FOREWORD

It Was Never Going to Be an Easy Ride

On the surface, the global economy appears poised for a gradual recovery from the powerful blows of the pandemic and of Russia's unprovoked war on Ukraine. China is rebounding strongly following the reopening of its economy. Supply-chain disruptions are unwinding, while the dislocations to energy and food markets caused by the war are receding. Simultaneously, the massive and synchronous tightening of monetary policy by most central banks should start to bear fruit, with inflation moving back toward its targets.

In our latest forecast, global growth will bottom out at 2.8 percent this year before rising modestly to 3.0 percent in 2024. Global inflation will decrease, although more slowly than initially anticipated, from 8.7 percent in 2022 to 7.0 percent this year and 4.9 percent in 2024.

Notably, emerging market and developing economies are already powering ahead in many cases, with growth rates (fourth quarter over fourth quarter) jumping from 2.8 percent in 2022 to 4.5 percent this year. The slowdown is concentrated in advanced economies, especially the euro area and the United Kingdom, where growth (also fourth quarter over fourth quarter) is expected to fall to 0.7 percent and –0.4 percent, respectively, this year before rebounding to 1.8 and 2.0 percent in 2024.

Below the surface, however, turbulence is building, and the situation is quite fragile, as the recent bout of banking instability reminded us.

Inflation is much stickier than anticipated even a few months ago. While global inflation has declined, that reflects mostly the sharp reversal in energy and food prices. But core inflation, excluding the volatile energy and food components, has not yet peaked in many countries. It is expected to decline to 5.1 percent this year (fourth quarter over fourth quarter), a sizable upward revision of 0.6 percentage point from our January update, well above target.

Activity too shows signs of resilience as labor markets remain historically tight in most advanced economies. At this point in the tightening cycle, we would expect to see stronger signs of output and employment softening. Instead, both output and inflation estimates have been revised upward for the past two quarters, suggesting stronger-than-expected demand, which may require monetary policy to tighten further or to stay tighter for longer.

Should we worry about the risk of an uncontrolled wage-price spiral? At this point, I remain unconvinced. Nominal wage inflation continues to lag far behind price inflation, implying a steep and unprecedented decline in real wages. Given the tightness in labor markets, this is unlikely to continue, and real wages should recover. Corporate margins have surged in recent years—this is the flip side of steeply higher prices but only modestly higher wages—and should be able to absorb rising labor costs on average. As long as inflation expectations remain well anchored, that process should not spin out of control. It may well, however, take some time.

More worrisome is that the sharp policy tightening of the past 12 months is starting to have serious side effects for the financial sector, as we have repeatedly warned might happen (October 2022 *Global Financial Stability Report;* January 2023 *World Economic Outlook* [WEO] *Update*). Following a prolonged period of muted inflation and extremely low interest rates, last year's rapid tightening of monetary policy has triggered sizable losses on long-term fixed-income assets. The stability of any financial system hinges on its ability to absorb losses without recourse to taxpayers' money. The financial instability last fall in the gilt market in the United Kingdom and the recent banking turbulence in the United States with the collapse of a few regional banks illustrate that significant vulnerabilities exist both among banks and nonbank financial institutions. In both cases the authorities took quick and strong action and have been able to contain the spread of the crisis so far (April 2023 *Global Financial Stability Report*). Yet the financial system may well be tested again.

Once again, downside risks dominate. Nervous investors often look for the next weakest link, as they did with Credit Suisse, a globally systemic but ailing European bank. Financial institutions with excess leverage, credit risk or interest rate exposure, too much dependence on short-term funding, or located in jurisdictions with limited fiscal space could become the next target. So could countries with weaker perceived fundamentals. A sharp tightening of global financial conditions—a "'risk-off" shock—could have a dramatic impact on credit conditions and public finances especially in emerging market and developing economies, with large capital outflows, a sudden increase in risk premia, a dollar appreciation in a rush toward safety, and major declines in global activity amid lower confidence, household spending, and investment. In such a severe downside scenario, global GDP per capita could come close to falling—an outcome whose probability we estimate at about 15 percent.

We are therefore entering a perilous phase during which economic growth remains low by historical standards and financial risks have risen, yet inflation has not yet decisively turned the corner. More than ever, policymakers will need a steady hand and clear communication. The appropriate course of action is contingent on the state of the financial system. As long as the latter remains reasonably stable, as it is now, monetary policy should stay firmly focused on bringing inflation down. A silver lining is that the banking turmoil will help slow aggregate activity as banks curtail lending in the face of rising funding costs and of the need to act more prudently. In and of itself, this should partially mitigate the need for further monetary policy tightening. But any expectation that central banks will abandon the fight against inflation would have the opposite effect: lowering yields, supporting activity beyond what is warranted, and complicating the task of central banks. Tighter fiscal policy can also play an active role. By cooling off economic activity, it would support monetary policy, allowing real interest rates to return faster to their low natural level (April 2023 WEO Chapter 2). Appropriately designed fiscal consolidations will also help rebuild much needed fiscal buffers and help strengthen financial stability (April 2023 WEO Chapter 3; April 2023 *Fiscal Monitor*).

Should a systemic financial crisis loom large, a careful and timely recalibration of policy will be needed to safeguard both the financial system and economic activity. It is important to stress that this is not where we are, even if more financial tremors are bound to occur. Regulators and supervisors should act now to ensure these do not morph into a full-blown financial crisis by actively managing market strains and strengthening oversight. For emerging market and developing economies, this also means ensuring proper access to the global financial safety net, including the IMF's precautionary arrangements, and access to the Federal Reserve repurchase facility for Foreign and International Monetary Authorities or to central bank swap lines, where relevant. Exchange rates should adjust as much as possible unless doing so raises financial stability risks or threatens price stability, in line with our Integrated Policy Framework.

Finally, our latest projections also indicate an overall slowdown in medium-term growth forecasts. Five-year-ahead growth forecasts declined steadily from 4.6 percent in 2011 to 3.0 percent in 2023. Some of this decline reflects the growth slowdown of previously rapidly growing economies such as China and Korea. This is predictable: Growth slows down as countries converge. But some of the more recent slowdown may also reflect more ominous forces: the scarring impact of the pandemic; a slower pace of structural reforms, as well as the rising threat of geoeconomic fragmentation leading to more trade tensions; less direct investment; and a slower pace of innovation and technology adoption across fragmented 'blocs' (April 2023 WEO Chapter 4). A fragmented world is unlikely to achieve progress for all or to allow us to tackle global challenges such as climate change or pandemic preparedness. We must avoid that path at all costs.

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