Times of change for economic policy

The global economic scenario continues to face the effects of a triple shock on global supply (bottlenecks, war and zero-COVID policy) which is keeping commodity prices strained, continues to erode confidence among economic agents and has sent alarm bells ringing in the financial markets, with increased volatility and sharp price corrections. In spite of all the above and the scarcity of information published for Q2, it seems that economic activity remains in positive territory thanks to the good performance of the services sector, the continued strength of the labour market in a number of countries and the excess savings accumulated over the last two years. Uncertainty continues to weigh on the mood of business leaders and investors, but the business cycle is proving highly resilient, although there is still a long way to go until the end of the year.

In this context, central banks are now accelerating the tightening of financial conditions in an attempt to eliminate demand-side pressures, at least while supply remains subject to all kinds of obstacles. Interest rate hikes are becoming widespread (with some exceptions, such as Japan), as central banks seek to minimise the risk of second-round effects that is intensifying as core inflation approaches 5%, or even exceeds it in the case of the US. It is not easy to anticipate the behaviour of price dynamics in a scenario as unusual as the current one, with so many shocks interacting at the same time. The cooling of economic activity and the base effects on prices that are expected to materialise by the end of this year could significantly narrow the gap with the central banks' targets. However, this will probably not be enough, and in any case the risk is asymmetric, as it will not be easy to distribute fairly among the various economic agents (in the wage pact) a deterioration in incomes as pronounced as that which we are currently witnessing.

Therefore, the high uncertainty that continues to characterise the economic scenario will have a particularly marked effect on monetary policy, which runs the risk of going either too far or not far enough when tackling an unexpected problem, especially given the time needed for it to take effect. What is clear, however, is that in the short term it will not be easy for monetary policy to restore the balance between supply and demand. In any case, the monetary shift that has been taking place since the beginning of the year was indispensable in order to keep economic agents' price expectations in check, in a context of continued negative inflation surprises. In this environment, the main development in recent weeks is the shift in the ECB's strategy. Specifically, by anticipating rate hikes at both the July and the September meetings, it has reflected that the balance of risks was beginning to pose a clear threat to its medium-term inflation target. This early warning has served to stem the depreciation of the euro against the dollar, bringing it close to parity. In a world undergoing transformations of all kinds and in which, not so long ago, there was a veiled threat of a currency war, central banks seem to be once again taking the strength of exchange rates into consideration. Doing so has a positive effect on inflation and also helps instil confidence among investors, who have been heavily penalised since the beginning of the year by the corrections in both the bond and the equity markets, rendering the protection of traditional portfolio diversification strategies of little use.

With monetary policy heading at least towards neutral territory, which could lead to interest rates ending up in the 2.75-3% range in the US and in the 1.25-1.75% range in Europe, the big question is what role the fiscal side can and should play, and thus whether or not the economic-policy response will be balanced. After the logical initial response to the energy shock triggered by the war, budgetary policies seem to be in no man's land, stuck between the effects of the fiscal packages approved two years ago, doubts over the next steps to take in the short term and fears of the risk of fragmentation. This is to be expected, given that the monetary normalisation process will involve rewriting the rules of play and investors paying greater attention to fiscal solvency, as we are already seeing with the rise in Italy's risk premium. Similarly, although the Stability Pact will remain suspended in Europe next year, the recommendation is to return to a neutral fiscal policy (with spending growing less than potential growth) while the new rules that will come into force in 2024 are being shaped. In any case, maintaining a highly expansionary fiscal tone in a context like the current one would limit the effectiveness of monetary policy in dealing with the inflation problem. After all, historical experience tells us that it is good for monetary and fiscal policies to go hand in hand.

José Ramón Díez