EXECUTIVE SUMMARY

Despite setbacks, an uneven global recovery continues. Largely due to weaker-than-expected global activity in the first half of 2014, the growth forecast for the world economy has been revised downward to 3.3 percent for this year, 0.4 percentage point lower than in the April 2014 World Economic Outlook *(WEO). The global growth projection for 2015 was lowered to 3.8 percent.*

Downside risks have increased since the spring. Short-term risks include a worsening of geopolitical tensions and a reversal of recent risk spread and volatility compression in financial markets. Medium-term risks include stagnation and low potential growth in advanced economies and a decline in potential growth in emerging markets.

Given these increased risks, raising actual and potential growth must remain a priority. In advanced economies, this will require continued support from monetary policy and fiscal adjustment attuned in pace and composition to supporting both the recovery and long-term growth. In a number of economies, an increase in public infrastructure investment can also provide support to demand in the short term and help boost potential output in the medium term. In emerging markets, the scope for macroeconomic policies to support growth if needed varies across countries and regions, but space is limited in countries with external vulnerabilities. And in advanced economies as well as emerging market and developing economies, there is a general, urgent need for structural reforms to strengthen growth potential or make growth more sustainable.

Despite further setbacks this year, an uneven global recovery continues. In advanced economies, the legacies of the precrisis boom and the subsequent crisis (including high private and public debt) still cast a shadow on the recovery. Emerging markets are adjusting to rates of economic growth lower than those reached in the precrisis boom and the postcrisis recovery. Overall, the pace of recovery is becoming more country specific.

Other elements are also affecting the outlook. Financial markets have been optimistic, with high equity prices, compressed spreads, and very low volatility. However, this has not translated into a pickup in investment, which—particularly in advanced economies—has remained subdued. And as discussed in the October 2014 *Global Financial Stability Report*, there are concerns that markets are underpricing risk, not fully internalizing the uncertainties surrounding the macroeconomic outlook and their implications for the pace of withdrawal of monetary stimulus in some major advanced economies. Geopolitical tensions have risen. So far their macroeconomic effects appear mostly confined to the regions involved, but there are tangible risks of more widespread disruptions. Some medium-term problems that predate the crisis, such as the impact of an aging population on the labor force and weak growth in total factor productivity, are coming back to the fore and need to be tackled. These problems show up in low potential growth in advanced economies—which may be affecting the pace of recovery today—and a decline in potential growth in emerging markets. Structural reforms to boost potential growth are needed in both.

Turning to the specifics of the outlook, global growth in the first half of 2014 did slow more than expected at the time of the April 2014 WEO. The weaker-than-expected growth reflects events in the United States, the euro area, Japan, and some large emerging market economies. In the United States, after a surprisingly dismal first quarter, activity picked up in the second quarter, and the evidence suggests that the weakness was mostly temporary. In the euro area, growth came to a halt in the second quarter, mainly on account of weak investment and exports, and uncertainty about the persistence of the growth slowdown remains. In Japan, the decline in domestic demand following the increase in the consumption tax was larger than expected. In Russia and the Commonwealth of Independent States, the weakness reflects the impact of geopolitical tensions on foreign investment, domestic production, and confidence. Lackluster domestic demand in other emerging market economies has once again proven to be more persistent than forecast—particularly in Latin America, with a contraction of GDP in Brazil and negative surprises to activity in several other countries. In China, after a weaker-than-expected first quarter, policy measures supported stronger growth in the second. Overall, weaker-than-expected growth in some emerging markets during the first half of the year may be related to the tightening of financial conditions during the first quarter, but not generally to the slowdown in the United States, given that U.S. imports have grown at a robust pace.

The forecast envisages a rebound in growth for both advanced economies and emerging markets in the remainder of 2014 and in 2015, but at a rate that for both years is below the April 2014 WEO projections. Specifically, the global growth projection for 2014 has been marked down to 3.3 percent, 0.4 percentage point below that in April, reflecting both the legacy of the weak first half of the year, particularly in the United States, and a less optimistic outlook for several emerging markets. The projection for 2015 has been marked down modestly to 3.8 percent. These projections of a growth rebound are predicated on the assumption that key drivers supporting the recovery in advanced economies identified in the April 2014 WEO remain in place, notably a moderating of fiscal consolidation (Japan being one exception) and the continuation of highly accommodative monetary policy. They also assume a gradual decline in geopolitical tensions. Among advanced economies, the more rapid recovery reflects primarily faster growth in the United States, but also a pickup in activity in the euro area. For emerging markets, the rebound reflects a variety of country-specific as well as global factors. The former include some recovery in countries affected by geopolitical tensions and/or domestic strife in 2014, or where growth this year has been much below potential, and in other countries the gradual lifting of structural impediments to growth. Global factors—easy global financial conditions and the increase in external demand from advanced economies—should also support the pickup in emerging market growth. These global factors are also expected to support growth in low-income developing countries, which is projected to exceed 6 percent in both 2014 and 2015—although the projected easing in nonfuel commodity prices will induce some deterioration in the terms of trade for net exporters of commodities.

Downside risks have increased since the spring. Increased geopolitical tensions could prove persistent, hampering recovery in the countries directly involved and taking a toll on confidence elsewhere. And a worsening of such tensions could lead to sharply higher oil prices, asset price declines, and further economic distress. Financial market risks include a reversal of recent risk spread and volatility compression triggered by a larger-than-expected increase in U.S. long-term rates—which would also tighten financial conditions for emerging markets. Secular stagnation and low potential growth in advanced economies remain important medium-term risks, given the modest and uneven growth in those economies despite very low interest rates and the easing of other brakes to the recovery. In some major emerging market economies, the negative growth effects of supply-side constraints could be more protracted.

The pace of the global recovery has disappointed in recent years. With weaker-than-expected global growth for the first half of 2014 and increased downside risks, the projected pickup in growth may again fail to materialize or fall short of expectations. This further underscores that in most economies, raising actual and potential growth must remain a priority. Robust demand growth in advanced economies has not yet emerged despite continued very low interest rates and easing of brakes to the recovery, including from fiscal consolidation or tight financial conditions. Avoiding premature monetary policy normalization remains a priority, as does fiscal adjustment attuned in pace and composition to supporting both the recovery and long-term growth. In this context, an increase in public infrastructure investment, particularly for advanced economies with clearly identified infrastructure needs and efficient public investment processes, could provide a boost to demand in the short term and help raise potential output in the medium term. And structural reforms to raise potential output are of the essence. In emerging markets, the scope for macroeconomic policies to support growth if needed varies across countries and regions, but space is limited in countries with external vulnerabilities. And here as well, there is a general, urgent need for country-specific structural reforms to strengthen growth potential or make growth more sustainable.