EDITORIAL

INTRINSIC INSTABILITY

The global economy faces a long list of uncertainties -growth, inflation, interest rates, political, geopolitical, tariffs, etc. When uncertainty is exceptionally high, as is the case today, the economic environment becomes intrinsically unstable and may evolve suddenly and drastically. This acts as an economic headwind because companies that are highly exposed to these sources of uncertainty may postpone investment and hiring decisions. This may weigh on household confidence, triggering a reduction in discretionary spending. Financial markets may also become more volatile because investors shorten their investment horizon. There is a clear urgency of creating a predictable policy environment.

When discussing the inevitable uncertainties of the economic outlook, central bankers or economic commentators in general, often refer to the balance of risks. ECB President Christine Lagarde stated in her press conference in December that risks to growth remain tilted to the downside.[1] In the US, Fed Chair Jerome Powell recently commented that the FOMC sees the risks to achieving its employment and inflation goals as being roughly in balance.[2] These statements are useful but they only tell us something about the risks that would tip the balance in one or another direction or that would keep each other in check. They do not convey information about a more fundamental question, which is the degree of uncertainty. Is it higher or lower than normal? At the current juncture, we can safely say that it is exceptionally high. The list of uncertainties is long: will the euro area see stagnation rather than subdued growth? Will inflation reaccelerate in the US due to measures taken by the Trump administration (tariffs, deportation of illegal immigrants, tax cuts)? Will the Fed hike rates this year instead of cutting them? Will US import tariffs be raised across the board or only on a selective basis? How will geopolitics influence the economic and market outlook? Will Wall Street continue to ignore the rise in Treasury yields?

Uncertainty is challenging because it forces us to take decisions without having all the relevant information. When uncertainty is abnormally high, the decision challenge increases exponentially. To illustrate this point, let us assume that economic growth depends on the level of inflation, long-term interest rates and the exchange rate. Suppose that when uncertainty is at a normal level, three outcomes can be considered for each variable. For growth, this implies that 27 (3^3) outcomes are possible, depending on the specific combinations of inflation/bond yields/the exchange rate. When uncertainty is higher than normal for each variable, the range of outcomes is wider. Suppose we now need to distinguish between five possible cases. That would imply that 125 (5^3) growth outcomes are possible. Admittedly, some or even many can be excluded (e.g. when inflation surprises to the upside, it is unlikely that bond yields would surprise to the downside). However, the feedback loops between the different variables mean that coming to grips with all the interconnections soon becomes excessively complex.

With this in mind, it is appropriate to label the current global economic environment as intrinsically unstable. To a large degree this is due to political, geopolitical and economic policy uncertainty.[3] An obvious example is the prospect of import tariff increases in the US and the retaliatory measures that other countries would take, which significantly increase the uncertainty that surrounds inflation and growth forecasts. Intrinsic instability does not imply that bad outcomes are inevitable. It simple reflects a situation that may evolve suddenly and change drastically. This uncertainty acts as an economic headwind because companies may postpone decisions that are irreversible -think of major investment projects-, preferring to wait until a clearer picture emerges. However, such caution comes with a cost because postponing a project means that the contribution to a company's profits will be missed -the opportunity cost of waiting- and there is also a risk of losing ground vis-à-vis competitors if the latter have implemented their investment plans. Clearly, the exposure to the source of uncertainty matters and in case of import tariffs, export-oriented companies will react differently than companies focusing on the domestic market. Geopolitical uncertainty also matters and empirical research shows it has a detrimental impact on US companies.[4] During periods of high macroeconomic uncertainty -which clearly is a broader concept than geopolitical uncertainty- US and European firms reduce hiring.[5] [6] Concerns about a worsening labour market and the risk of job loss may in turn weigh on household confidence and spending on a broad range of items such as health care, personal care products and services, recreation, holiday packages and luxury products.[7] Finally, in financial markets, investors may adopt a shorter investment horizon and show increased sensitivity to data surprises, implying an increase in volatility, which in turn also comes with an economic cost. To conclude, one couldn't agree more with the European Commission who, in a recent analysis of the consequences of uncertainty, stated that "ensuring a predictable policy environment and avoiding costly policy reversals are essential to foster a climate conducive to consumption and especially investment, ultimately enhancing the growth potential."[8]

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1 Source: ECB, Press conference, Christine Lagarde, President of the ECB, Luis de Guindos, Vice-President of the ECB, Frankfurt am Main, 12 December 2024.
2 Source: Federal Reserve, Transcript of Chair Powell's Press Conference, 18 December 2024.
3 Christine Lagarde speaks about self-inflicted uncertainty: "*Uncertainty about the actual political evolution, depending on elections, appointments or whatever, in several member states. That is self-inflicted uncertainty that we have nothing to do with, but which is caused by the current political situations. Things will, again, probably come to resolution, and we will see better the economic consequences of those decisions.*" Source: see footnote 1.
4 Source: Dario Caldara and Matteo Iacoviello, Measuring Geopolitical Risk, American Economic Review 2022, 112(4): 1194–1225. For a broader overview, see: William De Vijlder, Global economy: the economic consequences of geopolitical uncertainty, BNP Paribas, Ecoweek, 30 October 2023.
5 Source: Uncertainty and Labor Market Fluctuations, Soojin Jo and Justin J. Lee, Federal Reserve Bank of Dallas working paper 1904, 2 July 2019.
6 Uncertainty and firms' labour decisions. Evidence from European countries, Marta Martínez-Matute & Alberto Urtasun, Journal of Applied Economics, 2022, pp. 220-241.
7 Source: The effect of macroeconomic uncertainty on household spending, Olivier Coibion, Dimitris Georgarakos, Yuriy Gorodnichenko, Geoff Kenny, Michael Weber, IZA – Institute of Labor Economics, discussion paper 14213, March 2021."
8 European Commission, The cost of uncertainty – new estimates, European Economic Forecast, Autumn 2024.