



DOLLAR & SENSE: THE BROOKINGS TRADE PODCAST

“Previewing the US and global economies in 2023”

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Episode Summary:

Host David Dollar and Gian Maria Milesi-Ferretti, a senior fellow in Economic Studies, anticipate key trends in the U.S. and global economies. What’s the inflation picture and forecast for growth in the U.S.? What economic conditions will prevail in Europe, China, and Latin America? And what can poor, low-income, and emerging economies expect in the new year?

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DOLLAR: Hi, I'm David Dollar, host of the Brookings Trade podcast Dollar and Sense. Today, my guest is Gian Maria Milesi-Ferretti, a senior fellow in the Economic Studies program at Brookings and a leading expert on the international economy. We're going to be doing a scene setter for 2023, looking at different issues and scenarios. No one can predict the future, of course, but we can identify important issues to be looking at. So, welcome to the show, Gian Maria.

MILESI-FERRETTI: Thank you, David. And a very happy New Year to you and all the listeners.

DOLLAR: Yep. Happy New Year 2023. Let's start with the U.S. economy, where the Fed is trying to control inflation by raising interest rates. So, Gian Maria, how do you see the inflation picture in the U.S. and what are some of the issues and risks we should be aware of?

MILESI-FERRETTI: So, the inflation picture is clearly improving. We have seen a turnaround in both headline and core inflation. It's trending down. It's been helped by the fact that energy prices have moderated and also that some of the, in a sense the past increases have been built in so there has been no further bad news. We've had a general improvement in supply chain conditions which have contributed, together with lower commodity prices, to moderate the prices of goods that had been pushing up inflation. So, those are the positive news. On the global forces driving inflation, we see inflation pressures heading down.

The concerns are with core inflation in services, which typically responds more to labor market conditions and because the main source of cost is wages. And with very tight labor markets and nominal wage increases that, although they have not kept up with past inflation, are clearly high from the perspective of a 2% inflation target. There are some concerns that inflation will not revert rapidly to the 2% average inflation targeted by the Federal Reserve.

Bottom line, I see inflation coming down, but not coming down enough. Maybe getting stuck in the threes as a central scenario with a lot of uncertainty around it. And then the Fed will have to decide depending on what is happening to the real economy, depending on these various factors I have listed whether to tighten more or whether to stop and eventually reverse course.

DOLLAR: What about prospects for a recession in the U.S.? So how does this all add up to bottom line? Where do you put the probability for recession?

MILESI-FERRETTI: What I would say is the central forecast for growth during 2023 is low. The U.S., it's the range of say between zero and 1% on measuring growth from Q4 over the year 2023, from Q4 '22 to Q4 '23. With that type of central forecast, it is clearly very possible that growth will turn negative for a couple of quarters.

I don't think it is a big deal to the extent that the decline is a modest one. Quarter-to-quarter fluctuations to GDP happen. The unemployment rate is extremely low. So,

you could have a technical recession without having a spike in the rate of unemployment, without having any really disruptive macro developments.

But, it is very difficult to forecast under current conditions. We all missed the increase in inflation. There are many global uncertainties still playing out. How financial markets will behave in 2023, we don't know. It's another potential source of uncertainty. So, I think again, the possibility is there, not necessarily a difficult recession, but clearly in the realm of serious possibility.

DOLLAR: I know you returned recently from Europe, where the war in Ukraine is obviously a big issue, both a political issue, but affecting the economy, creating an energy shock. So, how do you see the conditions in Europe? Is Europe more likely to go into recession than the U.S.?

MILESI-FERRETTI: Yes. Europe is likely to be in a recession right now. But, because the size of the energy shock in Europe is so much larger than the shock that has affected the U.S., because even though oil prices are common across both sides of the pond, gas prices in Europe have spiked because of the war and the decision to stop purchases from Russia. And that same time Russia stopping deliveries of gas to Europe.

And gas prices are tied by electricity pricing mechanisms to the overall price of electricity. So, the price of electricity in Europe has spiked to an extent that these are absolutely unknown in the U.S. and that has put serious pressure on inflation, serious pressure on profit margins, made a bunch of industries uncompetitive. So, with that type of energy price shock, you also have, of course, consumers facing higher gas and electricity bills. You have more of a negative effect on consumption and investment.

The moderation of gas prices in recent weeks has made this likely recession be perhaps a bit less deep than it was feared. But it is very likely that the fourth quarter of this year and the beginning of next year are going to be with negative growth in Europe. And the picture changes a bit depending on the country. There are more a bunch of other implications we can go into during the course of our discussion. But the bottom line is, yes, Europe much more likely to be in a recession already.

DOLLAR: There's been some unusually warm weather throughout the northern hemisphere. So, I think that presumably has helped somewhat and just emphasizes the role of luck or idiosyncratic movements.

MILESI-FERRETTI: Absolutely, David. This is exactly the point. But one of the reasons why electricity prices and hence energy prices overall have moderated significantly in Europe has been because gas prices have fallen, because the consumption of gas for by industry and by consumers has declined very sharply. Part is, as you say, luck, a good part of it the weather has been much warmer, but there has been also very serious retrenchment, particularly by industry, but not just by industry in energy consumption in Europe, as both firms and consumers adapt to these changed circumstances. So, stocks of gas storage deposits are larger than was expected. This has helped moderate prices now.

Of course, the issue is not gone because it is not yet clear how those stocks would be replenished next winter and the winter after that if, as is likely, the situation with Russia does not lead to a resumption of gas imports from that source.

DOLLAR: China has just reported some really interesting numbers. It's starting to report its December data and the Purchasing Manager Index, if you dig into the details of the survey, the bottom line is December was terrible in terms of production both for industry and services. And yet there's an optimism throughout the Chinese economy about 2023, which is a little bit puzzling.

But they've obviously moved away from their zero-tolerance policy toward COVID. This move is very popular. But clearly the initial reaction is the spread of the COVID-19 disease. And that's probably why December was terrible. People are being very cautious in their behavior. Lots of production was disrupted.

But if China can get this under control, there's likely to be a certain amount of bounce back. Consumption, built-up, pent-up demand that affects the economy. But China also faces some pretty serious headwinds in real estate and a softening world economy you've described for the U.S. and Europe, that's going to affect China's exports. So, so how do you see ... what are some of the things we should be looking for in China? And how is that going to affect the rest of the world?

MILESI-FERRETTI: So, you've listed all the key elements, I think, but the one big unknown is how the how protracted the pandemic shock is going to be and what type of consequences it will bring for pressures on the health sector and more generally on public attitudes, public opinion.

The general expectation built in most forecasts sees a very strong second half of 2023 as the peak impact of the explosion in infections is past, and as the economy gets back to a services sector that operates more normally than it has been with all the pent-up demand that you have mentioned.

But of course, this would be a strong recovery compared to what we have seen the second half of 2022 and what we are likely to see in early 2023. It is not a strong recovery by Chinese standards. So, we're talking about growth rates that are clearly not in the range of the 5 and 10 that we had been used to during the past decade or so.

And both key factors that you mentioned—the woes of the real estate sector and the fact that global demand, particularly for manufacturing goods, is going to be relatively weak during 2023—both those factors will weigh on the likelihood of a very strong growth in China.

Still, the prospects are, I would say, better than under the previous COVID-related policies, and that given the gigantic size of China, a recovery there will have major implications for the region as a whole. Just one obvious link is the return of Chinese tourists that had been basically prevented from traveling for a very long time. That is very important, especially for some Asian tourist destinations from Thailand to Sri Lanka to many others, Indonesia as well. So, that is going to be helpful.

And I would say in general, a recovery in demand is good for exports that go beyond, of course, tourism services. The expectation is that, together with a big recovery you will see sort of a waning of any supply disruption caused by the pandemic. But that is, I would say, a source of uncertainty. We just don't know the extent to which the peak in infections is likely to be reflected in production, particularly of intermediate goods. That will be something to watch.

DOLLAR: So, let's turn to the rest of the developing world beyond China and distinguish between emerging markets and low-income, very poor countries. So, on the emerging markets, are there some general patterns in terms of exchange rate, inflation, capital flows? Let me just pause for a moment and tell our audience, if you go to Gian Maria's expert page on the Brookings website, he's got a fantastic database on global capital flows and how that results in net asset, net creditor or net debtor positions of different countries. So, really fantastic data about capital flows. So, how do we see that picture for emerging markets?

MILESI-FERRETTI: So, it is a differentiated picture across countries. But let me try to draw some common elements. I would say one that I could have mentioned at the beginning is that 2023 figures are likely to be considerably weaker than 2022, in part because of the sheer importance of momentum. So, we entered 2022 with a strong recovering train. So, the second half of 2021 was very good as the world economy was recovering. And that flattered any comparison in GDP between '22 and '21, which is the growth rate in 2022.

This year we are getting a bit of the opposite. The second half of 2022 has been generally weak. We don't have final data yet, but the fourth quarter in China is likely to be negative, the fourth quarter in the euro area is likely to be negative. So, many countries are slowing, even those that are not in a recession. So, we enter 2023 on a relatively weak footing. And as a general observation, the growth rate in emerging economies is going to be lower than it was in 2022. So that is if you want the bad news.

The good news is that there were many concerns that a host of global factors were going to trigger as potentially a set of disruptive conditions, external crisis in a number of emerging economies. Those forces went from very rapid increase in interest rates in advanced economies, particularly the U.S., a surge in the dollar value, which used to be a good metric to identify risks to external conditions for emerging economies that would see the domestic currency value of their dollar debt rise, the cost of financing rising because of higher interest rates, and a bunch of disruptions related to the war.

All those things have mapped into, for instance, extremely weak portfolio flows to emerging economies during 2022—some reversal actually happening—but have not caused the disruptive conditions that were feared in most large emerging economies. They have weathered these shocks much better than in the past. There will be a long discussion to go into the details as to why that is the case. But that is, I would say, the bit of good news, that the Brazils, the Mexicos, the Indias of this world, the Indonesias of this world, may have done—some have done well, some have done a bit less well, but certainly they haven't been as disrupted as one could have, one could have feared.

In Latin America, we have a slowdown. Inflation is coming down. Inflation had risen in emerging markets even before advanced economies but is generally slowing. Where Europe has had a tough year. You have Turkey, which has, of course, a bunch of very special circumstances, including inflation in the range of 80%. But of course, the figures are very heavily skewed by the dramatic contraction in the Ukraine and a recession in Russia. And then you have, of course, the impact of the higher energy prices on importing countries. I mean, think of Hungary, of Romania, and the like. So, very affected by the war.

So that, I would say, is the general picture for emerging economies—a slowdown. Some good news if China recovers more rapidly. Say, better conditions in general in emerging Asia compared to the rest. But as a year of, I would say, subdued growth also because advanced economies are not going to do very well. And that has an impact on emerging economies' exports, and we have the low-income and we can turn to those.

DOLLAR: Right. But on the emerging markets, let me just add that my impression having worked on a lot of these countries is that their overall macro management has improved a lot compared to the 1980s or 1990s. So, you have sustainable fiscal and reasonable monetary policies and more flexible exchange rates. So, I'm impressed, and again, there's a lot of differentiation, but many emerging markets have been managing this this pandemic and the economic fallout pretty well.

MILESI-FERRETTI: I fully agree with you. It's exactly the reason why they have really built resilience. They have reduced their dependence on overall dependence on dollar borrowing. Many of these emerging markets are now net creditors in foreign currency terms because flows into the country are often to purchase domestic currency instruments or to FDI or purchase equity, and hence that reduces the exposure of the balance sheet of the country to a sharp change in the exchange rate.

Macro management may not be perfect everywhere, but is definitely on a much sounder footing and has been so I would say for almost a couple of decades with, say, an increasing number of countries joining that group. I would say that the front-line emerging economies are less of a source of potential risk.

Where the situation instead looks grim is in a range of middling emerging economies and lower income countries, where this progress in macro management has not been as rapid, and economies where the structure makes them more vulnerable to global shocks. Think of Egypt, which has heavily kept, first, a fixed exchange rate and then really very heavily managed one. And it's a country that depends also on inflows, it's mostly in effects, and is a country that imports a lot of wheat and of course it subsidizes bread prices, which implies that for the budget an increase in the price of wheat is an enormous cost, and it's a country under clearly under pressure.

Think of Pakistan, which has been blighted by these horrible floods but is also a country that has high dependence on imported energy and hence suffers from both higher energy prices and higher food prices. So, those are sort of on the larger side, middling emerging economies that face very difficult conditions.

And those are really even more prevalent in some lower income countries that, again, are exposed to higher energy costs, to higher cost of international finance, to some extent also to a retrenchment of China from very rapidly growing foreign lending, too. And so a number of them are facing difficult conditions. And IMF, our former employers on both sides of 19th Street are going to be really, really busy even if in the aggregate, because of the large countries, the emerging world is actually not doing too badly.

DOLLAR: Yeah, let me add, 19th Street is the dividing line between the IMF and the World Bank headquarters here in Washington, D.C.

Focusing a little bit more on this issue of the debt of low-income countries, China has lent quite a bit of money to countries as part of its Belt and Road Initiative. A lot of that is what I would describe as close to commercial terms. And then a lot of these countries, frankly, have floated truly commercial bonds in the international market and also continue to borrow from the World Bank and other development sources. And now in a changed world, you've got quite a few countries really facing debt distress. So, are we doing enough, are those two institutions and the rest of the world doing enough? How do you see that debt crisis developing and hopefully being resolved over the next year or more?

MILESI-FERRETTI: I think the institutions as a whole are working very hard. Not enough is being done, I would say, but I think not enough is being done because the institutions have shareholders. They can lend, they can try to lead, to organize. But ultimately, you'll need the creditor countries to take action. And reaching an agreement when, as you pointed out, the nature of creditors has changed compared to the past has become so much more difficult.

In older times, and it was the Paris Clubs or the Club of Advanced Economies, that used to have the lion's share of the lending to poorer countries, would get together and decide on some write down of debt subject to some well behavior conditions by receiving countries. But now that you have commercial lending, you have a big yet obscure role of the Chinese finance too, reaching an agreement on debt write downs has become so much more difficult.

And of course, advanced economy creditors are reluctant to take huge cuts if they feel that other participants are not doing the same on their lending, all the more so since their lending is now likely to be the larger part of the lending to these countries.

There have been difficult negotiations—for Zambia, they have reached an agreement. There have been difficult negotiations for Chad. I would say again, there an agreement basically was saved by the fact that oil prices went up and reduced the need for actual disbursements. But the length of time it takes to clear, say, excess debt is of concern. And it would be great if the international community could make strides to streamline and speed up the process.

There is a lot of intellectual effort there. There is clearly a lot of pressure by Bretton Woods institutions to go in that direction. But finding agreement is hard. And clearly

the fact that the international environment on the geopolitical front has been more difficult than it was a decade ago is not helping.

DOLLAR: Last question for you, Gian Maria, is can you trace out a positive scenario for 2023? It would not be the baseline; I think we've covered a lot of the different risks and problems. But if 2023 were to go quite well, what would that look like?

MILESI-FERRETTI: I don't want to sound too pessimistic, but I would say the central scenario is a pretty benign one, because it is conditional on a number of bad things not happening. Big disruptions in financial markets and the like. I would say my wish list, I would put an end to hostilities between Russia and Ukraine in very first place. The odds of that happening, I leave to my colleagues in Foreign Policy, but I think are not high. But moving from discussions on what weapons to send to how to do the reconstruction on the ground and starting that would be a major shift.

I would say an environment where you have no accidents, no unexpected crisis, reasonably well-behaved financial markets, inflation that continues to come down, can come down gradually but it comes down, would be a very benign one.

The no disruption would imply energy prices moderating in Europe, avoiding the risk that entire sectors of European industry be priced out of world markets by the structure of their costs. And of course, conditions that allow those emerging markets, poor- and low-income economies more under stress to cope with their debt burdens would also be very helpful.

So, no major surprises on the interest rate front. No major tightening of global financial conditions. That would be a very positive 2023, in my view, even though, again, the headline growth is likely to be considerably lower than the previous two years.

DOLLAR: I'm David Dollar, and I've been talking to my colleague, Gian Maria Milesi-Ferretti. We've taken a virtual trip around the world and looked at some of the major issues and risks. Lots of things to be worried about for 2023. I think we've identified the different problems. And as I said at the beginning, nobody can predict what's actually going to happen. But we've provided a frame of reference for thinking about developments in 2023. So, thank you, Gian Maria.

MILESI-FERRETTI: Thank you, David. This was fun.

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DOLLAR: Thank you all for listening. We release new episodes of Dollar and Sense every other week. So, if you haven't already, follow us wherever you get your podcasts and stay tuned.

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Until next time, I'm David Dollar and this has been Dollar and Sense.