EDITORIAL

GROWTH HITS SPEED LIMIT

Judging by recent survey data, it seems many advanced economies are hitting against their speed limit in terms of economic growth. This has several consequences. It creates upside risks to inflation, something which is acknowledged by the Federal Reserve and the ECB. Labour shortages can cause faster wage growth but they should also underpin consumer confidence and spending. Supply bottlenecks should boost company investments. However, when growth is at the speed limit, future economic volatility may increase. Finally, it also creates an analytical challenge in understanding whether softer business surveys are demand or supply driven.

Economists often use metaphors to explain their views and, when discussing cyclical developments, reference is often made to speed. When growth is slowing significantly, stall speed is used to describe the point where the slowdown becomes self-reinforcing due to a drop in confidence, cutbacks in investments and hiring, etc.

The mirror image of that occurs during a recovery when escape velocity is reached. Growth then becomes self-sustained and no longer needs additional support from economic policy. The increase in demand can be so strong that supply can't follow. Bottlenecks develop and the economy then hits a speed limit. Judging by the recent purchasing managers' indexes (PMI), this seems to be the stage that many advanced countries have now reached.

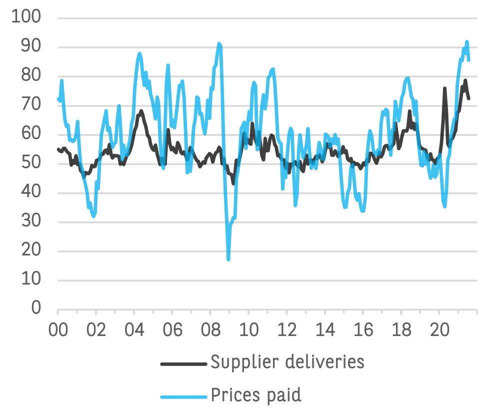
The reasons are well-documented. On the demand side, there is the unleashing of pent-up demand when restrictions on mobility are lifted, tapping into excess savings built up during lockdown, fiscal and monetary stimulus, etc. On the supply side, several factors are at work: the ripple effect of disruptions in global value chains, the inelastic nature of supply when faced with a sudden increase in demand, logistical issues (shipping capacity, container handling capacity in ports), etc.

Pressure on supply has been accumulating for several months, witness the lengthening delivery lags and rising input prices (chart 1). There are reasons to assume that this pressure should ease gradually. Demand growth is expected to slow from the recent, unsustainably fast pace[1] and supply should adjust as well. However, this could be a slow process. The flash PMI for August shows that in manufacturing and services, slightly fewer companies in the Eurozone are faced with higher input prices than the month before, but the level remains extremely high compared to history. In the US however the number continues to increase. The minutes of the July FOMC meeting have several references to supply bottlenecks, which may last longer than expected[2]. A similar message is heard in the Eurozone. The account of the July meeting of the ECB Governing Council mentions that "*in the latest ECB Corporate Telephone Survey, firms had reported that it was probably going to take until sometime next year before these supply constraints would no longer be an issue.*"[3] This implies that both in the US and the Eurozone, there are upside risks to inflation, something which is acknowledged by the respective central banks.

Labour shortages are another manifestation of the imbalance between demand and supply. In the US, according to FOMC participants, they limit the ability of firms to keep up with strong demand. In the Eurozone, as shown in chart 2, labour shortage in construction is close to the pre-pandemic high and in services it is also getting closer. In manufacturing, it has rebounded strongly and is now well above the previous cyclical peak.

There is plenty of anecdotal evidence of companies in the US and Europe complaining about difficulties in filling vacancies. This is a headwind for growth but eventually, it could also lead to higher wages.

US ISM MANUFACTURING



SOURCE: ISM, BNP PARIBAS

EUROZONE MANUFACTURING PMI

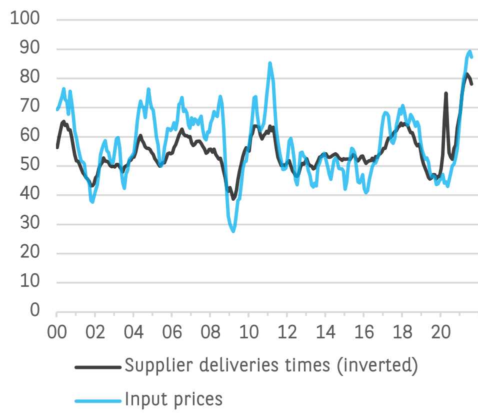


CHART 1

SOURCE: IHS MARKIT, BNP PARIBAS

1. Where restrictions have been lifted for quite some already, the mechanical boost to demand should wane. Price increases in certain sectors can also weigh on demand.
2. *"Many business contacts had expressed uncertainty and pessimism over prospects regarding the easing of supply constraints over the near term."* Source: Federal Reserve, Minutes of the Federal Open Market Committee, 27-28 July 2021.
3. Source: ECB, Account of the monetary policy meeting of the Governing Council of the European Central Bank held in Frankfurt am Main on Wednesday and Thursday, 21-22 July 2021.

Although this has occurred for certain types of jobs, it does not yet show up in overall wage growth numbers to any significant degree. A tight labour market should boost confidence of households about finding a job or holding on to their current job. In the Eurozone, unemployment expectations for the next 12 months have seen a large drop and the employment series of the PMI surveys have improved significantly this year, reflecting hiring intentions of companies. This should support consumer spending, although a lot depends on how the pandemic evolves. Aggregate demand should also benefit from an increase in corporate investment in reaction to rising capacity utilisation and strong demand.[4]

Another, less positive, potential consequence of 'growth at the speed limit' is an increase in future economic volatility. Faced with long delivery lags, clients of companies may be tempted to order more than strictly necessary. For the producers this complicates the assessment of the true state of demand. Orders may be cancelled subsequently. Investment plans may be frontloaded, at the risk of having too much capacity at a later stage. To the extent that inflation ends up being higher than anticipated, monetary policy expectations would be revised, leading to higher bond yields and, quite likely, lower equity prices.

Finally, the current environment also raises analytical challenges. The recent softening of survey data could be interpreted as signalling a weaker demand outlook, which, in combination with high inflation, could trigger a 'stagflation is back' narrative. At the current juncture however, it is more a reflection of supply constraints acting as a headwind in meeting demand. This inspires confidence in the growth outlook.

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LABOUR SHORTAGES IN THE EUROZONE

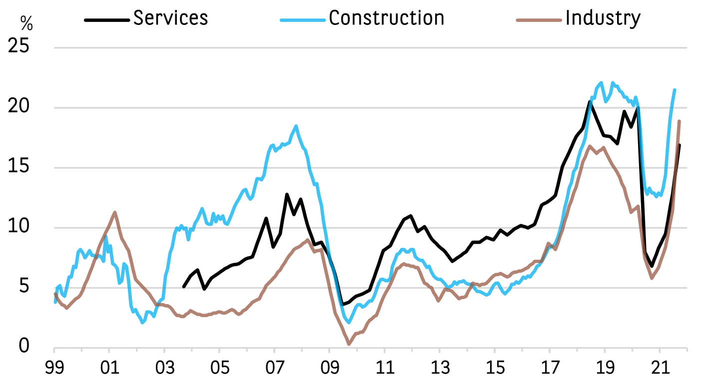

CHART 2 SOURCE: EUROPEAN COMMISSION SURVEYS, BNP PARIBAS

When economies hit their speed limit in terms of growth, this creates upside risks to inflation. It may also cause future economic volatility to rise.

4. In France, INSEE, in its July manufacturing investment survey, expects an increase of corporate investment of 10% in nominal terms this year compared to 2020.