The economic recovery: slower, with risks, but also hopeful

Which risks and challenges are currently keeping economists up at night? IESE's Juan José Toribio and Pedro Videla point to supply bottlenecks, fiscal deficits, instability in the bond market and China. And while our recovery is slower than previously expected, there are reasons for optimism ahead.

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It's not long COVID, but the economic recovery from our worldwide COVID-19 crisis is slowing down, with GDP not expected to return to the pre-COVID levels of 2019 until 2022 for the United States and the European Union. Make that 2023 for Spain and the United Kingdom. After lower-than-expected world output for 2021, the Purchasing Managers' Index (PMI) -- an important indicator for prevailing trends in manufacturing and services -- points to a decelerated recovery process for the next year.

In an online session with alumni on October 28, 2021, professors Juan José Toribio and Pedro Videla discussed the economic risks and challenges to watch now.

Supply bottlenecks in mining and energy, as well as pronounced issues with logistics (port congestions, freight costs and driver shortages), have caused the first supply-and-demand simultaneous exogenous shock in economic history. This situation is leading to large increases in prices, as measured by Consumer Price Indexes (CPIs), in both advanced and emerging economies in the latter half of 2021.

Fiscal deficits have skyrocketed, with government programs -- such as the U.S. CARES Act for coronavirus relief, the EU Solidarity Fund (EUSF) and national furlough and state aid programs -- requiring trillions in government spending, with further commitments on infrastructure and climate change to come. The result is that public debt relative to GDP is increasing to levels not seen, in some cases, since World War II.

Much of this debt has been bought up by central banks worldwide, bloating assets held by the U.S. Federal Reserve System and the European Central Bank (ECB), and creating financial **instability in the bond market**.

China

Pressures toward *de*globalization are intensifying, with the Biden administration declining to ease tensions with China inherited from the Trump era.

Meanwhile, China's growth is weakening due to a combination of clean energy commitments, which are constraining production; an overreliance on real estate; and a government withdrawal from state-owned enterprises. Longer term trends, such as a move toward more value-added rather than labor-intensive production in coastal areas, are also taking a toll on near-term growth.

That said, the PMI data from China indicates a strong recovery in the latest quarter, in contrast to European figures. And China's 2022 GDP is projected to be 117% higher than

2019 levels.

Next steps

Governments worldwide now face the following policy challenges: 1) avoiding inflation; 2) stabilizing or reducing government debts; and 3) consolidating government budgets to return to normal deficits. This three-pronged challenge is happening amidst growing opposition from populist movements, especially in South America, where a slew of upcoming elections may reflect people's discontent over particularly brutal lockdowns and subsequent negative outcomes for poverty and equality in the region.

Some governments may be tempted to encourage a certain amount of inflation as a way to reduce their stock of debt in relation to GDP and increase nominal growth rates. However, such a move comes with risks of fiscal dominance, the loss of central bank independence, and the possibility of stagflation -- a phenomenon not seen since the 1970s.

Hope for 2022 and beyond

Nevertheless, there are reasons for optimism: The International Monetary Fund (IMF), having revised its projection
s for 2021 downwards, is signaling that it is more optimistic about world output for 2022, with negative output gaps indicating excess capacity. Inflation is expected to ease worldwide from the first quarter of 2022 and be contained over the medium term. Indeed, some mineral prices are already falling, along with the prices of copper, iron ore, lead and gold.