Growth in the age of caution

This year has provided some key lessons and a turning point in our thinking about what recoveries look like

The year 2017 should be remembered as the first 'post' post-financial crisis year. Ever since the global economy nosedived nearly a decade ago when Lehman Brothers filed for bankruptcy, the advanced world has lived in the age of caution. Burned by the effects of the excesses that caused the crisis, firms, governments and households have acted with much more prudence than before.

While extraordinary central bank policies in the US and Europe have succeeded in reflating asset prices and lowering interest rates, instead of using the favourable credit environment to borrow and spend, households and firms have taken the opportunity to strengthen their balance sheets. Amid the caution, growth has been weaker than before. Firms have preferred to hire rather than invest to raise production. This has weighed on productivity growth.

But 2017 marked a turning point in the post-financial crisis recovery. The cautious growth of the past eight years is finally coming to an end. Looking back at this critical year, there are four clear lessons that will probably shape the expansion in the years ahead.

Lesson one: success breeds confidence. With eight years of growth in the bank and memories of the crisis fading, the advanced world is beginning to recapture some of its past vigour. After surviving the mini emerging-market and commodities crises in late 2015, and the Brexit vote, markets' confidence in the durability of the recovery has grown. For the first time in nearly a decade, markets are responding more stoically to the normal ups and downs in world affairs.

Lesson two: the old dog still has legs. Typically, as expansions mature, growth begins to slow as all the spare resources in the economy become employed. Meanwhile, some investors become extra cautious as they expect the 'ageing' upswing to end soon after years of unbroken growth. But this time is different. Late 2016 saw a broad-based improvement in global demand and trade that gained significant momentum in 2017. Rising profit expectations caused global equities to rally. Markets and firms recognise that, because the usual excesses in production, investment and credit have not yet occurred, there is no good reason to expect a recession soon. Unlike normal expansions where imbalances are typically appearing at this stage, a mid-cycle acceleration in economic growth can be sustained by improving fundamentals in the coming years.

Central banks are the ultimate source of liquidity

Lesson three: populism has probably peaked. Slow growth has fuelled populism in the Western world that reflects genuine frustration over stagnating living standards. But, as Donald Trump and Brexit have proven, populists cannot make good on their promises. Populism in continental Europe peaked well before the key elections in France and Germany this year. While French voters opted for a major regime shift, they did so by voting in centrist Emmanuel Macron and his new party En Marche instead of far-right eurosceptic Marine Le Pen's Front National. In Germany, where Angela Merkel prepares for a fourth term in office, populists did even less well than in France.

Lesson four: markets are becoming less reliant on central banks. As the monopoly suppliers of high-powered money, central banks are the ultimate source of liquidity. Through their extraordinary policies, including outright asset purchases and negative interest rates, central banks have provided a steady supply of liquidity to markets since the Lehman crisis. Remember the taper tantrum in 2013 when markets panicked at the thought of the US Fed taking the monetary crutch away? Fast forward to 2017, and the market is barely blinking as the Fed very gradually tightens its monetary policy and other key central banks slowly follow. When market sentiment is strong, investors are willing to trust each other and exchange assets freely. Markets by themselves provide the liquidity they need to function properly. In such a world, a gradual exit of central banks can occur in the background with little disruption.

For the advanced world, 2017 heralded the end of the age of caution and the first phase of a return to the more normal cyclical dynamics of boom and bust. Markets are now betting on a sustained upswing driven by investment and profit growth. Following the key trends of 2017, and, of course, barring a major unexpected shock, the medium-term economic outlook is more encouraging than it has been in a decade.

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