Central Banks / Financial Markets

Another August of Financial Turbulence

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Despite the apparent calm of recent days, the underlying elements of recent tensions in financial markets continue to cause concern for several reasons.

Firstly, the problems are the result of an unusual combination of factors generating geopolitical uncertainty. By this, of course, we mean the latest ratcheting up of tensions between the United States and China, following the announcement of new tariffs and the strong depreciation of the Chinese yuan, which also poses a potential threat to global financial stability. Then there is Brexit which, against a backdrop of great political chaos, remains unresolved with the United Kingdom once again leaning over the precipice. Neither of these two situations is new, but it feels as though we are on the brink of an abrupt conclusion that will have extremely negative consequences. Moreover, recent months have seen other sources of uncertainty re-emerge, such as geopolitical tensions between the United States and Iran, and protests in Hong Kong.

Secondly, the negative impact of trade uncertainty on the economy is becoming increasingly evident. The manufacturing sector is being heavily affected and leading indicators in many countries point to contraction, which explains, among other things, the fall in German GDP in the second quarter that could continue into the current one. This would confirm that the eurozone's leading economy is in a technical recession. Services and consumption are holding up well, which leaves us with these questions: how long can this divergence continue, and is the manufacturing sector anticipating a sharp global slowdown, as suggested by the bond market, or will the sector recover?

Thirdly, and by no means least importantly, doubts are growing as to the role of economic policies in addressing these shocks. Monetary policy space is limited, particularly in Europe, where the ECB has not been able to initiate a normalization of rates. Furthermore, their effectiveness in resolving this kind of situation is questionable — although this has not prevented both developed and emerging central banks from responding with new stimuli. The Fed may cut rates again this month, while the ECB could announce a new package of measures (including rate cuts and bond purchases). Hence the recommendation to center activity around fiscal policy, as expounded at the recent Jackson Hole symposium and in Christine Lagarde's speech just a few weeks before she takes over as President of the ECB. In addition, coordinating measures internationally will be much more complicated in the current environment than it was during the financial crisis.

Over the coming months, there will be opportunities to make decisions to reduce uncertainty and resolve this situation. Those decisions will define what the economic scenario will look like in the coming years.

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