FOREWORD

Six years after the world economy emerged from its broadest and deepest postwar recession, a return to robust and synchronized global expansion remains elusive. The revised forecasts in this latest *World Economic Outlook* report underscore the challenges all countries face. Despite considerable differences in country-specific outlooks, the new forecasts mark down expected near-term growth rates marginally, but nearly across the board. Moreover, downside risks to the world economy appear more pronounced than they did just a few months ago.

Near-term economic growth still looks stronger in advanced economies, compared with the recent past, but weaker in the emerging market and developing economies that account for a growing share of world output and will still account for the lion's share of world growth. Within advanced economies, receding legacies of recent crises, coupled with protracted monetary policy support and a return to fiscal neutrality, have underpinned generally accelerating output and falling unemployment, although deflationary pressures remain. Recovery is most advanced in the United States and the United Kingdom, where monetary policy looks likely to tighten soon, but is more tentative in the euro area and Japan. In countries outside of the advanced economies, the sources of slower growth are diverse, ranging from commodity price declines (which are also affecting a few advanced economies adversely), to overhangs from past rapid credit growth, to political turmoil. Of course, countries with multiple diagnoses are faring worst, in some cases also facing higher inflation. For emerging market and developing economies as a whole, our forecast is that 2015 will mark the fifth consecutive year of declining growth.

What underpins forecasts of moderating growth? First, the ongoing experience of slow productivity growth suggests that long-run potential output growth may have fallen broadly across economies. Persistently low investment helps explain limited labor productivity and wage gains, although the joint productivity of all factors of production, not just labor, has also been slow. Low aggregate demand is one factor that discourages investment, as the last *World Economic Outlook* report showed. Slow expected potential growth itself dampens aggregate demand, further limiting investment, in a vicious circle. Aging populations further restrain investment in a number of countries; in some others, institutional shortcomings or political instability are deterrents. In its more extreme forms, political conflict has created a large global stock of displaced persons, both within and across borders. The economic and social costs are immense.

Chapter 1 suggests that recessions may have a permanent negative effect not only on trend productivity levels, but on trend productivity growth. This mechanism would make current low productivity forecasts look in part like products of the post-2007 turbulence. Some economic historians advance the idea that the postwar global growth experience largely reflects diminishing returns along the extensive margin of technological innovation, punctuated temporarily by the entry of China and the former nations of the Soviet Union into the global market economy and by the information and communications technology revolution. Others counter that transformative innovation continues in many areas, from robotics to bioengineering. But like electrification over a century ago, these advances may take decades to embody in commercial production processes whose outputs are measured in national income. Only time can resolve these debates.

For countries that export oil and other commodities, changes in prices affect both the output gap and potential output itself, so recent movements in commodity prices also inform the near-term and longer-term output forecasts. Those movements have been dramatic, in part because of changes in China's economy, and affect low-income commodity exporters with particular force. Now the world's most important importer of metals, China maintained very rapid growth rates during the 2000s through 2011; as commodity prices rose, exporters invested heavily in capacity, fueling domestic growth. China's leadership has recently targeted lower growth rates, however, as it seeks to rebalance its formerly export- and investment-driven economy in favor of consumption, including of services. As Chapters 1 and 2 document, many real commodity prices, notably those of metals, have fallen from peaks reached in 2011, and fell particularly sharply in the recent weeks of financial volatility starting in mid-August. It remains unclear, at the time of publication, if the recent declines represent a downward overshooting, but the effects of earlier reductions are already reflected in commodity exporter growth. Chapter 2 estimates that on average about a third of the resulting growth reductions are attributable to the structural component of growth, mostly via reduced investment.

Commodity exporters in particular have seen sharp depreciations of their currencies, but a general trend of reduced financial inflows to emerging markets has resulted in more generalized depreciation against the U.S. dollar, euro, and yen. Chapter 3 suggests that these exchange rate changes should be associated with growing net exports for the depreciating countries, a development that is part of the natural adjustment process to differential growth rates that flexible exchange rates promote. Although one result may be an increase in the current account deficits of some advanced economies with relatively good growth performance, it is important that these exchange rate adjustments be seen as the natural shock absorbers they typically are rather than as intentional acts of "currency war." Indeed, past attempts by emerging markets to fix their exchange rates in the face of large financial outflows had quite negative consequences for global financial stability.

Large exchange rate depreciations carry the risk of negative balance sheet effects. A notable potential pressure point is offshore foreign-currency borrowing by emerging market corporations. Counteracting such risks are substantial reserve buffers, greater external equity finance, and a growing trend of domestic-currency denomination of onshore loans. Of course, other risks abide—renewed concerns about China's growth potential, Greece's future in the euro area, the impact of sharply lower oil prices, and contagion effects could be sparks for market volatility. In the advanced economies and in China, deflationary pressures, which continue to slow balance sheet adjustment, have not been entirely banished.

No single set of policy prescriptions is suitable for every country seeking to improve growth performance or build resilience. But some familiar general principles still apply in light of the shared challenges that countries face. Emerging market and developing economies need to be ready for monetary policy normalization by the United States. Advanced economies must continue to deal with crisis legacies where they persist. At the same time, monetary accommodation should continue where output gaps are negative, supplemented by fiscal measures where fiscal space permits. In particular, the case for infrastructure investment seems compelling at a time of very low long-term real interest rates. Investment is one way to enhance potential output growth, but targeted structural reforms can also play an important positive role. Such reforms help not only to enhance future growth, but to increase the resilience of growth. They can help low-income countries to diversify their export bases. In all countries, continued strengthening of micro- and macro-prudential policy frameworks will also support resilience to economic shocks, whether originating domestically or from abroad.

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