EDITORIAL

SOFT LANDING IN SIGHT, BUT DON'T UNBUCKLE SEAT BELTS YET

Less than 2 years after spiking to decades highs, inflation is back in the neighbourhood of central bank targets in most of the world. Yet it is too soon to declare victory, as there are still cross currents for economic policy-makers to navigate. As they have earned a good track record of it, and room to act, the year-ahead baseline scenario is fairly benign for both advanced economies and emerging markets, with gradually easing financial conditions (from lower interest rates and a likely weaker US dollar) allowing activity to stabilize around trend growth.

As we approach 5 years since the onset of the Covid pandemic and the historic economic turbulences it generated, a soft landing finally appears to be in sight for the global economy.

More specifically, inflation, less than 2 years after spiking to decades highs, is back in the neighbourhood of central bank targets in most of the world. Remarkably, this sharp decline was achieved without much if any of the expected economic cost: in most regions, employment is now higher than pre-pandemic, unemployment is near historic lows, and output growth has remained positive, indeed in some cases even above trend.

After executing the steepest tightening of monetary policy in decades and holding in highly restrictive territory for about a year, all bar one1 of the world's largest central banks have now embarked on an easing cycle, with the US Federal Reserve (Fed) finally joining the party with a jumbo 50 bps cut on 18 September.

Yet it is too soon to declare victory, as there are still cross currents for economic policy-makers to navigate, even leaving aside the current shock-prone geopolitical environment.

On the inflation side, services inflation remains stubbornly high—in the Eurozone about double its pre-COVID level, meaning that inflation is near target only thanks to two factors which may not last: good luck on food and energy prices; and well below-target inflation for goods. This could constrain the future pace and scope of monetary easing, and we are already seeing some early easers like the Banco Central do Brazil having to raise interest rates again.

On the growth side, there are 3 issues calling for alertness:

• Industry is in recession in most of the world, with China's slumping imports exerting a significant drag on global industrial activity. Recent policy support, and potential additional measures yet to come, will help Chinese activity to stabilize, albeit at a lower level than pre-covid. The most recent data out of Europe suggests weak sentiment and broadening softness in activity. Meanwhile, labour markets are softening worldwide, a welcome normalization that could however easily tip over into outright weakness, as some Fed policy makers recently acknowledged.

• Consumption, except in the US, has yet to see a boost from higher purchasing power brought about by lower inflation and lower interest rates. Instead, saving rates have gone up and are now well above pre-covid average in the Eurozone and the UK. Household confidence is weak and any deterioration in the labour market risks worsening it.

• With debt to GDP ratios much higher than pre-pandemic everywhere, fiscal policy needs to deliver sustained adjustment, particularly where it has been lacking in 2024. In most cases, it can afford to be gradual, with the headwind from it more than offset by monetary easing. Where politics fail to deliver such adjustment however, or even deliver a stimulus (a possible outcome of the upcoming US elections), then central banks may find themselves unable to ease nearly as much as expected, and market fears over debt sustainability might add an additional premium to the cost of debt, contributing to tighter overall financial conditions.

Thus, central bankers will have to keep walking a tightrope for some time longer. As they have earned a good track record of it, and room to act, the year-ahead baseline scenario is fairly benign for both advanced economies and emerging markets, with gradually easing financial conditions (from lower interest rates and a likely weaker US dollar) allowing activity to stabilize around trend growth.

Just the kind of environment needed for other economic policy makers to refocus on tackling the well-known long-term challenges that have only become more pressing: low productivity growth, aging populations, climate change; and the more recent one of economic security.

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