Forecasts in an unstable economy

The last few years have provided a dose of humility for economic prediction exercises. The string of shocks – varying widely in nature – has caused distortions in key variables such as growth and inflation, while the economic scenarios have had to be calibrated with hypotheses related to the evolution of the pandemic and the effects of the war on commodity prices, all of which has increased the degree of uncertainty in the forecasts. In a short space of time, economists have had to brush up on their knowledge of energy markets, take a crash course on the economic effects of epidemic diseases and put geopolitical risk back on the radar, all while trying to understand the nature and consequences of the mismatches between global supply and demand. Along the way, the intensity and duration of the inflationary episode which originated in early 2021 and the resilience of the business cycle to all kinds of disturbances were underestimated; so too, therefore, was the flexibility of households and businesses to overcome the successive obstacles emerging on the horizon. This ability of modern economies to adapt, as well as the tailwinds provided by extraordinarily expansive monetary and fiscal policies, explains the better-than-expected economic performance we have seen in recent months.

These signals are still present as we approach the end of the first half of the year, as the international economy is moving along at an acceptable cruising speed, albeit with divergences between countries and economic sectors. While headline inflation readings continue to improve and doubts remain regarding price behaviour in the medium term as the signs regarding a possible reduction in core inflation measures are inconclusive (especially in the food and services components) and this sheds little light on how the current cycle of interest rate hikes will end. The good news is that behind this pattern in the main economic variables lies a correction of many of the imbalances between global supply and demand, which demonstrates that economic policy transmission channels continue to operate and that the bottlenecks that were distorting production have cleared. That said, there is a feeling that this adjustment is still incomplete.

In this context, with the first episode of financial instability apparently stifled, there is an upward revision in the growth forecasts for this year, reflecting the fall in commodity prices since the summer, the better-than-expected economic activity data over the winter, the strength of the labour market and the improvement in agents' expectations. In our case, we have raised our economic activity forecasts for 2023 for the euro area (0.9% vs. 0.5%), Spain (2% vs. 1.3%) and the US (1.2% vs. 0.9%), although in all cases we have slightly lowered our forecasts for 2024 due to the delayed effect of the cumulative rise in interest rates.

Specifically, once the energy outlook has cleared, the main risks to the baseline projections are the behaviour of core inflation and the course of monetary policy, as well as the extent to which a tightening of the latter could trigger new episodes of financial turbulence like those we experienced in March. All in all, with fiscal policy converging towards neutrality, the key will lie in how central banks manage their dual mandate (financial stability versus price stability). That said, the main negative surprise of recent months has been the difficulties that the manufacturing sector is experiencing in breaking free from its recent sluggishness, which is affecting global trade and is clearly apparent in the economic data of countries such as Germany, where growth has been negative for three of the last four quarters. Moreover, this weakness has come at a time when industrial policy is in the midst of adapting to the new geostrategic challenges, a trend led by the US with the approval of the IRA (Inflation Reduction Act), which marks a turning point for the framework for transatlantic economic relations. In short, despite the encouraging signs of recent months, the international economy will continue to operate in an unstable equilibrium within the forecast horizon.

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