Global growth is in low gear, the drivers of activity are changing, and downside risks persist. China and a growing number of emerging market economies are coming off cyclical peaks. Their growth rates are projected to remain much above those of the advanced economies but below the elevated levels seen in recent years, for both cyclical and structural reasons. The United States has seen several quarters of solid private demand. Although public sector demand has been pushing in the opposite direction, this counterforce will diminish in 2014, setting the stage for higher growth. Japan’s economy is enjoying a vigorous rebound but will lose steam in 2014 as fiscal policy tightens. The euro area is crawling out of recession, but activity is forecast to stay tepid. In these three advanced economies, much slack remains and inflation pressure is expected to stay subdued.

These changing growth dynamics raise new policy challenges, and policy spillovers may pose greater concern. Two recent developments will likely shape the path of the global economy in the near term. First, markets are increasingly convinced that U.S. monetary policy is reaching a turning point. Talk by the Federal Reserve about tapering its quantitative easing measures led to an unexpectedly large increase in long-term yields in the United States and many other economies, much of which has not been reversed despite a subsequent decision by the Federal Reserve to maintain the amount of asset purchases and policy actions in other countries. Second, there is strengthening conviction that China will grow more slowly over the medium term than in the recent past—previous expectations that the Chinese authorities would react with a strong stimulus if output growth were to decline toward the government target of 7½ percent have had to be revised.

The October 2013 Global Financial Stability Report (GFSR) explains how spillovers from these changed perceptions have already provided a sort of mini stress test for financial systems. In emerging markets, the spillovers interacted with existing vulnerabilities and triggered both desirable and undesirable adjustments. The desirable adjustments feature reallocated capital flows and currency depreciations that help attenuate growing competitiveness problems: typically, the currencies that depreciated most were those that the 2013 Pilot External Sector Report had assessed as overvalued. At the same time, however, volatility has gone up, and the risk of overshooting could weigh on investment and growth.

Looking ahead, global activity is expected to strengthen moderately but the risks to the forecast remain to the downside. The impulse is projected to come from the advanced economies, where output is expected to expand at a pace of about 2 percent in 2014, about ¾ percentage point more than in 2013. Drivers of the projected uptick are a stronger U.S. economy, an appreciable reduction in fiscal tightening (except in Japan), and highly accommodative monetary conditions. Growth in the euro area will be held back by the very weak economies in the periphery. Emerging market and developing economies are projected to expand by about 5 percent in 2014, as fiscal policy is forecast to stay broadly neutral and real interest rates to remain relatively low. Unemployment will remain unacceptably high in many advanced economies as well as in various emerging market economies, notably those in the Middle East and North Africa.

Some new downside risks have come to the fore, while old risks largely remain. At the time of writing, a political standoff in the United States has led to a shutdown of its federal government. The projections assume that the shutdown is short, discretionary public spending is approved and executed as assumed in the forecast, and the debt ceiling—which may be reached by mid-October—is raised promptly. There is uncertainty on all three accounts. While the damage to the U.S. economy from a short shutdown is likely to be limited, a longer shutdown could be quite harmful. And, even more importantly, a failure to promptly raise the debt ceiling, leading to a U.S. selective default, could seriously damage the global economy.

Beyond immediate risks, the October 2013 Global Financial Stability Report underscores that the prospect of reduced monetary accommodation in the United States may cause additional market adjustments and
expose areas of financial excess and systemic vulnerability. In this setting, emerging market economies may face exchange rate and financial market overshooting as they also cope with weaker economic outlooks and rising domestic vulnerabilities; some could even face severe balance of payments disruptions. In the euro area, risks continue to flow from the unfinished business of restoring bank health and credit transmission and from corporate debt overhang. Insufficient fiscal consolidation and structural reforms in Japan could trigger serious downside risks, especially of the fiscal variety. In this regard, the October 2013 Fiscal Monitor emphasizes that the large public debt stocks and the absence of medium-term adjustment plans with concrete measures and strong entitlement reforms in key advanced economies, notably Japan and the United States, combine to keep fiscal risks at a stubbornly high level. Fiscal vulnerabilities are also building in emerging market and low-income economies to varying degrees. In the meantime, geopolitical risks have returned.

Policymakers have shown their determination to keep the global economy away from the precipice. Aside from new cliff events, a growing worry is a prolonged period of sluggish global growth. A plausible downside scenario for the medium term would be characterized by a continuation of only modest growth in the euro area because of persistent financial fragmentation and unexpectedly high legacy effects from private indebtedness, a hobbling of emerging market economies by imbalances and supply-side bottlenecks, and prolonged deflation in Japan. Meanwhile, the end of U.S. quantitative easing could come with a greater and longer-lasting tightening of global financial conditions than is presently expected. As a result, the global economy could grow by only slightly more than 3 percent a year over the medium term, instead of reaccelerating to over 4 percent. What is more worrisome, monetary policy in the advanced economies could be stuck at the zero interest bound for many years. Over time, worrisomely high public debt in all major advanced economies and persistent financial fragmentation in the euro area could then trigger new crises.

Forestalling the plausible downside scenario or the advent of new crises requires further policy efforts, mainly in the advanced economies. Old challenges to be addressed include repairing financial systems and adopting a banking union in the euro area and developing and implementing strong plans, supported by concrete measures, for medium-term fiscal adjustment and entitlement reform in Japan and the United States. Furthermore, in the euro area and Japan, in particular, there is a need to boost potential output, including through reforms that level the playing field between insiders and outsiders in labor markets and ease barriers to entry into product and services markets. A new challenge is for U.S. monetary policy to change tack carefully in response to changing growth, inflation, and financial stability prospects. Excessive tightening may be difficult to undo, and global growth may well fall short of, rather than exceed, medium-term growth and inflation projections.

Emerging market and developing economies are facing new policy challenges. The appropriate policy mix and the pace of adjustment will differ across economies, in view of the differences in output gaps, inflation pressure, central bank credibility, room for fiscal policy maneuvering, and the nature of vulnerabilities. However, many economies share five policy priorities. First, policymakers should allow exchange rates to respond to changing fundamentals but may need to guard against risks of disorderly adjustment, including through intervention to smooth excessive volatility. Second, where monetary policy frameworks are less credible, efforts may need to focus more on providing a strong nominal anchor. Third, prudential actions should be taken to safeguard financial stability, given legacy risks from recent credit booms and new risks from capital flows. Fourth, fiscal consolidation should proceed, unless activity threatens to deteriorate very sharply and funding conditions permit fiscal easing—issues discussed in more detail in the October 2013 Fiscal Monitor. Fifth, many economies need a new round of structural reforms, including investment in public infrastructure, removal of barriers to entry in product and services markets, and in the case of China, rebalancing growth away from investment toward consumption.