Economics

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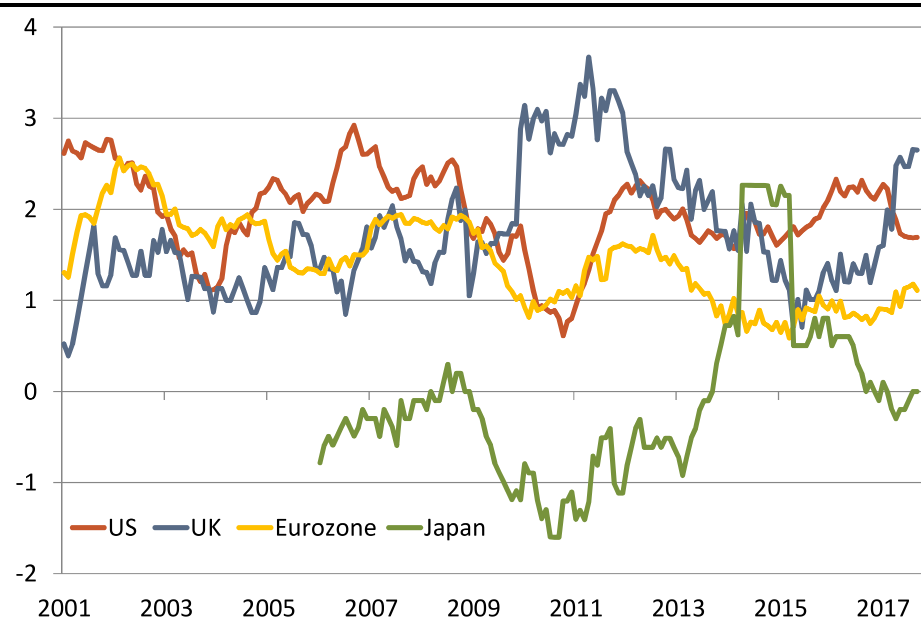
Beyond inflation: spotting the signs of excess

Chart 1: Core inflation (yoy %)



Monthly data. Source: Bureau of Labour Statistics, Office of National Statistics, Eurostat, Ministry of Internal Affairs and Communications, Berenberg calculations

- **"If all goes well, developed economies could enjoy their best year since 2007"** – this was our key message at the start of the year. The good news is that, after seven years of subdued economic growth, the developed world indeed seems to have recaptured some of its past vigour.
- **Synchronised upswing in the advanced world:** Responding to healthy gains in private consumption and stronger export demand after the end of the 2015/2016 correction in many emerging markets, businesses are stepping up capital spending and hiring. Outside the Brexit-stricken UK, demand growth has now accelerated well beyond the averages of the previous years and beyond estimates of trend growth. Nonetheless, inflation is yet to rear its ugly head. Apart from the UK, core inflation remains well below central banks' inflation targets of 2% (Chart 1). Economic fundamentals look promising as we head towards the new year.
- **But are we returning to boom/bust?** No, not yet. So far, we do not yet see major signs of excess in the advanced world that could require a cleansing recession within the next 2-3 years; wage and price gains remain subdued, firms are not over-producing or investing too much relative to demand, and credit growth remains modest relative to historical averages.
- **As economists, we need to watch out for potential future risks:** Taken at face value, the sharp rises in equity indices of c10-30% over the past year could signal that the upswing in the advanced world may accelerate further in the coming years (Chart 2). If so, this would matter for the appropriate direction of monetary policy and fiscal policy.

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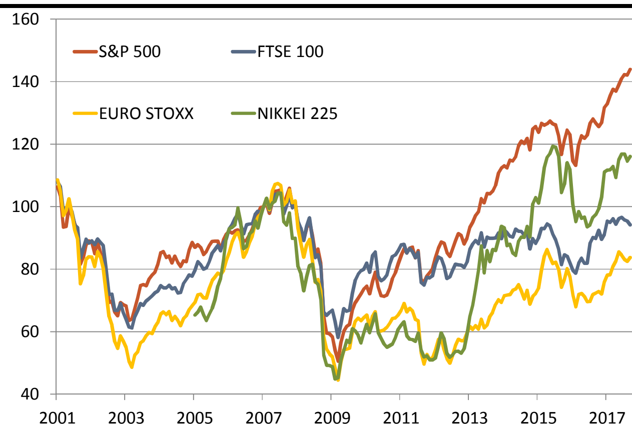
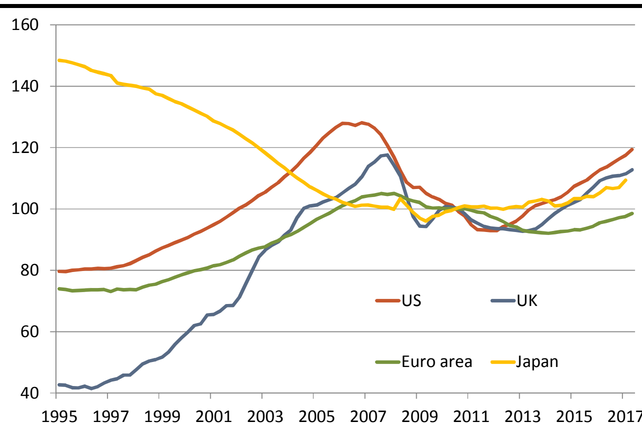
Central banks have managed to revive growth and fend off deflation risks over the past eight years: To mitigate one of the worst balance sheet crises in history in 2008/09, central banks across the developed world went to great lengths, including massive asset purchases and ultra-low policy rates, to support demand. As part and parcel of the healing process, prices of risk assets have rebounded strongly from their post-Lehman troughs. Central banks have learned the major lesson of The Great Depression by dealing with the crash and recovery in the right way. Looking forwards, the question now is whether they risk forgetting one of the key lessons of the more recent boom/bust tragedy. By increasing rates too slowly in the 2000s, the US Fed, the BoE and – to a much lesser extent – the ECB had engendered the excessive risk-taking that ended in the bust of 2008.

Chart 2: Real equities prices (Jan 2007 =100)



Monthly data. Source: Standard & Poor's, Financial Times, ECB, Berenberg calculations. Regional equity prices deflated by respective core series shown in Chart 1.

Chart 3: Real house price index (2010 Q1 = 100)



Quarterly data. Source: OECD

Monetary policy matters: Led by the Fed, the BoE, the ECB and eventually the BoJ will likely begin to slowly unwind their stimulative policies over the coming years. However, we see a risk that some central banks may take too much comfort from the low inflation environment and exit too slowly. As we argued in Notes on the inflation puzzle, the current low inflation rates are partly caused by structural factors. Central banks need to look beyond inflation for other signs of potential exuberance and excess, notably in credit and real estate markets. Otherwise, they may normalise their policy stance too late and too slowly.

No need to panic: On their own, the acceleration in GDP growth to above-trend rates in the US, the Eurozone and Japan and the equity price rally pose no major economic risks yet. However, if cyclical dynamics gather further momentum in line with the recent surge in equity prices, stronger credit growth and increasing speculation in real estate could create genuine bubble risks in the coming years. Exuberance in business investment and real estate markets, underpinned by excessive leverage, could sow the seeds of the next recession. So far, we are far away from such excesses. But especially in the US and the UK, policymakers need to mind the risks that may become more pertinent over time.

The lesson of history is clear: Cyclical dynamics can take hold fast. As monetary and fiscal policies work with a lag, by the time the economy is overheating it is often too late to defuse the problem gently. Central banks and governments need to watch such risks and be prepared to lean against stronger cyclical dynamics in the next few years. Stronger GDP growth and rising equities prices should enable policymakers to scale back their monetary stimulus or their fiscal deficits a bit faster without disrupting the real economy.

Lest we forget: Policy rates remain at or close to historical lows (Chart 4). Meanwhile, the fiscal debts incurred during the last crisis still have not been repaid, leaving little room for discretionary spending if unemployment were to rise (Chart 5).

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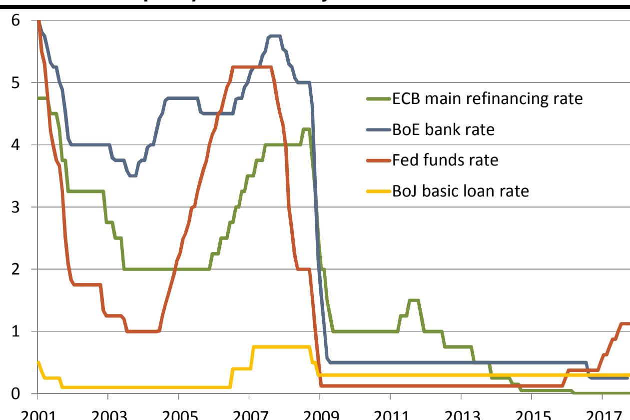
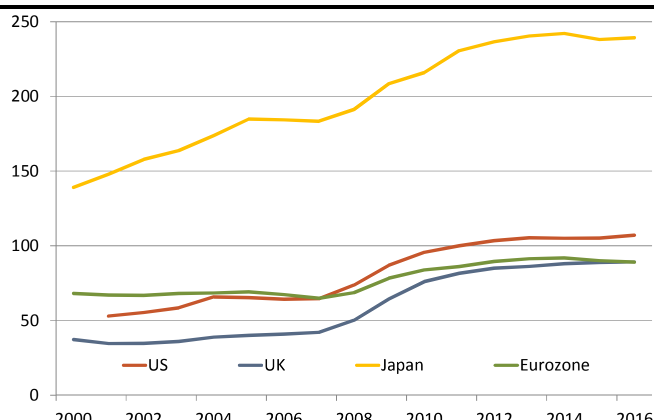
Chart 4: Main policy rates for major central banks



Monthly data. Source: Federal Reserve Board, Bank of England, European Central Bank, Bank of Japan.

Chart 5: Public debt as a % GDP



Annual data. Source: International Monetary Fund.

Prudence is a virtue: For a good while into the post-Lehman upswing, prices of risky assets fell short of economic fundamentals. Remember how markets would pull back on minor risks? But with less pervasive risk aversion, markets can continue to do well even as central banks withdraw their stimulus. In an ideal world, policymakers will strive to delay the next boom/bust cycle for as long as possible, giving major economies extra time to fully recover from their recent financial crises.

Aim for a long cycle: Governments should consider a faster fiscal rebalancing where it is still incomplete. In countries with a maturing economic upswing such as the US and the UK, central banks should exit their accommodative policies a little faster than currently planned. The ECB should signal that it does not intend to prolong its asset purchases beyond September 2018 and expects its next move to be a rate hike in due course if the economy meets the central bank's expectations. If GDP growth started to slow unexpectedly or too much, policymakers could ease off again. If growth held up while central banks keep the risks of potential exuberance in check, we would all benefit from a longer cycle.

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