Entering an area of turbulence

The tightening of financial conditions triggered by the actions of the central banks in recent weeks, the high uncertainty associated with a murky energy outlook, the rising financial instability and the early signs of a cooling in consumption all offer a glimpse of the obstacles that the business cycle will face over the coming quarters, especially in the euro area. The sudden shift in monetary policy that has occurred since the summer reflects the fact that tackling the inflationary pressures will require more than simply placing interest rates in neutral territory. This represents a major change in the assumptions on which the economic forecasts are based, particularly in Europe, and combined with the tensions in the gas market these developments demand a revision of the forecasts. In our case, we have revised our forecast for average euro area growth in 2023 down to 0.2% (1% in Spain), while we apply an upward revision of 1.4% to our inflation forecast, placing it at 5.1% (4.5% in Spain). This deterioration in the growth/inflation mix merely reflects the persistence of the significant imbalances between supply and demand, which are taking longer than expected to be diluted. The good news is that the gap ought to gradually narrow as the interest rate hikes cool demand and the bottlenecks are gradually cleared (something we are already seeing signs of). This in turn should lead to an improvement in the pattern of prices and economic agents' purchasing power beginning in the spring, especially if this cooling phase does not come at a significant cost in terms of jobs (as currently seems to be the case) and if economic policy can avoid contagion to the financial channel.

In this regard, it will be essential to maintain a balance between monetary and fiscal policy, while remaining aware that the financial markets will continue to be affected by high volatility and uncertainty in the coming months – a perfect breeding ground for episodes of increased financial instability, such as the one recently seen in the United Kingdom. The announcement of a mini-budget with significant tax cuts (amounting to 45 billion pounds), in a context of increased government spending to soften the blow of high energy bills, triggered a sharp correction in the sovereign debt markets and in the value of the pound – something more typical of an emerging economy than a market as liquid and established as the United Kingdom. It was only the Bank of England's intervention by announcing a two-week bond-buying programme, coupled with the British government's U-turn on the most controversial part of the measures, that calmed the waters. This episode reminded us just how easy it is to lose credibility, especially at the beginning of a government's term in office, often at a very high price in terms of risk premium. This should serve as a warning to the new government currently being formed in Italy.

So, with investor sentiment on tenterhooks, it seems that now is not the time for fiscal policy to throw stones in the path of the demanding process which the central banks are currently facing, especially when the monetary authorities' purchasing programmes are being wound down and variables such as the structural budget deficit will soon be back on the financial markets' radar. Thus, the phase of «Coffee for all» and «Do whatever it takes but keep the receipts» (IMF *dixit*) will give way to a fiscal policy of surgical precision aimed at helping the sectors and agents that are most vulnerable to the shifting financial and energy conditions, while trying not to compromise medium- and long-term budgetary balances. We are entering an area of turbulence, where volatility and uncertainty are on the rise, macroeconomic stability is back in focus and pilot error comes at a high price. It is at times like these that one appreciates the shelter provided by the euro's umbrella.

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