Flexibility in times of uncertainty

The publication of the Q1 economic data has confirmed that the economy made it through the winter without the dreaded cooling of activity. Annualised global growth (around 3.5%) was above potential and the most optimistic expectations. This was thanks to the continued strength of the labour market and of household and company balance sheets, the recovery of economic agents' expectations, the revival of the Chinese economy following its reopening and, finally, the positive effects of the decline in oil and gas prices in recent months. The economic dynamics have been favoured by the reduction of the mismatches between supply and demand, and this return to a certain degree of normality after the continuous disruptions of the last 36 months (the pandemic, supply chain issues, geopolitical risk, etc.) has allowed the business cycle to navigate the obstacles of the past few months better than expected.

But now is no time for complacency, as new challenges are emerging on the horizon. We are entering a different phase in which some of the problems of the previous one will continue to weigh down the economy. After all, the other side of the coin of the recent good performance in economic activity remains the uncertainty surrounding what will happen with inflation, given that the signs of improvement are still incomplete. Visibility in the medium-term outlook for price movements is limited, as beyond the improvements in general terms due to base effects, the underlying trend continues to show downside resistance. The key in the short term will be how the monetary tightening process is transmitted to inflation, but also to financial stability, and this will test the dual objective of the central banks. For now, the results from the credit surveys show that the interest rate hikes are already being reflected both in the supply and, especially, in the demand for financing from businesses and consumers. This suggests that we could see a cooling of consumption and investment in the second half of the year. The intensity of this reduction in demand and its ability to bring inflation back down to the 2% target in the medium term will determine whether or not the central banks' pause before the summer will be definitive. After the meetings of the first week of May, that time seems to have come for the Federal Reserve, while in the euro area we can expect to see one or two more 25-bp rate hikes before the ECB takes a well-deserved rest.

All this is framed within a more flexible approach to monetary policy implementation and is subject to the evolution of the economy, allowing the central banks to respond to any unexpected surprises in either the economic or the financial sphere. With regards to the latter, we continue to see the embers of the turbulence in March, when both the weaknesses in the business models of some regional US banks and the design failures in their regulation and supervision were revealed. Such sharp and intense interest rate rises constitute a demanding stress-test for banks with vulnerabilities in their solvency and/or liquidity. The acquisition of First Republic by JP Morgan, which in theory should have marked the beginning of the end of the first episode of financial instability in this monetary tightening cycle, has not entirely cleared the doubts surrounding the state of some small and medium-sized banks in the US. This has reinforced the view in the markets that the Fed will be forced to lower interest rates starting in the summer. That said, it seems too early to declare that we will see rate reductions so soon, judging by the messages from the central bank's board of governors. What investors and the Fed do agree on is the high probability of there being a decline in US economic activity by the end of the year, judging by the sharp reversal of the slope of the yield curve between 3 months and 10 years and the conservative growth forecasts given by the US monetary authority's staff.

In short, after a much better-than-expected start to the year, the strength of the global economy will be tested once again in the coming months. The flexibility and coordination of economic policy in the face of these new challenges will determine the capacity of the current business cycle to overcome them. To give just one example, just around the corner we will see how the US debt ceiling is managed.

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