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Recession Risks

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Falling economic indicators

A number of economic indicators last week pointed to the increasing risks of growth or recession. High inflation is dampening purchasing power and rising interest rates are already hitting the interest-sensitive segments of the US economy, for example the construction industry.

The preliminary purchasing managers' indices for the month of July showed a decline in all countries (Australia, Japan, Germany, France, Eurozone, UK, USA). Of concern is the decline in the overall number (aggregate of manufacturing and service sectors) in Germany (48), the Eurozone (49.4) and the US (47.5) below the 50 mark. A value below this mark indicates that business in the sector concerned contracted compared with the previous month, while values above 50 signal growth.

In the USA, several housing market indicators (NAHB Housing Market Index, housing starts, building permits, existing home sales), the Philadelphia Fed's business outlook survey and the Conference Board's leading indicator index fell further. In the Eurozone, the European Central Bank's bank lending survey showed a significant tightening of lending standards and consumer sentiment continued to fall. On the market side, in the US the benchmark 10-year yield is below the 2-year yield for the third week in a row (0.22 percentage points).

High inflation

Inflation rates remain surprisingly high. Last week, it was the United Kingdom's turn. Consumer price inflation rose 0.8% month-on-month to 9.4% year-on-year in the month of June. In line with this, the Bank of England's (BoE) Governor Andrew Bailey signaled a 0.5 percentage point rate hike in August. Since December 2021, the BoE has already raised the key interest rate five times from 0.1% to a total of 1.25%.

ECB ends negative interest rate policy

Late, but nevertheless, the European Central Bank (ECB) has also begun to exit its ultra-expansive monetary policy stance. Last Thursday, the ECB raised its three key interest rates by half a percentage point each. Of particular note was the increase in the discount rate from -0.5% to 0%. This marks the end of the negative interest rate policy that has been in place since 2014. The increase was more pronounced than had been signaled in June. For the future, the ECB signaled further hikes, but the forward guidance was softened. There is no indication of the extent of the rate hike for any particular ECB meeting. Interest rate decisions in the future will depend on the data situation.

Transmission Protection Instrument

At the same time, a new instrument was introduced by the ECB: the Transmission Protection Instrument (TPI). According to the ECB, the TPI can be activated to counter unwarranted, disorderly market dynamics that pose a serious threat to the transmission of monetary policy throughout the euro area. There are no restrictions on the amount or duration of purchases. Some eligibility criteria for the TPI have been mentioned, essentially based on a country's overall fiscal position, but the operational implementation is unclear. When an increase in the country credit risk spread is unwarranted, i.e., not consistent with a deterioration in the macroeconomic environment, is ultimately subjective. The most obvious case is when spreads rise sharply in one country (for example, Spain) because there is deterioration in another (for example, Italy).

Fed rate hike

A hike of another 0.75 percentage points to 2.5% (upper band) is expected for the Fed's interest rate decision tomorrow, Wednesday. Particular attention will be paid to whether the Fed incorporates the increased risks to growth into the rationale for interest rate policy.

Inflation expectations

Whether high inflation is a short-term or long-term development depends crucially on the development of inflation expectations. There is a growing body of academic research suggesting that inflation expectations are significantly influenced by past inflation developments. When inflation is low for a long time, people care little about it. However, when it is at an elevated level for some time, inflation becomes an important issue. Inflation expectations can then rise permanently because inflation has risen. This is referred to as adaptive expectation formation, i.e. an expectation formed from past values.

The current risk thus lies in an inflation spiral. In this context, the US labor cost index for the 2nd quarter is in focus this week. In the first quarter, labor costs already rose by 4.5%.

Monetary policy and economic growth

Central banks try to prevent an inflationary spiral by raising key interest rates. The aim of higher interest rates is to weaken economic growth, i.e. demand, to such an extent that inflationary pressure falls. Central banks want to manage a soft landing. In the past, however, key interest rate hikes have often triggered a recession.

Monetary policy and inflation

The problem with a restrictive monetary policy is that there are many uncertainties in the relationship between interest rates and inflation. Among other things, it could be that structural factors such as demographics and (de)globalization as well as external shocks (pandemic, energy and food prices) have a major impact on inflation developments and that monetary policy has surprisingly little influence on inflation developments.

Political uncertainty in Italy

In Italy, Prime Minister Mario Draghi has resigned. Early elections have been called for September 25. The rise in political uncertainty is particularly damaging in the current situation. The path for the development of government debt has thus become more uncertain (consolidation, stabilization or further increase). On the geopolitical level, cohesion in Europe vis-à-vis Russia could weaken.

Geopolitics and energy security

At the level of energy security, the resumption of gas supplies from Russia via Nord Stream 1 means that there will be no immediate rationing. Immediately, therefore, there will be no additional event that dampens economic activity. However, the risk of this remains for the second half of the year.

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He holds a degree from a polytechnical college and studied economics and business at Vienna University with a special focus on financial markets. He holds a CFA charter and participated from 2001 to 2003 in the doctoral programme for finance at the Center for Central European Financial Markets in Vienna.

From July 1997 to June 2007, he worked in research at CAIB, Bank Austria Creditanstalt, and UniCredit Markets & Investment Banking. His last position was as Executive Director for Fixed Income / FX Research and Strategy. He was responsible for research on asset allocation at Raiffeisen Zentralbank (RZB) in Vienna from July 2007 to February 2008.