Sleepwalking Into a Global Recession

By Andrew Sheng and Xiao Geng

HONG KONG – The International Monetary Fund and the World Bank held their Spring Meetings in Washington this month amid growing fears of a prolonged worldwide recession and following a series of reports predicting that global economic growth will continue to slow.

Earlier in April, a World Bank report estimated that global GDP growth will fall to 2.8% this year and increase to 3% in 2024, before weakening to 2.2% by 2030, roughly one-third below the 3.5% average rate of the previous decade. The Bank foresees a "prolonged period of weakness" for the global economy following further declines in investment and productivity.

The IMF's latest World Economic Outlook also warned of historically low growth, increased financial risks, and a "rocky road" ahead. The current wave of monetary tightening has slowed inflation but also popped several asset bubbles, triggering an interest-rate risk shock that wounded borrowers and fragile financial institutions. In one extreme (but plausible) scenario examined by the authors, higher interest rates and credit-supply shocks will pull down global growth to 1% this year.

The OECD's predictions are slightly more pessimistic than the IMF's, projecting that the world economy will grow by 2.6% this year and 2.9% in 2024, largely thanks to post-pandemic recoveries in China and India offsetting slower growth in the United States, Europe, and Japan. Given the escalating Sino-American rivalry, former US Treasury Secretary Lawrence Summers puts the chances of a recession in the US at 70%.

When the US Federal Reserve and the European Central Bank began hiking interest rates last year, developing economies worried about the adverse effects of monetary tightening and a strengthening dollar on the global economy. The current economic slowdown, together with the looming bifurcation of global supply chains, has compounded those concerns. In March, however, following months of quantitative tightening (QT), the Fed injected $300 billion in liquidity into cash-strapped banks to shore up confidence in the financial system following the collapse of Silicon Valley Bank. The move led capital markets to speculate that the Fed may soon revert to quantitative easing (QE) and loosen monetary policy in order to maintain domestic financial stability.

But QE is a double-edged sword. Since the 2008 global financial crisis, the G7 countries' loose monetary and fiscal policies have led to more than a decade of relative stability for the world's advanced economies. But they have also led to near-negative nominal interest rates and higher debt levels, fueled speculative asset bubbles, and encouraged investors to forsake long-term investments in favor of chasing short-term yields.

In addition to these trends, the massive monetary expansion that followed the 2008 crisis led to structural changes in the global financial system. First, it changed the composition of assets and liabilities on the balance sheets of central banks, commercial banks, and non-bank financial intermediaries (NBFIs) such as pension funds. According to the Financial Stability Board, the G7 countries' share of global financial assets fell from 75% in 2008 to 58% in 2020, reflecting the rapid growth of the G20's other members (the so-called G13).

Second, the QE decade dramatically expanded central banks' balance sheets. G7 central banks' assets more than tripled, rising from $5.7 trillion in 2008 to $23.5 trillion in 2020. By contrast, G13 central banks, which could not launch their own versions of QE because their currencies do not have global-reserve status, expanded their balance sheets from $6.7 trillion to $16.2 trillion over the same period, mostly due to their growing foreign-exchange reserves.

Third, post-2008 financial reforms encouraged banks to engage in regulatory arbitrage. As a result, the share of total G20 financial assets held by lightly-regulated NBFIs increased from 42% in 2008 to 47% in 2020.

Fourth, America's net international investment position (NIIP) – the difference between foreign assets owned by US residents and US assets owned by non-residents and foreign entities – deteriorated. By 2020, Americans owed $14.7 trillion more to the rest of the world than the world owed the US, up from $4 trillion in 2008. Meanwhile, rich countries increasingly borrowed from non-G7 countries. Consequently, the G7's NIIP deficit went widened sharply, from $1.7 trillion to $9 trillion.

The result is an unbalanced financial system in which the G7 still manages global monetary policy despite being deeply indebted to the rest of the world and controlling a declining share of international finance. The economic sanctions imposed on Russia in response to its invasion of Ukraine have effectively weaponized the reserve currencies of G7 countries, spurring other countries to seek ways to boost their resilience through de-dollarization and alternative trading and payment regimes.

The COVID-19 pandemic, together with the war in Ukraine, has further exacerbated the fragmentation of the global financial system. Similarly, governments' efforts to achieve economic security through self-sufficiency have accelerated deglobalization in energy, food, and technology markets, with the unintended effect of hampering international efforts to fight climate change.

The difference between today's financial contagion and that of 2008 is that back then, the G20 stepped up to lift the world out of crisis. China, for example, launched a CN¥4 trillion ($586.7 billion) stimulus package – then the world's largest – amounting to 12.5% of its GDP. But the Chinese government is not expected to repeat that this time, given that the 2008 program led to a debt binge, local governments borrowing as much as CN¥14 trillion by 2010 and creating huge imbalances that took nearly a decade to unwind. Moreover, any G20 agreement to revive the global economy would be conditional on finding a satisfactory resolution to the US-China conflict.

In the absence of multilateral cooperation and global coordination on fiscal and monetary policies, the world economy could sleepwalk into a recession that would likely trigger more debt and financial crises, as well as proxy wars. The current situation is reminiscent of the run-up to the global recession of the 1930s, which also led to increased military expenditures and set the stage for World War II. With so much at stake, the world's largest economies have only one good option.