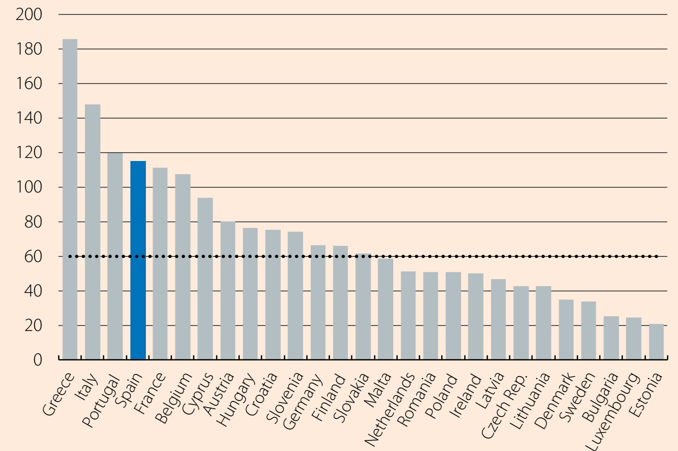
Winds of change

The starting point for the international economy in 2023, following the recent barrage of bad news, is all too familiar: heightened geopolitical risk, energy market disruptions, macroeconomic fragility, central banks' drastic response to the inflationary threat, and increased financial instability. This far from rosy picture is the result of the persistent imbalance between supply and demand that has been fuelled by the successive shocks we have faced in recent years (COVID, the war in Ukraine, bottlenecks, etc.). All this has driven the widespread rise in inflationary pressures and the sharp slowdown in growth which has been evident in the economic activity indicators since the summer. The big question is whether this process will culminate in a temporary drop in economic activity (a couple of quarters of negative growth) or whether we will face a deeper crisis that ends up affecting the labour market (stagflation?).

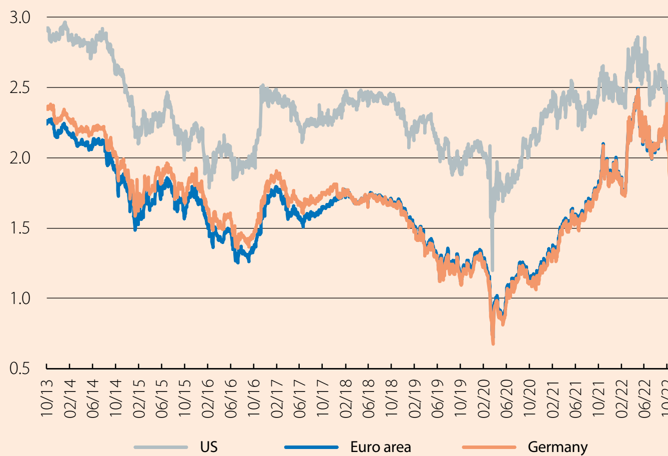
Public debt
(% of GDP)



Notes: *European Commission Spring Economic Forecast for 2022. The dotted line corresponds to 60% of GDP, the limit set by the European Treaties.*
Source: *CaixaBank Research, based on data from the AMECO database.*

Economic forecasting is a hazardous task at the best of times, but with the recent volatility in variables that are key to macroeconomic forecasting (energy prices, interest rates and exchange rates), the difficulty of incorporating geopolitical developments and their effects on expectations into the scenarios and, finally, the problem of gauging the monetary and fiscal policy response to the new challenges that are emerging almost daily, the task of making predictions for 2023 is proving particularly complicated. This is especially the case given that market sensitivity has been gradually increasing as global financial conditions have tightened over the past 12 months (+300 bps on average in advanced economies) – a trend spearheaded by the Fed, which after some initial hesitation has charged full steam ahead with no looking back.[1]

5y5y inflation swaps
(%)



Source: *CaixaBank Research, based on data from Bloomberg.*

Indeed, how this shift in monetary policy is digested by the markets, and thus the central banks' capacity (flexibility) to quell any episodes of financial instability, will be one of the key factors in determining the medium-term scenario. After all, the British mini-crisis which culminated in the resignation of Liz Truss has reminded us of the importance of fiscal policy being commensurate with the monetary challenge we face. Times are also changing for the optimal combination of economic policy that the economic situation demands. Ignoring budget tightening with a disorderly fiscal policy would distance us from the monetary authorities' target and increase the risk of financial accidents. In such a situation, the fiscal uncertainty could force the central banks to implement further interest-rate hikes, which would be akin to stepping on both the brake pedal and the accelerator at the same time, as the IMF reminded us at its latest half-yearly meeting.

Therefore, at a time when the goals of the fiscal and monetary sides are different, coordination between governments and central banks will emerge over the coming months as one of the key factors in determining how the business cycle will pan out in 2023. It is not easy to go from something resembling fiscal dominance to a regime in which short-term macroeconomic stability is once again a priority, especially with the noise that exchange-rate misalignments can generate. To a large extent, this process

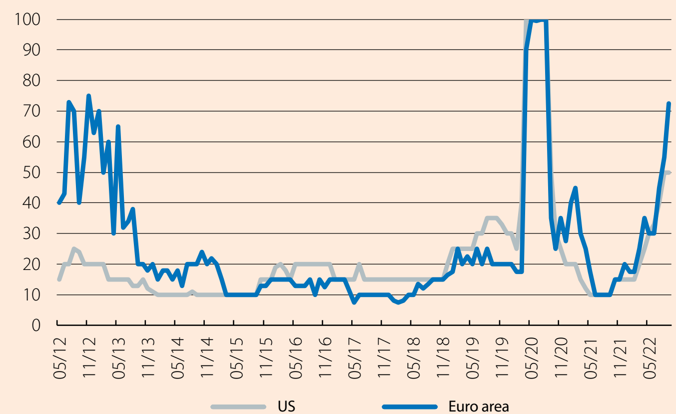
1. For further details, see the article «Is there light at the end of the tunnel? The outlook for monetary policy in 2023», in this same Dossier.

will determine the level at which the current cycle of rate hikes will culminate (the terminal rate), as well as how long it will take for inflation to once again converge on target rates.

In this context, the global economy could grow by 2.7% in 2023, with a sharp slowdown in average growth rates in both advanced countries (1% compared to 2.4% in 2022) and emerging economies (4% compared to 7% in 2022). With the current limited visibility, attempting to extrapolate what form the business cycle will take is a very difficult task. That said, it is logical to anticipate that the crisis will peak over the next six months for Europe, whereas in the case of the US the effects of the Fed's interest rate hikes are likely be felt more acutely in the spring, given the time it takes for monetary policy to affect economic activity. This cooling in demand in advanced economies up until the summer, together with the incipient improvement in the constraints on production, could lead to a gradual normalisation of the imbalances between supply and demand as the year progresses. This would allow for a moderation of inflation and a stabilisation of financial conditions, and it would lay the foundations for a return to potential growth rates beginning in the autumn of 2023, which are likely to be lower than those that existed prior to the pandemic. The question is what the short-term cost will be in terms of economic activity and jobs in order to tackle the inflation problem and, therefore, the fall in GDP over the next two quarters. This «sacrifice rate» will be determined by: the extent to which the energy commodity markets can be stabilised, central banks' credibility, and what happens with regards to second-round effects and thus whether the burden of the cost-of-living crisis we are seeing in so many countries can be shared equitably by increasing wages in line with inflation.

Probability of recession per the Bloomberg consensus

(%)



Notes: *Median among analysts participating in the Bloomberg consensus. Probability of recession in the next 12 months.*
Source: *CaixaBank Research, based on data from Bloomberg.*

The global economy will therefore continue to face major challenges in 2023, given the disruptive dynamics that continue to be present. With the unknowns regarding the performance of the Chinese economy and the evolution of the conflict in Ukraine, minimising the damage inflicted on the labour market by the current cycle of monetary tightening, as well as keeping the financial channel isolated from the noise, will be essential. It will be a year of transition, and the conditions must be laid for a return to a certain degree of normality beginning in 2024. However, there may be obstacles along the way, so economic policy must remain flexible and use surgical precision in order to make the most of an ever-shrinking margin for manoeuvre. In short, we will continue to be mired in that phase in which the old has not yet died and the new has not quite been born yet – hence the open debates on matters of such profound importance as: the suitability of current inflation strategies and targets, the role that China will play in the next decade, debt limits in the global economy, and the future of globalisation.

José Ramón Díez