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Storm Clouds Over the Global Economy

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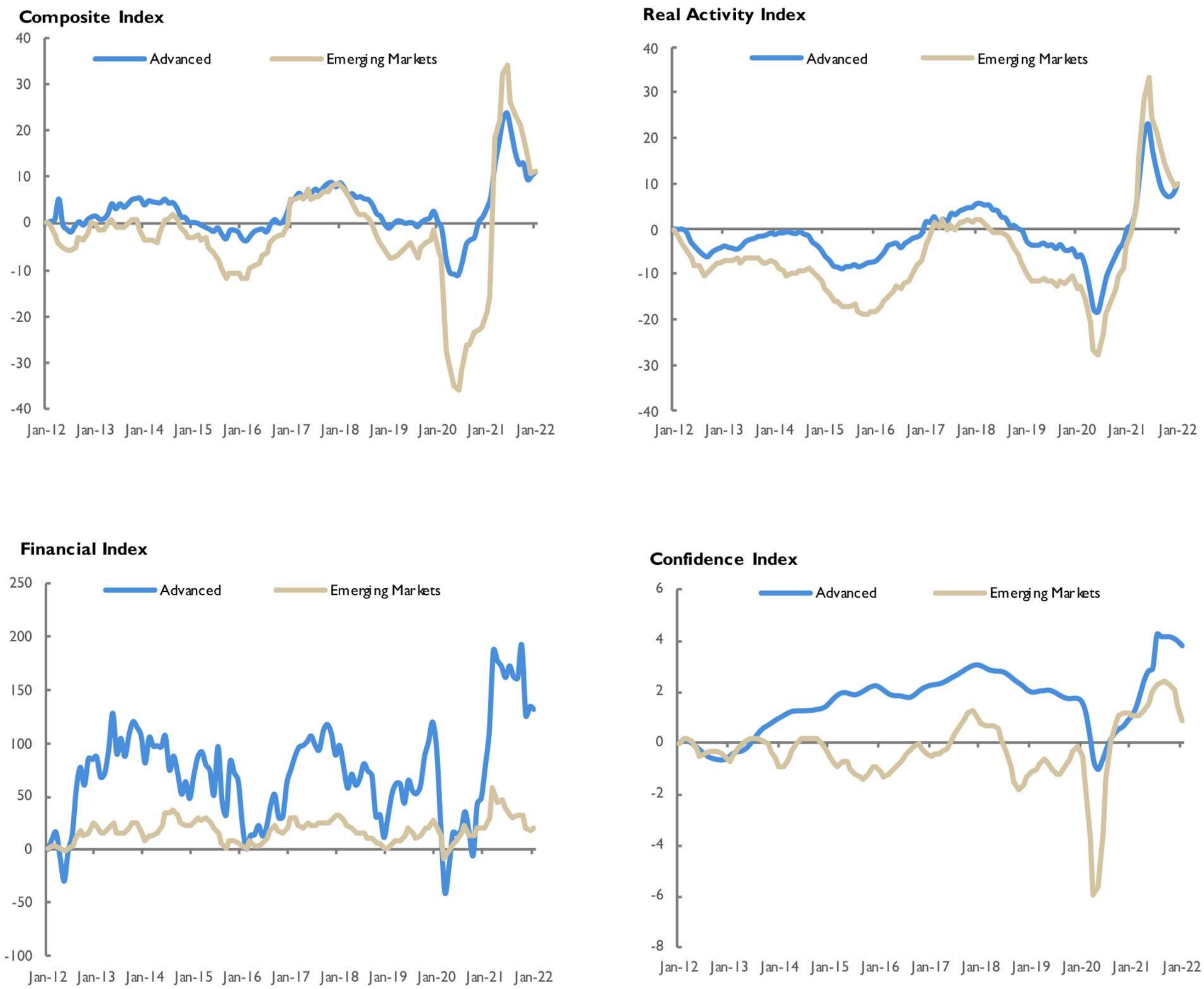
ITHACA – This was supposed to be the year of post-COVID normalization, labor-market healing, and a revival of economic growth. Yet it is turning out to be a fraught period of geopolitical realignments, persistent supply disruptions, and financial-market volatility, all of which are playing out in a context of surging inflationary pressures and limited policymaking space.
Owing to these developments, the latest update to the Brookings-Financial Times Tracking Indexes for the Global Economic Recovery (TIGER) shows an overall loss of growth momentum, with considerable unevenness across countries in their vulnerability to adverse domestic and international developments. The war in Ukraine, COVID-19's resurgence in China, and the lack of macroeconomic policy options available to most governments will make 2022 a tough year for global growth. And although COVID-19's disruptive effects seem contained in most parts of the world, the potential for new variants to emerge means that it will remain a wildcard.

The spike in geopolitical tensions has exacerbated global supply-chain disruptions. With prices already surging and demand holding up well in most major economies until recently, conditions are ripe for an escalation of inflationary pressures around the world. Worse, most governments and central banks will find it difficult to bolster demand if it shows signs of flagging in the face of mounting economic uncertainty and financial volatility. Consumer and business confidence have already taken a hit, and that bodes ill for consumer demand and especially for business investment.

The US economy continues to power along: headline employment and unemployment numbers have returned to their pre-pandemic levels; industrial output has been robust; and overall domestic demand remains strong, serving as a major engine of global growth. But the US Federal Reserve is at risk of losing control of the inflation narrative, which means that it could be forced to tighten monetary policy even more aggressively than it has signaled, raising the risk of a marked growth slowdown in 2023. High oil prices, a yield-curve inversion (when the yield on short-term debt is higher than on long-term debt), and a flailing stock market all point to – and feed – a widespread sense of impending difficulties.

Total, Advanced and Emerging Markets

Figure 1 - Recent Snapshot: Jan. 2012 -- Sep. 2020- Jan. 2022



Source: *Brookings Institution*

Meanwhile, China's determination to stick to its zero-COVID strategy has come to seem increasingly unviable. Consumer demand, investment, and production are all showing signs of weakening, which could have implications beyond China. On a more positive note, housing prices have leveled off, financial pressures have receded, and consumer price inflation remains relatively moderate. The Chinese government and central bank therefore have more room to maneuver than policymakers in other major economies do, and thus will probably enact more stimulus measures to counter weakening growth momentum. But the government's commitment to keeping a lid on longer-term financial risks will remain a constraining factor.

For their part, eurozone economies are engaged in the difficult task of weaning themselves off Russian natural gas as quickly as possible. That could be immensely disruptive to some industries, though with a modest and short-lived overall hit to growth.

If diminished energy supplies begin to exact a toll, the German economy's strong recovery will become much shakier.
Similarly, Japan's consumption-driven rebound has already been derailed by the disruptive effects of Omicron, clouding the prospects for a sustained recovery. And after bouncing back from the pandemic, the UK economy is heading into a difficult period, with rising inflation, higher taxes, and supply-chain disruptions accompanying a formidable set of global headwinds.

The vise is also tightening on many emerging-market and developing economies that were already suffering from surging global inflation, a rising dollar, and unfavorable financial conditions (restricting their access to foreign funds). That said, major emerging-market currencies have generally held up well, reflecting modest requirements for financing current-account deficits and healthy stocks of foreign-exchange reserves. And the spike in commodity prices has been good news for some developing economies.

While India is enjoying a sharp economic rebound, high inflation and rising oil prices could crimp growth if they prove persistent. Brazil, too, is experiencing a modest growth revival, but, with a presidential election in October, it remains beset by political instability. And the Russian economy, of course, has been hammered by a combination of trade and financial sanctions. This will not directly affect global growth, as Russia accounts for barely 2% of global GDP; but given the country's importance as a commodity exporter, its war in Ukraine will add to price pressures, which in turn will limit other central banks' room for maneuver.
Policymakers have a daunting high-stakes balancing act ahead of them. In most economies, monetary policy is constrained by inflationary pressures and fiscal policy is limited by high levels of public debt. Keeping the global economy on a reasonable growth track will require concerted action to fix the underlying problems. In addition to limiting pandemic-induced disruptions and managing geopolitical tensions, policymakers will need to consider more targeted measures – such as infrastructure investment – to boost long-term productivity rather than simply fortifying short-term demand. This will require domestic political will and concerted international cooperation, both of which remain in depressingly short supply.

Aryan Khanna contributed to this commentary.

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