

INTERNATIONAL MONETARY FUND

# WORLD ECONOMIC OUTLOOK UPDATE

Rising Caseloads,  
a Disrupted Recovery,  
and Higher Inflation

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JAN



# WORLD ECONOMIC OUTLOOK UPDATE

## Rising Caseloads, a Disrupted Recovery, and Higher Inflation

- The global economy enters 2022 in a weaker position than previously expected. As the new Omicron COVID-19 variant spreads, countries have reimposed mobility restrictions. Rising energy prices and supply disruptions have resulted in higher and more broad-based inflation than anticipated, notably in the United States and many emerging market and developing economies. The ongoing retrenchment of China's real estate sector and slower-than-expected recovery of private consumption also have limited growth prospects.
- Global growth is expected to moderate from 5.9 in 2021 to 4.4 percent in 2022—half a percentage point lower for 2022 than in the October World Economic Outlook (WEO), largely reflecting forecast markdowns in the two largest economies. A revised assumption removing the Build Back Better fiscal policy package from the baseline, earlier withdrawal of monetary accommodation, and continued supply shortages produced a downward 1.2 percentage-points revision for the United States. In China, pandemic-induced disruptions related to the zero-tolerance COVID-19 policy and protracted financial stress among property developers have induced a 0.8 percentage-point downgrade. Global growth is expected to slow to 3.8 percent in 2023. Although this is 0.2 percentage point higher than in the previous forecast, the upgrade largely reflects a mechanical pickup after current drags on growth dissipate in the second half of 2022. The forecast is conditional on adverse health outcomes declining to low levels in most countries by end-2022, assuming vaccination rates improve worldwide and therapies become more effective.
- Elevated inflation is expected to persist for longer than envisioned in the October WEO, with ongoing supply chain disruptions and high energy prices continuing in 2022. Assuming inflation expectations stay well anchored, inflation should gradually decrease as supply-demand imbalances wane in 2022 and monetary policy in major economies responds.
- Risks to the global baseline are tilted to the downside. The emergence of new COVID-19 variants could prolong the pandemic and induce renewed economic disruptions. Moreover, supply chain disruptions, energy price volatility, and localized wage pressures mean uncertainty around inflation and policy paths is high. As advanced economies lift policy rates, risks to financial stability and emerging market and developing economies' capital flows, currencies, and fiscal positions—especially with debt levels having increased significantly in the past two years—may emerge. Other global risks may crystallize as geopolitical tensions remain high, and the ongoing climate emergency means that the probability of major natural disasters remains elevated.
- With the pandemic continuing to maintain its grip, the emphasis on an effective global health strategy is more salient than ever. Worldwide access to vaccines, tests, and treatments is essential to reduce the risk of further dangerous COVID-19 variants. This requires increased production of supplies, as well as better in-country delivery systems and fairer international distribution. Monetary policy in many countries will need to continue on a tightening path to curb inflation pressures, while fiscal policy—operating with more limited space than earlier in the pandemic—will need to prioritize health and social spending while focusing support on the worst affected. In this context, international cooperation will be essential to preserve access to liquidity and expedite orderly debt restructurings where needed. Investing in climate policies remains imperative to reduce the risk of catastrophic climate change.

## The Forces Shaping the Outlook

Adverse developments since the October WEO mean that the global economy is entering 2022 in a weaker position than anticipated. News of the Omicron variant led to increased mobility restrictions and financial market volatility at the end of 2021. Supply disruptions have continued to weigh on activity. Meanwhile, inflation has been higher and more broad-based than anticipated, particularly in the United States. Adding to these pressures, the retrenchment in China's real estate sector appears to be more drawn out and the recovery in private consumption is weaker than previously expected.

*The pandemic's continued grip:* Since the start of October, COVID-19 deaths have averaged about 7,000 a day worldwide, down from about 10,000 in late August. The diffusion of vaccines—although still uneven—has played a major role, with over 55 percent of people having received at least one dose. Yet the emergence of the Omicron variant in late November threatens to set back this tentative path to recovery. As of mid-January, Omicron appeared to be more transmissible than Delta, but its symptoms are perhaps less severe. The net effect on hospitalizations and deaths is still unknown. The baseline forecast is conditioned on adverse health outcomes—severe illness, hospitalizations, and deaths—coming down to low levels in most countries by the end of 2022. This assumes that most countries achieve vaccination rates consistent with the [IMF's pandemic proposal<sup>1</sup>](#) by end-2022, therapies become widely accessible, and the combination proves effective in protecting against Omicron and any other variants that emerge. Some emerging market and developing economies are anticipated to fall short of the vaccination target in 2022 and achieve sufficiently broad coverage only in 2023.

*Downside surprises in the second half of 2021:* Supply disruptions continued into the fourth quarter, hindering global manufacturing—especially in Europe and the United States. A resurgence in COVID cases (particularly in Europe) also held back a broader recovery. In China, disruptions from COVID outbreaks, interruptions to industrial production from power outages, declining real estate investment, and a faster-than-expected withdrawal of public investment all contributed to a second-half slowdown. Although there were signs of a global turnaround in November—with a pickup in international trade and upside surprises for services activity and industrial production data—this only partially offset earlier declines.

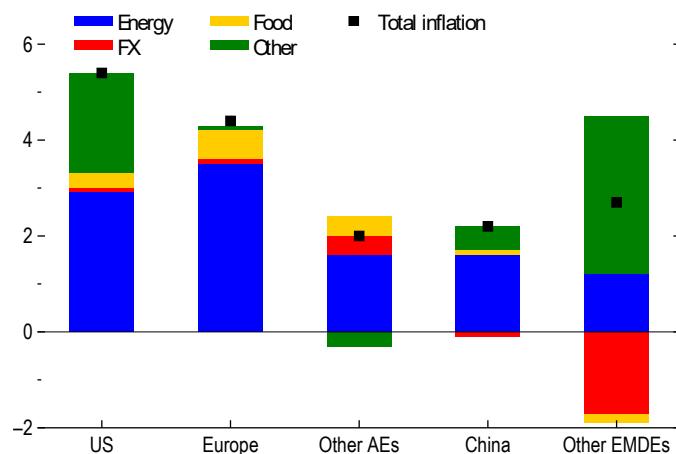
*Broadening price pressures:* The emergence of a new variant is not the only risk that has crystallized in recent months. Inflation continued to rise throughout the second half of 2021, driven by several factors of varying importance across regions (Figure 1). Fossil fuel prices have almost doubled in the past year, driving up energy costs and causing higher inflation, most prominently in Europe. Rising food prices have contributed to higher inflation, for example in sub-Saharan Africa. Meanwhile, ongoing supply chain disruptions, clogged ports, land-side constraints, and high demand for goods have also led to broadening price pressures, especially in the United States. Higher imported goods prices have contributed to inflation for example in Latin America and the Caribbean region.

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<sup>1</sup> Agarwal, R. and Gopinath, G., 2021. [A Proposal to End the COVID-19 Pandemic](#). *Staff Discussion Notes*, 2021(004).

*Monetary conditions have tightened globally* (see box). In the United States, with price and wage pressures broadening, the Federal Reserve decided to accelerate its taper of asset purchases and signaled that it will raise rates further in 2022 than previously expected. The European Central Bank (ECB) has announced it will end net asset purchases under the Pandemic Emergency Purchase Programme in March 2022, while it will temporarily increase net purchases by a modest amount under its longer-standing Asset Purchase Programme. The ECB has also committed to maintaining its key interest rates at current levels until adequate progress is made toward stabilizing inflation at its medium-term target.

**Figure 1. Change in Inflation, December 2020 — Latest (Percentage points)**



Sources: Haver Analytics; and IMF staff calculations.

Note: "Change in inflation" refers to the difference in year-over-year growth of the consumer price index between December 2020 and the latest available data. Stacked bars show the contribution of each component to that change. FX refers to short-term depreciation-induced inflation using estimates from Carrière-Swallow and others (2021). Sample includes countries for which all components are available. This covers 26 European countries, 2 other AEs, and 15 EMDEs. Purchasing-power-parity weights are used for aggregation. AEs = advanced economies; EMDEs = emerging market and developing economies; FX = import-weighted nominal effective exchange rate depreciation.

## Global Growth Set to Moderate and Inflation to Persist Longer

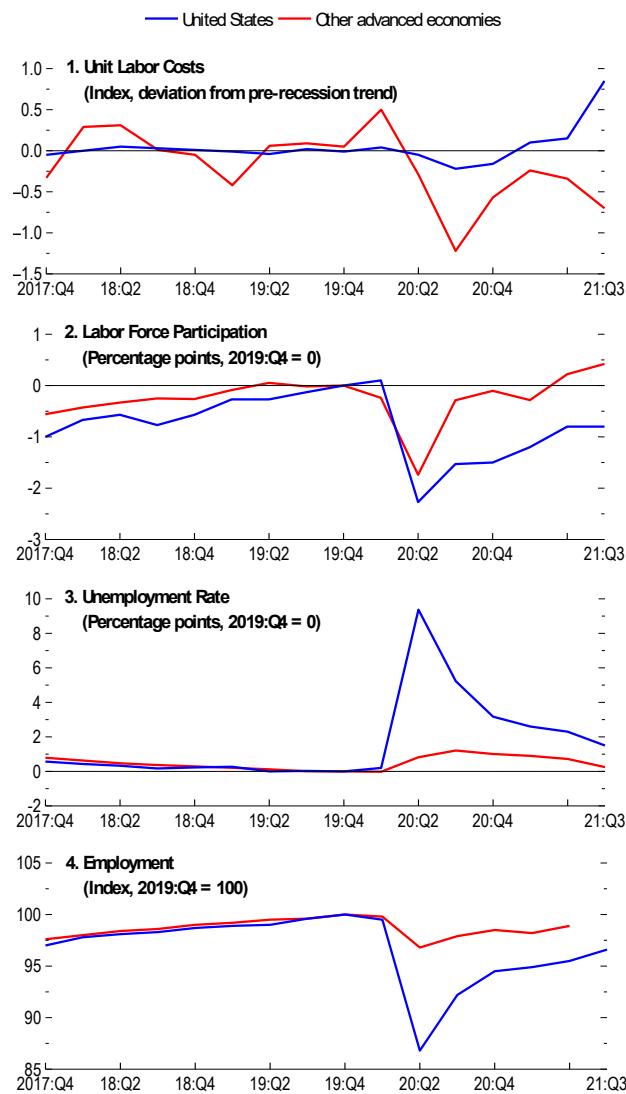
*Global growth* is estimated at 5.9 percent in 2021 and is expected to moderate to 4.4 percent in 2022, half a percentage point lower than in the October 2021 *World Economic Outlook* (Table 1). The baseline incorporates anticipated effects of mobility restrictions, border closures, and health impacts from the spread of the Omicron variant. These vary by country depending on susceptibility of the population, the severity of mobility restrictions, the expected impact of infections on labor supply, and the importance of contact-intensive sectors. These impediments are expected to weigh on growth in the first quarter of 2022. The negative impact is expected to fade starting in the second quarter, assuming that the global surge in Omicron infections abates and the virus does not mutate into new variants that require further mobility restrictions. Forecasts are based on information up to 18 January 2022.

Among changes to advanced economy forecasts for 2022, a revised assumption removing the Build Back Better fiscal policy package from the baseline, earlier withdrawal of monetary accommodation, and continued supply chain disruptions have contributed to a downgrade of 1.2 percentage points for the United States. In Canada, weaker data outturns toward the end of 2021 and anticipated softer external demand for 2022 (related to the US revision) have led to a 0.8 percentage-point downgrade. In the euro area, prolonged supply constraints and COVID disruptions produced a less severe revision of 0.4 percentage point—led by a markdown of 0.8 percentage point for Germany largely due to the economy's exposure to supply chain shocks. Mobility restrictions imposed toward the end of 2021 are expected to drag on growth in the euro area in early 2022. In the United Kingdom, disruptions related to Omicron and supply constraints (particularly in labor and energy markets) mean that growth is revised down by 0.3 percentage point to 4.7 percent.

The 2022 forecast downgrade also reflects revisions among a few large emerging markets. In China, disruption in the housing sector has served as a prelude to a broader slowdown. With a strict zero-COVID strategy leading to recurrent mobility restrictions and deteriorating prospects for construction sector employment, private consumption is likely to be lower than anticipated. In combination with lower investment in real estate, this means that the growth forecast for 2022 is revised down relative to October by 0.8 percentage point, at 4.8 percent, with negative implications for trading partners' prospects. The outlook has also weakened in Brazil, where the fight against inflation has prompted a strong monetary policy response, which will weigh on domestic demand. A similar dynamic is at work in Mexico, albeit to a lesser extent. In addition, the US downgrade brings with it the prospect of weaker-than-expected external demand for Mexico in 2022. In Russia, the forecast is marginally marked down because of a weak harvest and worse-than-expected third wave. South Africa's growth forecast is downgraded in light of a softer-than-expected second half in 2021 and a weaker outlook for investment as business sentiment remains subdued.

The upward revision to global growth in 2023 is mostly mechanical. Eventually, the shocks dragging 2022 growth will dissipate and—as a result—global output in 2023 will grow a little faster. Among prominent revisions not due to the pandemic, India's prospects for 2023 are marked up on expected improvements to credit growth—and, subsequently, investment and consumption—building on better-than-anticipated performance of the financial sector. Japan's 2023 growth outlook is also revised up by 0.4 percentage point, reflecting anticipated improvements in external demand and continued fiscal support. The upward revision to 2023 global growth is, however, not enough to make up ground lost due to the downgrade to 2022. Cumulative global growth over 2022 and 2023 is projected to be 0.3 percentage point lower than previously forecast.

Figure 2. Labor and Wages



Sources: Haver Analytics; Organisation for Economic Co-operation and Development; and IMF staff calculations.

Note: All panels present changes relative to 2019:Q4. Panel 1 shows deviations of labor cost indices from their pre-pandemic trend, estimated by linear regression using quarterly observations from 2017:Q4 to 2019:Q4. Panel 2 uses the labor force participation rate of the 15–64 age range, where available. Purchasing-power-parity weights are used for aggregation. Other advanced economies includes 30 countries.

**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 October 2021 WEO Projections 1/		Estimate		Projections
	2020	2021	2022	2023	2022	2023	2021	2022	2023
<b>World Output</b>	<b>-3.1</b>	<b>5.9</b>	<b>4.4</b>	<b>3.8</b>	<b>-0.5</b>	<b>0.2</b>	<b>4.2</b>	<b>4.0</b>	<b>3.4</b>
<b>Advanced Economies</b>	<b>-4.5</b>	<b>5.0</b>	<b>3.9</b>	<b>2.6</b>	<b>-0.6</b>	<b>0.4</b>	<b>4.4</b>	<b>3.7</b>	<b>1.7</b>
United States	-3.4	5.6	4.0	2.6	-1.2	0.4	5.3	3.5	2.0
Euro Area	-6.4	5.2	3.9	2.5	-0.4	0.5	4.8	3.2	1.8
Germany	-4.6	2.7	3.8	2.5	-0.8	0.9	1.9	4.2	1.6
France	-8.0	6.7	3.5	1.8	-0.4	0.0	5.0	1.9	1.7
Italy	-8.9	6.2	3.8	2.2	-0.4	0.6	6.2	2.5	1.7
Spain	-10.8	4.9	5.8	3.8	-0.6	1.2	4.9	5.0	2.5
Japan	-4.5	1.6	3.3	1.8	0.1	0.4	0.4	3.6	1.1
United Kingdom	-9.4	7.1	4.7	2.2	-0.3	0.3	5.6	5.8	-1.4
Canada	-5.2	4.7	4.1	2.8	-0.8	0.2	3.5	3.9	1.9
Other Advanced Economies 3/	-1.9	4.7	3.6	2.9	-0.1	0.0	3.8	3.4	2.5
<b>Emerging Market and Developing Economies</b>	<b>-2.0</b>	<b>6.5</b>	<b>4.8</b>	<b>4.7</b>	<b>-0.3</b>	<b>0.1</b>	<b>4.0</b>	<b>4.3</b>	<b>4.8</b>
Emerging and Developing Asia	-0.9	7.2	5.9	5.8	-0.4	0.1	3.7	5.4	5.7
China	2.3	8.1	4.8	5.2	-0.8	-0.1	3.5	5.1	5.0
India 4/	-7.3	9.0	9.0	7.1	0.5	0.5	4.3	5.8	7.5
ASEAN-5 5/	-3.4	3.1	5.6	6.0	-0.2	0.0	3.5	5.6	5.9
Emerging and Developing Europe	-1.8	6.5	3.5	2.9	-0.1	0.0	5.8	2.2	3.0
Russia	-2.7	4.5	2.8	2.1	-0.1	0.1	4.2	2.1	1.8
Latin America and the Caribbean	-6.9	6.8	2.4	2.6	-0.6	0.1	3.7	1.8	2.6
Brazil	-3.9	4.7	0.3	1.6	-1.2	-0.4	0.6	1.5	1.4
Mexico	-8.2	5.3	2.8	2.7	-1.2	0.5	2.9	3.4	1.9
Middle East and Central Asia	-2.8	4.2	4.3	3.6	0.2	-0.2	...	...	...
Saudi Arabia	-4.1	2.9	4.8	2.8	0.0	0.0	5.2	5.3	2.8
Sub-Saharan Africa	-1.7	4.0	3.7	4.0	-0.1	-0.1	...	...	...
Nigeria	-1.8	3.0	2.7	2.7	0.0	0.1	2.4	2.1	2.3
South Africa	-6.4	4.6	1.9	1.4	-0.3	0.0	1.3	2.6	0.9
<b>Memorandum</b>									
World Growth Based on Market Exchange Rates	-3.5	5.6	4.2	3.4	-0.5	0.3	4.2	3.9	2.8
European Union	-5.9	5.2	4.0	2.8	-0.4	0.5	4.9	3.5	1.9
Middle East and North Africa	-3.2	4.1	4.4	3.4	0.3	-0.1	...	...	...
Emerging Market and Middle-Income Economies	-2.2	6.8	4.8	4.6	-0.3	0.0	4.0	4.3	4.8
Low-Income Developing Countries	0.1	3.1	5.3	5.5	0.0	0.0	...	...	...
<b>World Trade Volume (goods and services) 6/</b>	<b>-8.2</b>	<b>9.3</b>	<b>6.0</b>	<b>4.9</b>	<b>-0.7</b>	<b>0.4</b>	...	...	...
Advanced Economies	-9.0	8.3	6.2	4.6	-0.7	0.6	...	...	...
Emerging Market and Developing Economies	-6.7	11.1	5.7	5.4	-0.7	0.0	...	...	...
<b>Commodity Prices (US dollars)</b>									
Oil 7/	-32.7	67.3	11.9	-7.8	13.7	-2.8	79.2	-4.7	-6.8
Nonfuel (average based on world commodity import weights)	6.7	26.7	3.1	-1.9	4.0	-0.4	17.2	1.5	-1.6
<b>Consumer Prices</b>									
Advanced Economies 8/	0.7	3.1	3.9	2.1	1.6	0.2	4.8	2.8	2.0
Emerging Market and Developing Economies 9/	5.1	5.7	5.9	4.7	1.0	0.4	5.9	5.1	4.3

Note: Real effective exchange rates are assumed to remain constant at the levels prevailing during December 10, 2021–January 7, 2022. 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 October 2021 WEO forecasts. Countries whose forecasts have been updated relative to October 2021 WEO forecasts account for approximately 90 percent of world GDP measured at purchasing-power-parity weights.

2/ For World Output, the quarterly estimates and projections account for approximately 90 percent of annual world output at purchasing-power-parity weights. For Emerging Market and Developing Economies, the quarterly estimates and projections account for approximately 80 percent of annual 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 forecasts are presented on a fiscal year basis, with FY 2021/2022 starting in April 2021. For the January 2022 WEO Update, India's growth projections are 8.7 percent in 2022 and 6.6 percent in 2023 based on calendar year. The impact of the Omicron variant is captured in the column for 2021 in the table.

5/ Indonesia, Malaysia, Philippines, Thailand, Vietnam.

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 price of oil in US dollars a barrel was \$69.07 in 2021; the assumed price, based on futures markets (as of January 10, 2022), is \$77.31 in 2022 and \$71.29 in 2023.

8/ The inflation rate for the euro area is 3.0% in 2022 and 1.7% in 2023, for Japan is 0.7% in 2022 and 2023, and for the United States is 5.9% in 2022 and 2.7% in 2023, respectively.

9/ Excludes Venezuela.

*Inflation* is expected to remain elevated in the near term, averaging 3.9 percent in advanced economies and 5.9 percent in emerging market and developing economies in 2022, before subsiding in 2023. Assuming medium-term inflation expectations remain well anchored and the pandemic eases its grip, higher inflation should fade as supply chain disruptions ease, monetary policy tightens, and demand rebalances away from goods-intensive consumption towards services. The rapid increase in fuel prices is also expected to moderate during 2022–23, which will help contain headline inflation. Futures markets indicate oil prices will rise about 12 percent and natural gas prices about 58 percent in 2022 (both considerably lower than the increases seen in 2021) before retreating in 2023 as supply-demand imbalances recede further. Similarly, food

prices are expected to increase at a more moderate pace of about 4½ percent in 2022 and decline in 2023. In many countries, nominal wage growth remains contained despite employment and participation returning almost to pre-pandemic levels (Figure 2). But in the United States the story is different: a sharp decline in unemployment has been accompanied by buoyant nominal wage growth. This suggests a degree of tightening in US labor markets not evident elsewhere. If US labor force participation remains below pre-pandemic levels and discouraged workers remain on the sidelines, tighter labor markets may feed through to higher prices. As a result, the Federal Reserve communicated in December 2021 that it will taper asset purchases at a faster pace and signaled that the federal funds rate will likely be raised to 0.75–1.00 percent by the end of 2022, some 50 basis points higher than in the previous guidance.

Less accommodative monetary policy in the United States is expected to prompt tighter global financial conditions, putting pressure on emerging market and developing economy currencies. Higher interest rates will also make borrowing more expensive worldwide, straining public finances. For countries with high foreign currency debt, the combination of tighter financial conditions, exchange rate depreciations, and higher imported inflation will lead to challenging monetary and fiscal policy trade-offs. Although fiscal consolidation is anticipated in many emerging market and developing economies in 2022, high post-pandemic debt burdens will be an ongoing challenge for years to come.

*Global trade* is expected to moderate in 2022 and 2023, in line with the overall pace of the expansion. Assuming that the pandemic eases over 2022, supply chain problems are expected to abate later in the year. The accompanying moderation in global goods demand will also help reduce imbalances. Cross-border services trade—particularly tourism—is expected to remain subdued.

## Risks to the Outlook

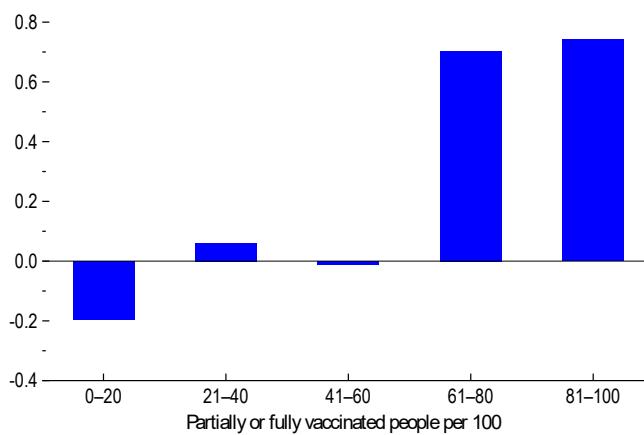
The balance of risks remains tilted to the downside, with the outlook for the global economy depending critically on five key questions.

### *What is the likely path of the pandemic?*

Despite rapid and effective rollouts of vaccination programs in most advanced economies, vaccination programs in many emerging market and developing economies are too slow. This sluggish progress has been a contributing factor weighing on the recovery in under-vaccinated countries (Figure 3).

The most pressing health risk is the impact of the Omicron variant. Even if symptoms are less severe, increased transmissibility could still add to labor shortages and put extra pressure on hospitals, prompting tighter and longer-lasting mobility restrictions beyond the

**Figure 3. Average Revisions to 2021 Output**  
(Percentage points, compared with October 2020)



Sources: Our World in Data; and IMF staff calculations.

Note: "Revision to 2021 output" refers to the difference between real GDP growth rates for 2021 estimated in the October 2020 *World Economic Outlook* and the latest IMF staff estimates, simple averages.

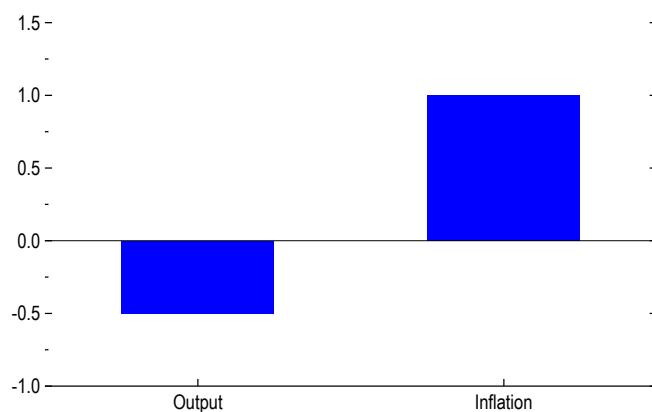
first quarter (as assumed in the baseline forecast). Global growth could fall below the baseline if these risks materialize.

Moreover, the global growth forecast assumes that adverse health outcomes—severe illness, hospitalizations, deaths—are brought to low levels in most countries by the end of 2022. But low current vaccination rates in many countries risk further new variants. The longer and more widely the COVID-19 virus circulates, the greater the likelihood of new mutations that evade vaccines, turn back the clock on the pandemic, and fuel social discontent if recurrent mobility restrictions are needed to slow transmission.

*How will less accommodative monetary policy in the United States affect global financial conditions?* With inflation on the rise and still large pent-up demand in the system in part due to the pandemic recovery program, US monetary policy will have to tighten. But how far and fast is not yet clear. The WEO forecast is conditioned on an end to asset purchases in March 2022 and three rate increases in both 2022 and 2023—consistent with what will be needed to bring inflation back down to the 2 percent medium-term goal. But there are upside risks. Inflation could turn out higher than expected (if, for instance, supply disruptions persist and wage pressures feed into inflation). A different policy stance will be required if circumstances change. Communicating such changes will be a delicate task and risks prompting strong market reactions that could, in turn, result in tighter financial market conditions. Markets' reactions to (actual or perceived) changes in Federal Reserve policies will govern how less-accommodative policy in the United States spills over to other countries, particularly emerging markets and frontier economies. Any miscommunication or misunderstanding of such changes may provoke a flight to safety, raising spreads for riskier borrowers. This may put undue pressure on emerging market currencies, firms, and fiscal positions.

*When will supply chain disruptions ease?* The shift toward goods consumption, particularly in advanced economies, overloaded global supply chain networks during the pandemic. This problem was compounded by pandemic-related impediments to transportation and staffing, as well as by the inherently fragile nature of just-in-time logistics and lean inventories. The resulting disruption to global trade led to shortages and higher prices for imported consumer goods. Disruptions in the United States have been particularly severe, consistent with the larger switch into goods consumption. IMF staff analysis suggests that supply disruptions shaved 0.5–1.0 percentage point off global GDP growth in 2021 while adding 1.0 percentage point to core inflation (see Figure 4).

**Figure 4. Impact of 2021 Shocks on World Output and Core Inflation (Percentage points)**



Sources: Haver Analytics; and IMF staff calculations.

Note: The figure shows the impact of global supply shocks as identified by the IMF staff global macro model, the Flexible System of Global Models.

Although international shipping fleets have limited spare capacity, the bottlenecks are often on land, with trucking and other services unable to move freight off the docks faster than new ships can bring it in. These supply chain disruptions will eventually ease, not least because the composition of demand is likely to shift back to services (households can buy only so many durable goods). The baseline assumes supply-demand imbalances will wane over the course of 2022. But the longer they persist, the more likely they are to feed through to expectations of higher future prices and the larger the risk to the world economy. Dysfunctional global supply chains also leave economies less able to adapt to a possible resurgence of the pandemic, as clogged ports impede the flow of goods needed to adapt to changing public health conditions. The impact of the Omicron variant may further limit the efficiency of ports, add to shipping problems, and delay the rebalancing of consumer demand from goods to services—thus exacerbating supply-demand imbalances.

*Will tight labor markets drive up wages and cause persistently higher inflation?* In the baseline forecast, inflation is expected to subside in the coming year and expectations to remain well anchored. Yet there is a risk that persistently elevated living costs and tighter labor markets will compel workers to ask for (and firms to accede to) higher wages. The resulting higher labor costs would in turn push up prices further, perpetuating an inflationary cycle that would require aggressive policy action to combat. These risks appear particularly salient in the United States, where labor market slack seems to have dissipated and labor costs have risen. Inflation in the United States also appears more broad-based—including shelter-related components—and supply disruptions are likely to last longer than in Europe or Asia (see more discussion below). In addition, workers who dropped out of in-person service professions (for example, leisure and hospitality), during the pandemic may be unwilling to return, leading to potential labor shortages in those industries. As such, wages in these professions will be an important bellwether for medium-term inflation as pre-pandemic activities resume and demand rebalances back toward service consumption.

*Will China's real estate slowdown intensify?* A broader slowdown in China will affect global prospects, principally via spillovers to commodity exporters and emerging markets. The baseline assumes a significant moderation in real estate investment growth in 2022, reflecting continued tight policies to rein in risks related to leveraged property developers. If the real estate slowdown intensifies further and balance sheet stresses spread beyond property developers, exposed banks and other financial intermediaries may be forced to shrink credit to the broader economy. Such an outcome would hold back investment and consumption, dragging overall growth lower with adverse implications for commodity exporters and other emerging markets.

Beyond these questions, *the ongoing climate emergency* continues to pose grave risks to the global economy. Major natural disasters are more likely, threatening all economies (as seen in the range of extreme weather events—floods, droughts, wildfires—across all continents in 2021). The recurrence of such events would deliver a twofold blow that would most harm vulnerable low-income (often low-vaccination) countries, while also further straining global supply chains. Despite the stated ambition at the Glasgow climate conference (COP26), current commitments to reduce greenhouse gases fall far short of limiting the increase in global temperature to 2 degrees Celsius above preindustrial levels.

*Other factors:* Geopolitical tensions, including in eastern Europe and east Asia, imperil energy supply, international trade, and policy cooperation. Social unrest, which had declined earlier in the pandemic, is once again on the rise in some countries—related in part to elevated food and energy prices. Moreover, many of the tariff increases introduced during 2018–19 are still in place, and cross-border technology frictions remain salient. All of these elements threaten additional roadblocks in the path to recovery.

## How Should Policymakers Respond?

An exit from the pandemic and a full economic recovery are both within the grasp of the global community. More limited fiscal space than earlier in the pandemic and rising inflation, however, pose difficult policy challenges. Bold and effective international cooperation will therefore be essential.

*Health policies:* Stamping out the pandemic demands an end to the persistent disparities in access to COVID-19 tools such as vaccines, tests, treatments, and personal protective equipment (PPE). However, the rollout of many such tools is proceeding at alarmingly unequal speeds. The fully vaccinated share of the population is about 70 percent for high-income countries, but below 4 percent for low-income countries. And 86 countries—accounting for 27 percent of the world’s population—fell short of the end-2021 40 percent vaccination target (excluding boosters) set out in the [IMF pandemic proposal](#). The aggregate shortfall of administered doses in these 86 countries was 974 million below the amount needed to meet the end-2021 vaccination target. Nearly all countries in this group face unpredictable supply. About half of these countries have absorptive capacity constraints and need support to scale up in-country deliveries. There is also deep testing inequity: testing rates are about 80 times higher in high-income countries than in low-income countries.

There is now broad agreement on global targets, but the world must come together to meet them. The spread of Omicron has only amplified the need for urgent action. This will require addressing the financing needs for vaccines, tests, treatments, PPE, and in-country delivery for developing economies, including by closing the financing gap of the ACT Accelerator of about \$23 billion. Urgent action is needed to ensure an equitable and predictable supply of vaccines to developing economies through COVAX and the African Vaccine Acquisition Trust. Scaling up absorptive capacity will require support for in-country vaccine delivery costs, addressing vaccine hesitancy, and improving health infrastructure, so that countries can administer doses as vaccines become available. The world community must balance the goal of helping all countries achieve the vaccine targets set out in the IMF pandemic proposal with the focus on rolling out boosters in highly vaccinated countries. Without this worldwide effort, the virus will be more likely to mutate further and extend the pandemic’s global grip. And because the effectiveness of oral antivirals is contingent on timely identification of cases, better testing remains imperative. Finally, consideration should be given to incentivizing global technology transfers and licensing arrangements that may speed diversification of production of vaccines and other lifesaving medical tools.

Countries with high levels of immunization will need to tread carefully, balancing risks from higher numbers of cases against the economic harm of continued restrictions. Policymakers

should also take care not to penalize countries where new variants are discovered for fear of disincentivizing timely disclosure of future developments.

*Monetary policy:* Even before Omicron, inflation pressure had become more broad-based in many economies. Central banks in some emerging market and developing economies—and a few advanced economies—have already been raising interest rates. For some the decision to tighten policy reflects a difficult choice, trading off the benefits of getting ahead of price pressures against the costs of potentially slowing an already subdued employment recovery. Policy responses will vary according to country-specific inflation and employment developments and the strength of central bank policy frameworks. Extraordinary support is likely to continue in the euro area and Japan to allow the recovery to take firmer hold. By contrast, it will very likely be withdrawn in the United States in 2022—where the recovery is more advanced—with the prospect of a broader return of interest rates to higher levels thereafter. The timing and extent of responses in emerging markets is uncertain and will be complicated by ongoing developments with the pandemic, both domestically and through imported inflation stemming from international supply disruptions. This underscores the need to carefully monitor key indicators of future inflationary pressures, including inflation expectations, wage growth and unit labor costs (particularly as demand rebalances back toward services), and firms' profit margins, which can foreshadow whether higher cost pressures are likely to be passed on to prices.

Effective monetary policy communication is a key tool to avoid provoking overreactions from financial markets. In countries where inflation expectations have increased, and there is a tangible risk of more persistent price pressures, central banks should continue to telegraph an orderly, data-dependent withdrawal. This is particularly important given the exceptional uncertainty around the impact of the Omicron variant. Central banks should clearly signal that the pace at which monetary support will be withdrawn may need to be recalibrated if the pandemic worsens again.

Moreover, a tighter stance of monetary policy, especially if not clearly communicated, could have financial stability implications as financial vulnerabilities remain elevated in a number of sectors. A sudden repricing of risk in markets, should investors reassess further the economic and policy outlook, could interact with such vulnerabilities and lead to tighter financial conditions. Policymakers should take early action and tighten selected macroprudential tools to target pockets of elevated vulnerabilities (see the October 2021 *Global Financial Stability Report*).

*Preparing for tighter external financial conditions:* Less accommodative monetary policy in advanced economies will pose challenges for central banks and governments in emerging market and developing economies. Higher returns elsewhere will incentivize capital to flow overseas, putting downward pressure on emerging market and developing economy currencies and raising inflation. Without commensurate tightening, this will increase the burden on foreign-currency borrowers, both public and private. But tighter policy also brings costs at home, as domestic borrowers will find credit harder to come by. Overall, tighter policies will likely be appropriate in many emerging market and developing economies to stave off the threat of persistently higher inflation. Moreover, emerging markets are generally more resilient, with higher reserves and better current account balances than in the previous tightening cycle—including during the 2013

taper tantrum. But financial vulnerabilities remain, and many countries have higher public and private debt. Debt service burdens could therefore rise significantly with higher interest rates.

Countries with stronger fiscal positions and clearer policy frameworks will be better placed to manage tighter global financial conditions. More generally, emerging market borrowers should extend debt maturities where feasible, while containing a further buildup of currency mismatches. Exchange rate flexibility can also help absorb shocks. But in economies with market distortions or balance sheet vulnerabilities limiting market access, the impact of capital flow reversals can imperil financial stability. In those economies, foreign exchange intervention may be needed to smooth disorderly market conditions and temporary capital flow management measures may be warranted—but should not substitute for needed macroeconomic policy adjustment. More generally, policymakers should strengthen resolution regimes where needed to facilitate orderly deleveraging and restructuring.

International cooperation will also be essential to minimize stress during the forthcoming tightening cycle. Ready access to reserve currency liquidity is an important buffer against the international amplification of these risks. IMF lending arrangements (precautionary or disbursing) can be an important backstop to smooth the impact of the shocks. For countries with large financing needs and unsustainable debt, liquidity relief may not be sufficient. In such cases, quick operationalization of the G20 Common Framework for debt treatment will provide an effective mechanism for timely and orderly debt restructuring. The progress in the initial country cases has been too slow. Urgent improvements are needed to move the process forward and extend its country coverage.<sup>2</sup>

*Fiscal policy:* Public finances will come under strain in the coming months and years, as global public debt has reached record levels to cover pandemic-related spending at a time when tax receipts plummeted.<sup>3</sup> Higher interest rates will also make borrowing more expensive, especially for countries borrowing in foreign currencies and at short maturities. As a result, fiscal deficits in most countries will need to shrink in the coming years, although the extent of consolidation should be contingent on the pace of the recovery. If the pandemic worsens, consolidation can be slowed where fiscal space permits. Where mobility restrictions are reintroduced, governments should reprise programs such as lifelines for the worst-affected households and firms as needed and increase support for the most vulnerable segments of the population. However, policy space is much reduced, so better targeting of such support will be essential to preserve fiscal sustainability. Initiatives should be nested in credible and sustainable medium-term fiscal plans. Decisive support from the international community to low-income countries with elevated debt levels will be necessary so that they can provide such fiscal support. On the other hand, in countries with upside growth surprises where the recovery continues to take hold (e.g., Chile, Colombia, Peru), there is scope to retire extraordinary crisis expenditures and enhance revenue mobilization.

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<sup>2</sup> Georgieva, G. and Pazarbasioglu, C., 2021. “[The G20 Common Framework for Debt Treatments Must Be Stepped](#).” *IMF Blog*, 2021.

<sup>3</sup> Gaspar, V., Medas, P. and Perrelli, R., 2021. “[Global Debt Reaches a Record \\$226 Trillion](#).” *IMF Blog*, 2021

Ultimately, higher growth and stronger tax revenues will be required for many countries to avoid the risk of debt distress. Such challenges make structural reforms (see below) and improvements to fiscal frameworks all the more essential ([October 2021 Fiscal Monitor](#)).

***Structural reforms:*** Higher long-term growth will require deep structural reforms and remedial measures to offset the scarring impact of the pandemic. Most notably, lockdowns and social distancing have interrupted the education of many children. This is most acute in low-income countries, where alternative teaching methods (such as online instruction) are less readily available. Unless these learning losses are remedied, the school closures are likely to have long-lasting effects on individual lifetime earnings and economy-wide productivity growth. Countries will also need to adapt to a labor market shaped by the pandemic, retooling and reskilling workers as needed to secure gainful employment in a likely more digital economy. In this context, the pandemic provides a unique opportunity to boost digitalization efforts and the adoption of new technologies. More immediately, reducing tariffs and trade barriers can help ease supply disruptions and inflation pressures globally while also facilitating better resource allocation over longer horizons. These efforts, combined with global cooperation on strengthening supply chains, would help reduce precautionary hoarding incentives and allow for smoother adjustment to future shocks.

***Climate policies:*** The ongoing climate emergency continues to require urgent international action. Much larger coordinated global policies—including carbon price floors—will be needed to meet the new goals laid out at the Glasgow climate conference and stave off catastrophic global climate change. Carbon pricing and reductions in fossil fuel subsidies can also generate resources for financing other elements of the needed policy response: green infrastructure investment and research subsidies for renewables and storage technologies, as well as compensatory transfers to those adversely affected by the energy transition. Such national-level measures will need to be reinforced with adequately resourced multilateral climate finance initiatives to ensure that all countries can invest in needed mitigation and adaptation measures.

## BOX 1. GLOBAL FINANCIAL STABILITY UPDATE

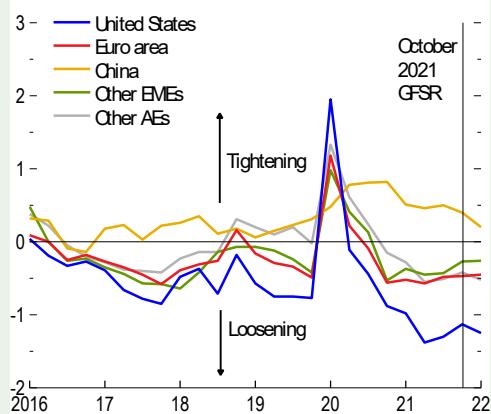
### Monetary Conditions Tighten Globally amid Heightened Inflation Risks

Global financial conditions have remained broadly accommodative since the October *Global Financial Stability Report*, despite some recent tightening driven by rising interest rates and spread of the Omicron variant (Figure 1.1). The ensuing surge in new infections has increased global financial market volatility, delayed business re-openings, and clouded the inflation outlook. Amid price pressure persisting more than anticipated, central banks in advanced economies have taken steps toward policy normalization, while policymakers in several emerging markets have continued to tighten monetary policy. As a result, front-end interest-rate-implied volatility has risen significantly (Figure 1.2) as the market-implied expected path of policy has moved higher (Figure 1.3). Driven by higher real rates, global long-term rates have increased sharply since the beginning of 2022 to pandemic-era highs, reflecting in part the perception that the Federal Reserve will accelerate its normalization process, thus undoing the decline seen in December on concerns about the impact of Omicron. Meanwhile, market-based measures of inflation expectations have declined in the last few weeks (Figure 1.4), partially reversing increases during 2021. Higher real rates have weighed on risk asset prices, with equity markets losing some ground.

**Emerging market assets have remained under pressure due to concerns about inflation, the policy outlook, and expected Fed policy tightening.** Spreads on hard currency bonds have widened, especially for frontier economies.

Emerging market capital flows have also come under pressure, with a moderation in hard currency bond issuance and continued weakness in local currency bond flows, excluding China (Figure 1.5). Market indicators point to expectations of inflation pressure, albeit with considerable regional differentiation. Facing mounting price pressures, many emerging market central banks have continued to raise policy rates, above pre-pandemic levels in several countries. Market participants expect the tightening cycle in emerging markets to continue over the next few quarters, particularly in Latin America and emerging Europe (Figure 1.3). Spillover effects to emerging markets from the policy normalization process

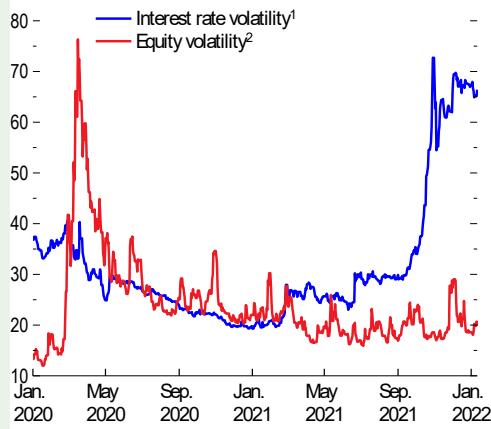
**Figure 1.1. Financial Conditions Indices**  
(Standard deviations from mean)



Sources: Bloomberg Finance L.P.; Haver Analytics; and IMF staff calculations.

Note: GFSR = *Global Financial Stability Report*; EMEs = emerging market economies; AEs = advanced economies.

**Figure 1.2. Implied Volatility Indices**  
(Percent)



Sources: Bloomberg Finance L.P.; and IMF staff calculations.

Note: <sup>1</sup>Average of the one-year one-year swaption volatility indices for the US dollar, euro, and pound.

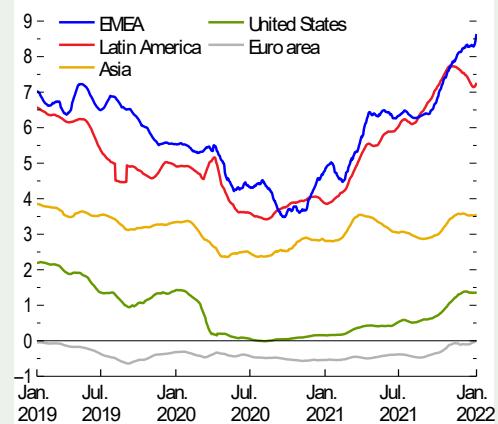
<sup>2</sup>Average of the implied volatility indices for the S&P 500, Euro Stoxx 50, and Nikkei 225.

in advanced economies could result in a marked rise in real rates. Such further tightening of domestic financial conditions at a time of high fiscal deficits and external financing needs could generate significant strains, putting the nascent growth recovery at risk.

### Risk assets face higher volatility amid stretched valuations.

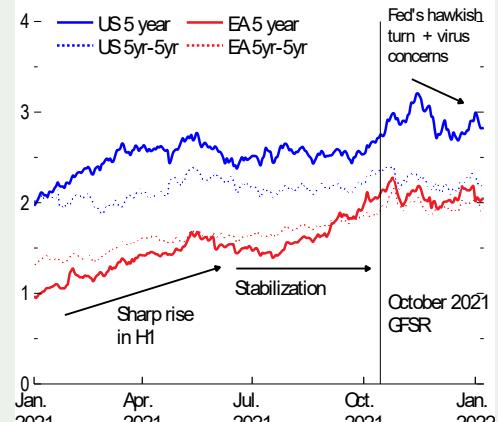
In early January, global risk markets—especially in North America and the technology sector—have come under pressure from rising real rates, demonstrating the vulnerability of risky assets to a sudden repricing. However, still negative real rates (Figure 1.6) and strong corporate earnings have continued to support equity markets. In the third quarter, companies in most large countries beat analyst expectations and recorded very high profits despite concerns about supply chain problems, inflation pressure, and rising labor costs. Many firms have been able to pass through higher costs to consumers which currently have healthy balance sheets, while some firms have accelerated the shift towards digitalization and automation. Earnings are expected to surpass pre-pandemic levels in 2022 in most sectors, though sectors linked to international travel remain vulnerable to the development of the virus. Valuation models (for example, forward price-to-earnings ratios) point to elevated equity valuations. In credit markets, bond spreads are still below average 2019 levels despite some modest widening in early 2022. Crypto-asset prices have been declining significantly since early November ahead of the 2022 “crypto sprint”<sup>4</sup> focus on these assets by US regulators and as part of a broad risk-off selloff.

**Figure 1.3. Market Expectations for Two-Year-ahead Policy Rates**  
(Percent, from swaps)



Sources: Bloomberg Finance LP; and IMF staff calculations.  
Note: EMEA = emerging Europe, Middle East, and Africa

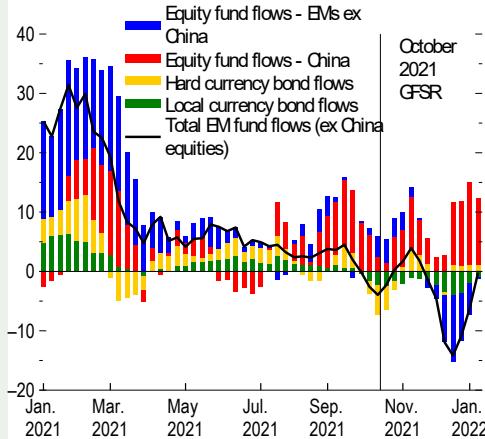
**Figure 1.4. Market-Based Inflation Expectations**  
(Percent)



Sources: Bloomberg Finance LP; and IMF staff calculations.  
Note: EA = euro area; GFSR = Global Financial Stability Report; yr = year.

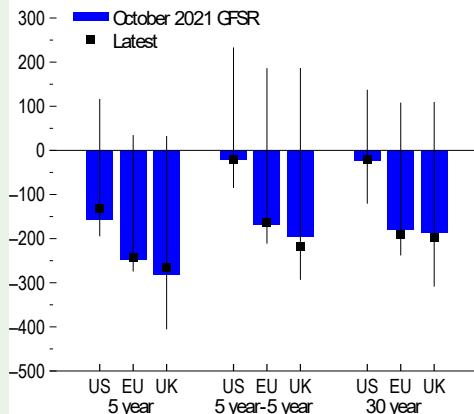
<sup>4</sup> On November 23, 2021, the Board of Governors of the Reserve System, Federal Deposit Insurance Corporation, and Office of the Comptroller of the Currency issued a joint statement on Crypto-Asset Policy Sprint Initiative. The so-called “crypto sprint” is part of a series of “policy sprints” conducted by these agencies. It aims to provide a common regulatory framework for crypto-assets-related activities focusing on legal permissibility, safety and soundness, consumer protection, and compliance with existing legal and regulatory obligations.

**Figure 1.5. Portfolio Flows to Emerging Markets**  
(Billions of US dollars)



Sources: Bloomberg Finance L.P.; MSCI; and IMF staff calculations.  
Note: EM = emerging market; GFSR = *Global Financial Stability Report*.

**Figure 1.6. Real Yields**  
(Basis points, from swaps)



Sources: Bloomberg Finance L.P.; and IMF staff calculations.  
Note: Vertical bars show 10-year historical ranges.

This box was prepared by Sergei Antoshin, Rohit Goel, and Sheheryar Malik. It provides an update on market developments since the October 2021 *Global Financial Stability Report*, whose data cutoff was around September 30, 2021.