HIGHLIGHTS from Special Focus 1:
Global Stagflation

Key Points

- *Global inflation has risen sharply from its lows in mid-2020, on rebounding global demand, supply bottlenecks, and soaring food and energy prices. Markets expect inflation to peak in mid-2022 and then decline, but to remain elevated.*
- *Global growth has declined sharply since the beginning of the year and, for the remainder of this decade, is expected to remain below the average of the 2010s.*
- *This has raised the risk of stagflation: a combination of high inflation and sluggish growth.*
- *Ending the stagflation of the 1970s required steep increases in interest rates, which triggered a global recession and a string of financial crises in emerging market and developing economies (EMDEs).*
- *If current stagflationary pressures intensify, EMDEs could again face challenges.*

Inflation at multi-year highs. In April 2022, global inflation (7.8 percent) and EMDE inflation (9.4 percent) were at their highest levels since 2008 (figure 1). Inflation in advanced economies was at its highest level since 1982. Inflation was above target ranges in all advanced economies and almost 90 percent of inflation-targeting EMDEs. Global inflation is expected to decline to 3 percent in mid-2023. This, however, would still be about 1 percentage point above its average in 2019.

Slowing growth. After its pandemic-related collapse in 2020, global growth rebounded to 5.7 percent in 2021, supported by unprecedented fiscal and monetary policy accommodation. It is now expected to slow to 2.9 percent in 2022 and 3.0 percent in 2023-24 because of the war in Ukraine, the fading of pent-up demand, and the withdrawal of policy support amid high inflation. Beyond the near-term, global growth is expected to slow further over the 2020s, reflecting a trend weakening of the fundamental drivers of growth.

Stagflation again? These developments raise concerns about stagflation—a period of both weak growth and elevated inflation similar to what happened in the 1970s. The experience of the 1970s is a reminder that there is a considerable risk that inflation remains high or continues to rise if supply shocks persist, inflation expectations become unanchored, or long-term disinflationary forces fade.

Back to the 1970s? The current juncture resembles the early 1970s in three key respects: supply shocks and elevated global inflation, preceded by a protracted period of highly accommodative monetary policy in major economies; prospects for weakening growth over the longer term, which echo the unforeseen slowdown in potential growth of the 1970s; and vulnerabilities in EMDEs to the monetary policy tightening by advanced economies that will be needed to quell inflation. For now, there are still some important differences from the 1970s. Energy and food prices are still lower (in inflation-adjusted terms) than they were after the spikes in the 1970s and their increases over the past two years have been less than in the 1970s; central banks have well-established inflation targets, strengthened operational autonomy, and, in many cases, substantial credibility built up over several decades; inflation expectations are better anchored; and economies have become more flexible in their ability to adjust to shocks.

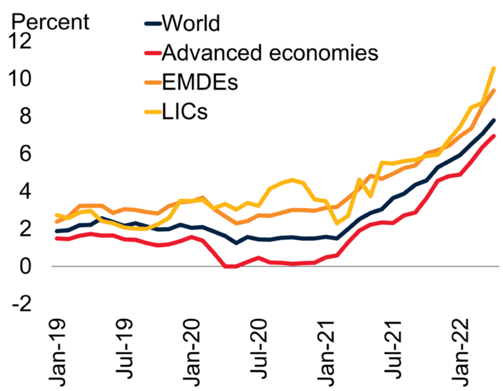
Threat of stagflation. If inflation expectations de-anchor, as they did in the 1970s, as a result of persistently elevated inflation and repeated inflationary shocks, the interest rate increases required to bring inflation back to target will be greater than those currently anticipated by financial markets. This raises the specter of the steep increases in interest rates that brought inflation under control but also triggered a global recession in 1982. That global recession also coincided with a string of financial crises and marked the beginning of a protracted period of weak growth in many EMDEs.

Challenges for EMDEs. If current stagflationary pressures intensify, EMDEs would likely again face severe challenges because of their less well-anchored inflation expectations, elevated financial vulnerabilities, and weakening growth fundamentals. This makes it urgent for EMDEs to shore up their fiscal and external buffers, strengthen their monetary policy frameworks, and implement reforms to reinvigorate growth.

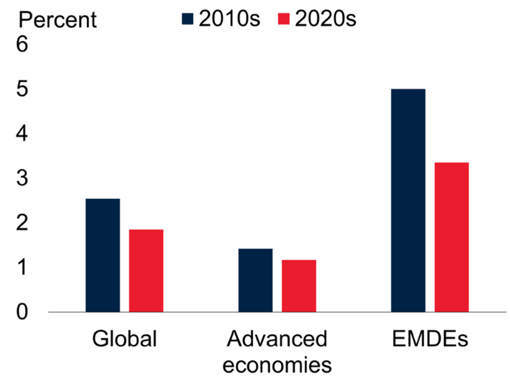
Figure 1. Global stagflation

In April 2022, global, advanced-economy, and EMDE inflation reached multi-year highs. Meanwhile, prospects are for weakening growth. Soaring oil prices are a similarity to the stagflationary 1970s but the widespread prioritization of price stability by central banks is an important difference. The end of the stagflation of the 1970s was followed by a series of financial crises in EMDEs. Record-high debt levels again make EMDEs vulnerable to the steep monetary policy tightening that might be needed to quell inflation.

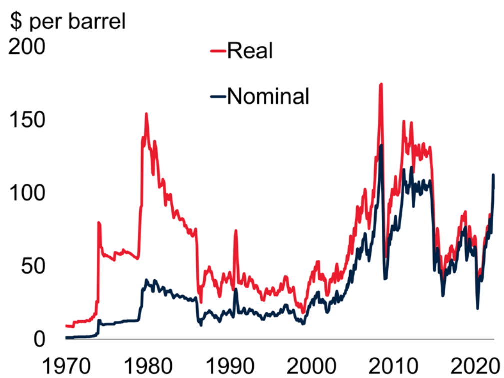
A. Inflation



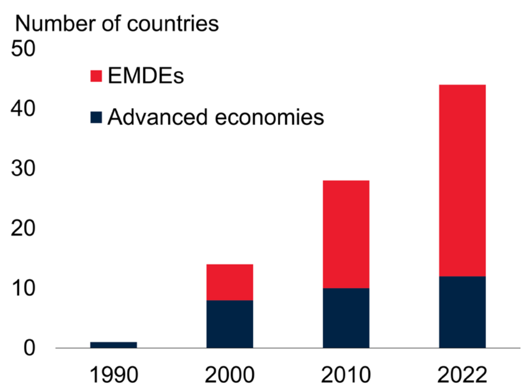
B. Potential growth prospects



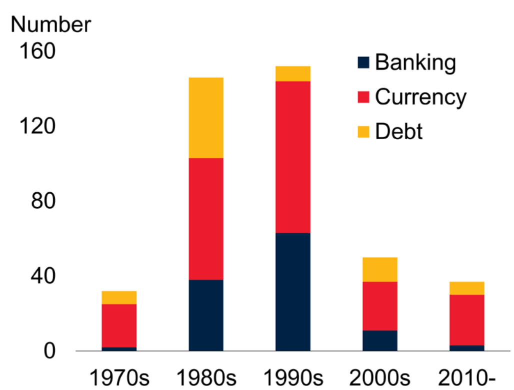
C. Oil price



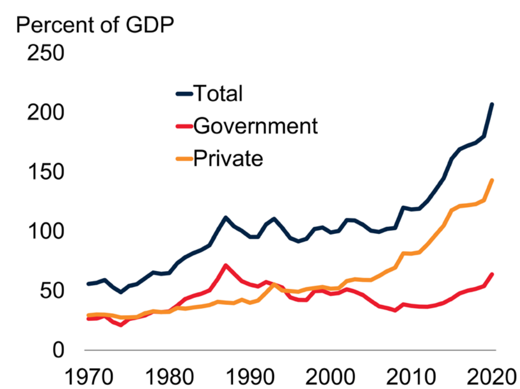
D. Number of countries with inflation targeting



E. Financial crises in EMDEs



F. Debt in EMDEs



Sources: Kose, Sugawara, and Terrones (2020); Havers Analytics; International Monetary Fund; Laeven and Valencia (2020); World Bank.

Note: EMDEs = emerging market and developing economies; LICs = low-income countries.

A. Year-on-year inflation. Lines show group median inflation for 81 countries, of which 31 are advanced economies and 50 are EMDEs. LICs inflation is based on 8 low-income countries. Last observation is April 2022.

B. GDP-weighted average (at 2010 prices and exchange rates) for 82 countries, including 52 EMDEs. Potential growth estimates based on a production function approach as described in Kilic Celik, Kose, and Ohnsorge (2020) and World Bank (2021b). 2020s forecasts in red bars assume that investment grows as expected by consensus forecasts, working-age population and life expectancy evolve as envisaged by the UN Population Projections, and secondary and tertiary school enrollment and completion rates decline by 2.5 percentage points.

C. Nominal and real crude oil prices (averages of Dubai, Brent, and WTI prices). Real oil prices are deflated by U.S. CPI index (March 2022 = 100).

D. Based on the clarification of IMF Annual Report on Exchange Arrangements and Exchange Restrictions and country-specific sources.

E. Total number of banking, currency, and sovereign debt crises in EMDEs over respective periods.

F. GDP-weighted averages based on a sample of up to 153 EMDEs.