Summer assignment

Having passed the year's half-way point, the effects of the mismatches between supply and demand on inflation continue to dominate the behaviour of the world economy, forcing both central banks and governments to adapt their roadmaps to the new reality. Thermometers such as Germany registering its first trade deficit in 30 years, the euro hitting parity with the US dollar and the re-emergence of the risk of financial fragmentation in Europe reflect the disruptions that the world economy is currently facing. In addition to the difficulties involved in tackling a challenge for which there are no precedents in the past four decades, we also face the complexity of incorporating the rising geopolitical tensions into the economic scenarios. All this comes at a time that is far from conducive to the coordination of economic policies that have been exhausted after the efforts made to deal with the pandemic.

The picture is particularly difficult for the central banks, as the price dynamics are gradually mutating, making it difficult to determine the appropriate dose when tightening the financial conditions in order to address the inflation problem while also minimising the collateral damage to growth and financial stability. Above all, it is becoming increasingly difficult to discern what portion of the price rally originates on the supply side and what portion on the demand side. Following the latest negative surprises, the feeling is that the price rallies are leaking into more components of the consumer price index basket, forcing an intensification of the monetary normalisation process, especially given that energy prices look set to remain high for longer than expected and that other supply problems (bottlenecks, labour market mismatches) will not disappear overnight. In the case of the ECB the task at hand is even more complex, as while the barrage of unconventional tools that were put in place to tackle the last two crises (PEPP, TLTRO, etc.) is dismantled, a new tool must be designed in record time to deal with the risk of fragmentation. What is more, not only will this new tool have to be flexible, but it will also have to be tied to certain conditions being met, incorporating measures that ensure the fiscal sustainability of the countries receiving support.

The erosion of economic agents' purchasing capacity as a result of rising prices, the central banks' tightening of the nut which has translated to the entire length of the interest rate curve and the impression that Russia could cut off gas supplies to Europe at any time have led to a deterioration in investor confidence, increased uncertainty and a downward revision of growth expectations. The question is whether this concern about what the autumn might bring could lead households to bring their purchasing decisions forward, taking advantage of their pent-up savings and thus giving the economy a boost over the summer months, or whether, on the contrary, its impact could be felt earlier through a deterioration in confidence.

In this delicate balance of certainties and expectations, the debate is whether the reduction in aggregate spending needed to contain the price tensions will end in a soft landing or, given the turbulent conditions that the business cycle is facing, we should expect a recession in the euro area and the US. Indeed, with double-digit inflation and such an accommodative starting point for monetary policy, there are few precedents to indicate how such strong inertia in prices can be contained without having a significant impact on economic activity. This is particularly the case in the US, where the members of the Fed are warning that monetary policy will need to be in restrictive territory in 2023, with interest rates above 3.5%. Following this move, the yield curve has inverted (2 years/10 years), reflecting expectations of a contraction in economic activity over the winter which would allow inflation to be tamed and would lay the ground for a new process of rate cuts, potentially even before the end of 2023.

In short, the debate in recent weeks has focused on assessing the likelihood of a global recession. However, we must bear in mind that a recession is more than just a phase of below-potential growth or a fall in GDP over a couple of quarters, because the drop in economic activity must be deep, lasting, widespread across the economy, and it must affect income, production and employment. It is true that the signs of slowdown are clear, and a new supply shock triggered by a cut in gas supplies to Europe would be the final blow to the business cycle. However, right now a global recession is by no means a certainty, at least as long as the labour markets remain strong and the financial markets continue to assimilate the shift in monetary policy in an orderly manner, that is, without an increase in instability. In this regard, one particularly important issue in the short term will be the design of the ECB's new tool, just as the most expansive monetary programme in Europe's history is being brought to a close. This is not a simple assignment during the height of the summer season for the European monetary authority.

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