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INTERNATIONAL ECONOMIC SITUATION REPORT

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INTRODUCTION

The (unexpected?) financial instability that unfolded a few weeks ago was the latest element hindering everyone, and particularly the central banks, in their assessment of the economic situation in the West and, with it, the following decisions to be made.

The persistence (and even recent rise) in core inflation, the strength of the labour market, the upward course of wages and corporate profits, the fear of repeating the mistakes of the last century's 70s, or the cuts in oil production by OPEC+ are factors that would demand the cycle of monetary tightening to continue for a while, along with the recovery of some fiscal discipline, also given the levels of accumulated public debt. On the other hand, just the opposite would be called for by subdued economic growth, the loss of purchasing power due to two years of (very) excessive inflation, the perception that rate hikes are beginning to have an effect in certain areas, such as real estate, or the risk of a severe credit squeeze given the instability of the situation and the recent difficulties of part of the banking system on both sides of the Atlantic. This debate will be covered extensively throughout the sections of this second 2023's *Quarterly Report*.

We shall begin devoting the *Spotlight* to the proximate cause (along with the ineptitude in the affected institutions' management and the rapidity of transmission of any turbulence at present) of the financial problems in the United States: the dizzying rise in long-term interest rates (and corresponding fall in bond prices) over the last year and a half. We should not lose sight of the fact that apart from the cost to multiple investors' positions (not just banks), in a highly indebted world, rising debt can have severe consequences beyond those already being felt in many developing countries.

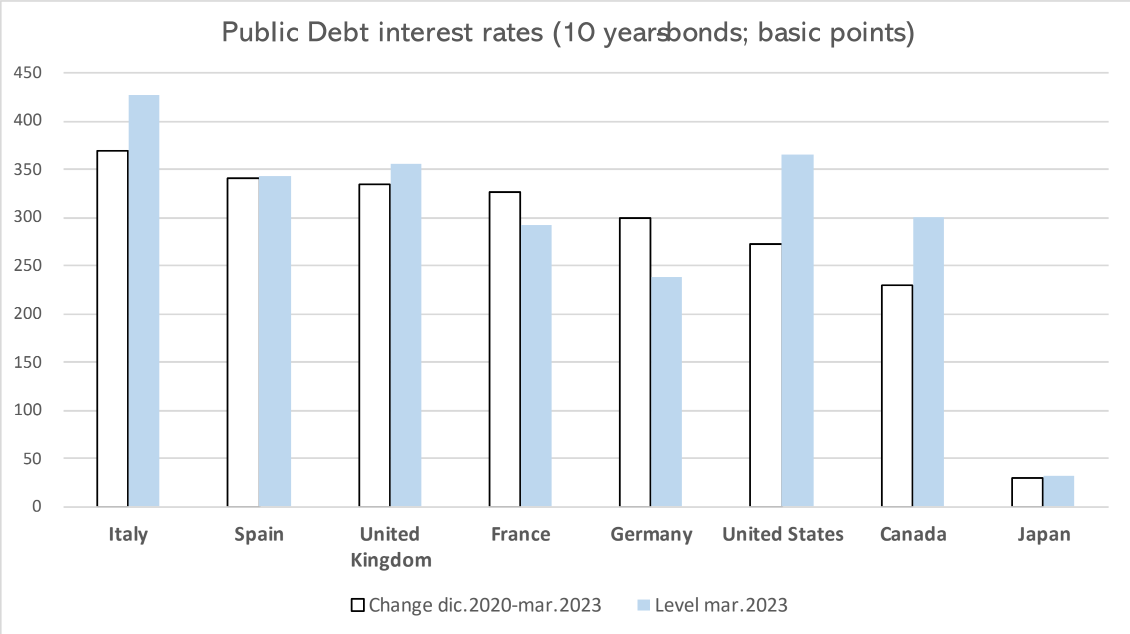
In the *International Reference Prices* section, as usual, we will review recent developments in interest rates (more and more Central Banks are ending the interest rate upward cycle), commodities (whose downward course is starting to be passed on, with the expected months of delay, to final consumers) and the main international currencies (with the dollar suffering slightly from the problems in the US banking system).

In *Understanding the Quarter in Seven Keys*, we will focus on some of the several aspects that underpin the two opposing positions mentioned in the first paragraph of this Introduction. We will discuss the still strong labour market, but also the weakened mortgage market, how to correct (or not) the unmistakable monetary policy asymmetry (and its consequences) of the past quarter century, how unanticipated inflation does seem to have some beneficiaries or about the particular moments experienced in places such disparate as Japan or Nigeria.

Lastly, in the section *The World in Two Variables*, we will present the evolution of global public and private debt levels since the beginning of the 21st century, whose upward trend (both in the emerging and developed world) has forced the International Monetary Fund and the World Bank, in their biannual meetings, which coincide with this *Report*'s elaboration, to seriously warn about this evolution and its potentially negative consequences, something which, indeed, the follower of these pages would have been able to read here previously.

With this fourth *Quarterly Report*, produced within the framework of the *Valenciaport Chair of Port Economics*, we wish to continue to provide its readers with the keys to understanding the complex and unstable situation of the current world economy.

II.- SPOTLIGHT: sooner or later, it was bound to happen



Source: Own elaboration. Data: OECD; National Central Banks

Multiple factors contributed to explaining the continued reduction in long-term interest rates in developed countries over the past quarter-century. Some of these factors had a nearly structural profile, such as the excess of global savings compared to investment levels (if there is more supply than demand for funds, the cost of funds is reduced) or price stability (expected inflation, which allows compensating the investor for their loss of purchasing power, is one of the factors that influence the interest rate on long-term debt).

However, in recent years, when Western public debt, first that of countries with greater credibility and then the rest, first at moderate maturities, then even that issued at 30 years, reduced its cost to levels close to zero and even negative[1], it was not only reasonable but necessary to anticipate that sooner or later, that scenario should change, with extraordinarily negative implications. Because ultimately, everyone is aware that interest rates of that calibre represent a loss for the investor if the bond is held until maturity. Therefore, this debt is only acquired to be sold in the secondary market to those who expect even lower rates, that is, even higher prices[2]. Again, these buyers acquire it to resell it to the next in the chain. Hence, it is traded not based on the asset's intrinsic value but on the possibility of early resale at a higher price. In other words, the exact definition of a bubble. One of the most significant distortions generated by the extremely loose monetary policy of the last fifteen years (more on this in our *Quarter's Keys*) has been nothing less than a massive bubble in the Western public debt markets.

[1] Up to $18 trillion of government bonds with interest rates below zero at their peak at the end of 2020.
[2] Opposing movements in interest rates and bond prices are one of the keys to the functioning of financial markets.

Indeed, not only monetary policy influenced the collapse of public debt interest rates, with their zero reference rates and massive purchases of such debt. Factors such as high uncertainty during the period or secular demographic ageing tend to generate more savings and demand for safe assets, such as Western government debt. And, of course, the new banking regulation arising from the Great Recession affected the need to increase banks' capital and liquidity, which, inevitably, has resulted in a decade of public debt accumulation by the entities under the obligation to do so. It is a shame that everyday regulation did not perform its task, with the reduction of the regulatory perimeter (in the United States[3]) and the failure to consider adverse scenarios regarding interest rate movements in the famous (and seemingly not very stressful) stress tests.

And then came the inevitable rise in interest rates. Belatedly, as has been stressed many times in these *Reports*, where the non-transitory rise in inflation has also been reflected upon. A very rapid rise in interest rates as a consequence. The paper losses on all this debt acquired at rock-bottom rates were potentially enormous. The actual ones, for the bonds held to maturity, smaller but still with many billions of dollars cost, for example, to Central Banks (see our *Quarter's Keys* from this year's *January Report* on this subject).

However, if you are forced to sell because of a massive withdrawal of deposits not covered by the public guarantee and affected by the panic, and you have no other assets, paper losses materialise, especially if you have been incompetent enough not to have structured any hedging against this eventuality (the rise in interest rates, which, by the way, had already been underway for a year when the crisis broke). Silicon Valley Bank (SVB) is a prime example of the debacle, with a few other banks down, many affected, and more waiting to avoid materialising the estimated 700 billion in potential losses in Treasury securities in the US alone due to monetary tightening. Still, best not to comment on the similar implications of declines in the non-residential real estate market, for example.

There is a conviction that, with improved regulation, these cases, or the very different one of Credit Suisse, are isolated episodes, and there will not be a generalised contagion that threatens the overall Western economy. For the moment, this seems to be the case. Just as it seemed to be after the first banking problems in 2007 and the spring of 2008. The system collapse only came in September 2008. Let us hope that history does not repeat itself, but regulation, at least in the United States, does not seem to guarantee this.

A final note. The bailout. "Too big", "too interconnected" ...; there is always an adjective to justify bailing out a bank. Now this saving public intervention is because SVB is "too strategic". If we let Silicon Valley's tech sector go under (half of California's tech start-ups were SVB customers, and their deposits would have been lost without the federal guarantee), only China stands to gain, the argument of the advocates of public intervention goes.

It is ironic (and hypocritical) that those who have loudly demanded such a bailout are none other than (almost all) the champions of the tech world and the capitalists who

[3] It is at least surprising that, in the wake of the recent crisis, 2,200 European banks were subject to Basel III regulations, while only 14 American banks were, under the not-so-innocent argument of excessive compliance costs for local, state and sectoral banks, which reduced that regulatory perimeter from 2018.

finance them, precisely those who are always calling for a diminished role for the state in the US economy. Long live moral hazard! Who will be prudent if it is timidly regulated and will be bailed out in the face of any problems resulting from its actions?

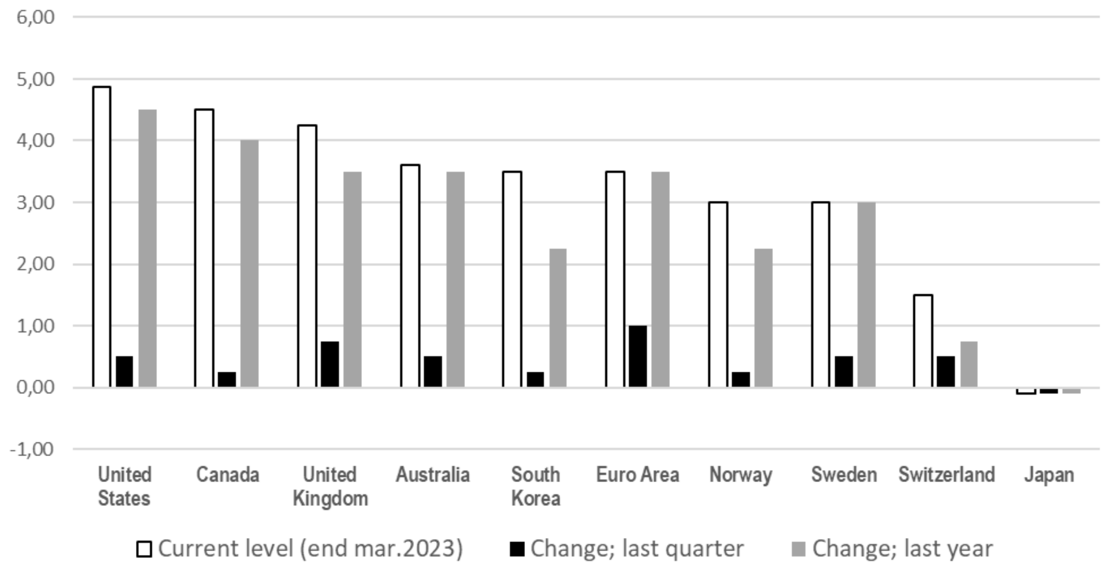
Of course, there is another perspective. If extreme monetary policy generates massive distortions in markets, including government bond markets, if regulators force banks to buy that debt as a guarantee of stability, and if those same authorities relax regulatory criteria for highly questionable reasons, is it not logical that those who have implemented those policies should be the ones to come to the rescue?

Better still, how about avoiding further extreme monetary exercises, widening the regulatory perimeter again, adjusting micro and macro supervision to changing circumstances, always erring on the side of caution, and making it clear that there will be no more "too much [+ adjective]"? That may be too much to ask.

III.- INTERNATIONAL REFERENCE PRICES

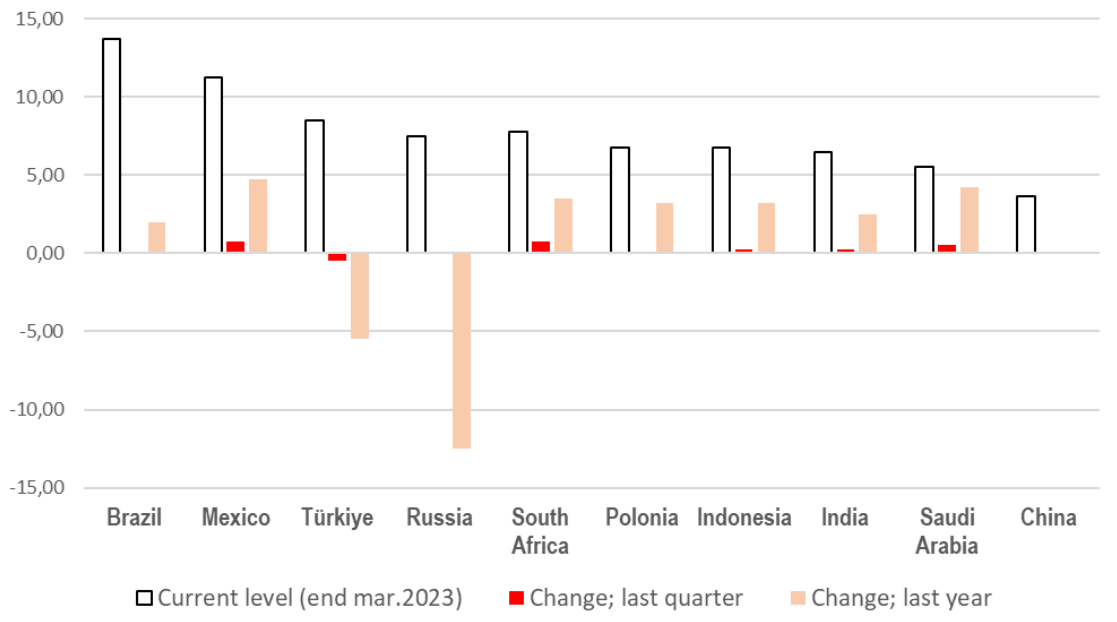
A.- Main interest rates

Graph III.1.- Main interest rate (%; selected Developed Economies´ Central Banks)



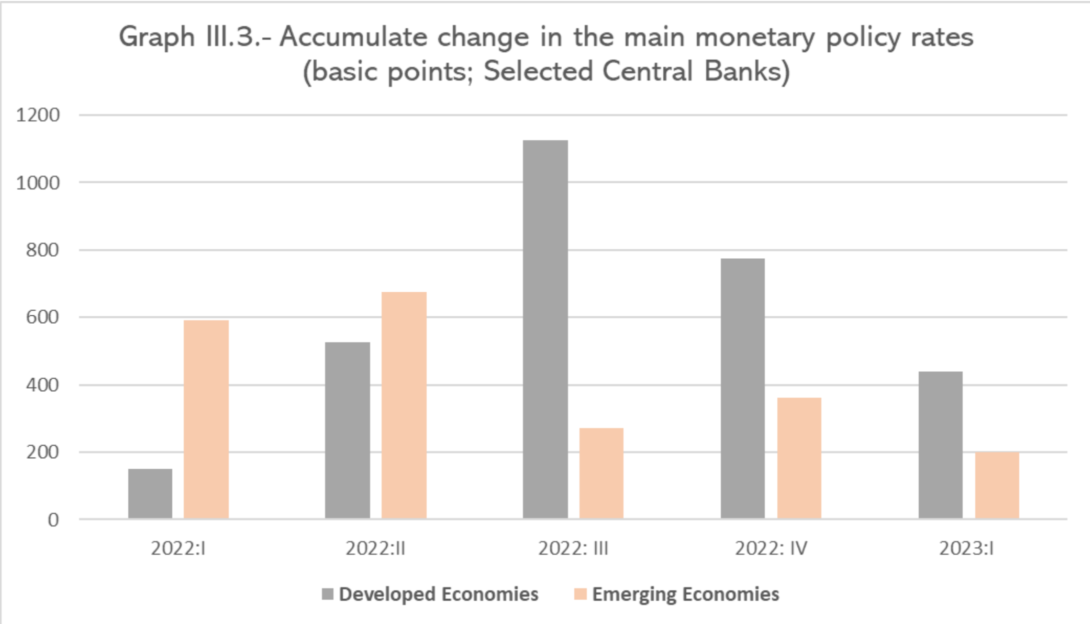
Source: Own elaboration. Data: National Central Banks.

Graph III.2.- Main interest rate (%; selected Emerging and Developing economies´ Central Banks)



Source: Own elaboration. Data: National Central Banks.

The Graphs above, like usual in this *Report*'s section, reveal the changes in monetary policy in the major developed and emerging countries, both in the last quarter and in the last year, precisely the moment when the Western monetary authorities finally decided to change the tenor of their policies (note that the current level of interest rates in developed countries is the result of the increases in the last year). Apart from Japan (we will return to the Japanese situation in our *Quarter's Keys*), Türkiye (subject to the parallel reality set by its President) and Russia (with monetary decisions, like the rest, conditioned by the war in Ukraine), the Graphs show both the intensity of monetary tightening and its progressive easing.



Source: Own elaboration. Data: National Central Banks.

Graph III.3 shows more clearly the aggregation of all the monetary policy changes made by the twenty central banks commonly used in this section, those shown in the previous two Graphs, over the past five quarters[4]. Three aspects stand out: first, policymakers in the emerging world reacted more promptly to inflationary pressures than their Western counterparts. Indeed, in several cases, they had already introduced rate hikes in 2021, hikes absent in the West. As a result, they have also slowed monetary tightening earlier. Second, the cumulative intensity of the increases in the West has not been seen in more than four decades (3000 basis points in five quarters among only nine Central Banks, given the stoic immobility of the Bank of Japan). Third, the pronounced inverted U-shape of the movements of interest rates for developed countries is further evidence of the acute delay in changing the monetary cycle, forcing tough and fast monetary decisions in the second half of 2022.

With the intense debate outlined in the *Introduction* to this *Report*, with factors that continue to suggest the need for further interest rate hikes and others that would justify an immediate halt to increases, we can expect the second half of 2023 to mark the end of the tightening cycle in the West and even the beginning of some easing, albeit very limited, in some emerging economies.

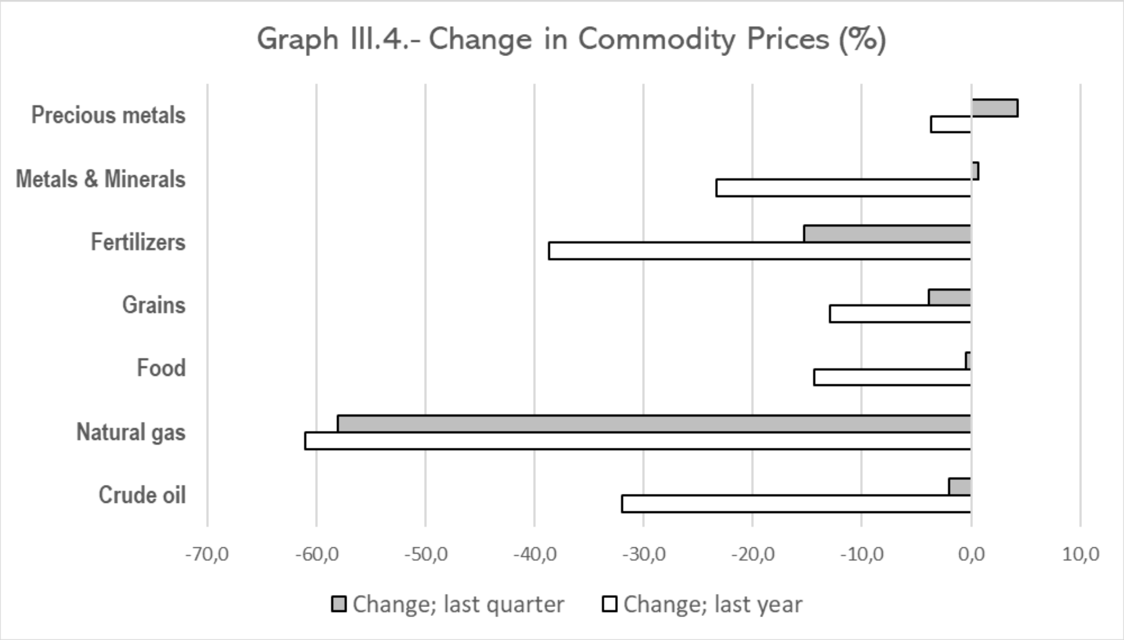
We will reflect on what lies ahead in the medium-term future in the *Quarter's Keys*.

[4] The increases, first and then decreases, of more than 1,000 basis points implemented by the Russian Central Bank in the wake of the invasion of Ukraine have been excluded from the calculations because they bear no relation to what would have occurred in a normal situation.

B.- Raw material prices

The process of the soaring commodity price increases sharp correction of 2021, and the first half of 2022 continues. As Graph III.IV shows, this fall in prices is generalised for all the major groups of raw materials and, in most cases, is between 15 and 30% in the last year, although the fall in the price of natural gas is concentrated in the last quarter.

The progressive resolution of the difficulties in the supply chains' functioning and lower demand pressure explain this generalised price decline. Nevertheless, the return to normality in China is already boosting demand in some categories, with Metals and Minerals prices already showing signs in this direction. As we pointed out in our previous *Report*, it takes some time for these downward movements in international markets to be passed on to the end consumer. Such a pass-through is already clearly perceptible in energy and should start to be seen in the second quarter of 2023 concerning food. Undoubtedly a relief in a generally complex economic environment.



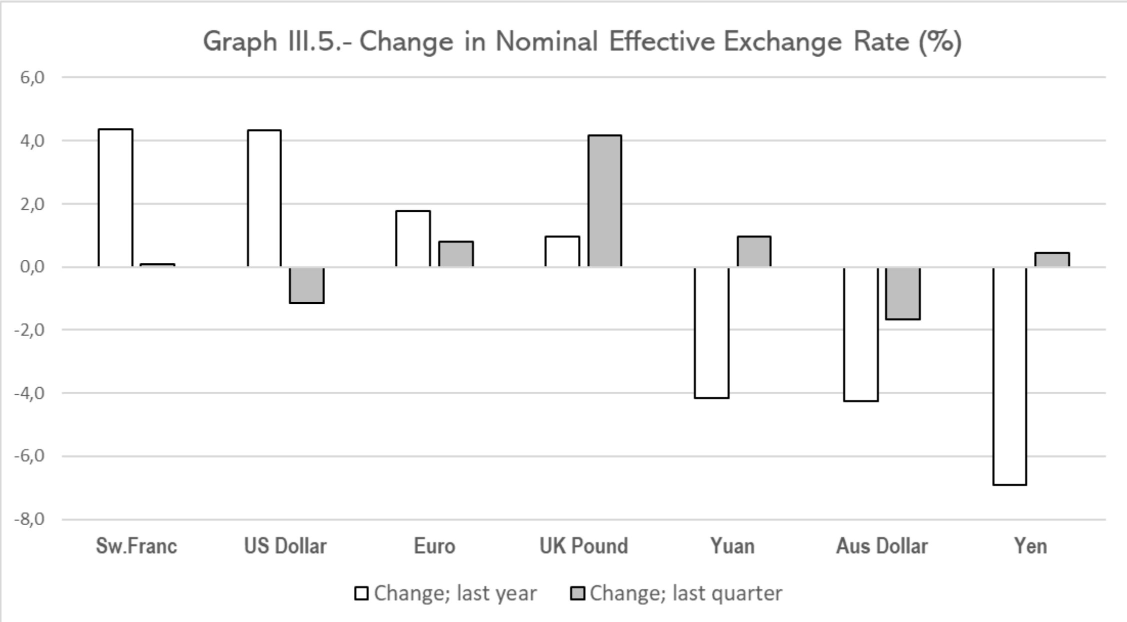
Source: Own elaboration. Data: World Bank.

The natural gas and oil situation requires some more specific comments. Regarding gas, the final stretch of health restrictions in China and a uniquely mild winter in the West (and, at least in some countries, remarkable efforts to reduce consumption) have concluded not only to remove fears of supply cuts to businesses and households but to force a major fall in prices. That said, the average price of natural gas in Europe (and Japan) in March 2023 was still 125% higher than just two years earlier, a factor of competitive advantage (and lower inflationary pressure) for the United States, where the price has already been 10% below the price twenty-four months earlier.

Concerning oil, the decline of the last months of 2022 slowed down at the beginning of this year. A (somewhat) less unfavourable outlook on the economic situation, at least before the recent financial turmoil, explains this prices' stabilisation. Nonetheless, there is no doubt that the decision by OPEC+, led by Saudi Arabia, to accentuate the production cuts set for 2022 may have a greater effect on the market. Beyond the strategic connotations (it is hard not to deduce that the world's leading producer is more interested in colluding with Russia than in sustaining Western growth), it is evident that an oil price moving towards 100 dollars per barrel, which is not unlikely, will revive inflationary pressures, further complicating monetary management and achieving positive growth. Oil producers will have to balance between maximising their profits and not causing global growth to slow so much that they end up suffering the opposite result.

C.- Main currencies

The most significant movement among the main international currencies in the first quarter of 2023 has been the remarkable pound appreciation, as Graph III.5 reveals. With the chaos generated by Elizabeth Truss and Kwasi Kwarteng (see our *October 2022 Report* on the subject) behind it, a steady Bank of England rate hike and relatively less pessimistic economic expectations, the British currency has made up for all the value lost over the past year.



Source: Own elaboration. Data: Bank for International Settlements Basel.
Note: Upward (downward) movements imply appreciation (depreciation) of the currency vis-à-vis those of the country's trading partners as a whole.

Otherwise, there have been no noticeable changes in recent months, despite coinciding with the financial problems in the United States and Switzerland. The dollar's slight depreciation in the first quarter predated these difficulties, and the franc has simply stopped appreciating. It is likely that, at least in the short term, the currencies of other economic areas would have suffered much more from the mistrust provoked by this type of turbulence. However, the refuge currencies are resistant to such episodes.

Moreover, some authors have recently commented on the famous "dollar smile"[5]: the greenback appreciates, as is typical for any currency when the economy is booming, but

[5]The expression "the dollar smile" and the idea behind it are attributed to Stephen Li Jen, current CEO of Eurizon SLJ Capital, when he was an analyst at Morgan Stanley two decades ago.

also in times of crisis, even if the crisis is generated in the United States, as long as it is susceptible to being transmitted to the rest of the economies due to its type and/or severity. In the latter case, faced with the risk of generalised problems, investors will turn to their refuge par excellence, the dollar.

IV.- UNDERSTANDING THE QUARTER IN SEVEN KEYS

1.- We will not dwell (beyond the notes made in our Spotlight) on the vicissitudes experienced by various banks, especially Silicon Valley Bank in the United States and Credit Suisse in Europe, in recent weeks. There has been a great deal of information and analysis on the subject.

Here we wish to stress that financial imbalances and fragility are just one more of the negative by-products of the unlimited monetary expansion that has been with us since the Great Recession (in fact, since before). That is why the "too low for too long", turned almost into a "zero forever" by some central bankers, economists and commentators, must not return. That should be the primary lesson from this long period of monetary exceptionality.

Because the stubbornness of a significant part of those who have designed, implemented and supported this monetary policy that it has not had negative consequences is so unsustainable that it is even offensive. Let us accept that, on balance, the alternative of a permanently expanding monetary policy between 2008 and 2022 has been better than any other option. That is why Western Central Banks have implemented it, and the numerous studies they have carried out on the subject have reaffirmed this hypothesis. None of the above is undisputed, as a good number (albeit a minority) of authors and institutions have pointed out, but let us accept that there was indeed no better option.

But that does not mean that it can be denied that this policy has led to undesirable consequences, such as:

- That inflation has NOT been under control throughout this period. The fixation on the evolution of the prices of goods and services has allowed the supporters of these policies to omit that asset prices have been systematically inflated by monetary expansion. And assets do exist. In fact, raising their prices has been an explicit objective of that monetary laxity, as central bankers themselves have often pointed out, since that greater wealth was supposed to stimulate consumption and, with it, growth, employment, and those inflation rates (of goods and services), that, apparently, were too low for them.
  Well, they have successfully generated those price rises: technology, housing, cryptocurrencies, commodities, non-residential construction and, the biggest of all, Western government debt, over the past two decades. But of course, everything that rises beyond the supply and demand fundamentals that affect that market ends up falling, and, truth be told, it does not usually do so in an orderly fashion. We have been witnessing this for twenty years, however much some would like to ignore it. If monetary policy stops fuelling bubbles, it will not only help stability but also make it easier for macroprudential policy to perform and reduce financial turbulence like the ones recently experienced.
- That a significant volume of zombie companies has been generated, which poses a severe burden on the economy. Keeping non-viable companies alive solely due to the availability of massive and cheap credit not only constitutes a threat for the future, in which bankruptcies will accumulate as soon as the interest rate scenario changes (as is currently happening). These companies also absorb

resources that should be directed towards others, often in different sectors with more potential. Moreover, they constitute a solid entry barrier for new projects, blocking innovative ideas and limiting productivity and economic growth. In short, continued ultra-expansionary monetary policy eviscerates the essential "creative destruction" necessary for the functioning of the capitalist system.

- That monetary policy has been a fundamental factor in increasing wealth inequality in the past two decades. Let us again accept that the impact of permanent monetary expansion on income distribution has been egalitarian, reducing unemployment, at least in the short run, relative to alternative paths. Nevertheless, with an explicit objective of raising asset prices and given the very unbalanced distribution of asset ownership among the population, inequality in terms of wealth has been seriously boosted by this policy. And no, it is not valid to claim that cheap money drives up the price of housing, which is precisely the asset whose ownership is most widespread among the Western population. Given that most of these citizens only have one home, this increase in wealth is merely potential. Yes, it increases spending power... on credit—more debt to be repaid. We know something about this in Spain.
- That prudent saving has been viciously penalised by ultra-expansionary monetary policy. We know that the aim was to stimulate consumption, but with ageing populations threatening the sustainability of pension systems, was it wise to punish the profitability of savings even in the longer terms? Moreover, with less income coming from each unit of savings, is consumption really stimulated, or are additional savings being made to maintain future income expectations from the total volume of savings? In other words, could continuously low-interest rates mean that we have reached the "reverse rate", where the consequences of interest rate reductions are the opposite of those expected a priori?

We could go on, but we believe the argument is clear. At some point, the benefits of ultra-expansive monetary policy, even if we are very optimistic about them, are outweighed by the costs. Some believe (we believe) that this point was reached well before the change in the monetary cycle in the spring of 2022.

Let us leave buried in the past the excess monetary laxity of the last quarter century, especially since 2010. Because moreover, monetary policy becoming "the only game in town"[6] makes it easier for fiscal policy to abandon its countercyclical profile and its assumption of its own responsibilities. And it allows governments to postpone *sine die* the necessary structural reforms. Too much cost for the benefit obtained.

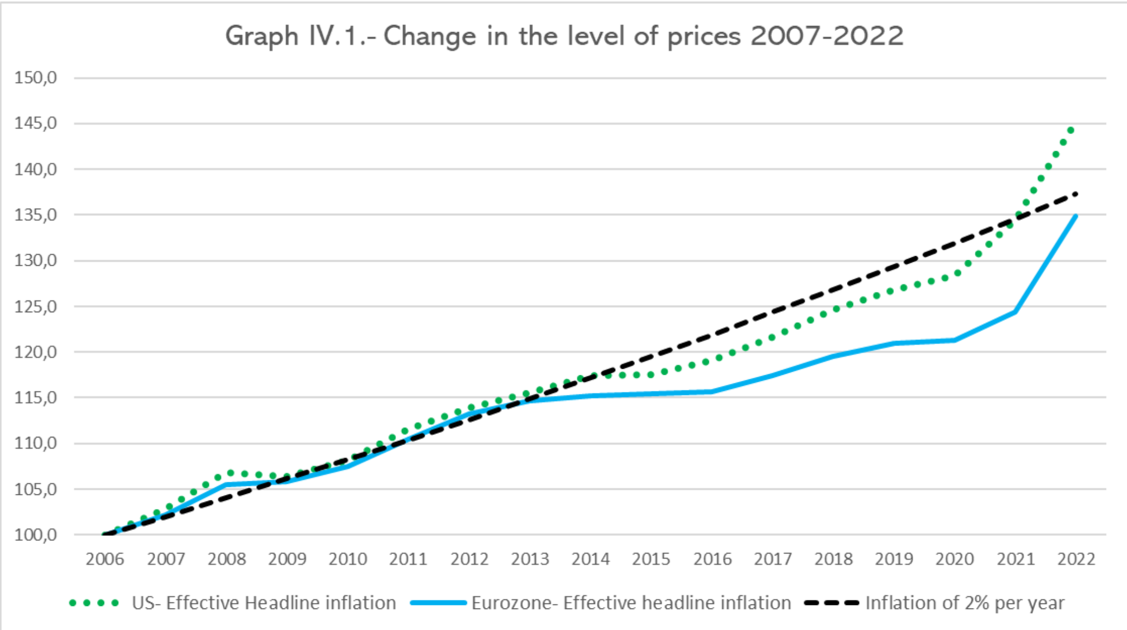
2.- The curious thing is that the measures already adopted or proposed to change the current design and implementation of monetary policy in the West are oriented in the opposite direction. How can further laxity be justified in the future? Interested readers can consult the new monetary policy strategies of the Federal Reserve[7] and the European Central Bank (admittedly both prior to the last two years of runaway inflation), which,

[6] In Mohamed El-Erian's well-known expression.
[7] https://www.federalreserve.gov/newsevents/speech/files/powell20200827a.pdf
https://www.ecb.europa.eu/home/search/review/html/index.en.html

especially in the US case, aim for even greater asymmetry (even more so) between combating (slowly and little) episodes of excess in price growth (especially if one understands that assets exist), and fighting (with urgency and fierceness) against "too low" inflation rates.

We also have a good number of proposals (led by Harvard professor and former IMF chief economist Olivier Blanchard) suggesting raising the inflation target rate to "increase the margin of action of monetary policy in the event of a crisis". The proposal usually ranges between 3% and 4% for the new annual inflation target. Of course, once inflation expectations are unanchored, we can raise it another couple of points in five years. If it is about creating margin... Or more recently, Andrew Haldane (former head of macroeconomic and regulatory policies at the Bank of England) opposed the former but suggested that, since the idea of medium-term price stability (which is the idea behind Western central banks' targets) has never been very precise about what "medium term" means, it would be better to delay the return of inflation to around 2% rates over time, to avoid excessive monetary tightening. This is probably a sensible alternative, given that we have already had two years of (very) excessive inflation (and more to come). Yet, it is another suggestion in the line of greater laxity.

Incidentally, throughout the period in which inflation (we will insist, that of goods and services, omitting that of assets) was below the mythical 2%, it was customary to argue that, instead of an inflation target, a price level target should be implemented. In the first case, if inflation is below the defined target in one year, it is simply ignored, and attempts are made to reach it in the following year (or in the "medium term"). With a price level target, annual deviations should be compensated in subsequent periods. So, after years of "insufficient price growth", this proposal argued that inflation above 2% should be sought in the future to compensate for that insufficiency. Something similar is actually included, albeit without explicitly changing the target (because such a change would be more challenging to convey to citizens than the current annual inflation target), in the new strategy of the Federal Reserve.

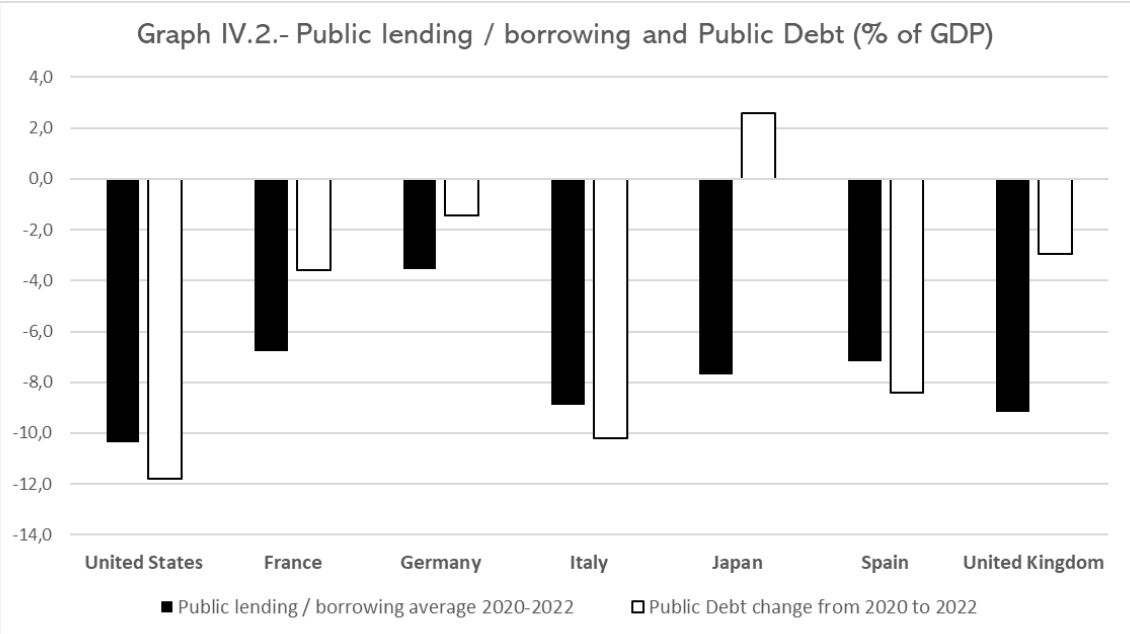


Source: Own elaboration. Data: European Central Bank; St. Louis Federal Reserve.

In Graph IV.1, we have compared the actual inflation in the United States and the Eurozone with the theoretical trajectory of an annual price level growth target of 2% between 2007 and 2022. By the end of 2022, we observe that the effective cumulative price increase over that period was already *higher* than that theoretical path in the United States; in the Eurozone, it will be higher by the end of 2023. Consistently, and with a symmetric view of monetary policy, this would imply that we should aim for inflation *below* 2% from 2024 onwards.

So, with that implication, it is not surprising that the shift to defining the monetary policy target in terms of the price level has been proposed much less recently.

3.- Just a mischief about the beneficiaries of the excessive inflation of the last two years. As the International Monetary Fund (see the April 2023 Fiscal Monitor) has pointed out, the harm is minor. Graph IV.2 helps us to understand this.

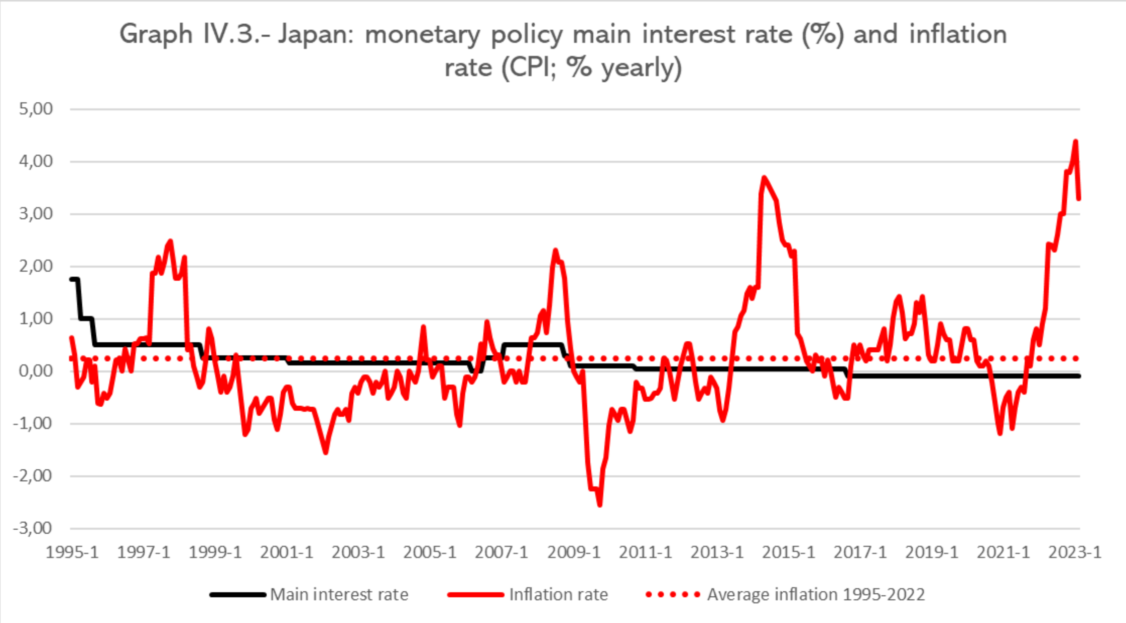


Source: Own elaboration. Data: IMF.

Note how the budget balance of the seven largest developed economies has been heavily in deficit for the past three years. That is understandable, given the response to the pandemic. Okay, but with little (or no, as in the case of Spain) cumulative growth over those three years and high deficits, how can the total volume of debt have been reduced by a few points - except in Japan? Here is an unexpected benefit of inflation... for governments. While the nominal cost of debt incorporates only *expected* inflation as compensation to savers, the nominal (not necessarily real) growth in activity due to higher *actual* inflation reduces the real cost of debt and its ratio to GDP (see Fiscal Monitor itself for more detail). Precisely because cumulative inflation in Japan in 2021 and 2022 has been much lower than in the other six economies, no such cut in the level of debt is perceived.

Increased incomes and spending by citizens and businesses (remember, nominal, not necessarily real) also increase government revenues. Of course, these favourable effects soon evaporate over time[8]. Newly issued debt requires higher interest rates if it is to be attractive to investors, so today's benefit becomes tomorrow's higher cost.

4.- If there is one place where monetary policy has been expansionary for an interminable period, it is Japan. Graph IV.3 reveals that the central bank's benchmark interest rate has not exceeded 0.5% since September 1995! Graph IV.3 also shows how, despite the above (and other monetary easing measures), the country's inflation rate has averaged just 0.25% over the past 27 years. The year-on-year price change has frequently been in negative territory. It has taken off only during brief periods, usually associated with sharp increases in commodity prices, on the import of which Japan is entirely dependent, or with some increase in indirect taxes on consumption.

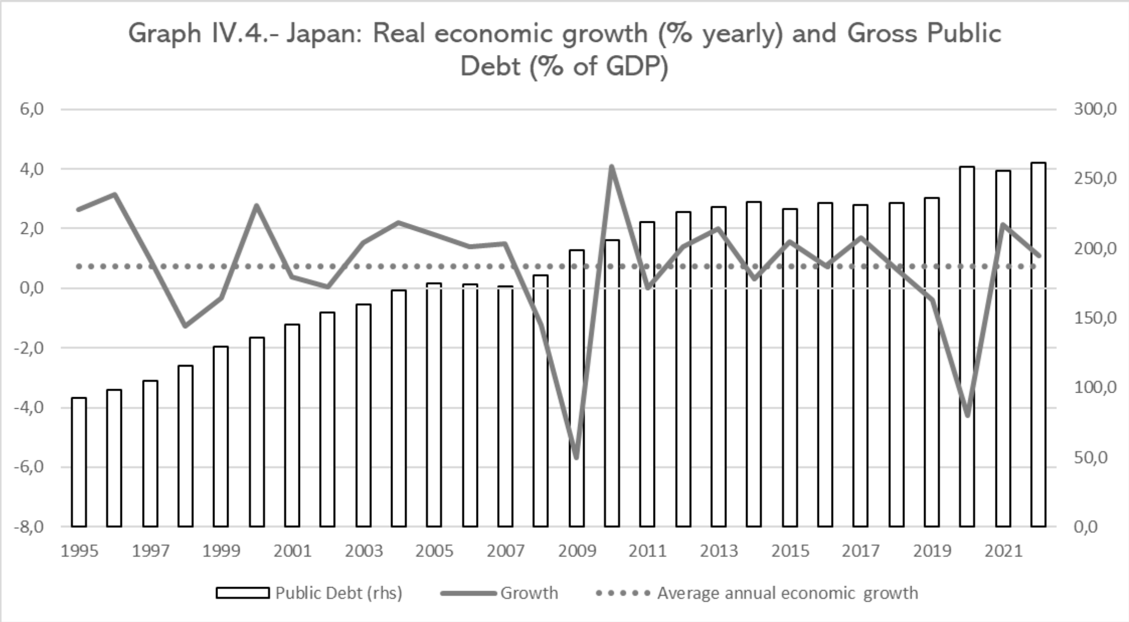


Source: Own elaboration. Data: BIS.

In addition, the country's economic growth during this period has only reached a paltry 0.7% annually, despite monetary stimuli being accompanied by countless fiscal stimulus programmes, particularly through (often unproductive) spending, which has increased public debt by one and a half times relative to GDP in this quarter of a century, pushing it to the highest level of any significant economy in the world. See Graph IV.4 for more information.

Einstein is credited with defining insanity as "repeating the same action over and over again and expecting different results". It is obvious to note that if the Japanese authorities have sought more sustained inflation, in line with the usual definition of "price stability", and more dynamic growth, their strategy has simply been, by that definition, folly.

[8] Immediately in the case of floating rate debt, which is adjusted based on actual inflation, although the percentage of Western government debt with this feature is small.

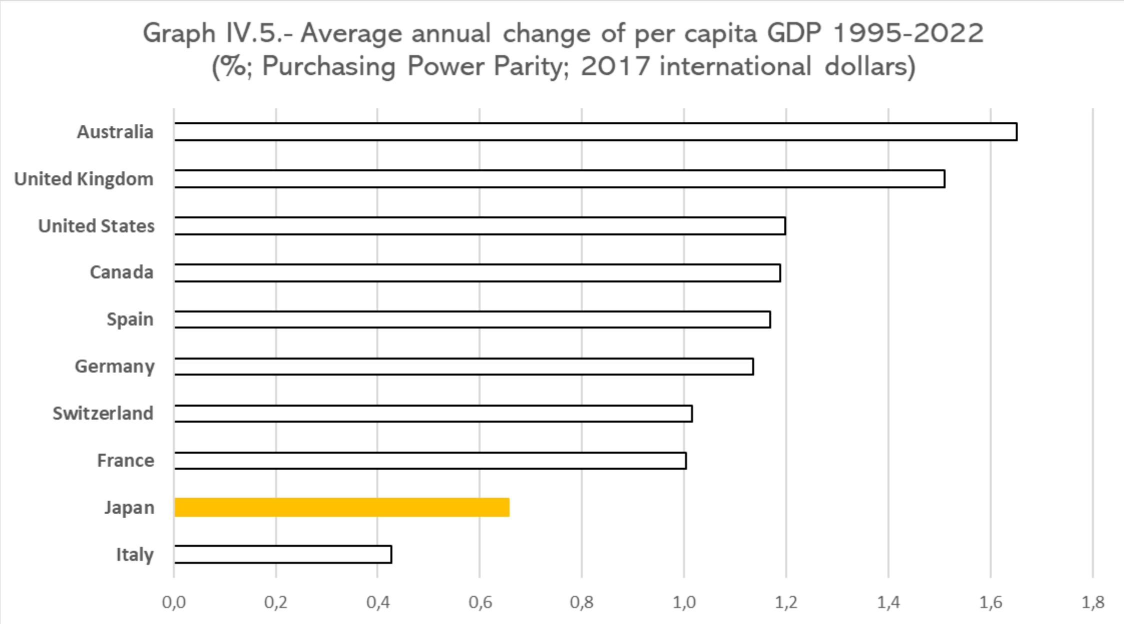


Source: Own elaboration. Data: IMF.

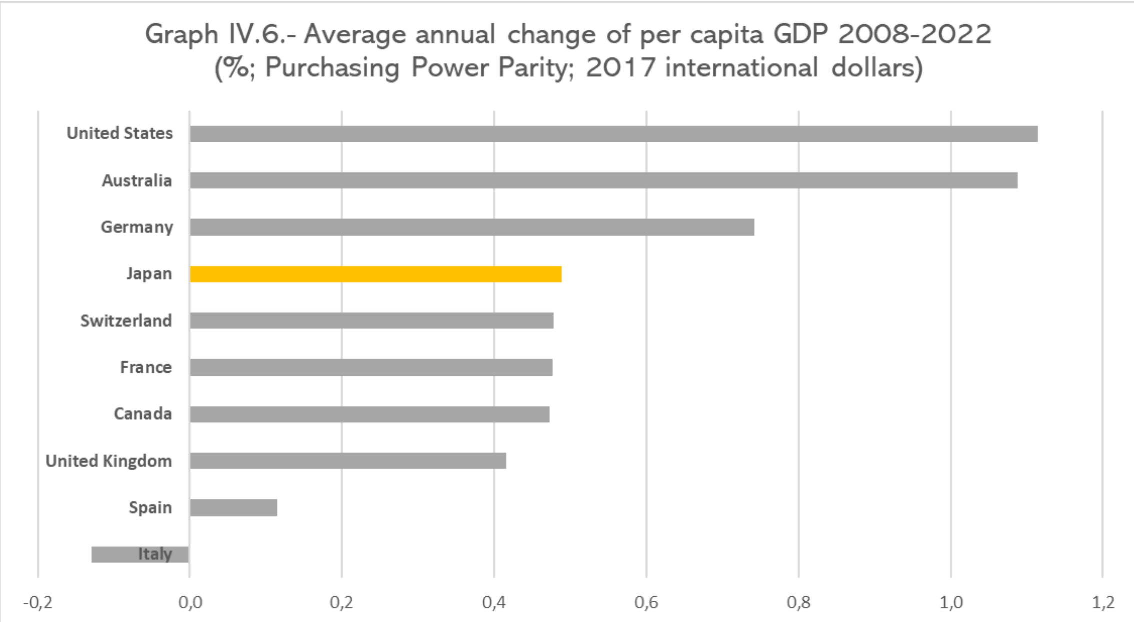
However, that does not seem to be the internal interpretation. A couple of weeks before the appearance of this *Report*, there was a change in leadership at the Bank of Japan (BoJ). Haruhito Kuroda, who has brought monetary expansion to an unrepeatable zenith, completed his term without improving one iota on previous periods' results. Despite keeping the reference rate at zero (or below) throughout that term. Despite acquiring public debt to the point of absorbing more than half of the country's outstanding sovereign debt. Despite limiting how far rates can move upwards for up to ten years with systematic purchases of more debt. Despite turning the BoJ into a regular and widespread financier for the Japanese private sector's as well, being the largest investor in the Tokyo Stock Exchange. Impossible to expand more... and achieve less.

When the late Shinzo Abe launched his famous "Abenomics" in 2011, there was talk of "three arrows" in the quiver of policies that would transform Japan. Monetary policy, even looser than the previous one; Kuroda has more than fulfilled this task. Fiscal policy, also expansionary but more efficient. The first is true, but not the second. And the third arrow, that of structural reforms? That has not even left the quiver. Neither in migration policy, nor in the reduction of bureaucracy, nor taxation, addressing above all the accumulation of profits - and excess savings - by companies, nor in the excessive protection of certain sectors, nor in the labour market... there have been any far-reaching changes in recent years. Thus, we return to Einstein's definition.

When the current prime minister, Fumio Kishida, nominated an outsider to the Bank of Japan's structures, the experienced economist Kakuo Ueda, as the new Governor, the markets reacted with the realisation that maybe, just maybe, there could be a change soon. First in debt purchases and control over long-term interest rates, and then in the benchmark rates. Nothing of the sort. The new Governor quickly pointed out that, even with the current inflationary solid bout, the monetary policy seems appropriate to him.



Source: Own elaboration. Data: International Monetary Fund.

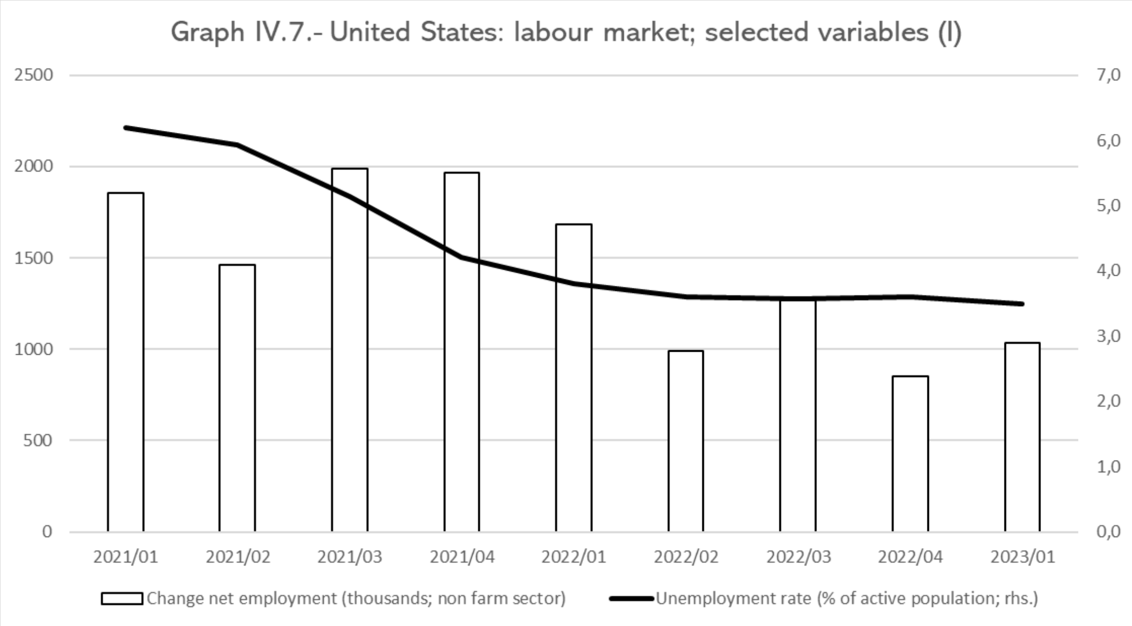


Source: Own elaboration. Data: International Monetary Fund.

Well, perhaps with a population that is not only ageing but shrinking and with no pressure from the public to make structural reforms in the areas indicated above, Japan is doing well with little growth and basically zero inflation. In the end, as Graphs IV.5 and IV.6 show, in terms of per capita growth (the size of the per capita pie is what matters), Japan has not fared much worse than continental Europe since the mid-1990s... and has even fared better than most of the West since the Great Recession.

V.- We now return, updating what we have analysed in previous *Reports*, to the primary focal point for the determination of the immediate monetary policy of the Federal

Reserve (alongside inflation data, particularly core inflation): the US labour market. It is still robust, indeed, but there are already signs of change, the ones the Fed is waiting for to close its cycle of interest rate hikes.

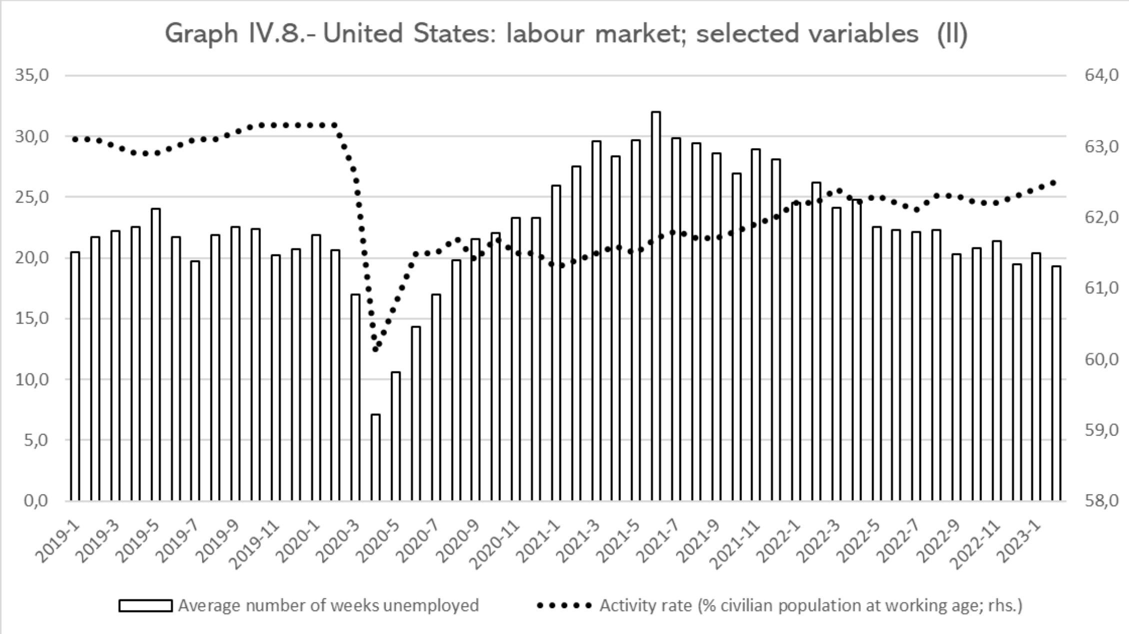


Source: Own elaboration. Data: St. Louis Federal Reserve.

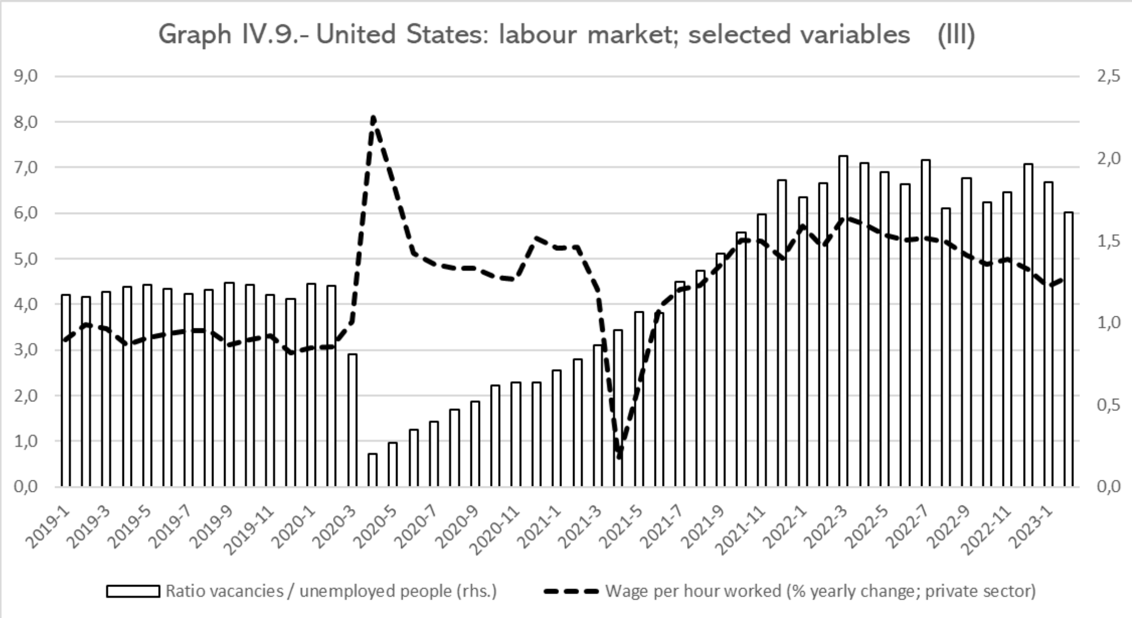
Graph IV.7 shows that the enviable rate of job creation continues to be around one million net jobs per quarter, and the unemployment rate remains close to what can be defined as full employment (around 3.5%). Moreover, the number of weeks that the average unemployed person remains unemployed has returned to pre-pandemic figures and the activity rate, although not yet reaching the 2019 level, has progressively approached it (Graph IV.8). In the latter's respect, the recovery of the usual flow of immigration, following the restrictions established by the Trump Administration and the net outflow of migrants caused by the pandemic, has been relevant. In any event, the most intense rates of improvement in these variables are now behind us, which helps to explain the behaviour of two very significant indicators, those shown in Graph IV.9: hourly wages and vacancies per unemployed person.

Indeed, these indicators still reflect the strength of the labour market, but they also point to a certain change in trend. Wages per hour worked have grown over the last year at a rate of 4.5%, which is strong, but appreciably lower than inflation and its behaviour a few quarters ago, when it was running at 6% year-on-year. Meanwhile, the existence of 1.7 job vacancies per unemployed person speaks of a labour market where the problem is more one of supply than of demand for workers, but the slack has also been reduced in recent months.

In conclusion, this only gradual change in a very robust labour market reaffirms the Fed's belief that a "soft landing", which it has been pursuing since the start of the rate hike cycle, is possible. Nevertheless, it also indicates that there is still some work to be done in the form of a further 25 basis points push and a clear signal that rates will not fall for several quarters.

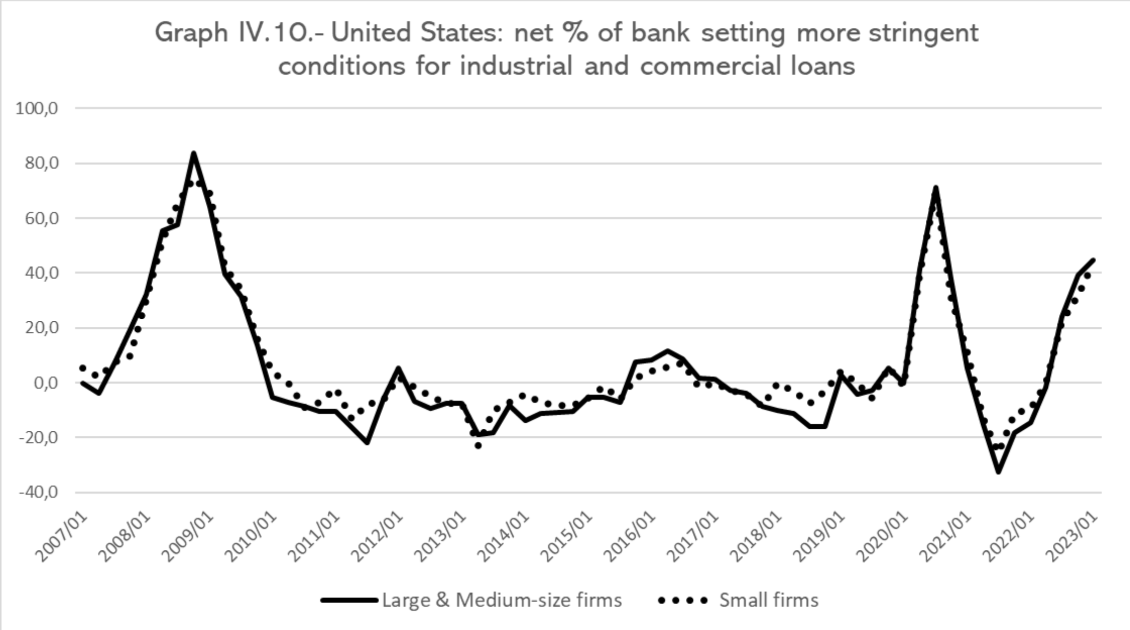


Source: Own elaboration. Data: St. Louis Federal Reserve.



Source: Own elaboration. Data: St. Louis Federal Reserve.

That said, beware of credit. Fed Governor Jay Powell stated that the impact of the financial turmoil could be equivalent (via restrictions on bank credit to companies and individuals to protect banks' balance sheets) to "one or more interest rate hikes". In the weeks following the collapse of SVB and other associated issues, according to the various Fed members who have spoken on the subject, there has been no such tightening of credit. However, as Figure IV.10 shows, US banks have been tightening credit conditions before this financial turmoil. We are still far from the pandemic levels and even further from the Great Recession, but the developments are worth paying close attention to.

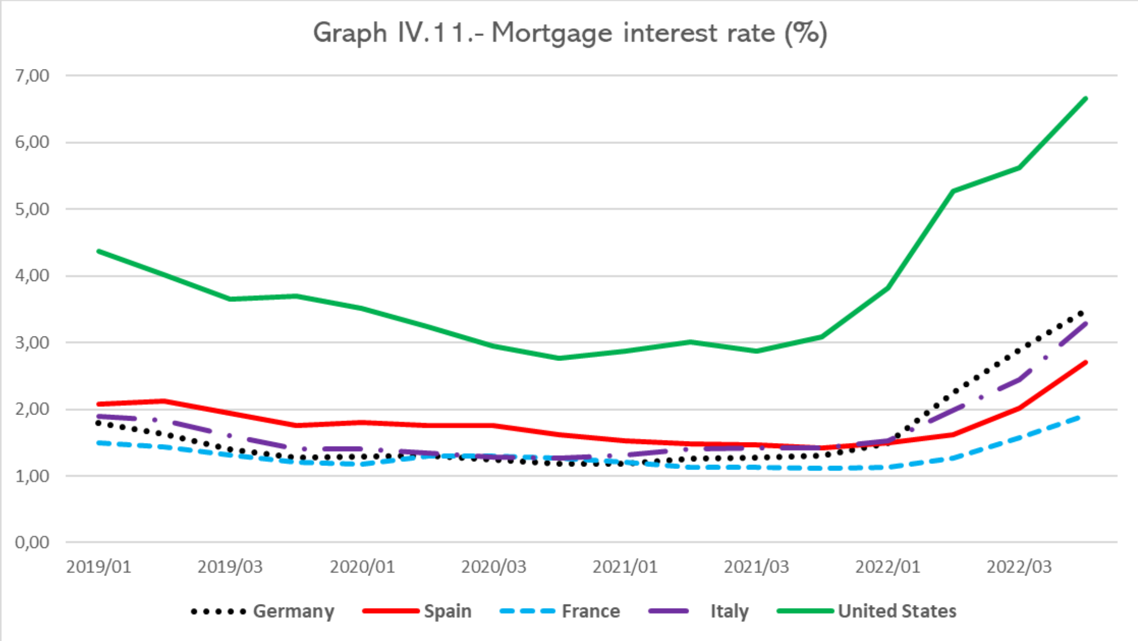


Source: Own elaboration. Data: St. Louis Federal Reserve.

VI.-

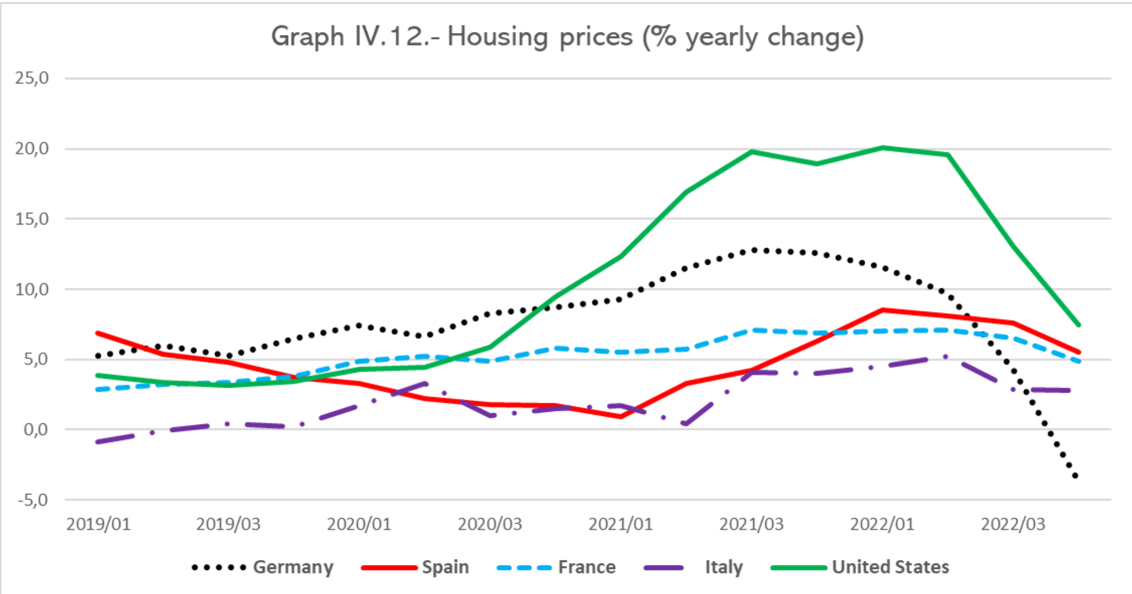
And when it comes to credit and its tightening, there is nothing more perceptible to the public than its impact on mortgages. For the moment, on both sides of the Atlantic, the problem lies more in the increase in mortgage loan costs (Graph IV.11) rather than limitations on accessing them. In fact, a sharp rise in interest rates, such as the current one, may end up affecting the demand for mortgage credit so much that it may even act more as a brake than the supply itself.

As well as making it more expensive to buy a new home, when existing mortgages are at variable rates (much more common in Europe than in the United States), rate rises reduce households' spending power in other areas. And, of course, they also reduce the appetite for higher-standard housing. Thus, house prices are beginning to feel the impact of the monetary tightening cycle (Graph IV.12), with particular virulence in the German case. It is not a bad thing that certain excesses accumulated in previous years (in Germany itself, for example) or where they were beginning to be perceived (as in Spain) are being corrected, but remember that, in addition to this subtraction from consumption of the higher cost of mortgages, there is also the negative wealth effect. And, of course, smaller acquisitions can put greater pressure on the rental market, which is notably tense, at least in some areas of different countries.



Source: Own elaboration. Data: St. Louis Federal Reserve; ECB
Note: The US rate corresponds to the most common rate, the 30-year fixed rate. The values for the Eurozone countries correspond to the estimate, weighted by the volumes granted in each mode, as calculated by the European Central Bank.

The housing market and its evolution will, of course, also require our careful observation in the coming quarters.



Source: Own elaboration. Data: OECD; Eurostat.

VII.- A brief final thought in these *Quarter's Keys*, to appeal for common sense from the authorities in emerging countries: currency issues are sensitive and unsuitable for ill-considered actions.

In November 2016, the Indian government decided to invalidate all medium and high-denomination banknotes overnight. The objectives were clear and laudable: to remove from circulation the numerous counterfeit notes that had accumulated over time and, more importantly, to bring to the surface vast amounts of black money, which could only be regularised with the subsequent recognition (and penalties) by the tax authorities. Nevertheless, in an economy where cash remained dominant and absolutely irreplaceable for lower income groups and small businesses, and the distribution of substitute banknotes had not been well planned, the results were, at least in the short term, chaos, discontent, problems in the day-to-day running of many citizens and businesses, and a negative impact on economic growth.

Now, six years later, Nigeria has decided to make the same move for similar reasons and with an identical lack of proper planning. To add another component to the nonsense, the radical currency change was established during a highly contested and controversial election campaign. The new President, Bola Tinubu, is due to take office at the end of May (not precisely with the acceptance of his two rivals, who have pointed to all sorts of irregularities in the election). We will see if, by then, the functioning of cash in the country has returned to normal.

While the former could be remedied with more precise planning, another idea that has emerged in recent months would require a good number of years before it could even be considered: the creation of a common currency between Brazil and Argentina (the "south"). We Europeans are pretty familiar with the costs of adopting a common currency, despite having many years of planning, having set macroeconomic requirements for access, having a solid institution (the European Central Bank) behind it and enjoying all the tangibles (and intangibles) that a dozen developed economies bring to such a process. Without high-factor mobility (especially labour), a central fiscal authority of sufficient size, and substantial compensation mechanisms between countries, asymmetric shocks can bring any monetary union to the brink of collapse. We experienced this between 2010 and 2012 in the Eurozone.

It is simply absurd that two completely disparate economies, lacking the necessary institutional solidity, at least one of them in a permanent state of instability, with highly volatile exchange rates, and with severe internal challenges (economic and non-economic), should consider creating a common currency. They should first solve all the existing and pressing problems for their citizens, plan in an orderly fashion the steps to be taken in the medium and long term, move forward with more modest intermediate steps and then, possibly with other partners who have done the same, think about a single currency. That way, it is much more likely to succeed.

V.- THE WORLD IN TWO VARIABLES

As in previous *Quarterly Reports*, we will conclude this one with the presentation of two macroeconomic indicators of interest that allow us to compare the three main groups of world economies: developed countries, emerging countries and developing countries[9]. As usual, we remind the reader of the structure followed in this analysis. The ten countries with the largest populations in each group are selected. The data for the largest (by far the largest in each case, which would distort the weighted average if they were included in the aggregate), respectively, the United States, China and India, are shown separately. The data for the other nine countries in each group are weighted according to their weight in the world economy (measured in Purchasing Power Parity) and shown together. See the *July 2022 Report's Annex* for population data and share of world GDP for the 30 selected economies.

The temporal approach followed is as follows: using annual data, we will go through what has happened since 2000 in the following sub-periods: 2000-2007, a phase of strong global growth, especially in the non-developed world; 2008-2011, the central years of the Great Recession, which mainly affected North America and Europe but had broad global repercussions; 2012-2019, again an expansionary period, much less dynamic than the previous one, especially for the non-Western world (with crises in many countries in these areas during the sub-period), and with growth sustained by increasing indebtedness (in quite a few countries in the three groups) and highly expansionary monetary policy in the developed world. The following is the initial year of the pandemic associated with COVID-19 (2020) and the initial rebound year (2021).

In this *Report*, we will reveal the magnitude of the exceptionally high accumulated indebtedness in the world economy and its rising trajectory during the present century (continuing an existing trend, albeit then centred only in the West). To do so, we will present the data on public debt, followed by the aggregate debt of households and non-financial corporations.

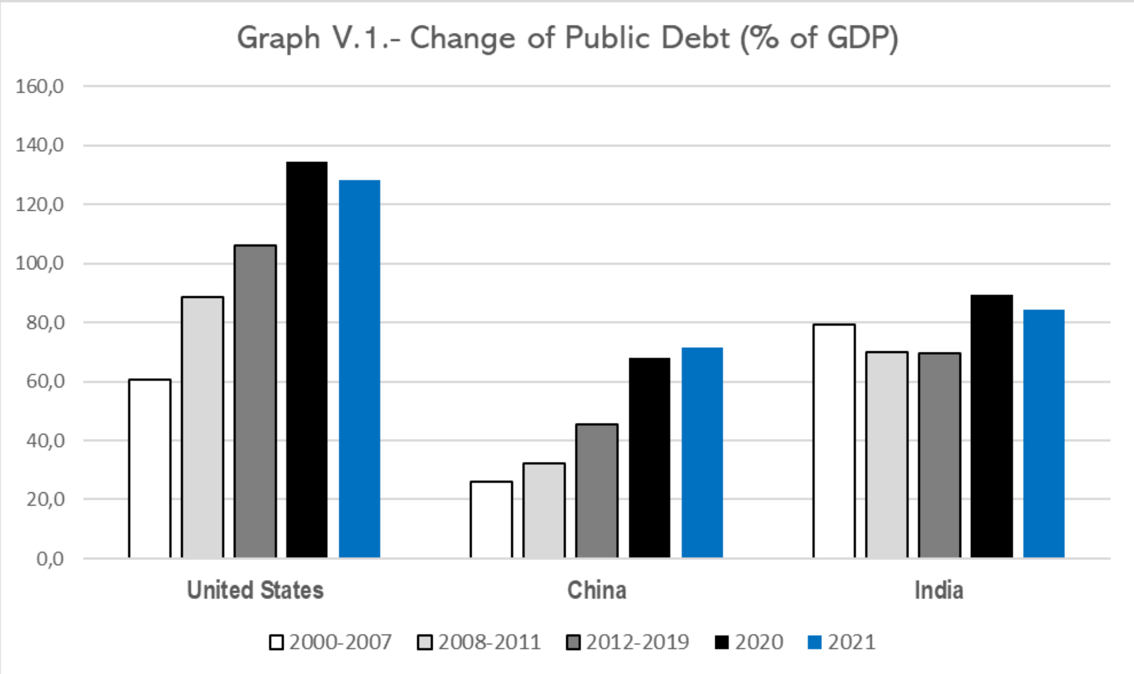
V.1.- PUBLIC DEBT EVOLUTION

Graphs V.1 and V.2 reproduce the behaviour of this indicator with the chosen country grouping and in the sub-periods explained.

Concerning developed economies, and before the effect of unexpected inflation already analysed in our *Quarter's Keys*, there is only one term needed to refer to the evolution of the stock of public debt (total and, more importantly, as a percentage of GDP) over the past two decades: growing. Constantly growing, if this reality is to be emphasised. Whether in periods of crisis or expansion, Western governments have always found reasons to increase their indebtedness and postpone fiscal adjustment programmes into

[9] The differentiation between these two groups is established exclusively based on their respective per capita incomes, with a separation figure of 13,000 dollars in Purchasing Power Parity in 2020. This explains the presence of India, usually considered an emerging country due to the overall size of its population and economy, in the third group.

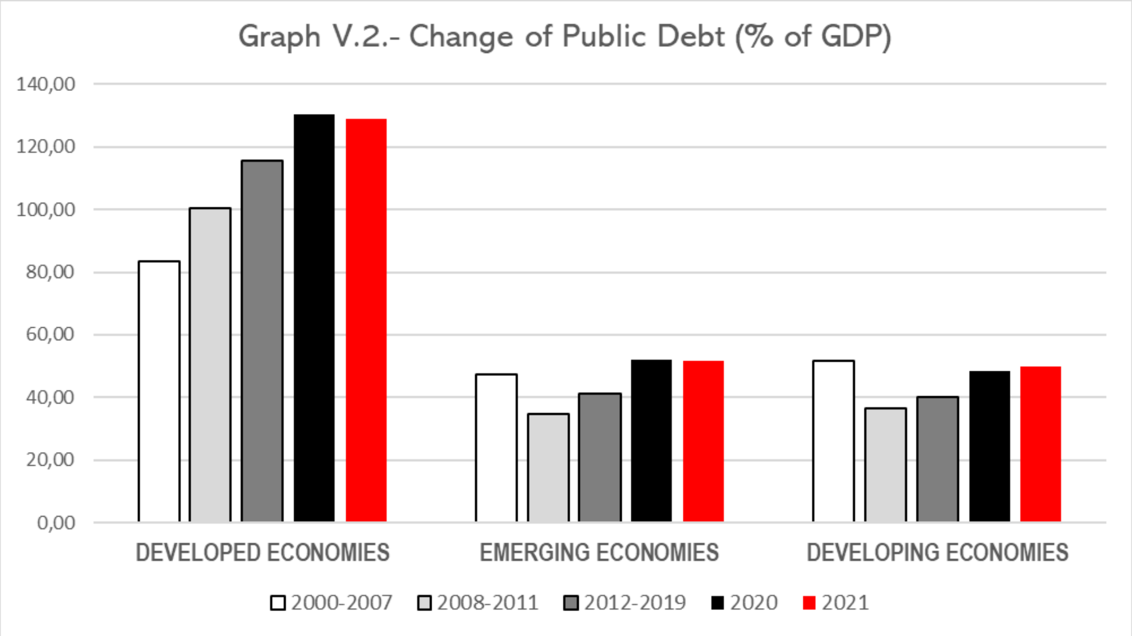
the indefinite future. Despite the often noisy debate on the matter, debt growth has been higher in the United States than in the rest of the developed world, as seen in the graphs. The spread of the idea that states should support an increasing variety of activities, both investment and current spending (perhaps as a way of compensating for the dissatisfaction of part of the Western middle class with the evolution of their situation as a result of the processes of globalisation and automation of production) is behind this acyclical increase in Western public debt. The massive acquisition of public debt by central banks (and that induced by the new financial regulation of private banks) is behind the relatively limited cost of this increase. The rise in interest rates, which is likely here to stay, makes this indebtedness a clear cause for concern.



Source: Own elaboration. Data: International Monetary Fund.

The overview, at least for the two decades, is somewhat more encouraging for the non-developed world. In general, before COVID-19, the boom periods were used to reduce the public debt stocks of the beginning of the century. However, the pandemic has (more than amply) wiped out all that improvement, bringing the level of debt back to over 50% of GDP. While for much of the emerging world, this percentage is manageable (not so much for countries that comfortably exceed it, such as South Africa or Brazil), the same figure is significantly worrying for developing countries, several of which are already defaulting on their obligations to creditors (Zambia, Sri Lanka, Ghana). They will not be the last.

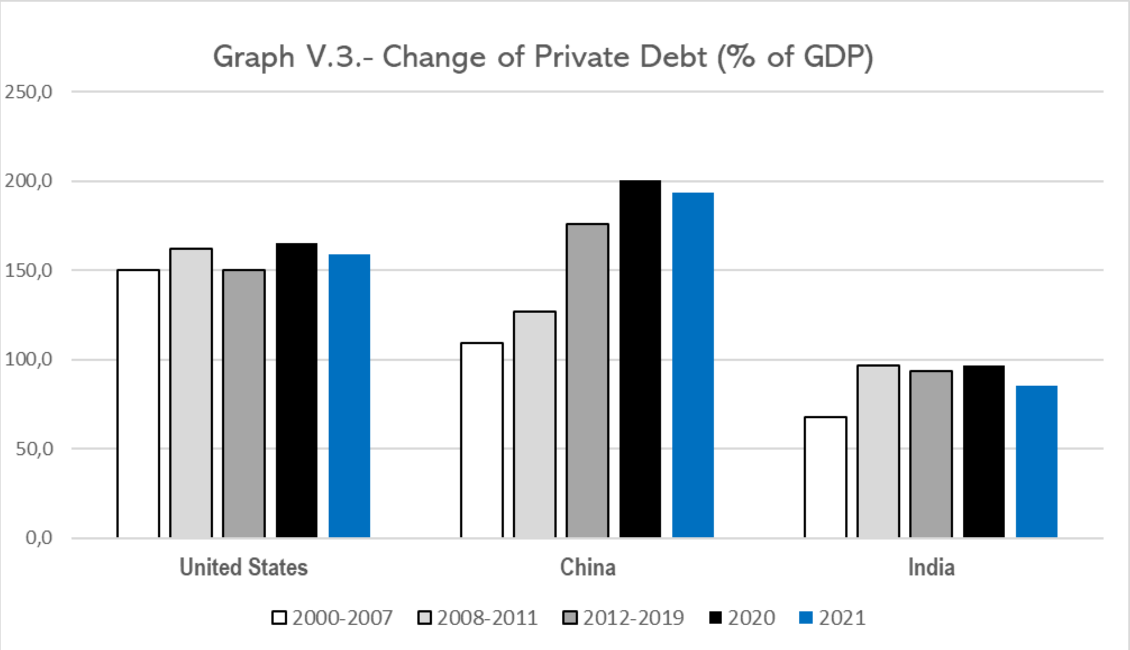
A final note focused on the evolution of China's public debt. Its behaviour is much more similar to that of the West (always on the rise) than that of the rest of the emerging bloc. It is no great relief that this debt is, to a small extent, central government debt. It corresponds above all to local and regional governments that have excessively increased their current spending and investment (often not very productive) during the real estate boom and the resulting revenues derived from it. The costs of the pandemic, in terms of increased spending and falling revenues, have accentuated this imbalance. The Xi administration should certainly consider correcting this situation as a priority of its economic policy.



Source: Own elaboration. Data: International Monetary Fund.

V.2.- PRIVATE DEBT EVOLUTION

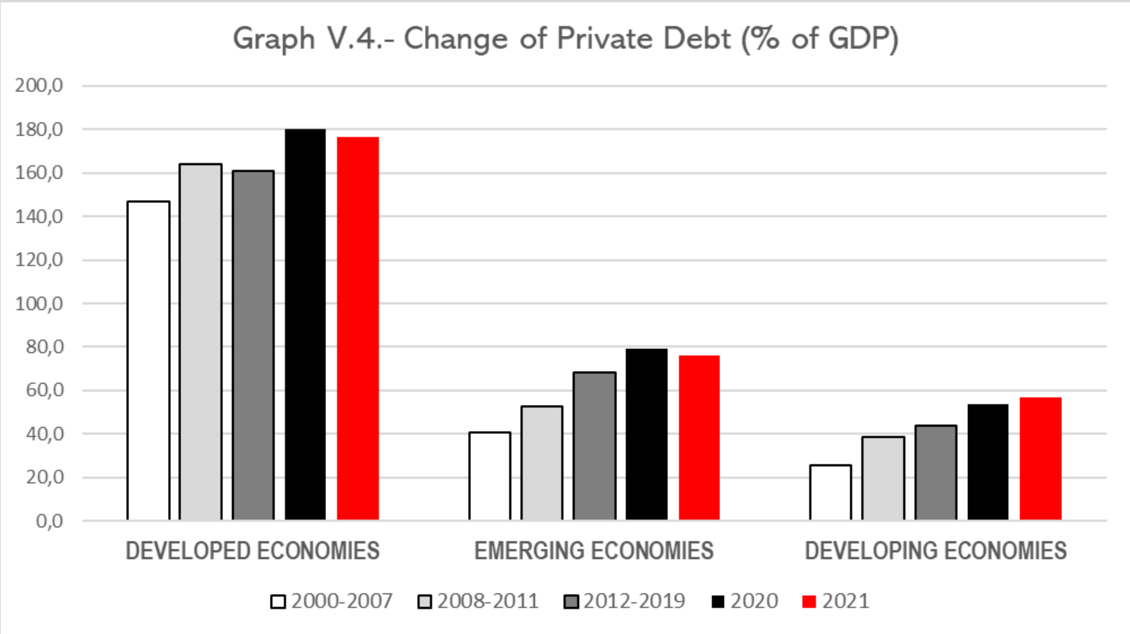
To complete the overview of global indebtedness, we now turn to the (worrying) evolution of private debt. We present this path, with the usual distribution by type of economy, in Graphs V.3 and V.4



Source: Own elaboration. Data: International Monetary Fund.

Admittedly, the accumulated stock of Western private debt is much higher than that of the rest of the world, as was the case with public debt. No surprise insofar as its financing is, on average, cheaper, and the assets of Western companies and citizens are also greater than those of the rest of the world. However, the latter does not detract from the fact that debt levels are already around 180% of GDP. In this case, however, we do note that, before the pandemic, private indebtedness had stagnated, or even fallen, in recent years, especially in the countries most affected by the Great Recession (such as Spain, the United Kingdom and the United States). It remains to be seen whether, with significantly higher interest rates, this trend of improvement will continue after COVID-19.

For the moment, and before this one, it seems that, at least partially, an era of extensive public aid to companies and families has converted part of the Western private debt into public debt.



Source: Own elaboration. Data: International Monetary Fund.; World Bank.

The story is radically different in the rest of the world. Graph V.4 shows the uninterrupted growth of private debt in developed and emerging countries since the beginning of the century. Even levels still significantly lower than those of developed countries imply significant difficulties for large population segments due to the lower ease and higher cost of accessing and renewing financing.

Even more than in the case of public debt, China deserves a separate reflection when referring to the private side of indebtedness. China's private debt has doubled in barely a decade and a half and now stands at around 200% of GDP, a percentage that exceeds even that of most (not all) Western economies. Most of this debt, both household and corporate, is linked to the residential construction sector, with many companies going bankrupt or on the verge of collapse (forcing the Chinese government to establish specific regulations to curb such excesses) and many households struggling to cope with the excessive prices resulting from a long real estate boom in many of the country's major cities. In fact, local and regional governments' debt is also linked mainly to overbuilding, making efforts to curb it the most relevant policy. Regardless, lest we forget, during the decade before the pandemic, the construction sector generated one-third of China's total growth, far more than it constituted even at its most exuberant moments in, for example, Spain. And it is not easy to replace that growth.