AN INCOMPLETE RECOVERY AMID UNCERTAINTY: FROM THE PANDEMIC TO THE RISE IN INFLATION AND THE OUTBREAK OF WAR

1 Introduction

The supply chain disruptions, the pick-up in inflation and, in 2022, the war in Ukraine have hampered the global economic recovery that followed the most acute phase of the pandemic. In the last two years, events on various levels with an impact on global economic activity have successively unfolded at a rapid pace. The restrictions on movement and contact, introduced to contain the pandemic, gave rise to a steep decline in activity in the spring of 2020 without precedent in recent history. The gradual lifting of those measures allowed a progressive recovery to begin in the summer of that year which was, nevertheless, stymied over the course of 2021 by a number of factors. These include the rise in the price of numerous commodities (mainly energy commodities) and the emergence of disruptions in global supply chains (bottlenecks), which have fuelled a sustained and sharp upturn in inflationary pressures. The Russian aggression against Ukraine in February 2022 has cast a dark shadow over the economic outlook and exacerbated price pressures in an environment marked by unusually high levels of uncertainty.

The gradual path of recovery of activity throughout 2021 was, in any event, highly uneven across geographical areas and sectors of activity. In the advanced economies, the swift roll-out of vaccines made it possible to cope with the successive waves of COVID-19 using only targeted restrictions rather than having to reintroduce pandemic containment measures with more adverse effects on economic activity. This gradual improvement in the epidemiological situation, together with the effectiveness of economic policies, has allowed many of these countries to reach their pre-crisis output levels. By contrast, in a large number of emerging economies the pandemic continued to hinder economic activity owing to the slow pace of vaccination. One factor that would explain the difference in progress, in both advanced and emerging market economies, is the sectoral composition of activity. Specifically, the countries that are lagging further behind tend to coincide with those where services in which personal interaction plays a major role (such as tourism-related services) account for a large share of the productive structure.

At the global level, supply was not able to respond quickly enough to the recovery in demand. The gradual lifting of the restrictions gave rise to a relatively swift revival of demand, aided by the broad support provided by macroeconomic policies. But global output did not react as quickly, largely because of the complexity of supply chains, which involve very distant providers in geographical terms that operate to order and with low stock levels. In particular, shortages of intermediate goods and the lack of means of transport disrupted these very fragmented supply chains at different stages, highlighting their fragility. More recently, these difficulties have been compounded by some countries' zero-COVID policies.

A salient feature of macroeconomic developments since the beginning of 2021 was the rise in commodity prices, particularly energy prices. The ultimate causes of this rise are not easy to disentangle, as discussed in Chapter 3 of this report. As noted above, this is due partly to the rigidity of the supply of some intermediate goods (including energy) following the recovery in demand and partly to the role of gas both as a primary source of energy and in electricity generation, particularly in the European context. As the invasion of Ukraine has tragically highlighted, gas markets are subject to geopolitical vagaries in terms of both cost and security of supply.

Since last year, this increase in commodity prices and the disruptions in supply chains have been leading to a surprisingly steep and persistent upturn in inflation across all geographical areas. Given the a priori temporary nature of the phenomena that originated it, initial assessments of the rise in input costs underlined their probable transitory nature. However, as these cost increases have grown sharper and longer-lasting, firms have started passing them through to their final prices. Moreover, since energy is a direct part of households' consumption basket, the higher energy prices are leading to a decline in the purchasing power of these agents. A potential full pass-through of firms' costs to their final prices and of energy consumer prices to wage growth would set in motion a price-wage feedback loop that would prolong inflation, with the ensuing loss of well-being.

Against this backdrop, the global macroeconomic outlook in early 2022 was moderately optimistic. Now that the Omicron variant has been overcome, the course of the pandemic appears to be having less of an impact on economic activity, particularly in the advanced economies. And, although persistent inflation and bottlenecks were emerging as a growing risk for the sustainability of the recovery, it was still considered that these factors would lose steam over the course of the year.

But Russia's aggression against Ukraine has drastically altered that scenario. The invasion is a shock of major proportions, with adverse consequences in terms of weaker economic growth and greater inflationary pressures. The complex channels through which this global economic disruption could materialise can be grouped into four categories, although they are not strictly independent from each other.

The most relevant channel is probably that related to the importance of Russia and Ukraine as global commodity producers. Europe's dependence on some of these commodities, such as gas, is very high. And although Spain is less dependent on them, it cannot escape rising prices on global markets. Furthermore, the war has raised the possibility that gas supplies could be interrupted, in response to which it would be difficult to find alternative suppliers in the short term. In addition, the war is affecting the supply of some agricultural commodities that are key to feeding the world's population and of some metals that play a central role in the production of certain goods, such as technological products and motor vehicles.

Second, the war is having a highly significant adverse effect on economic activity through its impact on private agents' confidence. Uncertainty about the duration and the actual course of the war and, therefore, about developments in household and corporate incomes tends to make these agents postpone their consumption and investment decisions.

Third, world trade could be substantially impaired. Spain's direct exposure to the two countries at war is small, but the indirect impact stemming from other more exposed economies and from the adverse effects that are arising in the production chains of some goods could be much more relevant than the direct effects. And there is a risk that these exposures will be exacerbated, in way that is not easy to anticipate, by the trade and financial sanctions introduced.

Lastly, there is a potential financial channel that could transmit the shock to the real economy. For the time being the financial effects, both globally and for Spain, have been small, in terms of both financial flows and their cost. However, the heightening of the inflationary process could have significant implications on monetary policy stance in the advanced economies, resulting in tighter financial conditions worldwide. Nor can it be ruled out that the effects will become more relevant in the future, particularly in the context of the possible implications of excluding Russia from global financial channels.

This extraordinarily uncertain setting makes it difficult to formulate macroeconomic projections. The most recent Banco de España projections, dating from early April, foresaw GDP growth of 4.5% in 2022 assuming no further escalation of the war, meaning that its biggest macroeconomic impact would be felt in 2022 Q2.[1] This high growth largely owed to the remarkable economic buoyancy at end-2021, which implied that the rate would remain high (at 3.1%) even if activity were to remain at its end-2021 level throughout 2022. Under this scenario, average inflation in 2022 would stand at 7.5%, the highest consumer price inflation rate in Spain since 1986.

That baseline scenario is subject to downside risks to GDP growth and upside risks to inflation. Part of those risks have already materialised, according to the information published after the projections cut-off date. Estimated GDP growth in 2022 Q1 has been lower than expected, automatically leading to a significant downward revision of average growth in 2022. Additionally, except for the energy component, consumer prices have recently recorded higher growth than anticipated by those projections. Besides the data already observed, the risks going forward

1 See Box 1, "Macroeconomic projections for the Spanish economy (2022-2024)" in the Quarterly Report on the Spanish Economy, *Economic Bulletin* 1/2022, Banco de España.

would be linked, above all, to the possibility that the fallout from the war could be more persistent and far-reaching, for example in terms of further commodity price increases or a complete halt in trade flows between the European Union and Russia. Moreover, activity and inflation would also perform more unfavourably in a scenario in which firms and workers tried to preserve their margins and wage levels in real terms, respectively, as this is not feasible in the face of a shock that entails a loss of income for the domestic economy vis-à-vis the rest of the world. An upside risk to activity would be the possibility that households will avoid reducing their consumption of goods and services in response to the lower disposable income by using the savings they accumulated during the pandemic. This possibility is moderated by the fact that lower-income households, where energy goods account for a larger share of the consumption basket and which are therefore more affected by energy price increases, were barely able to build up such savings buffers during the health crisis.

In the current setting, economic policies have a crucial role to play. Like other central banks, the European Central Bank (ECB) has begun a process of monetary policy normalisation. In an extraordinarily uncertain scenario, and provided that euro area medium-term inflation expectations remain anchored around its 2% target, the ECB has emphasised that its monetary policy response will depend on the performance of economic indicators, in addition to being gradual and maintaining all of the optionality and flexibility provided by its various instruments. In particular, the ECB Governing Council has insisted that it will take whatever action is needed to fulfil its price stability mandate and to safeguard financial stability.

Fiscal policy in Spain must continue to cushion the effects of the successive shocks of the last two years, but must act selectively and through temporary measures, given the high government indebtedness and the resulting limited scope for action. Following the increase in government debt in the wake of the pandemic, there is barely any budgetary room for manoeuvre. This calls for a very selective and temporary use of such measures, to avoid passing on an excessive burden to future generations and, more worryingly, compromising fiscal sustainability. This need to act in a selective manner makes it all the more advisable to rely on direct grants to support the agents most affected by the energy price increase rather than implement across-the-board price discounts, which are costlier and do not provide the right incentives to reduce consumption of these goods.

The nature of the most recent shocks makes an incomes agreement between firms and workers a particularly appropriate instrument for addressing them. As noted above, the rise in the cost of imported commodities entails a loss of income for the domestic economy, the sharing out of which should be agreed in the context of social dialogue. The agreement, whether explicit or tacit (as seems to have been the case so far), should be based on the premise that a wage-price spiral would entail an additional income loss for the domestic economy owing to the loss of external competitiveness and, therefore, a decline in net exports vis-à-vis the rest of the world.

In addition, pan-European policies can make a very relevant contribution. Current challenges obviously transcend national borders and can be more appropriately addressed through a joint European response. The war provides an opportunity to deepen integration in the continent, even if it has been partly missed due to the failure so far to mutualise the fiscal policy response.

Lastly, the war makes an additional geopolitical argument for decarbonising the Spanish and European economy. Far from pushing concerns about the consequences of climate into the background, the security of energy supply has made transitioning to renewable energy sources that reduce external dependence even more necessary. Chapter 4 of this Annual Report analyses the energy transition challenge for the Spanish economy.

2 The firming of the economic recovery and the rise in inflation at the global and euro area levels

The recovery in global economic activity firmed in 2021 and over the first months of 2022, although growth in this period slowed temporarily and even more so after the invasion of Ukraine by the Russian army in late February. World GDP rebounded by 6.1% in 2021 (see Chart 1.1.1), after the 3.1% decline in 2020, thanks to headway in the vaccination process (which enabled the health restrictions to be eased and bolstered consumer and business confidence) and to continued economic policy support. However, the recovery had a very volatile profile and lost some momentum from late 2021 onwards, as the pandemic worsened in some regions (owing to the emergence of new COVID-19 variants), bottlenecks in global supply chains persisted[2] and, as described in detail in Chapter 3 of this Annual Report, inflation picked up significantly mostly owing to higher energy and food prices.

By geographical area, the pace of economic growth proved uneven. Among the major economies, GDP growth in 2021 was 5.7% in the United States, 5.3% in the euro area and 7.4% in the United Kingdom. China grew by 8.1% in the year as a whole, although it experienced a marked deceleration in 2021 H2 as a result of the slowdown in the residential real estate sector and the imposition of strict health measures in response to fresh COVID-19 outbreaks. Among the emerging economies, the recovery was particularly strong in emerging Asia and Latin America,[3] with GDP growth rates of 7.3% and 6.8%, respectively. However, growth in the latter region's two largest economies (Brazil and Mexico) was dampened in 2021 H2 by the upsurge in inflation, the monetary policy tightening, the course of the pandemic and the persistence of bottlenecks.

2 See Kataryniuk, Del Río and Sánchez-Carretero (2021) and Alonso, Kataryniuk and Martínez-Martín (2021).

3 See Reports on the Latin American economy at https://www.bde.es/bde/en/areas/analisiseconomi/enfoque/americalatina/