Global activity has broadly strengthened and is expected to improve further in 2014–15, with much of the impetus coming from advanced economies. Inflation in these economies, however, has undershot projections, reflecting still-large output gaps and recent commodity price declines. Activity in many emerging market economies has disappointed in a less favorable external financial environment, although they continue to contribute more than two-thirds of global growth. Their output growth is expected to be lifted by stronger exports to advanced economies. In this setting, downside risks identified in previous World Economic Outlook reports have diminished somewhat. There are three caveats: emerging market risks have increased, there are risks to activity from lower-than-expected inflation in advanced economies, and geopolitical risks have resurfaced. Overall, the balance of risks, while improved, remains on the downside.

The renewed increase in financial volatility in late January of this year highlights the challenges for emerging market economies posed by the changing external environment. The proximate cause seems to have been renewed market concern about emerging market fundamentals. Although market pressures were relatively broadly based, countries with higher inflation and wider current account deficits were generally more affected. Some of these weaknesses have been present for some time, but with prospects of improved returns in advanced economies, investor sentiment is now less favorable toward emerging market risks. In view of possible capital flow reversals, risks related to sizable external funding needs and disorderly currency depreciations are a concern. Some emerging market economies have tightened macroeconomic policies to shore up confidence and strengthen their commitment to policy objectives. Overall, financial conditions have tightened further in some emerging market economies compared with the October 2013 World Economic Outlook. The cost of capital has increased as a result, and this is expected to dampen investment and weigh on growth.

Looking ahead, global growth is projected to strengthen from 3 percent in 2013 to 3.6 percent in 2014 and 3.9 percent in 2015, broadly unchanged from the October 2013 outlook. In advanced economies, growth is expected to increase to about 2¼ percent in 2014–15, an improvement of about 1 percentage point compared with 2013. Key drivers are a reduction in fiscal tightening, except in Japan, and still highly accommodative monetary conditions. Growth will be strongest in the United States at about 2¾ percent. Growth is projected to be positive but varied in the euro area: stronger in the core, but weaker in countries with high debt (both private and public) and financial fragmentation, which will both weigh on domestic demand. In emerging market and developing economies, growth is projected to pick up gradually from 4.7 percent in 2013 to about 5 percent in 2014 and 5¼ percent in 2015. Growth will be helped by stronger external demand from advanced economies, but tighter financial conditions will dampen domestic demand growth. In China, growth is projected to remain at about 7½ percent in 2014 as the authorities seek to rein in credit and advance reforms while ensuring a gradual transition to a more balanced and sustainable growth path.

The global recovery is still fragile despite improved prospects, and significant downside risks—both old and new—remain. Recently, some new geopolitical risks have emerged. On old risks, those related to emerging market economies have increased with the changing external environment. As highlighted in the April 2014 Global Financial Stability Report, unexpectedly rapid normalization of U.S. monetary policy or renewed bouts of high risk aversion on the part of investors could result in further financial turmoil. This would lead to difficult adjustments in some emerging market economies, with a risk of contagion and broad-based financial stress, and thus lower growth.

In advanced economies, risks to activity associated with very low inflation have come to the fore, especially in the euro area, where large output gaps have contributed to low inflation. With inflation likely to remain below target for some time, longer-term inflation expectations might drift down, leading to even lower inflation than is currently expected, or possibly
to deflation if other downside risks to activity materialize. The result would be higher real interest rates, an increase in private and public debt burdens, and weaker demand and output.

The strengthening of the recovery from the Great Recession in the advanced economies is a welcome development. But growth is not evenly robust across the globe, and more policy efforts are needed to fully restore confidence, ensure robust growth, and lower downside risks.

Policymakers in advanced economies need to avoid a premature withdrawal of monetary accommodation. In an environment of continued fiscal consolidation, still-large output gaps, and very low inflation, monetary policy should remain accommodative. In the euro area, more monetary easing, including unconventional measures, is necessary to sustain activity and help achieve the European Central Bank’s price stability objective, thus lowering risks of even lower inflation or outright deflation. Sustained low inflation would not likely be conducive to a suitable recovery of economic growth. In Japan, implementation of the remaining two arrows of Abenomics—structural reform and plans for fiscal consolidation beyond 2015—is essential to achieve the inflation target and higher sustained growth. The need for credible medium-term fiscal plans, however, extends beyond Japan. The April 2014 Fiscal Monitor highlights that the combination of large public debt stocks and the absence of medium-term adjustment plans that include specific measures and strong entitlement reforms is the main factor behind important medium-term fiscal risks in advanced economies, including in the United States. In the euro area, repairing bank balance sheets in the context of a credible asset quality review and recapitalizing weak banks will be critical if confidence is to improve and credit is to revive. Also essential for achieving these goals is progress on completing the banking union—including an independent Single Resolution Mechanism with the capacity to undertake timely bank resolution and common back-stops to sever the link between sovereigns and banks. More structural reforms are needed to lift investment and activity prospects.

Emerging market economies will have to weather turbulence and maintain high medium-term growth. The appropriate policy measures will differ across these economies. However, many of them have some policy priorities in common. First, policymakers should allow exchange rates to respond to changing fundamentals and facilitate external adjustment. Where international reserves are adequate, foreign exchange interventions can be used to smooth volatility and avoid financial disruption. Second, in economies in which inflation is still relatively high or the risks that recent currency depreciation could feed into underlying inflation are high, further monetary policy tightening may be necessary. If policy credibility is a problem, strengthening the transparency and consistency of policy frameworks may be necessary for tightening to be effective. Third, on the fiscal front, policymakers must lower budget deficits, although the urgency for action varies across economies. Early steps are required if public debt is already elevated and the associated refinancing needs are a source of vulnerability. Fourth, many economies need a new round of structural reforms that include investment in public infrastructure, removal of barriers to entry in product and services markets, and in China, rebalancing growth away from investment toward consumption.

Low-income countries will need to avoid a buildup of external and public debt. Many of these countries have succeeded in maintaining strong growth, partly reflecting better macroeconomic policies, but their external environment has also been changing. Foreign direct investment has started to moderate with declining commodity prices, and commodity-related budget revenues and foreign exchange earnings are at risk. Timely policy adjustments will be important to avoid a buildup in external debt and public debt.