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Party animals

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The best parties are the ones for which you have the lowest expectations. The worst? – those that you have spent weeks looking forward to and for which you have made a really special effort. The *very* worst? – fancy-dress parties; they seem such a good idea, conceptually, but almost always turn out to be stilted and dull; if you know me, please leave me off your invitation list. Since the end of the recession, we keep expecting the global economic party to get going again. At the start of every year, invitations to attend the festivities in the US are sent out by excited economists, and dutifully we turn up with our friends, only to find that the organisers have failed to book the band.

So, it seems that once again a disappointing start to the year is going to result in a disappointing outcome – that is, if you started with high hopes that the US was about to enjoy an acceleration to 3% growth. That feeling that this cannot be 'it' in terms of global growth still seems to pervade the economics debate. There still seems to be a belief that we are merely enjoying the pre-party drinks (I hesitate to say 'pre-lash' as this has distinctly the wrong connotations), but the real event has yet to begin. And, of course, that main event will be marked by a return to the rates of growth seen before the financial crisis, when the world seemed so much more fun.

The two economies that have probably been the most successful amongst the majors during the post-crisis period have been the US and the UK. Interestingly, over the past five years, both have recorded average annual GDP growth rates of 2.1%. Analysis of trends over very long periods suggests that growth around this pace can be supported largely by gains in productivity. As such, 2% momentum can be sustained with a minimum of cyclicality. Above this rate, growth tends to increase pressure within labour markets and also forces the pace of the investment cycle, thereby increasing the overall amplitude of growth and inflation cycles. The mistake that monetary authorities made during the period prior to the recession was in believing that much faster growth was normal – ignoring the increase in debt, rising trade imbalances and significant asset price inflation that was associated with such rapid expansion.

For professional economists, this presents a problem. For those of us who have been practising for a reasonable time (the different definitions of the verb 'practise' being appropriate), our careers have been largely taken up with analysing and forecasting the various aspects of the business cycle. For the moment, however, this framework is no longer appropriate. I often hear comments to the effect that this growth cycle has already exceeded the normal upswing by a number of years, therefore it is about time we had a recession. Trying to impose historical average cyclical timings to the current growth phase represents a fundamental misunderstanding of cycles and the causes of cyclicality.

But for those who do still hanker after a good party, all is not lost. Unless productivity picks up, even 2% GDP growth will not be sustainable in the US and UK, because even these comparatively dull growth rates are putting increasing pressure on labour markets. This exposes another problem that often confronts professional economists – that although we understand the general connections and relationships in the economies we look at, we are less good at determining timings and thresholds. Well before the financial crisis, many of us were warning that debt levels were becoming unsustainable, but they continued to rise for much longer without, seemingly, causing a problem... until they did eventually crash down on us. And so, in a different area of the economy, economists are currently sounding warnings that have to date not seemed justified. The warning is that tightening labour markets will eventually trigger a more obvious upswing in the wage cycle.

This has to be true – our problem is simply in identifying the degree to which the labour market can tighten before this becomes apparent and the timescale within which this might take place. Fortunately, that is still not the only outcome. 2% growth momentum can, in my view, be sustained almost indefinitely if it is largely supported by productivity improvements and that remains the key to continuing growth in advanced economies. Currently, I am seeing some positive early signs in both the US and UK. It is not fancy-dress time, but it might be a moment when we are able to crack open a bottle of elderflower cordial.

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