Economic downturn

Last year's edition of the *Global Risks Report* warned that inflation, debt and interest rate rises were emerging risks. Today, governments and central banks – led by developed markets, notably the United States of America, Eurozone and the United Kingdom of Great Britain – are walking a tightrope between managing inflation without triggering a deep or prolonged recession, and protecting citizens from a cost-of-living crisis while servicing historically high debt loads. Public-sector respondents to the GRPS ranked Debt crises (#6), Failure to stabilise price trajectories (#8) and "Prolonged economic downturn" (#10) in the top 10 risks over the next two years (Figure 1.3).

Managing inflation is a worldwide concern. "Rapid and / or sustained inflation" was also highlighted as a top-five risk over the next two years in 89 of the countries surveyed in the EOS, a significant increase from 2021 (Figure 1.5). It was ranked as the top threat in a number of G20 countries – including Brazil, South Korea and Mexico – although inflationary pressures have affected both developed and developing economies. Inflation rates rose above 80% in Argentina and Türkiye, while Zimbabwe, the Bolivarian Republic of Venezuela, Lebanon, the Syrian Arab Republic and Sudan witnessed triple-digit inflation. Inflation in the United States of America peaked above 9% in June last year and hit record highs in the United Kingdom of Great Britain and the Eurozone in October, at 11.1% and 10.6%, respectively, forcing interest rates higher and inflicting more pain on emerging economies.[15]

The IMF's most recent projections anticipate a decline in global inflation from almost 9% in 2022 to 6.5% this year and 4.1% in 2024, with a sharper disinflation in advanced economies.[16] However, downside risks to the outlook loom large. The complexity of inflationary dynamics is creating a challenging policy environment for both the public sector and central banks, given the mix of demand and supply-side drivers, including a prolonged war in Ukraine and associated energy-supply crunch, potential for escalating sanctions, and continued bottlenecks from a lingering pandemic or new sources of supply-side controls.

Given currently low headline unemployment in advanced economies, persistent price pressures will likely lead to higher interest rates to avoid inflation de-anchoring. Central banks have sped up the post- pandemic normalization of monetary policy. Nearly 90% (33 of 38) of central banks monitored by the Bank for International Settlements raised interest rates in 2022, a dramatic shift away from the loose financial conditions that characterized the previous decade.[17] With a rapid rise in rates, the risk of unintended consequences and policy error is high, with possible overshoot leading to a deeper and more prolonged economic downturn and potential global recession.

Sovereign debt in default

Even if the economic fallout remains comparatively contained, global growth is forecast to slow to 2.7% in 2023, with around one-third of the world's economy facing a technical recession – the third- weakest growth profile in over 20 years.[18] This downturn will be led by advanced markets, with projected growth falling to 1.1% in 2023, while the largest economies – the EU, China and the United States of America – face continued challenges to growth. However, for developing economies, there is a risk of further economic distress and tougher trade-offs. Stubbornly high inflation and more disorderly containment will raise the likelihood of stagnant economic growth, liquidity shocks and debt distress on a global scale. Energy importers in particular will bear the brunt of higher energy prices stemming from a strengthened US dollar, but its continued strength is importing inflation worldwide.

Globalized capital flows over recent decades have increased exposure of emerging and developing markets to rising interest rates, especially those with a high proportion of USD-denominated debt, such as Argentina, Colombia and Indonesia.[19] Early tightening of monetary policy in many markets – including Brazil, Mexico, Chile, Peru and Colombia – minimized initial exposure. But while some countries have resorted to foreign-exchange interventions to limit currency depreciation and debt-servicing loads, heightened volatility continues to drive demand for US assets. This has led to record capital outflows from markets with weaker macroeconomic fundamentals, with investors already withdrawing $70 billion from emerging market bond funds by October last year.[21]

Growth agendas, including the critical pivot to greener economies, have been based on the availability of cheap debt. The extent to which countries can continue to finance development
will be dependent on domestic political and debt dynamics. Sri Lanka's recent crisis provides a very real example of the spiraling risks to human security and health that can arise from economic distress, where a debt default and shortage in foreign currency limited imports; disrupted access to food, fuel, healthcare and electricity; and led to violent protests and the resignation of the President.

The scale of sovereign debt defaults could significantly rise in weaker emerging markets over the next two years, in terms of both the percentage value of total global debt and number of states in default (Figure 1.6). Although unlikely under the current trajectory to reach globally destabilizing levels, the proportion of countries in or at high risk of debt distress has already doubled from 2015 levels.[22] This will increase the global influence of creditor nations and heighten state fragility as the capacity to address simultaneous crises in food and energy will be limited.[23] Some countries will be unable to contain future shocks, invest in future growth and green technologies or build future resilience in education,

healthcare and ecological systems, with impacts exacerbated by the most powerful and disproportionately borne by the most vulnerable, as explored in Chapter 2.6: Economic stability.

Geoeconomic warfare

“Geoeconomic confrontation” was ranked the third-most severe risk over the next two years by GRPS respondents. Interstate confrontations were anticipated by both GRPS and EOS respondents
to remain largely economic in nature over the short term. Geoeconomic confrontation – including sanctions, trade wars and investment screening – was considered a top-five threat over the next two years among 42 countries surveyed by the EOS and featured as the top risk in many East and South- East Asian countries, among others. In comparison, “Interstate conflict” was ranked as a top-five risk in 28 countries surveyed by the EOS (Figure 1.7).

The weaponization of economic policy between globally integrated powers has highlighted vulnerabilities posed by trade, financial and technological interdependence - for the public and private sector alike. The Ukraine conflict triggered the imposition of sanctions, nationalization of key players, and government appropriation of assets, such as Germany’s seizure of Russian energy companies' stakes in local refineries last year.[24] Reputational and legal risks for multinational company operations in certain markets also grew: consumer good companies faced boycotts after continuing to provide basic necessities to Russia, and a European energy company was accused of “complicity in war crimes” due to linkages to a Russian gas field.[25]

In the face of vulnerabilities highlighted by the pandemic and then war, economic policy, particularly in advanced economies, is increasingly directed towards geopolitical goals. Countries are seeking
to build “self-sufficiency”, underpinned by state aid, and achieve “sovereignty” from rival powers, through onshoring and “friend-shoring” global supply chains. Defensive measures to boost local production and minimize foreign interference in critical industries include subsidies, tighter investment screening,
data localization policies, visa bans and exclusion of companies from key markets.

While initially driven by tensions between the United States of America and China, many policies are extra-territorial in nature or have been similarly adopted by other markets, with spill-over effects across a broad range of industries. For example, Switzerland is considering the introduction of a general cross-sectoral foreign direct investment screening regime for the first time. Expanded state aid to support self-sufficiency in “strategically important products”, including climate mitigation and adaptation, has also heightened competition within global blocs. The EU has already raised concerns about the USA's Inflation Reduction Act, which includes significant tax credits and subsidies for local green technologies.[26]

Economic levers are also being used to proactively constrain the rise of rivals. This includes delisting
of foreign companies, extensive use of the foreign direct product rule and export controls on key technologies and intellectual property as well as broad constraints on citizens and entities working with designated foreign companies. The introduction of an outbound investment screening regime has also been contemplated by the United States of America.[27]

Together, these trends towards geoeconomic warfare risk creating widespread spillovers. More extensive deployment of economic levers to meet geopolitical goals risks a vicious and escalating cycle of distrust. Financial and technological ramifications may highlight further vulnerabilities, leading states to proactively wind back other interdependencies in the name of national security and resilience over the next two years. This may spur contrary outcomes to the intended objective, driving resilience and productivity growth lower and marking the end of an economic era characterized by cheaper and globalized capital, labour, commodities and goods.

This will likely continue to weaken existing alliances as nations turn inwards, with enhanced state intervention perceived to drive a “race to the bottom”. Further pressure will be placed on multilateral governance mechanisms that act as mitigants to these risks, potentially mirroring the politicization of the World Health Organization (WHO) during the COVID-19 pandemic and the near paralysis of trade enforcement on more contentious issues by the World Trade Organization (WTO) in recent years.[28] It will also likely embed the importance of broader geopolitical spheres of influence in “dependent” markets, with global powers extensively exercising trade, debt and technological power.

Although some developing and emerging markets may wield critical resources as leverage, considered in Chapter 3: Resource Rivalries, anticipated controls on capital, labour, knowledge and technological flows risk widening the developmental divide.

In addition, spheres of influence will not be purely contained to global powers, nor “dependent” developing and emerging markets. The influence and alignment of the Middle East in regional and global politics will shift. Although the challenge of longer- term economic diversification remains a significant distraction domestically, the current energy crisis
will raise economic, military and political capital of numerous countries over the next two years. Comparative ties of the United States of America and China will have significant ramifications for the balance of power in the region, as well as global military dynamics, considered further in Chapter 2.4: Human security.[29]

Strategies to enhance security may also come
at a wider economic cost. Intensified geopolitical tensions risk weakening the economic landscape even further, resulting in lingering inflation or depressed growth even if current pressures subside. If on- and friend-shoring continue to be prioritized
– particularly in strategic industries such as technology, telecommunications, financial systems, agriculture, mining, healthcare and pharmaceuticals – consumers will potentially face rising costs well into the future. As costs of compliance with divergent political and economic systems climb, multinational companies may pragmatically pick a side, speeding up divergence between various market models.

While intended to lower risks associated with geopolitical and economic disruption, shortened supply chains may also unintentionally heighten exposure to geographically concentrated risks, including labour shortages, civil unrest, pandemics and natural weather events. Geopolitical risks posed by geographic hotspots that are critical to the effective functioning of the global financial and economic system, in particular in the Asia-Pacific, also pose a growing concern.

A looming investment shortfall

Even in the absence of a global crisis, the 1980s “lost decade” of development in Latin America and Sub-Saharan Africa provides a very real example of the economic and humanitarian crisis that can arise from a sovereign debt default, including currency free falls, collapses in output, cost-of-living crises and rapid increases in poverty. The 41 countries that defaulted on their debt in the first half of the decade required eight years, on average, to reach their pre-crisis GDP per capita.[136] Debt distress and restructuring will also have an impact on investment. According to GRPS results, the risk of Debt crises drops in perceived severity over the longer-term time frame, but the Collapse or lack of public infrastructure and services becomes more severe. The ability to finance continued productivity and resilience will be hampered by economic and political dynamics on both a global and national level.

Advanced economies will have more autonomy to invest in future priorities, while developing markets may be more beholden to the demands of the creditor, meaning money could be diverted from the areas of greatest social need, including expenditure in public goods and infrastructure. Beyond the growing financial cost of natural disasters, emerging and developing economies will need to spend a higher proportion of GDP on the green transition and sustainable infrastructure, with knock-on ramifications for other public spending
and services.[137] By contrast, within the limits of inflationary pressures, advanced economies can continue to leverage more accessible financing for economic development, such as stronger industrial policy, to underpin the energy transition, widening the divide between countries. Necessary fiscal consolidation in emerging and developing economies may also rely heavily on spending cuts, which could rapidly remove social protection available to low-income and vulnerable populations, increasing poverty and inequality within countries, alongside social and political unrest.

Yet in a structurally different low-growth, low- investment economic era, even advanced economies will need to make trade-offs. Rising unemployment, social unrest and political polarization, and even technologically-driven churn in both blue- and white- collar jobs may influence the prioritization of current expenditure over longer-term capital expenditure, while security considerations may mean there is
less fiscal headroom for social and environmental development over the medium term. The potential result is the de-prioritization of investment and slow decay of public infrastructure and services in both developing and advanced markets.[138] Around two- fifths of low- and lower-middle-income countries cut expenditure on education by an average of 13.5% since 2020, which, despite a minor rebound, fell again in 2022.[139]

As referenced in Chapter 2: Human health, the lingering economic, educational and healthcare overhang of the pandemic continues to weaken the capacity of public systems that also face compounding pressure from ageing populations in advanced economies, and rapidly expanding populations in some developing markets. This is a slow-burning risk: impacts are subtle, lagged and cumulative in nature, but can be highly corrosive in overall impact to the strength of human capital and development – a critical mitigant to the impact and likelihood of other global risks.

Acting today

In recognition of the risks posed to broader financial stability, timely and deeper debt write-downs could allow a faster return to developmental progress for vulnerable countries and render a future default less likely. The private sector could be incentivized to participate in debt restructuring through a variety of mechanisms, including issuing of new bonds with stronger legal protections, loss reinstatement commitments and value recovery instruments – with the latter enabling private creditors to gain from upside developments in debtor countries in the future, such as GDP-linked instruments in Costa Rica, Argentina, Greece and Ukraine.[140]

As a complementary mechanism to more comprehensive debt restructuring, there may be increased deployment of debt-for-development deals (see Chapter 2.2: Natural ecosystems), particularly relating to climate-positive adaptation, to help break the correlation between exposure to climate change and debt vulnerability.[141] However, this should not just be limited to environmental concerns. Social bond issuances have already jumped sevenfold, to $148 billion in 2022,

targeting healthcare, education and small and medium-sized enterprises.[142] While debt swaps may not create fiscal space beyond the specific objective, SDG-linked conditionality may enhance the willingness of creditors to consider debt relief, particularly for countries where other forms of fiscal support, including write-downs and conditional grants, may be less likely.[143]

Finally, we are unlikely to be able to double down on debt to the same extent to cushion the next crisis.
A more proactive approach to countries that are not yet on the verge of debt distress could help mitigate the systemic risk of sovereign debt contagion. Recognition of simultaneous crises – debt, climate impacts and food security – could be integrated into greater flexibility and more concessional forms of financing available to vulnerable markets. With particular respect to the climate agenda, there is a growing expectation that packages will include grants, rather than rely solely on loans that add to overall debt burdens.[144] Bilateral and multilateral underwriting of risk could also enable much-needed flows of private capital, while support for longer-term projects that can help crowd-in private capital, such as the IMF's Resilience and Sustainability Trust, is also critical.[145]