World Bank's June 2022 Global Economic Prospects Report warns of global stagflation scenario

Summary of OeNB webinar on June 29, 2022

with Franziska Ohnsorge (Manager) and Collette Wheeler (Senior Economist) of the Prospects Group in the Equitable Growth, Finance and Institutions Practice Group at the World Bank

moderated by Julia Wörz (Head) of the Central, Eastern and Southeastern Europe Section at the OeNB

Russia's invasion of Ukraine and its effects on commodity markets, supply chains, inflation and financial conditions have steepened the slowdown in global growth. One key downside risk is the possibility of stubbornly high inflation accompanied by tepid growth, reminiscent of the stagflation of the 1970s. This prolonged period of global stagflation in the 1970s ended in the global recession of 1982 that helped spark a series of emerging market debt crises. Much has changed in global macroeconomic policymaking since then. In this context, the World Bank's June 2022 Global Economic Prospects Report – presented by Franziska Ohnsorge and Collette Wheeler at a webinar hosted by the Oesterreichische Nationalbank (OeNB) on June 29, 2022 – sheds light on three important questions: What are the near-term prospects for the global economy? What threat does stagflation present for emerging and developing economies (EMDEs)? And what are the policy implications?

Collette Wheeler started off by pointing to the fact that commodity prices started rising before the Russian invasion of Ukraine, amid supply bottlenecks due to lockdowns. Despite the more pronounced economic growth slowdown compared to what was anticipated in January, energy prices continue their steady upward path, leading to downward revisions of growth forecasts for all economies except for energy exporters. The downward revision in GDP growth amounts to half a percentage point for EMDEs, even when excluding Russia and Ukraine, which will experience extraordinarily deep recessions. While forecasts for 2023 are not lowered further, a permanent output loss will arise, as the World Bank does not assume a rebound to take place, thus compounding the pandemic-induced output loss. Mutually amplifying risks to the forecast are mounting. Some risks are already partly materializing, such as financial stress and energy and supply disruptions. At the same time, further renewed COVID-19 outbreaks (with strongest economic effects in China) cannot be ruled out. Taken together, these risks would bring global economic growth close to zero or even send the economy into recession.

Franziska Ohnsorge continued by highlighting that, at 8% globally and 9% for EMDEs, inflation was at a 14-year high, given pent-up demand and the war in Ukraine. In other words, inflation is running above target in all inflation targeting economies around the globe (90% of EMDEs). The plateau should be reached in mid-2022, yet inflation levels are likely to remain still one percentage point above pre-crisis levels in 2023, which might not be sufficient to bring inflation back to target any time soon. Given expected lower potential growth, the World Bank warns of stagflation in its report. Ohnsorge moreover pointed to differences when comparing the current situation to the high inflation phase in the 1970s: This time, the dominance of inflation targeting frameworks and anchored inflation expectations as well as the swift response by central banks have helped build credibility. Also, headline inflation is only half as high as it had been in the 1970s, and core inflation only amounts to one fifth. Hence, lower interest rates are sufficient to bring inflation back down. She then made a case for early and thus smaller policy reactions (which we are currently observing), for subsidies to support the most vulnerable and encourage consumption, and for efficiency-enhancing (regulatory) changes in favor of renewables. The next few years will require careful calibration of macroeconomic policies and a forceful policy response to boost growth, bolster macroeconomic frameworks and reduce financial vulnerabilities.

Following Ohnsorge's presentation, Julia Wörz added more detailed information on recent inflation developments in the economies of Central, Eastern and Southeastern Europe (CESEE). Inflation is not only on an unabated upward trend in the region, it is also becoming much more broad based, both when compared over time and when compared to developments in the euro area. Drawing on evidence from the OeNB Euro Survey, she argued that more recent inflation experiences are likely to influence inflation expectations more strongly in CESEE than in Western Europe – a fact which has possibly led both policymakers and consumers to react much faster to the increase in inflation.

The general discussion then centered on the future course and the global implications of the Fed's and the ECB's monetary policy. In Ohnsorge's view, the policy response in advanced economies is highly critical as EMDEs are, on average, rather exposed to market risks. In the absence of new shocks, inflation will come down. Still, fiscal policy will also have to tighten, as the large fiscal packages of 2020 (35% of global GDP) will have to be unwound. Referring to current fiscal measures cushioning the impact of high inflation, Ohnsorge stressed the importance of sunset clauses. Wheeler concluded by highlighting the importance of credibility of local monetary policy, referring to Russia and Turkey as two examples to the contrary.