

Outside of the box: World economy heads for soft landing amid uncertainty

International Monetary Fund/World Bank meetings conclude

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The world economy is on course for a soft landing next year after a bumpy journey. Markets are eyeing some risks and must navigate more uncertainty. That was the view at the International Monetary Fund (IMF)/World Bank annual meetings held last week in Morocco. Attracting dignitaries from around the world, the meetings marked the first held in a location outside of Washington DC since the pandemic and the first annual meetings back in Africa in 50 years, in addition to being put on despite the devastating earthquake to rock the nation last month.

ESM senior officials attended close to 30 meetings with public sector institutions, international banks, and investors over several days. As the ESM's Chief Financial Officer, responsible for both bond issuance and portfolio investments, these meetings provided me with important insights into institutional thinking and market reactions.

Following these insightful discussions with peers and the financial community, I share six key takeaways.

Geo politics top of the agenda

The political situation in the world is fragmenting with conflicts in the Middle East, Ukraine, Central Asia, and parts of Africa, with potential consequences for capital markets. These geopolitical risks are currently not fully priced in and are, thus far, considered tail risks. But they have the capacity to dominate, as witnessed with the

Ukrainian conflict last year. So, investors are cautiously watching the geopolitical shift and assessing how to price it in.

Higher for longer interest rate risks

Just three years ago, the theme of the IMF/World Bank annual meetings was 'lower for longer' rates. But rapid changes over the last two years make 'higher for longer' yields the main policy and investment topic today. Market participants have not fully priced that in, still pricing in rate cuts for late 2024. But at the meetings, the 'higher for longer' theme permeated the investment outlook with the anticipation of prolonged elevated inflation. This poses new challenges. We have already seen significant repricing in markets, with investors absorbing the possibility of a 'higher for longer' investment scenario. Higher rates will create financial stability concerns for higher indebted corporates, financial institutions, and countries. A topic the market will be watching closely moving into 2024.

Monetary and fiscal policy mismatch

Over the last year, we have seen sharp monetary tightening across the world to counter inflation. This has been the fastest spate of rate increases in modern history in both the US and in Europe. Tighter monetary policy should move in step with tighter fiscal policy to exit a high inflation environment more quickly. Yet, there is currently a mismatch where monetary policy tightens while persistence of large fiscal deficits remains in many parts of the world, including Europe and the US. Investors and banks are concerned about this and expect a clear and firmer policy reaction.

Political and electoral uncertainty

More than two billion people globally are due to vote in 2024, including in the EU, the US, and India. Recent elections in Europe have resulted in the rise of populist parties as issues such as migration and the cost-of-living crisis become increasingly pertinent to the average citizen. The outcome of crucial elections coming up in the Netherlands, the EU, and the US will impact markets and define how attractive it is to invest in different asset classes.

More innovation needed in the market

For multilateral development banks (MDBs), innovation came with the emergence of hybrid capital, whereby perpetual bonds can be considered as equity-like products boosting leverage and lending capacity. The World Bank and the African Development Bank are amongst the MDB leaders in this space. Technological innovations in capital markets are slowing, and their introduction has been less disruptive than expected. But the need for innovation has not petered out, with advancements such as a strong [central bank digital currency](#) being a potential game changer in the marketplace.

Environmental, social, and governance agenda needs refocusing

A surge in environment, social, and governance (ESG) labelled products since 2007 has slowed as of 2022, with expectations that labelled bonds and issuance will remain subdued for 2023. There are several reasons for this. First, overall issuance levels have fallen since the end of the Covid-19 crisis. Second, ESG litigation risk makes issuers and investors more wary. In addition, ESG regulation is overwhelming market participants. Third, there is a systemic change in investments due to the high increase in yields. Investors have shortened their maturity profiles and are looking for short-end products. Labelled securities, originally more equipped for long-term issuance, are less suited for the short end of the curve. Austria is a world leader with its green bill programme, but there are not enough other issuers to cater to this new investment appetite. To boost ESG labelled investments, more shorter maturity products like green commercial paper, green bills, and short-end labelled bonds could be an area for future growth.

Final remarks

While there is uncertainty on the horizon, Europe is financially more resilient compared to a decade ago during the global financial crisis and European sovereign debt crisis. The IMF World Economic Outlook forecast for 2024 ^[1] predicts a soft landing and is more optimistic than in the previous year. Savings rates are higher in Europe and the financial architecture is stronger. The positive impact of Next Generation EU, where Europe invests in digitalisation and greening projects for the post-pandemic recovery, will be felt over the coming years. The ESM currently has a roughly EUR417 billion lending capacity

to assist its member countries should they need it and will, like the IMF, review its lending toolkit next year to make it future proof. These foundations to stand upon should make it easier to navigate the future and give confidence to markets, investors, policy makers and citizens.

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Footnotes

[1] IMF (2023) World Economic Outlook October 2023

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