FOREWORD

The Global Battle against Inflation Is Almost Won; A Policy Triple Pivot Is Now Needed

The global battle against inflation has largely been won, even though price pressures persist in some countries. After peaking at 9.4 percent year over year in the third quarter of 2022, headline inflation rates are now projected to reach 3.5 percent by the end of 2025, below the average level of 3.6 percent between 2000 and 2019.

Moreover, despite a sharp and synchronized tightening of monetary policy around the world, the global economy has remained unusually resilient throughout the disinflationary process, avoiding a global recession. Growth is projected to hold steady at 3.2 percent in 2024 and 2025, even though a few countries, especially low-income developing countries, have seen sizable downside growth revisions, often as a result of increased conflicts.

While the global decline in inflation is a major milestone, downside risks are rising and now dominate the outlook: an escalation in regional conflicts, monetary policy remaining tight for too long, a possible resurgence of financial market volatility with adverse effects on sovereign debt markets (see October 2024 *Global Financial Stability Report*), a deeper growth slowdown in China, and the continued ratcheting up of protectionist policies.

What accounts for the decline in inflation? As Chapter 2 of this report argues, the surge and subsequent decline in global inflation reflects a unique combination of shocks: broad supply disruptions coupled with strong demand pressures in the wake of the pandemic, followed by sharp spikes in commodity prices caused by the war in Ukraine. These shocks led to an upward shift and a steepening of the relationship between activity and inflation, the Phillips curve. As supply disruptions eased and monetary policy tightening started to constrain demand, normalization in labor markets allowed inflation to decline rapidly without a major slowdown in activity. Clearly, much of the disinflation can be attributed to the unwinding of the shocks themselves, followed by improvements in labor supply, often linked to immigration. But monetary policy played an important role too by helping to keep inflation expectations anchored, avoiding deleterious wage-price spirals and a repeat of the disastrous inflation experience of the 1970s.

The return of inflation to near central bank targets paves the way for a much-needed policy triple pivot.

The first—on monetary policy—has started. Since June, major central banks in advanced economies have started to cut their policy rates, moving their policy stance toward neutral. This will support activity at a time when many advanced economies' labor markets are showing signs of weakness, with rising unemployment rates. It will also help ward off the downside risks.

The change in global monetary conditions is easing the pressure on emerging market economies, with their currencies strengthening against the US dollar and financial conditions improving. This will help reduce imported inflation pressures, allowing these countries to pursue more easily their own disinflation path.

However, vigilance remains key. Inflation in services remains too elevated, almost twice as high as before the pandemic. Some emerging market economies are facing a resurgence of inflationary pressures, sometimes because of elevated food prices. Furthermore, we have now entered a world dominated by supply disruptions—from climate, health, and geopolitics. It is always harder for monetary policy to maintain price stability when faced with such shocks, which simultaneously increase prices and reduce output. Finally, while inflation expectations have remained well anchored this time around, it may be harder next time, as workers and firms will be more vigilant in protecting their standards of living and profits going forward.

The second pivot is on fiscal policy. Fiscal space is also a cornerstone of financial stability. After years of loose fiscal policy, it is now time to stabilize debt dynamics and rebuild much-needed fiscal buffers. While the decline in policy rates provides some fiscal relief by lowering funding costs, this will not be

sufficient, especially as long-term real interest rates are much above prepandemic levels. In many countries, primary balances, the difference between fiscal revenues and public expenditures net of debt service, need to improve. For some countries, like the United States and China, debt dynamics are not stabilized under current fiscal plans (see October 2024 *Fiscal Monitor*). In many others, while early fiscal plans showed promise after the pandemic and cost-of-living crises, there are increasing signs of slippage. The path is narrow: unduly delaying adjustment increases the risk of disorderly market-imposed adjustments, while an excessively sharp turn toward fiscal consolidation would be self-defeating and hurt economic activity. Success requires staying the course by implementing gradual and credible multiyear adjustments without delay, where consolidation is necessary. The more credible and disciplined the fiscal adjustment, the more monetary policy will be able to play a supporting role. But the willingness and ability to deliver disciplined and credible adjustments have been lacking.

The third pivot—and the hardest—is on structural reforms. Much more needs to be done to improve growth prospects and lift productivity, as this is the only way we can address the many challenges we face: rebuilding fiscal buffers, aging and declining populations in many parts of the world, young and growing populations in Africa in search of opportunity, tackling the climate transition, increasing resilience, and improving the lives of the most vulnerable, within and across countries. Unfortunately, medium-term global growth remains lackluster, at 3.1 percent. While much of this reflects China's weaker outlook, medium-term prospects in other regions, such as Latin America and the European Union, have also deteriorated. The recently published Draghi report offers a clear-eyed assessment of the diminished prospects in the region—and the associated challenges.

Faced with increased external competition and structural weaknesses in manufacturing and productivity, many countries are implementing industrial and trade policy measures to protect their workers and industries. While these measures can sometimes boost investment and activity in the short run—especially when they rely on debt-financed subsidies—they often lead to retaliation, are unlikely to deliver sustained improvements in standards of living at home or abroad, and should be firmly resisted when they do not carefully address well-identified market failures or national security concerns. Instead, economic growth must come from ambitious domestic reforms that boost technology and innovation, improve competition and resource allocation, further economic integration, and stimulate productive private investment.

Yet while structural reforms are as urgent as ever, they often face significant social resistance. Chapter 3 of this report explores the factors that shape the social acceptability of reforms, one of the prerequisites for their eventual success. A clear message emerges from the chapter: better communication can only go so far. Instead, building trust between the government and its people—a two-way process throughout the policy design—and the inclusion of proper compensatory measures to mitigate distributional effects are essential features. This is an important lesson that should also resonate when thinking about ways to further improve international cooperation and bolster our multilateral efforts to address common challenges as we celebrate the 80th anniversary of the Bretton Woods institutions.

Pierre-Olivier Gourinchas
Economic Counsellor