

Resilient Global Economy Is Limping Along, with Growing Divergences

The global economy continues to recover slowly from the blows of the pandemic, Russia's invasion of Ukraine, and the cost-of-living crisis. In retrospect, the resilience has been remarkable. Despite the disruption in energy and food markets caused by the war, and the unprecedented tightening of global monetary conditions to combat decades-high inflation, the global economy has slowed, but not stalled. Yet growth remains slow and uneven, with growing global divergences. The global economy is limping along, not sprinting.

Global activity bottomed out at the end of last year while inflation—both headline and underlying (core)—is gradually being brought under control. But a full recovery toward prepandemic trends appears increasingly out of reach, especially in emerging market and developing economies.

According to our latest projections, global growth will slow from 3.5 percent in 2022 to 3 percent this year and 2.9 percent next year, a 0.1 percentage point downgrade for 2024 from our July projections. This remains well below the historical average.

Headline inflation continues to decelerate, from 9.2 percent in 2022, on a year-over-year basis, to 5.9 percent this year and 4.8 percent in 2024. Core inflation, excluding food and energy prices, is also projected to decline, albeit more gradually than headline inflation, to 4.5 percent in 2024.

As a result, projections are increasingly consistent with a “soft landing” scenario, bringing inflation down without a major downturn in activity, especially in the United States, where the forecast increase in unemployment is very modest, from 3.6 to 3.9 percent by 2025.

But important divergences are appearing. The slowdown is more pronounced in advanced economies than in emerging market and developing ones. Within advanced economies, the US surprised on the upside, with resilient consumption and investment, while euro area activity was revised downward. Many emerging market economies proved quite resilient and surprised on the upside, with the notable exception of

China, facing growing headwinds from its real estate crisis and weakening confidence.

Three global forces are at play. First, the recovery in services is almost complete. Over the past year, strong demand for services supported service-oriented economies—including important tourism destinations such as France and Spain—relative to manufacturing powerhouses such as China and Germany. High demand for labor-intensive services also translated into tighter labor markets, and higher and more persistent services inflation. But services activity is now weakening alongside a persistent manufacturing slowdown, suggesting services inflation will decrease in 2024 and labor markets and activity will soften.

Second, part of the slowdown is the result of the tighter monetary policy necessary to bring inflation down. This is starting to bite, but the transmission is uneven across countries. Tighter credit conditions are weighing on housing markets, investment, and activity, more so in countries with a higher share of adjustable-rate mortgages or where households are less willing, or able, to dip into their savings. Firm bankruptcies have increased in the US and the euro area, although from historically low levels. Countries are also at different points in their hiking cycles: advanced economies (except Japan) are near the peak, while some emerging market economies, such as Brazil and Chile, have already started easing.

Third, inflation and activity are shaped by the incidence of last year's commodity price shock. Economies heavily dependent on Russian energy imports experienced a steeper increase in energy prices and a sharper slowdown. Some of our recent work shows that the pass-through from higher energy prices played a large role in driving core inflation upward in the euro area, unlike in the United States, where core inflation pressures reflect instead a tight labor market.

Despite signs of softening, labor markets in advanced economies remain buoyant, with historically low unemployment rates helping to support activity. So far, there is scant evidence of a “wage-price spiral,” and real wages remain below prepandemic levels. Further, many countries experienced a sharp—and welcome—compression

in the wage distribution. Some of this compression reflects the higher amenity value of flexible and remote work schedules for high earners, reducing wage pressures for that group.

Risks

While some of the extreme risks—such as severe banking instability—have moderated since April, the balance remains tilted to the downside.

First, the real estate crisis could deepen further in China, an important risk for the global economy. The policy challenge is complex. Restoring confidence requires promptly restructuring struggling property developers, preserving financial stability, and addressing the strains in local public finance. If real estate prices decline too rapidly, the balance sheets of banks and households will worsen, with the potential for serious financial amplification. If real estate prices are artificially propped up, balance sheets will be protected for a while, but this may crowd out other investment opportunities, reduce new construction activity, and have an adverse impact on local government revenues through reduced land sales. Either way, China's economy needs to pivot away from a credit-driven real estate model of growth.

Second, commodity prices could become more volatile under renewed geopolitical tensions and disruptions linked to climate change. Since June, oil prices have increased by about 25 percent, on the back of extended supply cuts from OPEC+ (the Organization of the Petroleum Exporting Countries plus selected nonmembers) countries. Food prices remain elevated and could be disrupted further by an escalation of the war in Ukraine, causing important hardship for many low-income countries. This, of course, represents a serious risk to the disinflation strategy. Goeconomic fragmentation has also led to a sharp increase in the dispersion in commodity prices across regions, including critical minerals. As Chapter 3 of this report analyzes, this could pose serious macroeconomic risks going forward, including to the climate transition.

Third, while both underlying and headline inflation have decreased, they remain uncomfortably high. Near-term inflation expectations have risen markedly above target, although they now appear to be turning a corner. As Chapter 2 of this report details, bringing these near-term inflation expectations back down is critical to winning the battle against inflation. With tight labor markets, ample

excess savings in some countries, and adverse energy price developments, inflation could become more entrenched, requiring even more forceful action from central banks.

Fourth, fiscal buffers have eroded in many countries, with elevated debt levels, rising funding costs, slowing growth, and an increasing mismatch between the growing demands on the state and available fiscal resources (see the October 2023 *Fiscal Monitor*). This leaves many countries more vulnerable to crises and demands a renewed focus on managing fiscal risks.

Finally, despite the tightening of monetary policy, financial conditions have eased in many countries (see the October 2023 *Global Financial Stability Report*). The danger is of a sharp repricing of risk, especially for emerging markets, that would appreciate further the US dollar, trigger capital outflows, and increase borrowing costs and debt distress.

Policies

Under our baseline scenario, inflation continues to recede as central banks maintain a tight stance. With many countries near the peak of their tightening cycles, little additional tightening is warranted. However, easing prematurely would squander the gains achieved in the past 18 months. Once the disinflation process is firmly on its way and near-term inflation expectations are decreasing, adjusting the policy rate downward will allow the monetary policy stance, that is, the real interest rate, to remain unchanged until inflation targets are in sight.

Fiscal policy needs to support the monetary strategy and help the disinflation process. In 2022, fiscal and monetary policies were pulling in the same direction, as many of the pandemic emergency fiscal measures were unwound. In 2023, the degree of alignment has decreased. Most worrying is the case of the United States, where the fiscal stance has deteriorated substantially. Fiscal policy in the US should not be procyclical, even less so at this stage of the inflation cycle. More broadly, fiscal policy everywhere should focus on rebuilding fiscal buffers that have been severely eroded by the pandemic and the energy crisis, for instance, by removing energy subsidies.

We should also return our focus to the medium term. Here the picture is becoming darker. Medium-term growth prospects are weak, especially for emerging market and developing economies. The implications are profound: a much slower

convergence toward the living standards of advanced economies, reduced fiscal space, increased debt vulnerabilities and exposure to shocks, and diminished opportunities to overcome the scarring from the pandemic and the war.

With lower growth, higher interest rates, and reduced fiscal space, structural reforms become key. Higher long-term growth can be achieved through a careful sequence of structural reforms, especially those focused on governance, business regulations, and the external sector. These “first-generation” reforms help unlock growth and make subsequent reforms—whether to credit markets, or for the green transition—much more effective.

Multilateral cooperation can help ensure that all countries achieve better growth outcomes. First, countries should avoid implementing policies that

contravene World Trade Organization rules and distort international trade. Second, countries should safeguard the flow of critical minerals needed for the climate transition, as well as that of agricultural commodities. Such “green corridors” would help reduce volatility and accelerate the green transition.

Finally, all countries should aim to limit geoeconomic fragmentation that prevents joint progress toward common goals and instead work toward restoring trust in rules-based multilateral frameworks that enhance transparency and policy certainty and help foster a shared global prosperity. A robust global financial safety net with a well-resourced IMF at its center is essential.

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