FOREWORD

When I arrived at the International Monetary Fund about a year ago, our worries focused on China's growth prospects amid domestic rebalancing, the struggles of primary commodity exporters, and the timing and impact of the Federal Reserve's first interest rate increase since 2006. Today, stable growth performance has reduced near-term concerns about China, commodity prices have partially recovered, and the Federal Reserve's initial interest rate hike is behind us. Global asset markets seem placid after these developments, with advanced economy equity prices at high levels, market-based volatility measures low, and renewed capital inflows to emerging market economies. And our baseline forecast sees improving world growth in the years ahead. That projected improvement is driven by emerging market and developing economies: as conditions in economies under stress gradually normalize, China's growth rate—while declining—remains high, and the recovery is gaining traction elsewhere.

A closer look, however, gives cause for disquiet. China's growth stability owes much to macroeconomic stimulus measures that slow needed adjustments in both its real economy and financial sector. Commodity exporters still struggle with past investment overhangs in extractive sectors, along with the challenges of fiscal adjustment and longer-term economic diversification. And the Federal Reserve, despite an ever-strengthening U.S. job market, has so far judged a second interest rate rise to be too risky, several times citing worrisome economic developments abroad.

Asset prices and emerging market capital inflows are supported by ultra-low interest rates in advanced economies that now seem poised to persist considerably longer than they did last October. But while lower-for-longer interest rates have their upsides, they also reflect difficult economic realities. Our expectations for future global growth and productivity have fallen in light of recent disappointing outcomes. Deflation pressures persist. And policy uncertainty in the global economy, as reflected in news-based measures, is elevated. The current outlook remains subdued.

Political tensions have now made advanced economies a major locus of policy uncertainty. Most dramatically, the unexpected vote for Brexit on June 23 leaves unclear the future shape of the United Kingdom's trade and financial relations with the remaining 27 European Union (EU) members, introducing political and economic uncertainties that threaten to dampen investment and hiring throughout Europe. Alongside economic anxiety and other factors, the Brexit vote reflects a resentment of cross-border migration that has fueled nationalist sentiment in Europe and called into question the way forward for EU integration. These trends are exacerbated by the difficulties of absorbing a large volume of refugees who have fled tragic events in the Middle East. In general, centrifugal political forces across the continent are making it harder to advance or even maintain economic reforms. Similar tensions afflict the U.S. political scene, where anti-immigrant and anti-trade rhetoric have been prominent from the start of the current presidential election round. Across the world, protectionist trade measures have been on the rise.

Inside the *World Economic Outlook*

Not coincidentally, the chapters in this new *World Economic Outlook* focus on several of these concerns. After Chapter 1's summary of the global outlook, Chapter 2 analyzes the forces behind the recent growth slowdown in the volume of international trade. A major driver is slower growth in aggregate demand, particularly in investment, which is especially apt to generate international trade flows in the form of capital goods and intermediate inputs. But key roles are also played by the slowing momentum of trade liberalization measures, the return of some protectionist measures, and the (possibly related) retraction of global value chains. Some of the trade slowdown may reflect a natural maturation of the tendencies that propelled trade growth in the past, but it also seems likely that more worrisome pressures are at work, and that these may in turn reduce business dynamism and productivity growth.

The topic of Chapter 3 is the persistently low inflation in many economies and its relationship to falling commodity prices, remaining output gaps, global excess capacity, and possibly de-anchored inflation expectations. The chapter finds that medium-term measures of inflation expectations generally remain reasonably close to central bank targets so far, but also shows that for countries with policy interest rates at their effective lower bounds, expectations of medium-term inflation have become more sensitive to weaker-than-expected inflation outcomes. The danger is that expectations will diverge downward from targets, raising real interest rates and thereby reducing monetary policy effectiveness while dragging these economies into low inflation or deflation traps.

Finally, Chapter 4 focuses on two salient cross-border economic spillovers that have driven recent global economic and political developments: repercussions from China's slowing growth and migration. Spillovers from China's economy have increased markedly since the mid-1990s, operating primarily through trade linkages and through the impact of China growth shocks on global commodity prices. China's growing global role makes it all the more important for it to address its internal imbalances so as to approach smoothly a more sustainable consumption- and service-oriented growth framework. Regarding migration, Chapter 4 finds that both sending and receiving countries are impacted. Most striking, perhaps, is the result that low-skilled and high-skilled migrants alike contribute to positive long-term productivity effects in receiving advanced economies. Moreover, these effects raise per capita income broadly across the income distribution. Demands to reduce immigration would foreclose these income gains, while accentuating the negative effects of workforce aging.

Policy Implications

A common thread connecting the chapters of this *World Economic Outlook* is the still weak and precarious nature of the global recovery, and the threats it faces. Especially in a low-demand environment where key policy interest rates are near effective lower bounds, tepid growth risks becoming self-perpetuating as investment falls, productivity growth declines, labor markets become less dynamic, and human capital erodes. Moreover, declining growth rates, along with increased income inequality and concerns about the impact of migration, contribute to political tensions that block constructive economic reforms and threaten a rollback of trade integration. These tensions will only worsen as governments struggle more and more to make good on social entitlements in the face of shrinking tax bases.

Some argue that current economic growth rates are acceptable, being consistent with past historical averages, and that they appear even more favorable when viewed in per capita terms. This argument ignores the still sizable slack in many advanced economies and the large number of emerging market and developing economies in recession or with stagnant per capita incomes. True, exogenous factors such as demographics likely weigh even on per capita growth, as does China's necessary rebalancing. But significant opportunities for boosting jobs and incomes around the world are being lost today through short-sighted policy approaches.

What can be done to close remaining output gaps, fight deflation, and lift potential output?

A comprehensive, three-pronged policy approach that supports overstretched monetary policies with fiscal policy (where fiscal space allows) and structural reforms is essential. Even where fiscal space is limited, there is scope to change the composition of spending and revenues in a way that supports near-term growth and future productive capacity. One cause of economic uncertainty, however, is the fear that each of these three tools faces economic or political constraints, which could prevent policymakers from responding aggressively to a new global slowdown. Policy space can be created, however, if policy is based on consistent frameworks that communicate to markets how instruments will be used to attain objectives over time, exploiting their synergies while safeguarding medium-term inflation goals and fiscal sustainability. This is intranational policy coordination. International coordination can create even more policy space, thanks to positive, mutually reinforcing spillovers between different countries' demand support measures. Both intranational and international coordination make the whole greater than the sum of its parts.

The policy framework should include measures that mitigate the adverse income-distribution effects of economic changes, whether due to technology, globalization forces, or other developments. Educational investments that equip people with adaptable skills, as well as better social insurance mechanisms and appropriate income tax regimes, can enhance risk sharing and resilience for all, not just those with access to sophisticated financial markets.

It is vitally important to defend the prospects for increasing trade integration. A global environment hostile to trade will make it impossible for commodity exporters and low-income countries in general to develop new export models and gradually narrow income gaps with richer countries. It will also broadly deter global productivity growth, the spread of knowledge and technology, and investment. In short, turning back the clock on trade can only deepen and prolong the world economy's current doldrums.

The need for international cooperation extends to a much broader set of international public-good problems—refugees, climate, infectious disease, security, corporate taxation, and financial stability, for example. An increasingly interdependent world will achieve more growth and stability if governments engage cooperatively around the many areas where their interests intersect.

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