Stagflation or permacrisis?

Geopolitical shock: a higher-risk environment on the horizon. In recent months, we have seen both supply- and demand-side shocks multiply, resulting in an economic scenario with higher inflation and lower growth than we were anticipating a few quarters ago. The legacy of the pandemic – bottlenecks, pent-up demand and a recovering labour market – has been compounded by the outbreak of the war in Ukraine, the resulting energy shock and restrictive monetary policies, with the fastest cycle of interest rate hikes in decades in economies such as the US and the euro area. In this environment, the word stagflation re-entered our lexicon. However, what perhaps better defines the current environment is the high degree of uncertainty and an international context in which geopolitical tensions have returned to centre stage. So far this year, the geopolitical risk (GPR) index has reached 160 points. Since 1985, on an annual average, only between 2001 and 2003 had the index exceeded 150 points. So it is no surprise that the British Collins dictionary has named «permacrisis» (an extended period of instability and insecurity) as the word of the year.

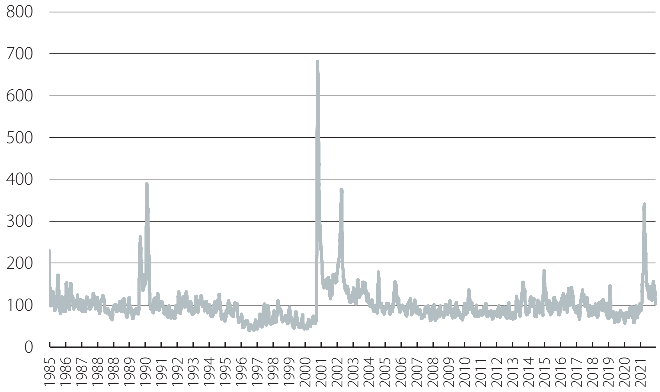
Energy shock: persistently high gas prices. One of the main factors shaping the current scenario is the energy crisis. In November, the average spot price of gas per the main European benchmark (TTF) fell to €118/MWh (–15% compared to October). This moderation was supported by the high levels of reserves across the EU, which were at around 92% of capacity at the end of November (compared to an average level at the same time of year of 82% over the last five years), as a result of the high substitution of imports and reduced consumption. However, this decline occurred in a month with relatively warm temperatures and, in any case, prices are still 44% higher than a year ago and six times higher than the historical average (around €20/MWh). In addition, futures contracts continue to point to prices above €100/MWh in the next two years, suggesting that the high energy prices will continue to constrain business and household activity.

Inflationary shock: is the peak finally behind us? As a result of the moderation in energy prices, headline inflation in the euro area stood at 10.0% in November (versus 10.6% in October), the first decline since mid-2021. Core inflation (excluding energy and food) remained stable at 5.0%. In the US, inflation continued to moderate in October (the latest available data), with the headline index falling to 7.7% (versus 8.2% in September) and the core index down to 6.3% (6.6% in September). This cooling of inflation may support a moderation in the pace of the interest rate hikes by the Fed and the ECB. It is still too early to declare that inflation has peaked, and there will likely be volatility in the data, but we can expect to see a gradual moderation during the course of 2023. In particular, the base effects themselves, the greater stability of energy prices, the easing of the bottlenecks, the cooling of economic activity and the limited second-round effects should, on the whole, allow for a correction of the imbalances between supply and demand and, thus, support a gradual reduction in inflation next year.

Supply shock: the downside risks have moderated. In the euro area, the composite PMI figure (47.8 in November versus 47.3 in

Global: geopolitical risk (GPR) index

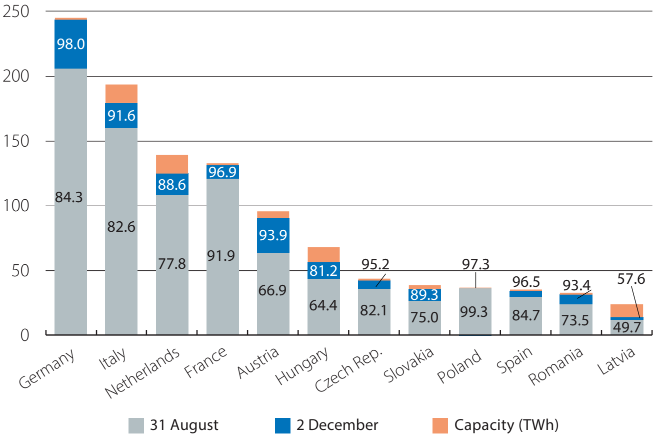
Level (100 = average for the period 1985-2019)



Note: *The chart shows the 30-day moving average. The geopolitical risk index is built using newspaper articles by searching for keywords related to geopolitical risks. A higher index value indicates increased geopolitical risk.*
Source: *CaixaBank Research, based on data from D. Caldara and M. Iacoviello (2022). «Measuring Geopolitical Risk», American Economic Review, April, 112 (4), pages 1194-1225 (data downloaded from https://www.matteoiacoviello.com/gpr.htm on 12 December 2022).*

Europe: gas reserves

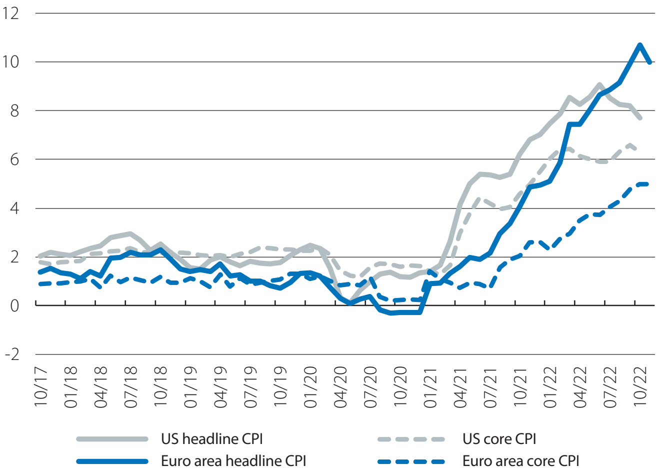
Storage level (TWh and % of total capacity)



Note: *The chart shows the sum of the percentages corresponding to the storage levels at each date, relative to each country's total capacity.*
Source: *CaixaBank Research, a partir de datos de Gas Infrastructure Europe.*

US and euro area: CPI

Year-on-year change (%)



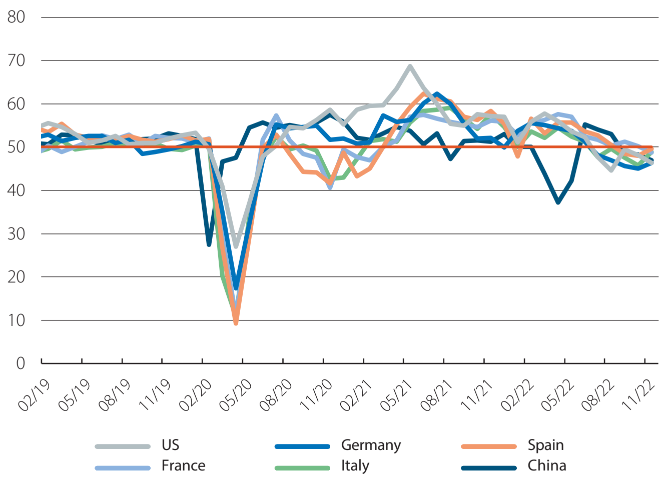
Source: *CaixaBank Research, based on data from the Bureau of Labor Statistics and Eurostat.*

October) was better than expected, albeit consistent with a slight contraction in GDP in Q4. The improvement was concentrated in the manufacturing PMI (which climbed from 46.4 to 47.1 in November), which could reflect the normalisation of supply chains. On the other hand, the services PMI remained unchanged, and also in contractionary territory (48.6 points). The publication of the Ifo Business Climate Index for Germany in November underscores this same message. Despite a slight increase in November (from 84.5 to 86.3 points), the data are consistent with a decline in economic activity. On the other hand, in the US, the data also showed signs of a cooling in activity. In particular, the manufacturing ISM in November was below 50 points for the first time since May 2020, while in the labour market the pace of job creation slowed to 263,000 jobs, a relatively high figure but lower than in October.

Food shock: emerging economies in a vulnerable situation. As the World Bank recently pointed out, food price inflation has exceeded headline inflation in 90% of the 156 countries with available data. Developing and emerging economies are particularly vulnerable, with around 90% of them experiencing food inflation in excess of 5%. Despite the recent price moderation, the risks remain high. The deterioration in the geopolitical environment, and the war in Ukraine in particular, is the number one concern. However, the global environment of higher inflation and higher interest rates is also a major source of risk, as it exerts upward pressures on food costs due to the higher commodity prices, wages, and capital costs. The World Bank also notes that the percentage of the world's population in a situation of food insecurity will continue to rise, exacerbating all the adverse effects which such a situation generates in the long term.

Succession of shocks in China: the health restrictions will continue to hold back the economy. Economic activity in China continues to show signs of weakness in Q4. As the country struggles to contain the largest new outbreak of COVID-19 cases since the beginning of the pandemic, and while the authorities are debating the zero-COVID policy, economic activity is showing clear signs of slowdown. China's official composite PMI suffered its fifth consecutive fall in November, dropping to 47.1 points (versus 49.0 in October). In addition, the latest surge in cases is the one that poses the greatest risks since the first wave due to its geographical extension: over 100 cities have reported cases in recent days (compared to around 50 in April). The low level of vaccine coverage, coupled with the lack of capacity in the health system, make it difficult to imagine a steady reopening of the Chinese economy over the coming months (see the Focus «China's symptoms: more than COVID» in this same report). Although signs have emerged of a concerted effort to introduce flexibility into the country's health policy, there is still a long way to go. The low immunity of the population poses a major obstacle for the sustained reopening of the economy, and relatively severe restrictions are most likely to be required to contain the pressure on the health system in the short term. Moreover, the experience of the reopening process in other Asian countries shows that mobility rates take over six months to return to normal.

Global: composite PMI
Level



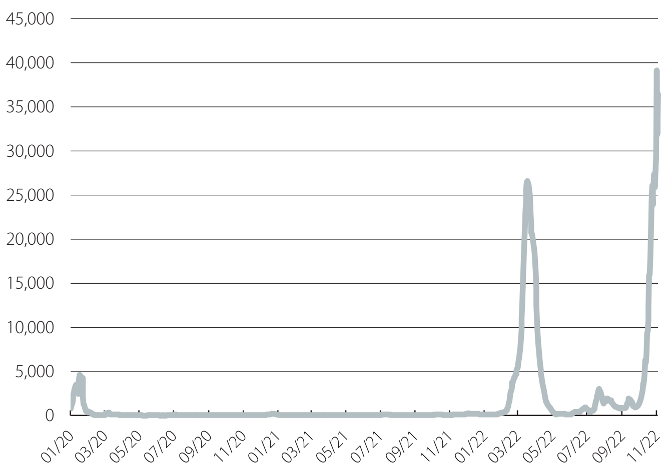
Source: *CaixaBank Research, based on data from PMI Markit, via Refinitiv.*

Global: food price inflation
Year-on-year change (%)

Country	Nominal food inflation	Country	Real food inflation
Zimbabwe	321%	Zimbabwe	52%
Lebanon	208%	Lebanon	46%
Venezuela	158%	Iran	32%
Turkey	99%	Sri Lanka	20%
Argentina	87%	Rwanda	17%
Sri Lanka	86%	Hungary	15%
Iran	84%	Colombia	15%
Rwanda	41%	Uganda	15%
Suriname	40%	Turkey	13%
Laos	39%	North Macedonia	13%

Notes: *The table shows the top 10 countries with the highest food price inflation (real and nominal). Real food price inflation is calculated as food inflation minus headline inflation.*
Source: *CaixaBank Research, based on data from the World Bank's latest food security update (November 2022).*

China: new confirmed cases of COVID-19
Daily cases (7-day average)



Source: *CaixaBank Research, based on data from Johns Hopkins University, via Our World in Data.*