

A Perfect (Macroeconomic) Storm

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The outlook for the world economy in 2023 does not inspire optimism. After struggling to deal with the fallout from disruptions caused by the global pandemic, is the world ready for another recession?

The World Economic Outlook by the International Monetary Fund (IMF) in October 2022 highlights the difficult situation the global economy finds itself in as we enter 2023. If the global economy falls into recession, it will be just three years after the world was hit by a deep contraction caused by a pandemic. What went wrong?

There is no easy answer, as each recession is unique. The same could be said about today's economic environment. The world is facing an unusual set of economic risks that can easily tilt the economy towards a recession. Predicting how

many of these risks will materialise or what their economic impact will be is a challenge.

As a result, we see not only a deterioration of economic forecasts for 2023 but also increasing uncertainty. A manageable slowdown, a mild recession or a large and persistent global crisis all look plausible.

What causes recessions?

Let's take a step back and understand what causes recessions. In some instances, we can blame bad luck or what economists like to call "shocks". A perfect example is the 2020 global

crisis, which was caused by a pandemic that led to policy-driven lockdowns as well as decreases in consumer and business confidence.

There are recessions that are not caused by bad luck but by the accumulated excesses of the preceding years. The 2008 global financial crisis fits into this category. A real estate bubble that had emerged over the previous years, combined with increasing hidden risks in financial markets, pushed the global economy into one of the worst recessions on record.

At the time of writing, the world economy is not yet in a recession. However, a worrisome combination of imbalances and bad luck could very easily tip it into a crisis.

Inflationary pressure

The largest imbalance is straightforward: inflation. After decades of low inflation during which central banks built very strong credibility, 2021 surprised with inflation rates that were higher than anything seen since the early 1980s.

Inflation is a classic macroeconomic imbalance that calls for central banks to raise interest rates to slow down the economy and reduce pressure on prices. The best central bankers can hope for is a “soft landing”, a situation where the economy slows down enough to ease inflation without causing a recession. But while airplane pilots practice “soft landings” regularly in their jobs, central bankers do not have the same experience.

In many countries, it has been decades since the economy has faced a situation like the one today. We have to be ready for policy mistakes and a harder landing than what central banks are hoping for.

Rising debt and uncertainty

A second source of imbalance the global economy currently faces is debt. In recent decades there has been a steady increase in government debt levels and, in many instances, private ones as well.

Today, while interest rates (adjusted for inflation) remain low and do not threaten the sustainability of government debt, they are increasing and can cause investors to question the credibility of governments. This will raise interest rates further, leading to sovereign debt crises. The failed tax-cutting budget in the UK and the sharp U-turn within the space of a month is a perfect example of how fast things can go awry.

The Chinese economy

A final source of imbalance is the Chinese real estate market. In recent years this sector has contributed an excessive share to China’s gross domestic product, to levels seen only before housing bubbles burst. For years, the Chinese government has tried to rebalance its economy away from investment towards consumption but has failed. A sharp correction in this sector could put Chinese growth rates under serious strain.

And then there are all the potential strokes of bad luck. Starting with the leftovers of the Covid crisis that are still being felt in some countries, for example, China with its zero-Covid policy. The threat of new, more virulent variants cannot be ruled out. The invasion of Ukraine by Russia has led to a massive energy crisis in Europe and higher energy and food prices in the rest of the world. The coming months could produce a variety of scenarios in this war, some of which could be very damaging from an economic point of view.

That is where the world economy is today, navigating difficult imbalances while surrounded by events that pose very large downside risks to the growth potential of many economies. As the IMF puts it, we are not yet in a global recession, but the scenarios ahead suggest that the worst is (possibly) yet to come. ■

This article is adapted from “A Perfect (Macroeconomic) Storm” published in INSEAD Knowledge.