

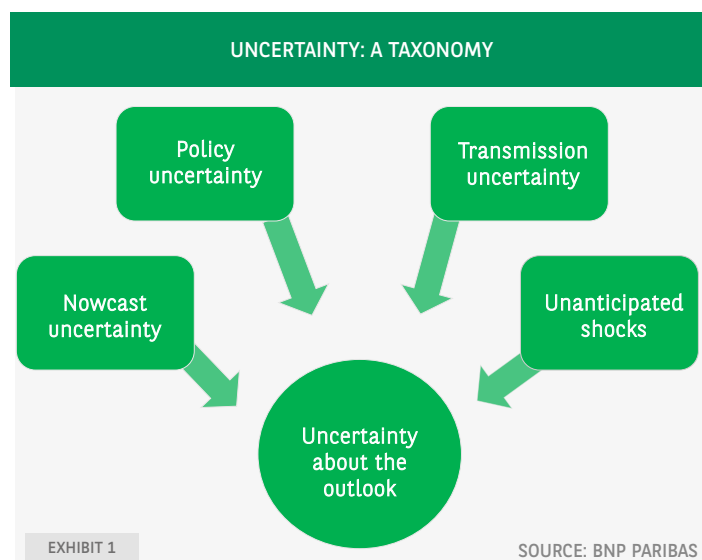
## FROM INFLATION TO GROWTH: THE MIGRATION OF UNCERTAINTY

Recently, the word uncertainty has been frequently used by the Federal Reserve and the ECB in their communication. It is something they must take into account when taking policy decisions. Likewise, households, firms and investors face different types of uncertainty. That of not exactly knowing the current state of the economy, uncertainty about future economic policy and monetary policy in particular, uncertainty about the transmission of past shocks -including interest rate hikes- and the risk of events -geopolitical, climate-related, etc.- that would have economic repercussions. Every month, the European Commission asks firms and households how difficult or easy it is to make predictions about their future business or financial situation. The balance of opinions captures their economic uncertainty. It seems that, until recently, inflation has been the dominant source of uncertainty but going forward, economic growth should take over this role as the attention will shift to the delayed impact of past increases in official interest rates.

The word uncertainty is omnipresent in recent central bank communication. At the Federal Reserve symposium in Jackson Hole at the end of August, Fed Chair Jerome Powell said that *"there is always uncertainty about the precise level of monetary policy restraint"*, adding that the assessment of the appropriate monetary stance is *"further complicated by uncertainty about the duration of the lags with which monetary tightening affects economic activity and especially inflation."* Also, some shocks to supply and demand in this cycle have been unique and have introduced uncertainty about whether the ensuing dynamics will persist or not<sup>1</sup>. ECB President Christine Lagarde mentioned uncertainty five times in her Jackson Hole speech, emphasizing that *"monetary policy should not itself become a source of uncertainty"* and that central banks should *"talk about the future in a way that better captures the uncertainty we face"* in order to maintain their credibility<sup>2</sup>.

In summary, households, firms and investors face four different types of uncertainty (*exhibit 1*). The first one consists of not exactly knowing the state of the economy. Households may worry about the risk of losing their job, firms may wonder about the strength of customer demand, etc. We can call this 'nowcast uncertainty', i.e. the difficulty of producing a reliable assessment of the current state of the economic and business environment. A second type of uncertainty concerns economic policy, particularly monetary policy at the current juncture: will official interest rates be hiked further and, once the terminal rate has been reached, how long will they stay there? Closely related is the question about the lagged response of the economy to past shocks, monetary and other. The shocks caused by the pandemic, the war in Ukraine, the jump in inflation may still make themselves felt. The lags of monetary policy transmission are also long, variable and impossible to estimate with any precision. This underpins uncertainty about the outlook<sup>3</sup>. Fourth and finally, uncertainty is also influenced by the risk of shocks -geopolitical, climate-related, etc.- that would have economic repercussions.

In the context of its business and consumer surveys, the European Commission has developed an economic uncertainty indicator. To this end, survey participants are asked how difficult or easy it is to make predictions about their future business or financial situation<sup>4</sup>.



The charts show the evolution of the uncertainty indicators in recent years in different business sectors as well as for households. Unsurprisingly, the dynamics across industry, services, retail trade and construction are very similar. In 2020, the Covid-19 pandemic caused a jump in uncertainty, which subsequently declined. Last year, the war in Ukraine caused another jump, again followed by a reduction in uncertainty. Consumer uncertainty also increased in reaction to these events, but the biggest jump occurred in the latter part of 2022.

The European Commission surveys allow to explore whether the evolution of uncertainty is related to changes in the economic environment and outlook. To this end, the charts to the left compare the uncertainty indicator with the evolution of business/household confidence. *A priori*, one would expect a negative correlation. This is the case for households but for business, the correlation was negative when the pandemic struck and when the war in Ukraine started, whereas since the second half of last year, uncertainty has been declining alongside business confidence.

<sup>1</sup> Source: Inflation: Progress and the Path Ahead, Remarks by Jerome H. Powell, Chair Board of Governors of the Federal Reserve System at "Structural Shifts in the Global Economy," an economic policy symposium sponsored by the Federal Reserve Bank of Kansas City, Jackson Hole, Wyoming, 25 August 2023.

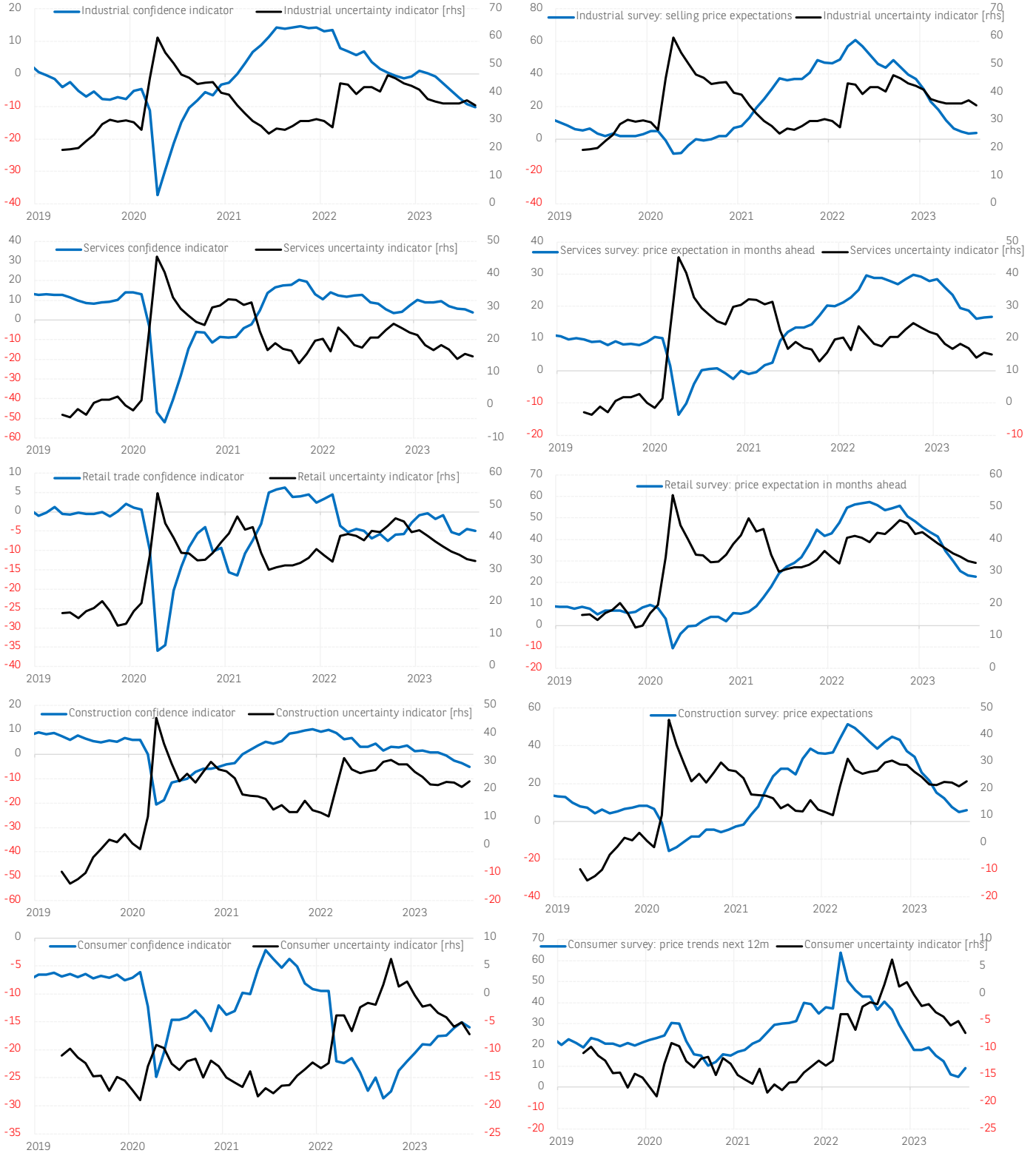
<sup>2</sup> Source: Policymaking in an age of shifts and breaks, Speech by Christine Lagarde, President of the ECB, at the annual Economic Policy Symposium «Structural Shifts in the Global Economy» organised by Federal Reserve Bank of Kansas City in Jackson Hole, Jackson Hole, 25 August 2023.

<sup>3</sup> The latest account of the ECB's governing council reported that its members "felt that it was important to look for further evidence on whether the latest deterioration in the growth outlook reflected the impact of monetary policy measures or could also be due to residual effects of the pass-through of earlier shocks or longer-lasting structural issues weighing on the supply side." Source: ECB, Account of the monetary policy meeting of the Governing Council of the European Central Bank held in Frankfurt am Main on Wednesday and Thursday, 26-27 July 2023.

<sup>4</sup> The indicator shows the balance of the answers. For more detail, see European Commission, The Joint Harmonised EU Programme of Business and Consumer Surveys User Guide, update January 2023.



EUROZONE: CONFIDENCE, INFLATION OUTLOOK AND UNCERTAINTY



CHARTS

SOURCE: EUROPEAN COMMISSION, BNP PARIBAS



BNP PARIBAS

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