the Commonwealth of Independent States, and sub-Saharan Africa show some signs of improvement. In advanced economies, the notable 2017 growth pickup is broad based, with stronger activity in the United States and Canada, the euro area, and Japan. Prospects for medium-term growth are more subdued, however, as negative output

gaps shrink (leaving less scope for cyclical improvement) and demographic factors and weak productivity weigh on potential growth.

Changes to aggregate growth forecasts relative to the April 2017 WEO are generally positive but modest, with some meaningful changes for specific country groups and individual countries.

- In line with stronger-than-expected momentum in the first half of 2017, the forecast sees a stronger rebound in advanced economies in 2017 (to 2.2 percent versus 2.0 percent foreseen in April), driven by stronger growth in the euro area, Japan, and Canada. In contrast, compared with the April 2017 WEO forecast, growth has been marked down for 2017 in the United Kingdom and for both 2017 and 2018 in the United States, implying a 0.1 percentage-point aggregate growth downgrade for advanced economies in 2018. Activity in the United Kingdom slowed more than anticipated in the first half of 2017; as for the United States, given the significant policy uncertainty, the forecast now uses a baseline assumption of unchanged policies, whereas in April it assumed a fiscal stimulus driven by then-anticipated tax cuts.
- Growth prospects for emerging and developing economies are marked up by 0.1 percentage point for both 2017 and 2018 relative to April, primarily owing to a stronger growth projection for China. The country's 2017 forecast (6.8 percent, against 6.6 percent in April) reflects stronger growth outturns in the first half of 2017 as well as more buoyant external demand. For 2018, the revision mainly reflects an expectation that the authorities will maintain a sufficiently expansionary policy mix to meet their target of doubling real GDP between 2010 and 2020. Growth forecasts have also been marked up for emerging Europe for 2017, reflecting stronger growth in Turkey and other countries in the region, for Russia for 2017 and 2018, and Brazil in 2017.

Financial market sentiment has generally been strong, with continued gains in equity markets in

both advanced and emerging market economies. Given current expectations of a more gradual pace of monetary policy normalization compared with March, US long-term interest rates have declined by some 25 basis points since then, and the dollar has depreciated by more than 5 percent in real effective terms, with a commensurate real appreciation of the euro. Despite expectations of more robust global demand going forward, commodity prices have remained low, with oil prices reflecting stronger-than-anticipated supply.

Headline consumer price inflation has softened since the spring, as the boost to prices from the oil price recovery of 2016 has faded and the decline in oil prices in recent months has started to exert downward pressure. Despite stronger growth in domestic demand, core inflation has generally remained muted across advanced economies, reflecting still-weak wage growth (Chapter 2). Inflation is likely to rise only gradually toward central bank targets. Across emerging and developing economies, the waning of pass-through effects from earlier currency depreciations against the US dollar, and in some cases recent appreciations, have helped moderate core inflation rates.

Short-term risks are broadly balanced. On the positive side, the recovery could strengthen further, supported by strong consumer and business confidence and benign financial conditions. At the same time, in an environment of high policy uncertainty and geopolitical tensions, policy missteps—which the baseline assumes will be avoided—could take a toll on market confidence, resulting in tighter financial conditions and weaker asset prices.

Risks to growth in the medium term are still skewed to the downside, owing to several potential hazards:

- *A more rapid and sizable tightening of global financial conditions.* This could take the form of higher long-term interest rates in the United States and elsewhere, triggered by faster-than-expected monetary policy normalization or a decompression of term premia, with adverse repercussions for vulnerable economies. Monetary policy tightening in the euro area, if it had to come while the recovery in prices and growth is still lagging in highly indebted member economies, could pose risks for these economies if they have not undertaken the needed fiscal adjustment and implemented structural reforms to boost supply potential. Tighter global financial conditions could also result from a sharp decrease in global risk appetite from its currently strong levels,

which would take a toll on macroeconomic activity through weaker confidence, lower asset valuations, and wider risk premia.

- *Financial turmoil in emerging market economies.* The upward revision to China's growth forecasts reflects a slower rebalancing of activity toward services and consumption, a higher projected debt trajectory, and diminished fiscal space. Unless the Chinese authorities counter the associated risks by accelerating their recent encouraging efforts to curb the expansion of credit, these factors imply a heightened probability of a sharp growth slowdown in China, with adverse international repercussions. Following a period of abundant credit supply, a sudden tightening of global financial conditions (and an associated US dollar appreciation) could expose financial fragilities in some emerging markets, imposing strains on economies with US dollar pegs, high leverage, and balance sheet mismatches.
- *Persistently low inflation in advanced economies.* If domestic demand were to falter, it could lead to a decline in medium-term inflation expectations, prolonging and reinforcing the weakness in inflation. Low inflation and nominal interest rates would in turn reduce central banks' capacity to lower real interest rates to restore full employment in an economic downturn.
- *A broad rollback of the improvements in financial regulation and oversight achieved since the global financial crisis.* Such a rollback could lower capital and liquidity buffers or weaken supervisory effectiveness, with negative repercussions for global financial stability.
- *An inward shift in policies.* A shift toward protectionism would reduce trade and cross-border investment flows, harming global growth.
- *Noneconomic factors.* These would include geopolitical tensions, domestic political discord, risks from weak governance and corruption, extreme weather events, and terrorism and security concerns, which could derail growth.

These risks are closely 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 while shaking 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 on emerging markets.

The welcome cyclical pickup in global economic activity after disappointing growth over the past few years provides an ideal window of opportunity to undertake key reforms designed to boost potential output and ensure that its benefits are broadly shared and to build resilience against downside risks. With countries still facing differences in cyclical conditions, varied stances of monetary and fiscal policy remain appropriate. Completing the economic recovery and adopting strategies to ensure fiscal sustainability remain important goals in many economies.

Important areas of strategic focus include:

- *Raising potential output:* Structural reforms and growth-friendly fiscal policy are needed to boost productivity and labor supply, with differing priorities across countries. Looking ahead, ongoing structural transformation (labor-saving technological change and cross-border competition) demands comprehensive policy approaches, including policies that reduce the pain of adjustment and provide opportunities for all.
- *Securing the recovery and building resilience:* In advanced economies, monetary policy settings should remain accommodative until there are firm signs of inflation returning to targets. As documented in Chapter 2, still-subdued wage pressures mostly reflect remaining slack, not fully captured by headline unemployment rates. At the same time, stretched asset valuations and increasing leverage in some parts of the financial sector require close monitoring, with proactive micro- and macroprudential supervision, as necessary. The stance of fiscal policy should be aligned with structural reform efforts, taking advantage of favorable cyclical conditions to place public debt on a sustainable path while supporting demand where still needed and feasible. As Chapter 4 emphasizes, higher public spending designed to boost potential output can result in both domestic benefits as well as positive spillovers

to other countries, especially if it involves economies with slack and monetary accommodation. Indeed, adopting these policy recommendations would help reduce external imbalances, notably for advanced economies with excess surpluses, where stronger domestic demand would offset negative demand effects from the needed rebalancing by deficit countries. In many emerging market and developing economies, fiscal space to support demand is limited, especially in commodity exporters. But monetary policy can generally be supportive, as inflation appears to have peaked in many countries. Exchange rate flexibility helps with the adjustment to commodity price shocks. Efforts to improve governance and the investment climate would also strengthen growth prospects. In low-income countries, many of which need to undertake durable fiscal adjustment efforts and reduce financial vulnerabilities, growth-enhancing reforms would help make the best use of the coming demographic dividend by spurring job creation.

- *Strengthening international cooperation:* For many of the challenges that the global economy confronts, individual country actions can be more effective if supported by multilateral cooperation. Preserving the global economic expansion will require policymakers to avoid protectionist measures and to do more to ensure that gains from growth are shared more widely. In addition to preserving an open trading system, key areas for collective action include: safeguarding global financial stability; achieving equitable tax systems and avoiding a race to the bottom; continuing to support low-income countries as they pursue their development goals; and mitigating and adapting to climate change. As Chapter 3 illustrates, many of the economies suffering the worst consequences of higher temperatures and changed weather patterns are those with the fewest resources to deal with these challenges. Richer countries will increasingly feel direct negative effects from unmitigated climate change, however, and will not be immune to spillovers from the rest of the world.