FOREWORD

Global recovery continues, but at an ever-slowing and increasingly fragile pace. The months since the last *World Economic Outlook* have seen a renewed episode of global asset market volatility, some loss of growth momentum in the advanced economies, and continuing headwinds for emerging market economies and lower-income countries. In addition, several stresses of noneconomic origin threaten economic activity. Not only do these developments lead us to a further broad-based reduction in our baseline projections for economic growth in 2016 and 2017; they also suggest that possible nonbaseline outcomes are at the same time less favorable and more likely.

Notwithstanding this cloudier picture of economic fundamentals, financial markets in advanced economies have, at this writing, partially reversed their swoon of the first weeks of 2016. Some improved data releases, a firming of oil prices, lower capital outflows from China, and decisions by major central banks have all contributed to improved sentiment. These developments are consistent with our central projection that growth over the next two years, while lower than we believed likely just a few months ago, will still be slightly higher than in 2015. Yet that outcome is far from assured. Significant downside risks remain, and events that make those risks more salient may well trigger renewed financial turbulence.

What are the risks? Important among purely economic risks is a return of financial turmoil itself, impairing confidence and demand in a self-confirming negative feedback loop. Despite the recent rebound in asset prices, financial conditions in the United States, Europe, and Japan have been on a tightening trend since mid-2014, as the new *Global Financial Stability Report* documents.

Yet financial conditions have tightened even more outside the advanced economies. Increased net capital outflows from emerging markets—the subject of Chapter 2 of this *World Economic Outlook* report—could lead to further depreciation of their currencies, eventually triggering adverse balance sheet effects. Market perceptions of constrained macroeconomic policy space added to the recent bout of pessimism. These worries remain and are especially relevant for emerging market and developing economies.

China, now the world's largest economy on a purchasing-power-parity basis, is navigating a momentous but complex transition toward more sustainable growth based on consumption and services. Ultimately, that process will benefit both China and the world. Given China's important role in global trade, however, bumps along the way could have substantial spillover effects, especially on emerging market and developing economies.

Another threat is that persistent slow growth has scarring effects that themselves reduce potential output and with it, consumption and investment. Consecutive downgrades of future economic prospects carry the risk of a world economy that reaches stalling speed and falls into widespread secular stagnation.

Adding to this list are several pressures with origins in political, geopolitical, or natural developments. In both the United States and Europe, the political discussion is turning increasingly inward. The causes are complex but certainly reflect growing income inequality as well as structural shifts, some connected with globalization, that are seen as having favored economic elites while leaving others behind. Fear of terrorism also plays a role. The result could be a turn toward more nationalistic policies, including protectionist ones.

In the United Kingdom, the planned June referendum on European Union membership has already created uncertainty for investors; a "Brexit" could do severe regional and global damage by disrupting established trading relationships. Adding to political strains in Europe is the tragedy of large-scale refugee inflows, especially from the Middle East. Of course, a sizable fraction of refugee flows originates in violent extremism or sectarian strife, factors that devastate source economies and threaten their neighbors. Yet there are also natural causes of population displacement, some linked to climate change. Extreme flooding and drought from the current El Niño is worsening poverty and displacement in a range of emerging markets and low-income developing countries.

Apart from these risks, the April *World Economic Outlook* also describes a further weakening of global growth under its baseline scenario. An important cause is that demand, notably investment demand, remains weak worldwide, but especially in commodity exporters, whose terms of trade have collapsed. China's rebalancing process has subtracted measurably from world investment growth, and generally higher uncertainty about global growth prospects is also a factor. Weak investment demand, in turn, has been associated with slower growth in international trade, given the important roles played by capital and intermediate goods.

Emerging market and especially low-income commodity exporters will struggle to restore growth until they have diversified their export bases, a process that will take time. While in principle terms-of-trade losses by commodity exporters should translate into symmetric gains for importers, in practice the negative effects on producers seem to have dominated so far. The situation is not without precedent. In his classic 1973 book *The World in Depression: 1929–1939*, Charles P. Kindleberger noted a similar dynamic in the commodity price deflation of the 1920s: "The view taken here is that symmetry may obtain in the scholar's study, but that it is hard to find in the real world. . . . The consuming countries might ultimately have realized that their real incomes had increased and permitted them to expand spending. Meanwhile the primary producers cannot wait." As Chapter 1 in this *World Economic Outlook* report points out, commodity importers with policy interest rates currently near zero will face an additional offset to the positive income effect of lower commodity prices.

A diminished economic outlook burdened with larger downside risks raises the premium on intensifying and extending sound policies that safeguard near-term growth and boost potential output. Monetary policy must remain accommodative in the face of deflationary pressures, including through additional unconventional measures if needed. But monetary policy cannot bear the entire burden of responding to current challenges; it must be supported by other policies that directly boost supply and demand.

Infrastructure investment is needed across a range of countries and should be attractive in a setting of very low real interest rates. Countries with fiscal space should not wait to take advantage of it. Public action to encourage research and development activity, as documented in the new *Fiscal Monitor*, can boost output. At the same time, as Chapter 3 in this *World Economic Outlook* report shows, structural reforms in product and labor markets can be effective in boosting output, even in the short term, and especially if coupled with fiscal support. Tax reform, even when budget neutral, can create demand if well targeted, while simultaneously improving labor force participation and enhancing social cohesion. Not only financial stability, but the transmission of monetary and fiscal policy, would be enhanced by further financial reforms, including the resolution of impaired assets still held on banks' books.

These measures should be taken now, but countries should also cooperate to design collective measures to be deployed in the future in case downside risks materialize. A range of demand- and supply-side policies can be more effective through positive output spillovers across countries; policymakers could already formulate contingent plans.

In addition, cooperation to enhance the global financial safety net and the global regulatory regime is central to a resilient international monetary and financial system. Some of the risks coming from noneconomic sources likewise present public goods problems solvable through international coordination, on the model of the December 2015 Paris climate agreement.

The current diminished outlook and associated downside possibilities warrant an immediate response. If national policymakers were to clearly recognize the risks they jointly face and act together to prepare for them, the positive effects on global confidence could be substantial. The result would be stronger growth under the baseline outcome as well as insurance against a derailed recovery.

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