FOREWORD

One year ago economic activity was accelerating in almost all regions of the world and the global economy was projected to grow at 3.9 percent in 2018 and 2019. One year later, much has changed: the escalation of US–China trade tensions, macroeconomic stress in Argentina and Turkey, disruptions to the auto sector in Germany, tighter credit policies in China, and financial tightening alongside the normalization of monetary policy in the larger advanced economies have all contributed to a significantly weakened global expansion, especially in the second half of 2018. With this weakness expected to persist into the first half of 2019, the *World Economic Outlook* (WEO) projects a decline in growth in 2019 for 70 percent of the global economy. Global growth, which peaked at close to 4 percent in 2017, softened to 3.6 percent in 2018, and is projected to decline further to 3.3 percent in 2019. Although a 3.3 percent global expansion is still reasonable, the outlook for many countries is very challenging, with considerable uncertainties in the short term, especially as advanced economy growth rates converge toward their modest long-term potential.

While 2019 started out on a weak footing, a pickup is expected in the second half of the year. This pickup is supported by significant policy accommodation by major economies, made possible by the absence of inflationary pressures despite closing output gaps. The US Federal Reserve, in response to rising global risks, paused interest rate increases and signaled no increases for the rest of the year. The European Central Bank, the Bank of Japan, and the Bank of England have all shifted to a more accommodative stance. China has ramped up its fiscal and monetary stimulus to counter the negative effect of trade tariffs. Furthermore, the outlook for US–China trade tensions has improved as the prospects of a trade agreement take shape.

These policy responses have helped reverse the tightening of financial conditions to varying degrees across countries. Emerging markets have experienced a resumption in portfolio flows, a decline in sovereign borrowing costs, and a strengthening of their currencies relative to the dollar. While the improvement in financial markets has been rapid, those in the real economy have yet to materialize. Measures of industrial production and investment remain weak for most advanced and emerging economies, and global trade has yet to recover.

With improvements expected in the second half of 2019, global economic growth in 2020 is projected to return to 3.6 percent. This return is predicated on a rebound in Argentina and Turkey and some improvement in a set of other stressed emerging market and developing economies, and therefore subject to considerable uncertainty. Beyond 2020 growth will stabilize at around 3½ percent, bolstered mainly by growth in China and India and their increasing weights in world income. Growth in advanced economies will continue to slow gradually as the impact of US fiscal stimulus fades and growth tends toward the modest potential for the group, given ageing trends and low productivity growth. Growth in emerging market and developing economies will stabilize at around 5 percent, though with considerable variance between countries as subdued commodity prices and civil strife weaken prospects for some.

While the overall outlook remains benign, there are many downside risks. There is an uneasy truce on trade policy, as tensions could flare up again and play out in other areas (such as the auto industry) with large disruptions to global supply chains. Growth in China may surprise on the downside, and the risks surrounding Brexit remain heightened. In the face of significant financial vulnerabilities associated with large private and public sector debt in several countries, including sovereign-bank doom loop risks (for example, in Italy), there could be a rapid change in financial conditions owing to, for example, a risk-off episode or a no-deal Brexit.

With weak expansion projected for important parts of the world, a realization of these downside risks could dramatically worsen the outlook. This would take place at a time when conventional monetary and fiscal space is limited as a policy response. It is therefore imperative that costly policy mistakes are avoided. Policymakers need to work cooperatively to help ensure that policy uncertainty doesn't weaken investment. Fiscal policy will need to manage trade-offs between supporting demand and ensuring that public debt remains on a sustainable path, and the optimal mix will depend on country-specific circumstances. Financial sector policies must address vulnerabilities proactively by deploying macroprudential tools. Low-income commodity exporters should diversify away from commodities given the subdued outlook for commodity prices. Monetary policy should remain data dependent, be well communicated, and ensure that inflation expectations remain anchored.

Across all economies, the imperative is to take actions that boost potential output, improve inclusiveness, and strengthen resilience. A social dialogue across all stakeholders to address inequality and political discontent will benefit economies. There is a need for greater multilateral cooperation to resolve trade conflicts, to address climate change and risks from cybersecurity, and to improve the effectiveness of international taxation.

This issue of the WEO also tackles three major developments that need to be addressed to enhance long-term growth. The first is rising inequality, the second is weak investment, and the third is rising protectionism in trade. Chapter 2 investigates the evolution of corporate market power (as measured by markups) and its ability to explain several macro phenomena, including weak investment and the declining labor shares that help fuel inequality. The finding is that the aggregate increase in markups since 2000 has been modest and, consequently, the implications for the macroeconomy relatively modest. There is, however, significant heterogeneity, with the aggregate increase driven mainly by a more substantial increase in markups by a small number of firms that are the more productive and innovative firms. The increase in aggregate market power therefore appears to be, as of now, less a phenomenon of poor competition and more one of winner-takes-most dynamics, where markups compensate in part for investment in intangible assets. However, going forward this market dominance could lead to unfair advantages that weaken market entry and competition and, more significantly, dampen investment and innovation. It is therefore important to cut barriers to market entry and reform and strengthen competition law to better align with the new economy.

Chapter 3 highlights the benefits for investment of reducing trade barriers. Over the past three decades, the relative price of machinery and equipment has fallen in all countries, driven both by higher productivity in the capital-goods-producing sector and increased trade integration. This decline has supported the rise in real investment rates in machinery and equipment, benefiting developing countries. Rising trade tensions could reverse these price declines and damage investment at a time when investment is already weak, which only further emphasizes the need to quickly resolve trade disagreements.

The final chapter of the WEO examines the link between bilateral trade tariffs and trade imbalances. US–China trade frictions have brought a focus on the question of whether bilateral trade imbalances can (or should) be addressed using bilateral trade measures. This chapter demonstrates that the link between the two is precarious. Bilateral trade balances since the mid-1990s have reflected mostly aggregate macroeconomic forces known to determine aggregate trade balances at the country level and have had much less to do with bilateral tariffs. Targeting bilateral trade balances will likely only lead to trade diversion, with limited impact on country-level balances. The findings of this chapter help explain why, despite the tariff measures, the US trade deficit is the largest it has been since 2008. The chapter also establishes that the negative impact of tariffs on output is significantly higher today than in 1995 owing to the bigger role of global supply chains in world trade.

This is a delicate year for the global economy. If the downside risks do not materialize and the policy support put in place is effective, then global growth will return to 3.6 percent in 2020. If, however, any of the major risks materialize, then the expected recoveries in stressed economies, export-dependent economies, and highly indebted economies may not occur. In that case, policymakers will need to adjust. Depending on circumstances, this may require synchronized, country-specific policy stimulus across economies, complemented by accommodative monetary policy. Synchronization can make fiscal stimulus more effective through signaling effects that raise household and business confidence, and through the mitigation of leakages via imports. Finally, adequate resources for multilateral institutions remain essential to retain an effective global safety net, which would help stabilize the global economy.

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