Foreword

More than three years after the coronavirus touched off the deepest global recession since World War II, the world economy remains hobbled—far short of the strength that will be necessary to make substantial progress on global ambitions to eliminate extreme poverty, counter climate change, and replenish human capital.

Emerging market and developing economies (EMDEs) today are struggling just to cope—deprived of the wherewithal to create jobs and deliver essential services to their most vulnerable citizens. The optimism that arose with the end of China's COVID-19 shutdown earlier this year proved to be fleeting. In EMDEs other than China, a pronounced slump is underway: growth is set to slow to 2.9 percent in 2023 from 4.1 percent in 2022. Besieged by high inflation, tight global financial markets, and record debt levels, many countries are simply growing poorer. By the end of 2024, per-capita income growth in about a third of EMDEs will be lower than it was on the eve of the pandemic. In low-income countries—especially the poorest—the damage is even larger: in about one-third of these countries, per capita incomes in 2024 will remain below 2019 levels by an average of 6 percent.

Yet, as the World Bank Group's latest *Global Economic Prospects* report makes clear, new hazards are threatening to make matters worse. Despite the steepest global interest-rate hiking cycle in four decades, inflation remains high; even by end-2024, it will remain above the target range of most inflation-targeting central banks. Policymakers in most economies will need to be exceptionally agile to cope with the risks that come with such rate hikes. Today, high interest rates aren't merely crimping growth in EMDEs; they are also dampening investment and intensifying the risk of financial crises. These challenges would intensify in the event of more widespread banking-sector strains in advanced economies.

Low-income countries are especially vulnerable. Relative to the average EMDE, these countries spend only the tiniest fraction of government revenues on their most vulnerable citizens—barely 3 percent of GDP. Today, interest payments are taking an ever-bigger bite out of these resources—more than one-fifth of revenues in many countries—leaving them with little fiscal space to cope with the next shock or make the investments necessary to revive growth.

In addition, all the major drivers of global growth—including productivity, trade, labor force and investment growth—are expected to weaken over the remainder of this decade. Potential growth—the maximum growth the global economy can sustain over the longer term without igniting inflation—is expected to fall to a three-decade low over the remainder of the 2020s.

These problems must be tackled promptly if the world is to establish the economic footing necessary for even a semblance of success on global development goals. To curb climate change, stave off pandemics, and rebuild after conflict, developing countries need substantial resources. The necessary financing ramp-up to generate these resources depends both on faster growth and a more dynamic private sector.

The World Bank's latest projections indicate that the world economy will remain frail—and at risk of a deeper downturn—this year and in 2024. Our baseline scenario calls for global growth to slow from 3.1 percent in 2022 to 2.1 percent in 2023, before inching up to 2.4 percent in 2024. Even this tepid growth assumes that stress in the banking sector of advanced economies does not spill over to EMDEs.

The lessons of economic history are forbidding. Rapid interest-rate increases of the kind that have been underway in the United States over the past year are correlated with a higher likelihood of financial crises in EMDEs. And if the current banking stress in advanced economies metastasizes into widespread financial turmoil affecting EMDEs, the worst-case scenario would have arrived: the global economy would experience a deep downturn next year.

This report offers a roadmap for policymakers—not only for avoiding the worst outcomes but also on how to put the global economy back on track. Five steps can make the difference:

1. *Mitigating financial contagion*: Central banks—especially those in advanced economies—can curb the risk of disruptive spillovers to global financial markets by communicating their intentions as early and clearly as possible and calibrating their strategies so as to avoid abrupt changes in the policy outlook.

2. *Reducing domestic vulnerabilities:* EMDE monetary authorities may need to tighten their own policies in order to moderate capital outflows, currency depreciation, and resultant increases in inflation. Prudential standards and capital and liquidity buffers at EMDE banks and other financial institutions can be shored up to reduce the risk of financial contagion from banks in advanced economies. In addition, EMDEs need to rebuild currency reserve buffers to mitigate the impact of volatile capital flows.

3. *Restoring fiscal sustainability*. Among EMDEs, tax collection and administration must be improved to shore up revenues. Revenues in low-income countries have long been well below EMDE averages—and heavily dependent on grants from donors. But since 2015, grant financing has been declining as a share of their GDP. These countries will need to prioritize domestic resource mobilization, spending efficiency, and better debt management.

4. *Reinvigorating long-term growth.* The slowdown in potential growth can be reversed with steps to accelerate productivity-enhancing investment, strengthen health systems, improve student learning, and increase the participation of women and older workers in the labor force. Policies that promote trade and private capital mobilization—particularly for investments in digital technology and climate-related projects—will help a great deal.

5. *Alleviating debt distress and strengthening the global financial safety net.* This means ensuring that international financial institutions are adequately funded and focused on rapid support for EMDEs in distress. It also requires new mechanisms to speedily and sensibly restructure the public debt of countries in debt distress. In the wake of bank failures in advanced economies, a renewed focus on global financial regulatory reform is also necessary.

The global economy is in rough shape—and the extraordinary series of severe economic shocks and serious policy misjudgments are both to blame. Yet years before COVID-19 arrived, governments had already been turning their backs on free and fair trade. And long before the outbreak of the pandemic, governments across the world had developed an appetite for huge budget deficits. They turned a blind eye to the dangers of rising debt-to-GDP ratios. If a lost decade is to be avoided, these failures must be corrected—*now, not later*.

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