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WORLD BANK

The Global Economy's Output Gap Has Closed

For the first time in a decade, the global economy appears to be operating at its potential, according to World Bank economists

Commuters board a train in Berlin. The euro area saw better-than-forecast growth in 2017, part of a broader international uptick. PHOTO: KRISZTIAN BOCSI/BLOOMBERG



By

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A broad uptick in economic growth around the world in 2017 has led economists at the World Bank to conclude that, for the first time in a decade, the global economy is operating at its potential.

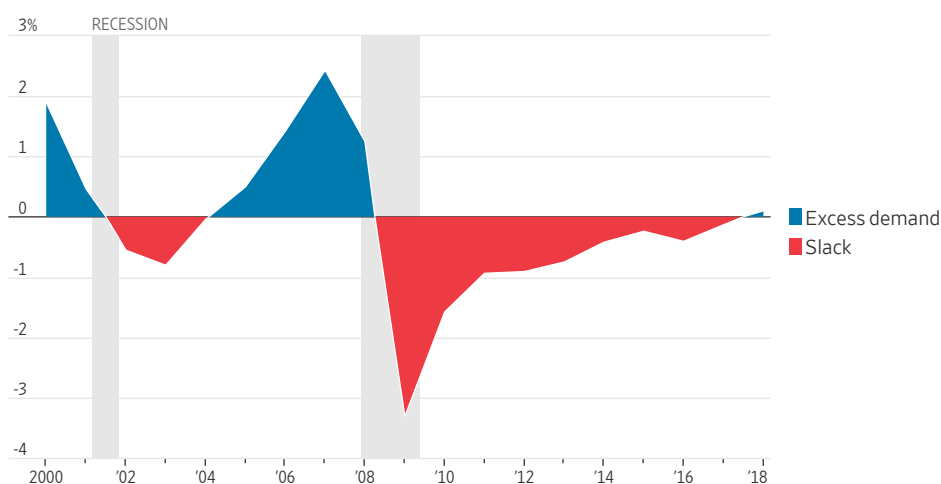
“The year 2018 will likely mark a turning point for the global economy because, for the first time since 2008, the negative global output gap is expected to be closed,” the World Bank said in its flagship report on the global economy, known as the Global Economic Prospects report.

At the root of this observation is a calculation that the world economy performed far worse than its potential in the decade after the global financial crisis that sent most of the world's economies into severe recession. This difference between the economy's actual performance and its potential is known as the output gap. When output gaps are large, as they have been the past 10 years, it indicates weak economic demand, spare capacity of businesses and factories, widespread unemployment and a major drag on inflationary pressures.

Closing the Gap

The output gap, defined as the difference between actual global output and potential output, has closed for the first time in a decade.

Global output gap as a percent of potential gross domestic product



Source: World Bank

Although the overall global output gap has closed, some countries are still operating below potential, especially commodity exporters. Others, especially the world's advanced economies, appear to be somewhat “above potential,” meaning that the economy has more demand than is sustainable in the long-run. Excess demand is likely to lead to inflationary pressures, an increase in asset prices and pressure on central banks to raise interest rates.

Closing the output gap could trigger a broad change in economic conditions around the world.

For much of the past decade, inflation around the world has been weak, with many nations fearing they could slip into deflationary spirals. A large global output gap meant that countries faced little price pressure from the rest of the world. Central banks such as the Federal Reserve or European Central Bank have had the luxury to move slowly in reversing years of unprecedented expansionary monetary policy, because inflation pressures were so low. Now, international inflationary pressures could be on the return.

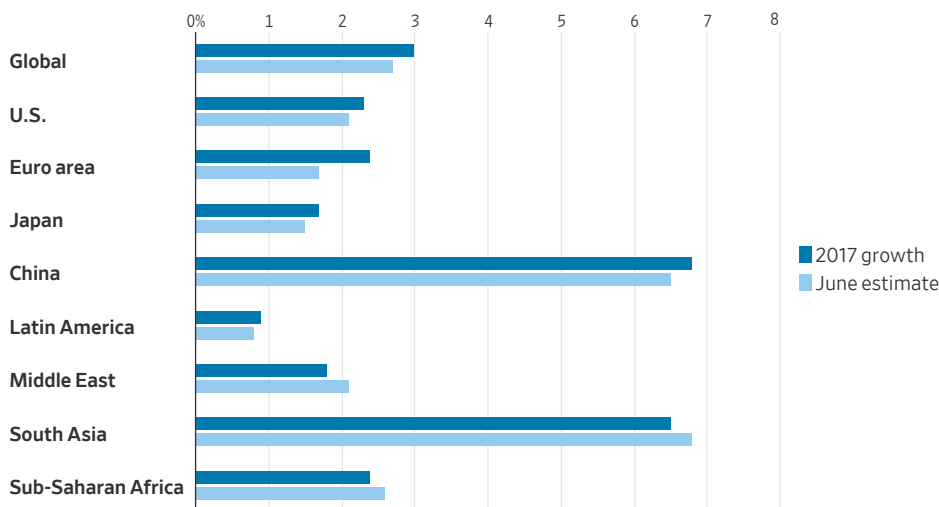
“Slack in the rest of the world forces firms to keep costs at a certain level,” said Ayhan Kose, the director of the World Bank’s Development Economic Prospects Group. “In 2018, that is disappearing.”

With the gap only narrowly closed, and uncertainty around that estimate, Mr. Kose cautions that the inflationary pressures could remain modest in 2018.

Beating Expectations

Growth around the world has come in higher than forecast

Percent change in real gross domestic product in 2017 vs. estimates for the year made in June



Source: World Bank

The closing of the gap owes to a broad-based improvement in growth around the world.

In the World Bank’s latest estimates, U.S. and Japanese economic growth in 2017 came in 0.2 percentage points stronger than in the previous round of estimates in June. China’s growth beat June’s estimates by 0.3 percentage points. Growth in the euro area came in 0.7 percentage points stronger.

Overall, the world’s economy grew 3% in 2017, the World Bank said, up from the June estimate of 2.7%, and a considerable strengthening from the 2.4% growth that was logged in 2016. The World Bank forecasts that growth will pick up a bit more in 2018, rising to 3.1%.

Despite a growth surge and closing output gap, however, the report’s authors caution that risks to the economy remain significant, with potential growth slowing in many economies due to aging demographics, slowing productivity growth and less investment than in the past. Adding to those risks are global central banks shifting to tighter monetary policies, and many governments around the world with unsustainable fiscal outlooks.

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