Executive summary

Prospects for global macroeconomic development

The global economy remains trapped in a prolonged episode of slow growth

In 2016, the world economy expanded by just 2.2 per cent, the slowest rate of growth since the Great Recession of 2009. Underpinning the sluggish global economy are the feeble pace of global investment, dwindling world trade growth, flagging productivity growth and high levels of debt. Low commodity prices have exacerbated these factors in many commodity-exporting countries since mid-2014, while conflict and geopolitical tensions continue to weigh on economic prospects in several regions.

World gross product is forecast to expand by 2.7 per cent in 2017 and 2.9 per cent in 2018, with this modest recovery more an indication of economic stabilization than a signal of a robust and sustained revival of global demand. The slight increase in gross domestic product (GDP) growth projected for developed economies in 2017 is largely driven by the end of the destocking cycle in the United States of America and additional policy support in Japan.

Economies in transition are expected to expand by 1.4 per cent in 2017, following two consecutive years of decline, as the region has largely absorbed the sharp terms-of-trade shock that several countries suffered in 2014-2015. Commodity exporters in developing countries are also expected to see some uptick in growth, as commodity prices stabilize and inflationary pressures driven by sharp exchange rate depreciations ease. East and South Asia will continue to grow more rapidly than other regions, benefiting from robust domestic demand and space for more accommodative macroeconomic policy. The outlook remains subject to significant uncertainties and downside risks. If these downside risks were to materialize, the moderate acceleration in growth currently projected would be derailed.

Given the close linkages between demand, investment, trade and productivity, the extended episode of weak global growth may prove self-perpetuating in the absence of concerted policy efforts to revive investment and foster a recovery in productivity. This would impede progress towards the Sustainable Development Goals (SDGs), particularly the goals of eradicating extreme poverty and creating decent work for all.

Weak investment is at the foundation of the slowdown in global growth

Investment growth has slowed significantly in many of the major developed and developing economies, as well as in many economies in transition. Protracted weak global demand has reduced incentives for firms to invest, while economic and political uncertainties have also weighed on investment. Since 2015, many countries have seen sharp contractions in investment in the oil and extractive industries, although these declines are mostly cyclical, rather than signalling significant structural progress towards a less fossil fuel-intensive economy. Lack of access to finance has also acted as a constraint in some cases, especially in countries where banks remain undercapitalized or where financial markets are under-developed. Despite record-low, often negative bond yields, Governments in developed countries have made steep cuts in public investment since 2010, reflecting fiscal adjustment policies implemented in response to high levels of government debt. Since mid-2014, Governments in many commodity-exporting countries have also curtailed much-needed investment in infrastructure and social services, in response to the sharp loss of commodity revenue. In some other developing countries in East and South Asia and parts of Africa, on the other hand, weaker private sector investment has been partially offset by an expansion of government infrastructure projects.

The extended period of weak investment is a driving factor behind the slowdown in productivity growth

Labour productivity growth has slowed markedly in most developed economies, and in many large developing and transition countries. Investment in new capital can affect factors such as the rate of innovation, labour force skills and the quality of infrastructure. These in turn drive the technological change and efficiency gains underpinning labour productivity growth in the medium term.

Government support for public goods, such as combating climate change, remains crucial, as private investors tend to evaluate risk and return over a short-term horizon and under-invest in public priorities. Investment in key areas, such as research and development, education and infrastructure, would serve to promote sustainable development and social and environmental progress, while also supporting productivity growth. While fiscal space to support an expansion of investment remains limited in many countries, especially commodity exporters that have suffered a sharp loss of commodity revenue, some large economies do have the scope to take advantage of low borrowing costs to finance investment.

Aggregate growth in the least developed countries (LDCs) remains well below the Sustainable Development Goal target of "at least 7 per cent GDP growth"

Aggregate growth in the LDCs will remain well below the SDG target in the near term, but is expected to rise modestly from an estimated 4.5 per cent in 2016 to 5.2 per cent and 5.5 per cent in 2017 and 2018, respectively. The below-target growth poses a risk to critical public expenditure on healthcare, education, social protection and climate change adaptation. The latter is all the more critical since the LDCs remain highly vulnerable to natural catastrophes and weather-related shocks.

Further efforts are also needed to diversify exports of the LDCs, which remain highly concentrated in a few primary products vulnerable to price volatility and external shocks. Under the current growth trajectory, nearly 35 per cent of the population in the LDCs may remain in extreme poverty by 2030. Without an acceleration in both GDP growth and progress towards improving income inequality, eradicating the high levels of extreme poverty in the LDCs by 2030 is a formidable challenge.

Garnering the resources to finance the investment needed in the LDCs remains difficult. Investment in these countries would need to expand at an average annual rate of at least 11 per cent through 2030, a significant acceleration relative to recent trends. Foreign direct investment (FDI) continues to bypass many LDCs and remains concentrated in extractive industries. Greater efforts are needed to mobilise domestic and international, public and private resources for achieving the SDGs of these countries.

Sustained improvements in carbon emissions mitigation will require concerted efforts to improve energy efficiency and promote renewable energy

The level of global carbon emissions has stalled for two consecutive years. This positive development reflects the declining energy intensity of economic activities, a rising share of renewables in the overall energy structure, and slower economic growth in major emitters.

However, the world remains some distance from achieving a sustained decoupling between economic growth and carbon emissions growth. Despite advancements, especially in developing countries, where the level of new renewable energy investment exceeded that of developed countries in 2015, renewable energy still accounts for only a small share of global power generation. New renewable investment dropped sharply in the first half of 2016, and the improvements to emissions mitigation witnessed in recent years could easily reverse without concerted efforts from the public and private sectors to improve energy efficiency and promote renewable energy, supported by international cooperation on clean technology transfer and climate finance.

International trade and finance

World trade at a standstill

Dwindling world trade growth is both a contributing factor and a symptom of the global economic slowdown. World trade volumes expanded by just 1.2 per cent in 2016, the third-lowest rate in the past 30 years. Cyclical factors — such as the composition of global demand and heightened uncertainty — continue to restrain global trade growth, while the impact of a number of structural shifts that favoured the rapid expansion of global trade in the 1990s and 2000s have started to wane, coupled with slower progress in trade liberalisation. The ratio of world trade growth to world gross product growth has declined significantly since the 1990s. While global import penetration is expected to exhibit a modest recovery, world trade growth is unlikely to outpace world gross product significantly in the coming years. World trade is projected to expand by 2.7 per cent in 2017 and 3.3 per cent in 2018.

Closing the investment gap to achieve the SDGs by 2030 requires the mobilization of significant financial resources

The prolonged slowdown in global economic growth makes generating the long-term investment necessary for achieving the SDGs particularly challenging. International finance is a critical complement to domestic revenue mobilization, which has grown steadily in developing countries over the last 15 years, but has yet to close investment financing gaps.

However, international capital inflows remain volatile, and net flows to developing countries are estimated to remain negative at least through 2017, underscoring the challenges of financing long-term sustainable development.

Since the global financial crisis, low interest rates have prompted sovereign bond issuance by developing countries in international capital markets. However, in some cases, concerns over debt sustainability are now being realised, especially where repayment burdens are subject to significant exchange rate movements. The provision of international public finance, including official development assistance (ODA) from Members of the OECD Development Assistance Committee, increased in 2015, but remains below United Nations targets. The increase in ODA to a large extent reflects the resources spent on refugees in host countries. Lending by multilateral development banks and through South-South cooperation also increased in 2015. Nonetheless, available domestic and international financial resources remain insufficient to fill investment financing gaps for sustainable development, particularly in the poorest countries.

Aligning institutional investment with sustainable development requires a change in the incentive structure

Aligning investment with the SDGs, including building sustainable and resilient infrastructure, requires policies and regulatory frameworks that incentivize changes in investment patterns. Current FDI patterns are not fully aligned with sustainable development, and the bulk of recent flows have been directed towards cross-border mergers and acquisitions, which may have limited impact on jobs and development. A reallocation of 3 to 5 per cent of institutional investor assets towards long-term investment in sustainable development could have an enormous impact. Yet to date, investment by institutional investors in the long-term illiquid assets necessary for sustainable development has been limited. Investment by institutional investors has tended to be short-term oriented, as reflected in the volatility of cross-border portfolio flows. Volatile international portfolio and banking flows can undermine sustainable development rather than support it.

Aligning incentives in capital markets with long-term investment in sustainable development and also incentivizing greater direct investment can be addressed through the financial governance architecture, and supported through various policy mixes including pricing externalities, effective regulatory frameworks, blended finance and guarantees and leveraging private investment through public intermediaries, such as development banks.

Uncertainties and risks

The materialization of several key downside risks could prolong the period of weak global growth

Global economic prospects remain subject to significant uncertainties and risks that are weighted on the downside, with the potential to obstruct the modest acceleration in growth that is currently forecast for 2017-2018. Some of these risks stem from monetary policy actions in major developed economies. The impact of introducing untested monetary policy instruments — such as the negative interest rate policies in Japan and Europe — remains unclear. There is a risk that such measures could lead to a deterioration of bank balance sheets, causing credit conditions to tighten, with the potential to destabilize fragile and undercapitalized banks. The timing of interest rate rises in the United States is another area of uncertainty. As interest rate differentials relative to other developed economies widen, this has the potential to trigger financial volatility, reversal of capital inflows to developing economies, and abrupt adjustments in exchange rates. Such volatility would exacerbate vulnerabilities associated with high levels of debt and rising default rates in a number of developing countries, with the potential to push up borrowing costs, raise deleveraging pressures, and increase banking sector stress.

Policy uncertainty in the United States and Europe has widened the confidence bounds around global economic forecasts

There are also considerable uncertainties in the international policy environment. For example, uncertainties remain high with respect to the forthcoming changes by the new Administration of the United States to important policies in international trade, immigration, and climate change. The decision by the United Kingdom of Great Britain and Northern Ireland to leave the European Union, or "Brexit", and its potential implications for the free movement of goods and workers in Europe, also poses considerable regional uncertainty. All of these uncertainties have the potential to undermine any projected recovery in business investment, impede international trade growth and even derail the already weak global growth.

Policy challenges and the way forward

A more balanced policy mix is needed, moving beyond excessive reliance on monetary policy

Many economies continue to place excessive dependence on monetary policy to support their objectives. In order to restore the global economy to a healthy growth trajectory over the medium-term, as well as tackle issues in the social and environmental dimensions of sustainable development, a more balanced policy approach is needed. In addition to a more effective use of fiscal policy, balanced achievement of the SDGs requires moving beyond demand management, to ensure that macroeconomic policy measures are fully integrated with structural reforms and policies that target, for example, poverty, inequality and climate change.

A broader policy toolkit is called for, to be adapted as appropriate to individual country circumstances. For example, structural reforms could encompass a broader use of income policy to tackle inequalities and sustain demand, as well as active labour market policies to support vulnerable or marginalized sectors of the labour market. Effective financial regulation and incentives should mobilize resources and encourage investment in inclusive and resilient infrastructure, social services and green technology. In addition, investment in education, worker training and the research base will promote workforce skills and foster innovation. Policies should encourage a dynamic business environment aligned with sustainable development, including inclusive access to finance, transparent administrative procedures and effective regulatory frameworks.

With domestic resource mobilization limited by structural factors, additional concessional international public financing is needed to support developing countries, especially the LDCs.

Enhancing international policy coordination under the new 2030 Agenda

International coordination is needed to ensure consistency and complementarities among trade policy, investment policy and other public policies and to better align the multilateral trading system with the 2030 Agenda for Sustainable Development, ensuring inclusive growth and decent work for all. These efforts would be supported by a transparent international services market that facilitates the participation of service providers from developing countries in particular. International cooperative efforts are also needed to reduce high trade financing gaps, especially among the poorest countries in Africa, developing Asia, and the small island developing States. To ensure that development concerns are addressed by the global trading system, a stronger role for the World Trade Organization is warranted.

Deeper international cooperation is also needed in many other areas, such as expediting clean technology transfer, supporting climate finance, expanding international public finance and ODA, strengthening international tax cooperation and tackling illicit financial flows, providing a global financial safety net and coordinating policy to address the challenges posed by large movements of refugees and migrants. These issues were recognized at the Hangzhou G20 Summit, where the need for deeper international policy coordination was duly stressed.