INTERNATIONAL MONETARY FUND

WORLD ECONOMIC OUTLOOK

UPDATE

Near-Term Resilience, Persistent Challenges

2023
JUL

Near-Term Resilience, Persistent Challenges

- *Global growth is projected to fall from an estimated 3.5 percent in 2022 to 3.0 percent in both 2023 and 2024. While the forecast for 2023 is modestly higher than predicted in the April 2023* World Economic Outlook *(WEO), it remains weak by historical standards. The rise in central bank policy rates to fight inflation continues to weigh on economic activity. Global headline inflation is expected to fall from 8.7 percent in 2022 to 6.8 percent in 2023 and 5.2 percent in 2024. Underlying (core) inflation is projected to decline more gradually, and forecasts for inflation in 2024 have been revised upward.*
- *The recent resolution of the US debt ceiling standoff and, earlier this year, strong action by authorities to contain turbulence in US and Swiss banking, reduced the immediate risks of financial sector turmoil. This moderated adverse risks to the outlook. However, the balance of risks to global growth remains tilted to the downside. Inflation could remain high and even rise if further shocks occur, including those from an intensification of the war in Ukraine and extreme weather-related events, triggering more restrictive monetary policy. Financial sector turbulence could resume as markets adjust to further policy tightening by central banks. China's recovery could slow, in part as a result of unresolved real estate problems, with negative cross-border spillovers. Sovereign debt distress could spread to a wider group of economies. On the upside, inflation could fall faster than expected, reducing the need for tight monetary policy, and domestic demand could again prove more resilient.*
- *In most economies, the priority remains achieving sustained disinflation while ensuring financial stability. Therefore, central banks should remain focused on restoring price stability and strengthening financial supervision and risk monitoring. Should market strains materialize, countries should provide liquidity promptly while mitigating the possibility of moral hazard. They should also build fiscal buffers, with the composition of fiscal adjustment ensuring targeted support for the most vulnerable. Improvements to the supply side of the economy would facilitate fiscal consolidation and a smoother decline of inflation toward target levels.*

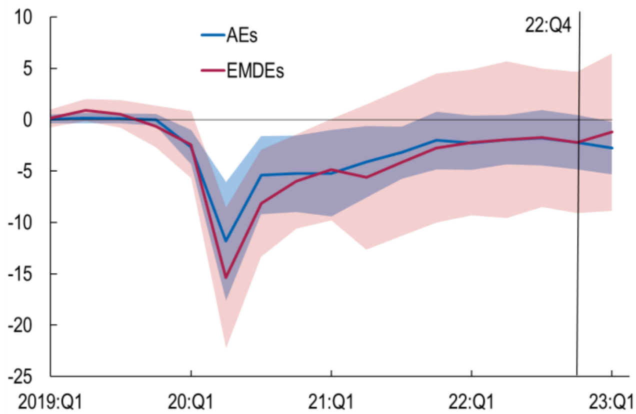
Forces Shaping the Outlook

The global recovery from the COVID-19 pandemic and Russia's invasion of Ukraine is slowing amid widening divergences among economic sectors and regions.

The World Health Organization (WHO) announced in May that it no longer considers COVID-19 to be a "global health emergency." Supply chains have largely recovered, and shipping costs and suppliers' delivery times are back to pre-pandemic levels. But forces that hindered growth in 2022 persist. Inflation remains high and continues to erode household purchasing power. Policy tightening by central banks in response to inflation has raised the cost of borrowing, constraining economic activity. Immediate concerns about the health of the banking sector have subsided, but high interest rates are filtering through the financial system, and banks in advanced economies have significantly tightened lending standards, curtailing the supply of credit. The impact of higher interest rates extends to public finances, especially in poorer countries grappling with elevated debt costs, constraining room for priority investments. As a result, output losses compared with pre-pandemic forecasts remain large, especially for the world's poorest nations.

Despite these headwinds, global economic activity was resilient in the first quarter of 2023, with that resilience driven mainly by the services sector. The post-pandemic rotation of consumption back toward services is approaching completion in advanced economies (including in tourism-dependent economies of southern Europe), and it accelerated in a number of emerging market and developing economies in the first quarter (Figure 1). However, as mobility returns to pre-pandemic levels, the scope for further acceleration appears more limited.

Figure 1. Value Added in the Services Sector: Distance to Pre-Pandemic Trends
(Percent)



Sources: Haver Analytics; and IMF staff calculations.
Note: The lines denote means and the bands represent one standard deviation around the means. For 18 AEs, the sample comprises AUS, CAN, CHE, CZE, DEU, DNK, ESP, FRA, GBR, ISR, ITA, KOR, NOR, NZL, SGP, SWE, TWN, and USA. For 16 EMDEs, the sample comprises ARG, BRA, CHL, CHN, COL, HUN, IDN, IND, MEX, MYS, PER, PHL, RUS, THA, TUR, and ZAF. Economy list uses International Organization for Standardization (ISO) country codes. AEs = advanced economies; EMDEs = emerging market and developing economies.

At the same time, nonservices sectors, including manufacturing, have shown weakness, and high-frequency indicators for the second quarter point to a broader slowdown in activity. Amid softening consumption of goods, heightened uncertainties regarding the future geoeconomic landscape, weak productivity growth, and a more challenging financial environment, firms have scaled back investment in productive capacity. Gross fixed capital formation and industrial production have slowed sharply or contracted in major advanced economies, dragging international trade and manufacturing in emerging markets with them. International trade and indicators of demand and production in manufacturing all point to further weakness. Excess savings built up during the pandemic are declining in advanced economies, especially in the United States, implying a slimmer buffer to protect against shocks, including those to the cost of living and those from more restricted credit availability.

The fight against inflation continues. Inflation is easing in most countries but remains high, with divergences across economies and inflation measures. Following the buildup of gas inventories in Europe and weaker-than-expected demand in China, energy and food prices have dropped substantially from their 2022 peaks, although food prices remain elevated. Together with the normalization of supply chains, these developments have contributed to a rapid decline in headline inflation in most countries. Core inflation, however, has on average declined more gradually and remains well above most central banks' targets. Its persistence reflects, depending on the particular economy considered, pass-through of past shocks to headline inflation into core inflation, corporate profits remaining high, and tight labor markets with strong wage growth, especially in the context of weak productivity growth that lifts unit labor costs. However, to date, wage-price spirals—wherein prices and wages accelerate together for a sustained period—do not appear to have taken hold in the average advanced economy, and longer-term inflation expectations remain anchored. In response to the persistence of core inflation, major central banks have communicated that they will need to tighten monetary policy further. The Federal Reserve paused rate hikes at its June meeting but signaled further ones ahead, and the Reserve Bank of Australia, Bank of Canada, Bank of England, and European Central Bank have continued to raise rates. At the same time, in some other economies, particularly in East Asia, where mobility curbs during the pandemic restricted demand for services longer than elsewhere, core inflation has remained low. In China, where inflation is well below target, the central bank recently cut policy interest rates. The Bank of Japan has kept interest rates near zero under the quantitative and qualitative monetary easing with yield curve control policy.

Acute stress in the banking sector has receded, but credit availability is tight. Thanks to the authorities' swift reaction, the March 2023 banking scare remained contained and limited to problematic regional banks in the United States and Credit Suisse in Switzerland. Accordingly, since the April 2023 WEO, global financial conditions have eased (Box 1), a sign that financial markets may have become less concerned about risks to financial stability coming from the banking sector. But tight monetary policy continues to put some banks under pressure, both directly (through higher costs of funding) and indirectly (by increasing credit risk). Bank lending surveys in the United States and Europe suggest that banks restricted access to credit considerably in the first quarter of 2023, and they are expected to continue to do so in coming months. Corporate loans have been declining lately, as has commercial real estate lending.

Following a reopening boost, China's recovery is losing steam. Manufacturing activity and consumption of services in China rebounded at the beginning of the year when Chinese authorities abandoned their strict lockdown policies; net exports contributed strongly to sequential growth in February and March as supply chains normalized and firms swiftly put backlogs of orders into production. Nonetheless, continued weakness in the real estate sector is weighing on investment, foreign demand remains weak, and rising and elevated youth unemployment (at 20.8 percent in May 2023) indicates labor market weakness. High-frequency data through June confirm a softening in momentum into the second quarter of 2023.

Growth Slowing, with Shifting Composition

Global growth is projected to fall from 3.5 percent in 2022 to 3.0 percent in both 2023 and 2024 on an annual average basis (Table 1). Compared with projections in the April 2023 WEO, growth has been upgraded by 0.2 percentage point for 2023, with no change for 2024. The forecast for 2023–24 remains well below the historical (2000–19) annual average of 3.8 percent. It is also below the historical average across broad income groups, in overall GDP as well as per capita GDP terms. Advanced economies continue to drive the decline in growth from 2022 to 2023, with weaker manufacturing, as well as idiosyncratic factors, offsetting stronger services activity. In emerging market and developing economies, the growth outlook is broadly stable for 2023 and 2024, although with notable shifts across regions. On a year-over-year basis, global growth bottomed out in the fourth quarter of 2022. However, in some major economies, it is not expected to bottom out before the second half of 2023.

World trade growth is expected to decline from 5.2 percent in 2022 to 2.0 percent in 2023, before rising to 3.7 percent in 2024, well below the 2000–19 average of 4.9 percent. The decline in 2023 reflects not only the path of global demand, but also shifts in its composition toward domestic services, lagged effects of US dollar appreciation—which slows trade owing to the widespread invoicing of products in US dollars—and rising trade barriers.

These forecasts are based on a number of assumptions, including those regarding fuel and nonfuel commodity prices and interest rates. Oil prices rose by 39 percent in 2022 and are projected to fall by about 21 percent in 2023, reflecting the slowdown in global economic activity. Assumptions regarding global interest rates have been revised upward, reflecting actual and signaled policy tightening by major central banks since April. The Federal Reserve and Bank of England are now expected to raise rates by more than assumed in the April 2023 WEO—to a peak of about 5.6 percent in the case of the Federal Reserve—before reducing them in 2024. The European Central Bank is assumed to raise its policy rate to a peak of 3¾ percent in 2023 and to ease gradually in 2024. Moreover, with near-term inflation expectations falling, real interest rates are likely to stay up even after nominal rates start to fall.

Table 1. Overview of the *World Economic Outlook* Projections
(Percent change, unless noted otherwise)

	Year over Year						Q4 over Q4 2/		
		Estimate	Projections		Difference from April 2023 WEO Projections 1/		Estimate	Projections	
	2021	2022	2023	2024	2023	2024	2022	2023	2024
World Output	**6.3**	**3.5**	**3.0**	**3.0**	**0.2**	**0.0**	**2.2**	**2.9**	**2.9**
Advanced Economies	**5.4**	**2.7**	**1.5**	**1.4**	**0.2**	**0.0**	**1.2**	**1.4**	**1.4**
United States	5.9	2.1	1.8	1.0	0.2	–0.1	0.9	1.4	1.1
Euro Area	5.3	3.5	0.9	1.5	0.1	0.1	1.8	1.2	1.5
Germany	2.6	1.8	–0.3	1.3	–0.2	0.2	0.8	0.5	1.5
France	6.4	2.5	0.8	1.3	0.1	0.0	0.6	0.9	1.6
Italy	7.0	3.7	1.1	0.9	0.4	0.1	1.5	0.9	1.1
Spain	5.5	5.5	2.5	2.0	1.0	0.0	3.0	1.8	2.2
Japan	2.2	1.0	1.4	1.0	0.1	0.0	0.4	1.5	1.0
United Kingdom	7.6	4.1	0.4	1.0	0.7	0.0	0.6	0.5	1.3
Canada	5.0	3.4	1.7	1.4	0.2	–0.1	2.1	1.6	1.8
Other Advanced Economies 3/	5.5	2.7	2.0	2.3	0.2	0.1	1.0	1.8	2.1
Emerging Market and Developing Economies	**6.8**	**4.0**	**4.0**	**4.1**	**0.1**	**–0.1**	**3.1**	**4.1**	**4.1**
Emerging and Developing Asia	7.5	4.5	5.3	5.0	0.0	–0.1	4.2	5.3	4.9
China	8.4	3.0	5.2	4.5	0.0	0.0	3.1	5.8	4.1
India 4/	9.1	7.2	6.1	6.3	0.2	0.0	6.1	4.3	6.4
Emerging and Developing Europe	7.3	0.8	1.8	2.2	0.6	–0.3	–1.3	2.7	2.0
Russia	5.6	–2.1	1.5	1.3	0.8	0.0	–3.1	1.9	0.8
Latin America and the Caribbean	7.0	3.9	1.9	2.2	0.3	0.0	2.6	0.8	2.9
Brazil	5.0	2.9	2.1	1.2	1.2	–0.3	2.5	1.3	2.2
Mexico	4.7	3.0	2.6	1.5	0.8	–0.1	3.7	1.9	1.7
Middle East and Central Asia	4.4	5.4	2.5	3.2	–0.4	–0.3	. . .	. . .	. . .
Saudi Arabia	3.9	8.7	1.9	2.8	–1.2	–0.3	5.5	2.0	2.9
Sub-Saharan Africa	4.7	3.9	3.5	4.1	–0.1	–0.1	. . .	. . .	. . .
Nigeria	3.6	3.3	3.2	3.0	0.0	0.0	3.2	2.6	3.6
South Africa	4.7	1.9	0.3	1.7	0.2	–0.1	1.3	0.9	2.0
Memorandum									
World Growth Based on Market Exchange Rates	6.0	3.0	2.5	2.4	0.1	0.0	1.8	2.5	2.4
European Union	5.5	3.7	1.0	1.7	0.3	0.1	1.8	1.5	1.7
ASEAN-5 5/	4.0	5.5	4.6	4.5	0.1	–0.1	4.7	4.6	4.8
Middle East and North Africa	4.0	5.4	2.6	3.1	–0.5	–0.3	. . .	. . .	. . .
Emerging Market and Middle-Income Economies	7.1	3.9	3.9	3.9	0.0	–0.1	3.1	4.1	4.1
Low-Income Developing Countries	4.1	5.0	4.5	5.2	–0.2	–0.2	. . .	. . .	. . .
World Trade Volume (goods and services) 6/	**10.7**	**5.2**	**2.0**	**3.7**	**–0.4**	**0.2**	**. . .**	**. . .**	**. . .**
Advanced Economies	9.9	6.1	2.3	3.2	–0.1	0.3	. . .	. . .	. . .
Emerging Market and Developing Economies	12.2	3.7	1.5	4.5	–0.9	–0.2	. . .	. . .	. . .
Commodity Prices									
Oil 7/	65.8	39.2	–20.7	–6.2	3.4	–0.4	8.8	–13.0	–4.9
Nonfuel (average based on world commodity import weights)	26.7	7.9	–4.8	–1.4	–2.0	–0.4	–0.4	–0.0	0.8
World Consumer Prices 8/	**4.7**	**8.7**	**6.8**	**5.2**	**–0.2**	**0.3**	**9.2**	**5.5**	**3.9**
Advanced Economies 9/	3.1	7.3	4.7	2.8	0.0	0.2	7.7	3.3	2.5
Emerging Market and Developing Economies 8/	5.9	9.8	8.3	6.8	–0.3	0.3	10.5	7.4	5.1

Note: Real effective exchange rates are assumed to remain constant at the levels prevailing during May 2, 2023–May 30, 2023. Economies are listed on the basis of economic size. The aggregated quarterly data are seasonally adjusted. WEO = World Economic Outlook.
1/ Difference based on rounded figures for the current and April 2023 WEO forecasts. Countries for which forecasts have been updated relative to April 2023 WEO forecasts account for approximately 90 percent of world GDP measured at purchasing-power-parity weights.
2/ For World Output (Emerging Market and Developing Economies), the quarterly estimates and projections account for approximately 90 percent (80 percent) of annual world (emerging market and developing economies') output at purchasing-power-parity weights.
3/ Excludes the Group of Seven (Canada, France, Germany, Italy, Japan, United Kingdom, United States) and euro area countries.
4/ For India, data and projections are presented on a fiscal year basis, with FY 2022/23 (starting in April 2022) shown in the 2022 column. India's growth projections are 6.6 percent in 2023 and 5.8 percent in 2024 based on calendar year.
5/ Indonesia, Malaysia, Philippines, Singapore, Thailand.
6/ Simple average of growth rates for export and import volumes (goods and services).
7/ Simple average of prices of UK Brent, Dubai Fateh, and West Texas Intermediate crude oil. The average assumed price of oil in US dollars a barrel, based on futures markets (as of June 1, 2023), is $76.43 in 2023 and $71.68 in 2024.
8/ Excludes Venezuela.
9/ The inflation rate for the euro area is 5.2% in 2023 and 2.8% in 2024, that for Japan is 3.4% in 2023 and 2.7% in 2024, and that for the United States is 4.4% in 2023 and 2.8% in 2024.

For *advanced economies*, the growth slowdown projected for 2023 remains significant: from 2.7 percent in 2022 to 1.5 percent in 2023, with a 0.2 percentage point upward revision from the April 2023 WEO. About 93 percent of advanced economies are projected to have lower growth in 2023, and growth in 2024 among this group of economies is projected to remain at 1.4 percent.

- In the *United States*, growth is projected to slow from 2.1 percent in 2022 to 1.8 percent in 2023, then slow further to 1.0 percent in 2024. For 2023, the forecast has been revised upward by 0.2 percentage point, on account of resilient consumption growth in the first quarter, a reflection of a still-tight labor market that has supported gains in real income and a rebound in vehicle purchases. However, this consumption growth momentum is not expected to last: Consumers have largely depleted excess savings accumulated during the pandemic, and the Federal Reserve is expected to raise rates further.
- Growth in the *euro area* is projected to fall from 3.5 percent in 2022 to 0.9 percent in 2023, before rising to 1.5 percent in 2024. The forecast is broadly unchanged, but with a change in composition for 2023. Given stronger services and tourism, growth has been revised upward by 0.4 percentage point for *Italy* and by 1.0 percentage point for *Spain*. However, for *Germany*, weakness in manufacturing output and economic contraction in the first quarter of 2023 means that growth has been revised downward by 0.2 percentage point, to –0.3 percent.
- Growth in the *United Kingdom* is projected to decline from 4.1 percent in 2022 to 0.4 percent in 2023, then to rise to 1.0 percent in 2024. This is an upward revision of 0.7 percentage point for 2023, reflecting stronger-than-expected consumption and investment from the confidence effects of falling energy prices, lower post-Brexit uncertainty (following the Windsor Framework agreement), and a resilient financial sector as the March global banking stress dissipates.
- Growth in *Japan* is projected to rise from 1.0 percent in 2022 to 1.4 percent in 2023, reflecting a modest upward revision, buoyed by pent-up demand and accommodative policies, then slow to 1.0 percent in 2024, as the effects of past stimuli dissipate.

For *emerging market and developing economies*, growth is projected to be broadly stable at 4.0 percent in 2023 and 4.1 percent 2024, with modest revisions of 0.1 percentage point for 2023 and –0.1 percentage point for 2024. However, this stable average masks divergences, with about 61 percent of the economies in this group growing faster in 2023 and the rest—including low-income countries and three of the five geographic regions described in what follows—growing more slowly.

- Growth in *emerging and developing Asia* is on track to rise to 5.3 percent in 2023, then to moderate to 5.0 percent in 2024, reflecting a modest (0.1 percentage point) downward revision for 2024. The forecast for *China* is unchanged at 5.2 percent for 2023 and 4.5 percent for 2024, but with a change in composition: Consumption growth has evolved broadly in line with April 2023 WEO projections, but investment has underperformed due to the ongoing real estate downturn in that country. Stronger-than-expected net exports have offset some of the investment weakness, although their contribution is declining as the global economy slows. Growth in *India* is projected at 6.1 percent in 2023, a 0.2 percentage point upward revision compared with the April projection, reflecting momentum from stronger-than-expected growth in the fourth quarter of 2022 as a result of stronger domestic investment.
- Growth in *emerging and developing Europe* is projected to rise to 1.8 percent in 2023, reflecting a 0.6 percentage point upward revision since April, and to rise further to 2.2 percent in 2024. The forecast for *Russia* in 2023 has been revised upward by 0.8 percentage point to 1.5 percent, reflecting hard data (on retail trade, construction, and industrial production) that point to a strong first half of the year, with a large fiscal stimulus driving that strength.
- *Latin America and the Caribbean* is expected to see growth decline from 3.9 percent in 2022 to 1.9 percent in 2023, although this reflects an upward revision of 0.3 percentage point since April,

and to reach 2.2 percent in 2024. The decline from 2022 to 2023 reflects the recent fading of rapid growth during 2022 after pandemic reopening, as well as lower commodity prices; the upward revision for 2023 reflects stronger-than-expected growth in *Brazil*—marked up by 1.2 percentage points to 2.1 percent since the April WEO—given the surge in agricultural production in the first quarter of 2023, with positive spillovers to activity in services. It also reflects stronger growth in *Mexico*, revised upward by 0.8 percentage point to 2.6 percent, with a delayed post-pandemic recovery in services taking hold and spillovers from resilient US demand.

- Growth in the *Middle East and Central Asia* is projected to decline from 5.4 percent in 2022 to 2.5 percent in 2023, with a downward revision of 0.4 percentage point, mainly attributable to a steeper-than-expected growth slowdown in *Saudi Arabia*, from 8.7 percent in 2022 to 1.9 percent in 2023, a negative revision of 1.2 percentage points. The downgrade for Saudi Arabia for 2023 reflects production cuts announced in April and June in line with an agreement through OPEC+ (the Organization of the Petroleum Exporting Countries, including Russia and other non-OPEC oil exporters), whereas private investment, including from "giga-project" implementation, continues to support strong non-oil GDP growth.
- In *sub-Saharan Africa*, growth is projected to decline to 3.5 percent in 2023 before picking up to 4.1 percent in 2024. Growth in *Nigeria* in 2023 and 2024 is projected to gradually decline, in line with April projections, reflecting security issues in the oil sector. In *South Africa*, growth is expected to decline to 0.3 percent in 2023, with the decline reflecting power shortages, although the forecast has been revised upward by 0.2 percentage point since the April 2023 WEO, on account of resilience in services activity in the first quarter.

Core Inflation Declining More Gradually Than Headline Inflation

Global headline inflation is set to fall from an annual average of 8.7 percent in 2022 to 6.8 percent in 2023 and 5.2 percent in 2024, broadly as projected in April, but above pre-pandemic (2017–19) levels of about 3.5 percent. About three-quarters of the world's economies are expected to see lower annual average headline inflation in 2023. Monetary policy tightening is expected to gradually dampen inflation, but a central driver of the disinflation projected for 2023 is declining international commodity prices. Differences in the pace of disinflation across countries reflect such factors as different exposures to movements in commodity prices and currencies and different degrees of economic overheating. The forecast for 2023 is revised down by 0.2 percentage point, largely on account of subdued inflation in China. The forecast for 2024 has been revised upward by 0.3 percentage point, with the upgrade reflecting higher-than-expected core inflation.

Core inflation is generally declining more gradually. Globally, it is set to decline from an annual average of 6.5 percent in 2022 to 6.0 percent in 2023 and 4.7 percent in 2024. It is proving more persistent than projected, mainly for advanced economies, for which forecasts have been revised upward by 0.3 percentage point for 2023 and by 0.4 percentage point for 2024 compared with the April 2023 WEO. Global core inflation is revised down by 0.2 percentage point in 2023, reflecting lower-than-expected core inflation in China, and up by 0.4 percentage point in 2024. On an annual average basis, about half of economies are expected to see no decline in core inflation in 2023, although on a fourth-quarter-over-fourth-quarter basis, about 88 percent of economies for which quarterly data are available are projected to see a decline. Overall, inflation is projected to remain above target in 2023 in 96 percent of economies with inflation targets and in 89 percent of those economies in 2024.

Risks to the Outlook

The balance of risks to global growth remains tilted downward, but adverse risks have receded since the publication of the April 2023 WEO. The resolution of US debt ceiling tensions has reduced the risk of disruptive rises in interest rates for sovereign debt, which would have increased pressure on countries already struggling with increased borrowing costs. The quick and strong action authorities took to contain banking sector turbulence in the United States and Switzerland succeeded in reducing the risk of an immediate and broader crisis.

Upside risks. More favorable outcomes for global growth than in the baseline forecast have become increasingly plausible. Core inflation could fall faster than expected—from greater-than-expected pass-through of lower energy prices and a compression of profit margins to absorb cost increases, among other possible causes—and declining job vacancies could play a strong role in easing labor markets, which would reduce the likelihood of unemployment having to rise to curb inflation. Developments along these lines would then reduce the need for monetary policy tightening and allow a softer landing. Scope exists for more favorable surprises to domestic demand around the world, as in the first quarter of 2023. In numerous economies, consumers have not yet drained the stock of excess savings they accumulated during the pandemic; this could further sustain the recent strength in consumption. Stronger policy support in China than currently envisaged—particularly through means-tested transfers to households—could further sustain recovery and generate positive global spillovers. Such developments, however, would increase inflation pressure and necessitate a tighter monetary policy stance.

Downside risks. Despite the recent positive growth surprises, plausible risks continue to be skewed to the downside:

- *Inflation persists:* Tight labor markets and pass-through from past exchange rate depreciation could push up inflation and risk de-anchoring longer-term inflation expectations in a number of economies. The institutional setup of wage setting in some countries could amplify inflation pressures on wages. Moreover, El Niño could bring more extreme temperature increases than expected, exacerbate drought conditions, and raise commodity prices. The war in Ukraine could intensify, further raising food, fuel, and fertilizer prices. The recent suspension of the Black Sea Grain Initiative is a concern in this regard. Such adverse supply shocks might affect countries asymmetrically, implying different dynamics for core inflation and inflation expectations, a divergence in policy responses, and further currency movements.
- *Financial markets reprice:* Financial markets have adjusted their expectations of monetary policy tightening upward since April but still expect less tightening than policymakers have signaled, raising the risk that unfavorable inflation data releases could—as in the first quarter of 2023—trigger a sudden rise in expectations regarding interest rates and falling asset prices. Such movements could further tighten financial conditions and put stress on banks and nonbank financial institutions whose balance sheets remain vulnerable to interest rate risk, especially those highly exposed to commercial real estate. Contagion effects are possible, and a flight to safety, with an attendant appreciation of reserve currencies, would trigger negative ripple effects for global trade and growth.
- *China's recovery underperforms:* Recent developments shift to the downside the distribution of risks surrounding China's growth forecast, with negative potential implications for trading partners in the region and beyond. The principal risks include a deeper-than-expected contraction in the real estate sector in the absence of swift action to restructure property developers, weaker-than-

expected consumption in the context of subdued confidence, and unintended fiscal tightening in response to lower tax revenues for local governments.

- *Debt distress increases:* Global financial conditions have generally eased since the March 2023 episode of banking stress (Box 1), but borrowing costs for emerging market and developing economies remain high, constraining room for priority spending and raising the risk of debt distress. The share of emerging market and developing economies with sovereign credit spreads above 1,000 basis points remained at 25 percent as of June (compared with only 6.8 percent two years ago).
- *Geoeconomic fragmentation deepens:* The ongoing risk that the world economy will separate into blocs amid the war in Ukraine and other geopolitical tensions could intensify, with more restrictions on trade (in particular that in strategic goods, such as critical minerals); cross-border movements of capital, technology, and workers; and international payments. Such developments could contribute to additional volatility in commodity prices and hamper multilateral cooperation on providing global public goods.

Policy Priorities

Conquer inflation. Central banks in economies with elevated and persistent core inflation should continue to clearly signal their commitment to reducing inflation. A restrictive stance—with real rates above neutral—is needed until there are clear signs that underlying inflation is cooling. Multilayered uncertainty complicates the task for central banks: Levels of neutral rates and lags of policy transmission are difficult to estimate with confidence, and the potency of the transmission mechanism may differ across economic sectors. In view of these uncertainties, adjusting policy in a data-dependent manner and avoiding a premature easing before price pressures have adequately receded is warranted, while continuing to use tools to maintain financial stability when needed. Although the primary responsibility for restoring price stability lies with central banks, legislated government spending cuts or tax increases aimed at ensuring public debt sustainability can, by reducing aggregate demand and reinforcing the overall credibility of disinflation strategies, further ease inflation. This is especially the case in countries with overheated economies and steep inflation-unemployment trade-offs.

Maintain financial stability and prepare for stress. The fast pace of monetary policy tightening continues to put the financial sector under pressure. Strengthened supervision (by implementing Basel III and removing forbearance measures) and monitoring risks to anticipate further episodes of banking sector stress is warranted. The intensity of supervision must be commensurate with banks' risks and systemic importance, and it is essential to address oversight gaps in the nonbank financial sector. Macroprudential policy measures could be employed preemptively to address emerging risks in banks and nonbank financial institutions. Where market strains emerge, deploying tools that provide liquidity support promptly and forcefully, while mitigating the risk of moral hazard, would limit contagion. Because central banks are not equipped to deal with insolvency problems, it is important for governments to rebuild fiscal space in the event real resources need to be mobilized. Countries at risk of external shocks can make full use of the global financial safety net afforded by international financial institutions, including IMF precautionary financial arrangements.

Rebuild fiscal buffers while protecting the vulnerable. With fiscal deficits and government debt above pre-pandemic levels, credible medium-term fiscal consolidation is in many cases needed to restore budgetary room for maneuver and ensure debt sustainability. Fiscal adjustment is currently projected to average 0.5 percent of GDP in 2024 (based on the change in structural fiscal balances) in both advanced economies and emerging market and developing economies. For economies with access to international markets, the pace of fiscal consolidation should depend on the strength of private demand. The composition of fiscal adjustment should protect targeted support for the most vulnerable. Phasing out untargeted fiscal measures, including those that blunt price signals—such as energy subsidies—is warranted, especially since energy prices have broadly returned to pre-pandemic levels. In cases in which countries are in or at high risk of debt distress, achieving debt sustainability may require not only well-timed fiscal consolidation, but also debt restructuring (Chapter 3 of the April 2023 WEO).

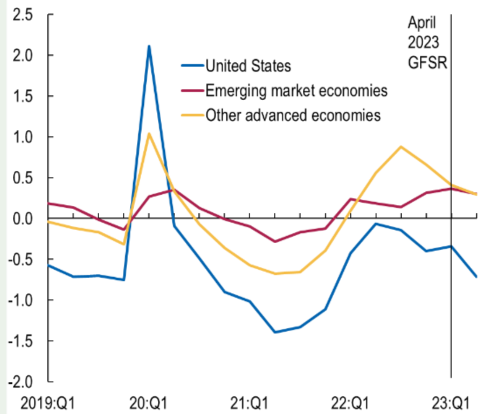
Ease the funding squeeze for developing and low-income countries. Large short-term external financing needs are stretching the ability of numerous emerging market economies and low-income countries to service their debt. Sovereign spreads remain historically elevated, impeding market access for many economies reliant on short-term borrowing. Faster and more efficient coordination on debt resolution, including through the Group of Twenty (G20) Common Framework and the Global Sovereign Debt Roundtable, is needed to provide a positive signal that lowers short-term borrowing costs and to avoid the risk of debt crises' spreading. The recent agreement between Zambia and its official creditor committee is a welcome step in that direction.

Enhance the supply side and strengthen resilience to climate change. Reforms that loosen labor markets—by encouraging participation and reducing job search and matching frictions—would facilitate fiscal consolidation and a smoother decline in inflation toward target levels. They include short-term training programs for professions experiencing shortages, passing labor laws and regulations that increase work flexibility through telework and leave policies, and facilitating regular immigration flows. Carefully designed industrial policies could be pursued—fiscal space permitting—if market failures are well established, but domestic-content requirements and barriers to trade should be avoided, as they can lower productivity, weaken trade relations, jeopardize food security, and hold back countries seeking to converge to higher income levels. A push on clean energy investment is necessary to ensure sufficient energy supplies given countries' decarbonization goals. Multilateral cooperation is essential to speed the green transition, mitigate climate change, and regulate potentially disruptive emerging technologies such as artificial intelligence.

Box 1. GLOBAL FINANCIAL STABILITY UPDATE

Financial markets appear sanguine, and financial conditions have mostly continued to ease. Since the April 2023 *Global Financial Stability Report*, central banks have communicated that they could need to tighten monetary policy further. Even as yield curves remain inverted and recession concerns are prominent, financial conditions have mostly eased (Figure 1.1). A rally in the technology sector and higher equity prices, undoing some of the disinflationary impulses from tighter monetary policy, has supported this easing. In such circumstances, upside surprises to inflation could cause a sudden, sharp repricing of financial assets. The resulting tightening in global financial conditions could then interact with existing vulnerabilities in the financial system, which could amplify the tightening.

Figure 1.1. Financial Conditions Index
(Standard deviations from the mean)

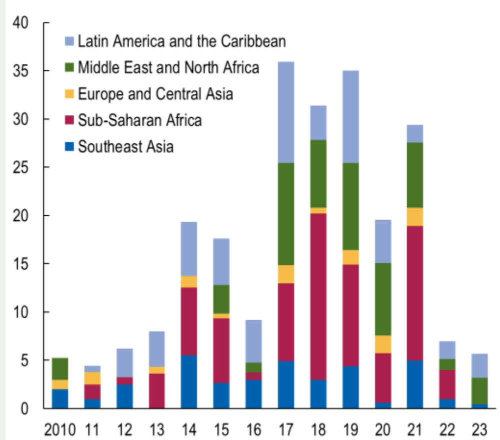


Sources: Bloomberg Finance L.P.; Haver Analytics; national data sources; and IMF staff calculations.
Note: The Financial Conditions Index (FCI) is calculated using the latest available variables. The emerging market economy sample excludes Russia, Türkiye, and Ukraine. The index is designed to capture the pricing of risk. It incorporates various pricing indicators, including real house prices, but does not include balance sheet or credit growth metrics. For details, please see Online Annex 1.1 of the October 2018 *Global Financial Stability Report* (GFSR).

Immediate concerns about the banking sector have eased, but growth in bank loans in advanced economies has slowed, and high interest rates will likely lead to tighter credit conditions. The shift of deposits in the United States from regional to large banks and money market funds has subsided, but a tighter monetary environment continues to challenge banks and nonbank financial intermediaries. In the euro area, mandatory repayments of loans from targeted longer-term refinancing operations are confronting banks that had relied on this source of funding, whereas in the United States, ongoing quantitative tightening and issuance of large amounts of Treasury bills after the recent debt ceiling episode could lead to further outflows from the banking system. In the meantime, the quality of business borrowers' credit is weakening as higher rates are starting to bite, raising credit costs, further curtailing bank lending, and slowing corporate debt issuance. Moreover, falling prices for commercial real estate—particularly office space—and residential property in many jurisdictions could add to pressures on indebted households and firms and weaken nonbank financial institutions exposed to vulnerable sectors.

Major emerging markets have generally remained resilient in this uncertain environment and largely avoided the banking sector turmoil in March 2023. However, many lower-rated issuers of sovereign bonds in emerging and frontier markets are still struggling to maintain access to international markets. In the second quarter, spreads for investment-grade sovereigns have stayed at about average historical levels, while spreads on those below investment grade have remained well above the historical range for issuances (880 basis points). Notably, 18 countries have spreads at distressed levels (more than 1,000 basis points). These high spreads have made issuance of new hard-currency debt very challenging for frontier markets so far in 2023 (Figure 1.2).

Figure 1.2. Frontier Sovereign Issuance by Region
(Billions of US dollars)



Sources: Bond Radar; and IMF staff calculations.
Note: The figure is based on 44 frontier economies defined as sovereigns in JP Morgan Next Generation Markets Index, plus any low-income countries that have issued eurobonds. Values for 2023 are year to date.

This box was prepared by the Monetary and Capital Markets Department's Global Markets Analysis division. It provides an update on market developments since the April 2023 *Global Financial Stability Report*, the data cutoff for which was March 30, 2023.

WEO Update ©2023• ISBN:979-8-40024-321-9