The search to recover the lost balance

The data published in recent weeks have confirmed the worsening combination of growth and inflation in the world economy during Q3 of this year. The slowdown in the growth rate of global economic activity has resulted from the loss of momentum in the three major global economies (China, the US and Germany), which have been hampered by the bottlenecks in global supply and the effects of rising energy prices. Particularly significant are the problems that are beginning to manifest themselves in the industrial sector in countries such as Germany as a result of the distortions in supply chains, as well as mismatches in the labour markets of some countries such as the US, Germany and even Spain, where the number of unfilled job vacancies is approaching 120,000 (the peak of the last decade). As a result, for the first time in years supply is unable to respond to the surge in demand which is occurring as a result of both the spending of pent-up savings accumulated during the lockdowns and the extraordinarily expansionary tone of economic policy. This mismatch continues to manifest itself in delays in deliveries of all kinds of goods and the de-supply of many product categories as the pressure relief valve (inflation) begins to reach levels not seen in decades. At this juncture, we must also consider the fact that the current disconnect between global supply and demand will continue in the last two months of the year, given the traditional increase in consumption that occurs in this period.

The trade-off for economic policy, especially on the monetary side, is either to continue to bank on the flexibility of supply and, therefore, on the transitory nature of the price rallies, or to begin easing the tensions on the demand side by adapting the financial conditions to an environment which now bears little resemblance to that of a year ago. What is more, as is almost always the case in economics, the time variable is the key. If there is no radical change in consumer preferences, the most likely outcome is that supply will move to respond to the rise in demand. But how long will it take to do this? And how will investors respond during this adjustment period to the unfavourable inflation data?

For the first question there is currently no answer. As for the second, we are beginning to see movement in the financial markets after months anaesthetised by the monetary authorities' messages of tranquillity. Yield curves are experiencing a flattening of their slopes as returns on short-term maturities rise (the increases in longer maturities have been more moderate). In other words, the market continues to place confidence in the central banks' ability to meet inflation targets (otherwise, the slope of the curve would have steepened), but to this end it considers it necessary to make moderate adjustments to the financial conditions in the coming quarters. In fact, a good number of central banks in the OECD (the US, Australia, the United Kingdom, Canada and New Zealand) are already in the first phase of the monetary policy normalisation process. However, the ECB, which has just revised its monetary policy strategy this summer, prefers to take things more slowly with a wait-and-see approach, even if that means falling behind the curve of market expectations. In this new scenario which has emerged in recent weeks, investors now anticipate official rate hikes next autumn, while five-year euro area inflation swaps rose to 2.3%. Therefore, rightly or wrongly, the financial markets are beginning to anticipate the need for monetary policy to help close the gap between supply and demand. Indeed, this is a necessity if we are to avoid second-round effects on prices which could turn the transitory shift into a permanent one. That will mean reduced rates of public and private debt purchases before the end of the year and gentle interest rate rises during the course of 2022.

The reality is that the imbalances in the markets for goods and production factors are a reflection of the current situation in the international economy, at a time when a large number of countries have not yet recovered their lost GDP levels. In most cases (commodities, transportation of goods, etc.), these imbalances are global in nature and result from the uniqueness of the COVID-19 crisis, making it difficult to anticipate when they might fade. The question is whether economic policy should try to reduce these imbalances in the short term or continue to rely on the capacity of supply to respond and on consumption's return to «normality». The risk is that the current mismatch becomes entrenched until well into next year, which could alter the global economy's path to recovery.

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