Global activity strengthened during the second half of 2013, as anticipated in the October 2013 World Economic Outlook (WEO). Activity is expected to improve further in 2014–15, largely on account of recovery in the advanced economies. Global growth is now projected to be slightly higher in 2014, at around 3.7 percent, rising to 3.9 percent in 2015, a broadly unchanged outlook from the October 2013 WEO. But downward revisions to growth forecasts in some economies highlight continued fragilities, and downside risks remain. In advanced economies, output gaps generally remain large and, given the risks, the monetary policy stance should stay accommodative while fiscal consolidation continues. In many emerging market and developing economies, stronger external demand from advanced economies will lift growth, although domestic weaknesses remain a concern. Some economies may have room for monetary policy support. In many others, output is close to potential, suggesting that growth declines partly reflect structural factors or a cyclical cooling and that the main policy approach for raising growth must be to push ahead with structural reform. In some economies, there is a need to manage vulnerabilities associated with weakening credit quality and larger capital outflows.

Global activity and world trade picked up in the second half of 2013. Recent data even suggest that global growth during this period was somewhat stronger than anticipated in the October 2013 WEO. Final demand in advanced economies expanded broadly as expected—much of the upward surprise in growth is due to higher inventory demand. In emerging market economies, an export rebound was the main driver behind better activity, while domestic demand generally remained subdued, except in China.

Financial conditions in advanced economies have eased since the release of the October 2013 WEO—with little change since the announcement by the U.S. Federal Reserve on December 18 that it will begin tapering its quantitative easing measures this month. This includes further declines in risk premiums on government debt of crisis-hit euro area economies. In emerging market economies, however, financial conditions have remained tighter following the surprise U.S. tapering announcements in May 2013, notwithstanding fairly resilient capital flows. Equity prices have not fully recovered, many sovereign bond yields have edged up, and some currencies have been under pressure.

Turning to projections, growth in the United States is expected to be 2.8 percent in 2014, up from 1.9 percent in 2013. Following upward surprises to inventories in the second half of 2013, the pickup in 2014 will be carried by final domestic demand, supported in part by a reduction in the fiscal drag as a result of the recent budget agreement. But the latter also implies a tighter projected fiscal stance in 2015 (as the recent budget agreement implies that most of the sequester cuts will remain in place in FY2015, instead of being reversed as assumed in the October 2013 WEO), and growth is now projected at 3 percent for 2015 (3.4 percent in October 2013).

The euro area is turning the corner from recession to recovery. Growth is projected to strengthen to 1 percent in 2014 and 1.4 percent in 2015, but the recovery will be uneven. The pickup will generally be more modest in economies under stress, despite some upward revisions including Spain. High debt, both public and private, and financial fragmentation will hold back domestic demand, while exports should further contribute to growth. Elsewhere in Europe, activity in the United Kingdom has been buoyed by easier credit conditions and increased confidence. Growth is expected to average 2¼ percent in 2014–15, but economic slack will remain high.
In Japan, growth is now expected to slow more gradually compared with October 2013 WEO projections. Temporary fiscal stimulus should partly offset the drag from the consumption tax increase in early 2014. As a result, annual growth is expected to remain broadly unchanged at 1.7 percent in 2014, given carryover effects, before moderating to 1 percent in 2015.

Overall, growth in emerging market and developing economies is expected to increase to 5.1 percent in 2014 and to 5.4 percent in 2015. Growth in China rebounded strongly in the second half of 2013, due largely to an acceleration in investment. This surge is expected to be temporary, in part because of policy measures aimed at slowing credit growth and raising the cost of capital. Growth is thus expected to moderate slightly to around 7½ percent in 2014–15. Growth in India picked up after a favorable monsoon season and higher export growth and is expected to firm further on stronger structural policies supporting investment. Many other emerging market and developing economies have started to benefit from stronger external demand in advanced economies and China. In many, however, domestic demand has remained weaker than expected. This reflects to varying degrees, tighter financial conditions and policy stances since mid-2013, as well as policy or political uncertainty and bottlenecks, with the latter weighing on investment in particular. As a result, growth in 2013 or 2014 has been revised downward compared to the October 2013 WEO forecasts, including in Brazil and Russia. Downward
revisions to growth in 2014 in the Middle East and North Africa region, and upward revisions in 2015, mainly reflect expectations that the rebound in oil output in Libya after outages in 2013 will proceed at a slower pace.

In sum, **global growth** is projected to increase from 3 percent in 2013 to 3.7 percent in 2014 and 3.9 percent in 2015.

**Not yet out of the woods**

Turning to **risks to the forecast**, downside risks—old ones discussed in the October 2013 WEO and new ones—remain. Among new ones, risks to activity associated with very low inflation in **advanced economies**, especially the euro area, have come to the fore. With inflation likely to remain below target for some time, longer-term inflation expectations might drift down. This raises the risks of lower-than-expected inflation, which increases real debt burdens, and of premature real interest rate increases, as monetary policy is constrained in lowering nominal interest rates. It also raises the likelihood of deflation in the event of adverse shocks to activity.

Downside risks to financial stability persist. Corporate leverage has risen, accompanied in many emerging market economies by increased exposures to foreign currency liabilities. In a number of markets, including several emerging markets, asset valuations could come under pressure if interest rates rose more than expected and adversely affected investor sentiment.

In **emerging market economies**, increased financial market and capital flow volatility remain a concern given that the Fed will start tapering in early 2014. The responses to the related December announcement have been relatively muted in most economies, possibly helped by the Fed’s policy communication and recalibration (including revisions to forward guidance). Nevertheless, portfolio shifts and some capital outflows are likely with Fed tapering. When combined with domestic weaknesses, the result could be sharper capital outflows and exchange rate adjustments.

Turning to policies, ensuring robust growth and managing vulnerabilities remain global priorities despite the expected strengthening of activity.

In **advanced economies**, policy priorities remain broadly those discussed in the October 2013 WEO. With prospects improving, however, it will be critical to avoid a premature withdrawal of monetary policy accommodation, including in the United States, as output gaps are still large while inflation is low and fiscal consolidation continues. Stronger growth is needed to complete balance sheet repair after the crisis and to lower related legacy risks. In the euro area, the European Central Bank (ECB) will need to consider additional measures toward this end. Measures such as longer-term liquidity provision, including targeted lending, would strengthen demand and reduce financial market fragmentation. Repairing bank balance sheets through the Balance Sheet Assessment exercise and recapitalizing weak banks and completing the Banking Union by unifying both supervision and crisis resolution will be essential for confidence to improve, for credit to revive, and to sever the link between sovereigns and banks. More structural reforms are needed to lift investment and prospects.

In **emerging market and developing economies**, recent developments highlight the need to manage the risks of potential capital flow reversals. Economies with domestic weaknesses and partly related external current account deficits appear particularly exposed. Exchange rates should be allowed to depreciate in response to deteriorating external funding conditions. When there are constraints on exchange rate adjustment—because of balance sheet mismatches and other financial fragilities, or large pass-through to inflation because of monetary policy frameworks that lack transparency or consistency in their implementation—policymakers might need to consider a combination of tightening macroeconomic policies and stronger regulatory and supervisory policy efforts. In China, the recent rebound highlights that investment remains the key driver in growth dynamics. More progress is required on rebalancing domestic demand from investment to consumption to effectively contain the risks to growth and financial stability from overinvestment.