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## At full throttle into the boom

*by Michael Heise*

Since the 2008 financial crisis we have grown accustomed to subdued economic growth, low inflation and unconventional monetary policy. This “new normal” also feeds into expectations for the future which are traded on the financial markets. Rate hikes are not seen on the horizon for either Europe or Japan, in the US the rise in rates is expected to be much lower than Fed governors themselves are assuming. This perception is less and less consistent with the current economic situation, with the world economy now expanding strongly.

Three factors lie behind this. In the first place, trade has recently recovered vigorously despite the protectionist polemics by some heads of government. Thanks to improved developments in Asia and rising commodity prices, world trade has overcome the weakness seen in 2015 and 2016. Secondly, in all major economic regions, companies and households are evidently more willing to take on debt. In the eurozone the new credit cycle is still in its infancy, but here too the phase of business and household deleveraging is evidently over. The boost to demand from trade and increasing demand for credit is colliding – and that is the third factor – with more or less full capacity utilization in most regions, including the eurozone. Companies must now invest more and take on more staff if they want to expand production. In this way they boost the economy and ultimately wages and prices further.

In normal circumstances, interest rates and bond yields should be in line with overall economic development. Especially in Germany and the eurozone, this has not been the case for years. German ten-year interest rates are around 0.4 percent, while nominal growth has been around 3.5 percent for some time. This discrepancy can be attributed largely to monetary policy. It warns against too much economic optimism and pushes interest rates down further with its bond purchases on the capital market. The full impetus of monetary policy stokes the economy further and exacerbates excesses on the financial markets.

At some point, the boom will turn into a downturn, which most countries would be extremely ill-prepared to face in terms of monetary and financial policy. The ECB should therefore no longer hesitate with a cautious normalization of monetary policy. Sure, the reaction of the financial markets is not easy to predict. What can be said, however, is that the conditions for a withdrawal from the huge bond purchase programs are favorable in the current economic environment. And if overreactions occur in the financial markets, the central bank would have sufficient resources to counteract them. If monetary policymakers dally further, they are likely to be pushed into action by the economic development soon.