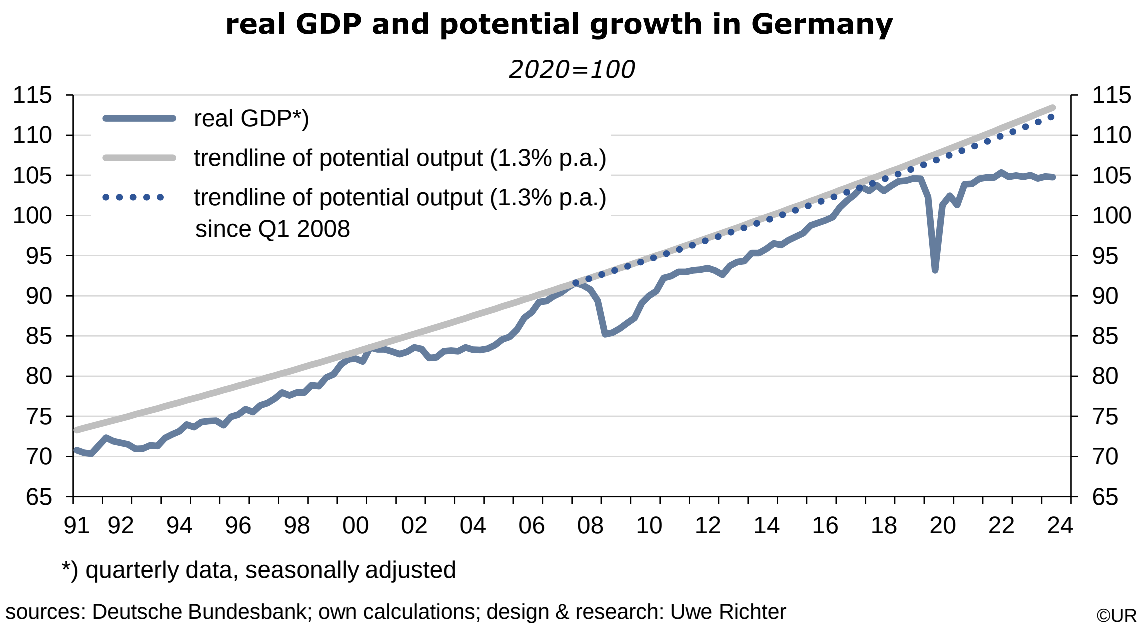
Large output gaps everywhere – inflation and interest rates on the way down

Mainz, September 16, 2024 | *Dieter Wermuth*

For several months now, European and American inflation rates have come in lower than expected by most market participants while China's price levels continue to fluctuate between moderate deflation and absolute stability. The main reason: in the largest economies the rates of capacity utilization are unusually low, especially in manufacturing industries. In such a situation it is not easy for business to raise prices. Moreover, if I look at leading indicators, there is now a non-negligible risk of a new recessions, both in OECD countries and in China. The main central banks are therefore probably just at the beginning of rate cutting cycles.

One approach to calculate economic output gaps (and thus the rate of capacity utilization) is to compare actual real GDP with potential GDP, ie, with the trendline that connects previous cyclical highs and extrapolates it to the present.

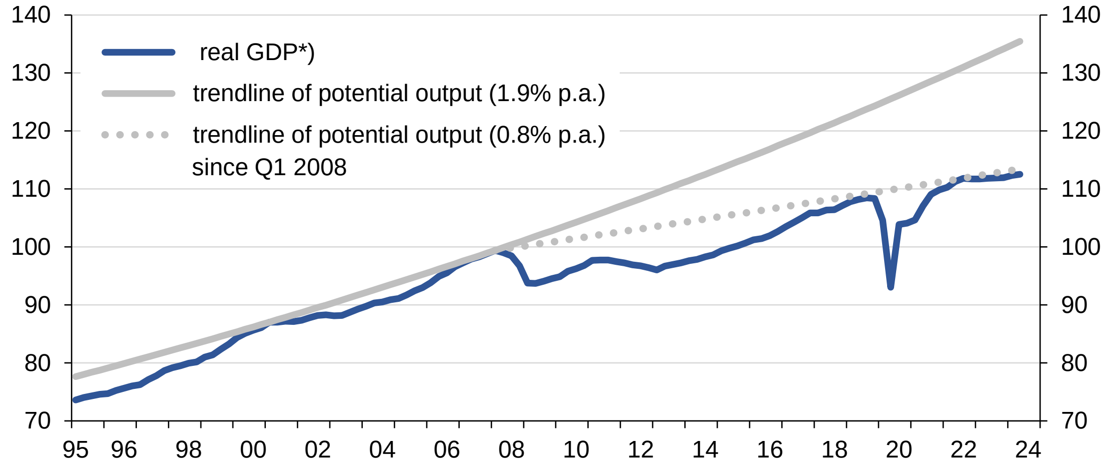
Let me start with the **German economy**. I get a surprisingly stable trendline of about 1.3% per year for potential GDP, no matter whether I base it on the 2001 and 2008 or the 2008 and 2017 peaks. Since the country's real GDP is stagnating since 2019, it is now about 7% below trend, a gap that has previously only been reached during recessions. The risk of rising inflation rates is very low.



For reasons I don't quite understand, **euro area** potential GDP growth is 1.9% p.a. if I take, for the calculation of the trendline, 2001 as the first cyclical peak – but just 0.8% if I use the first quarter of 2008. There seems to have been a structural break around the year 2008. Going by the first of the two trendlines gives me an output gap of no less than 17% today, but almost no gap at all if I take the trendline based on the 2008 and 2022 peaks. The „true" value of the output gap is probably somewhere in the middle, perhaps around 10% – which is also rather large.

real GDP and potential growth in the euro area

2015 = 100



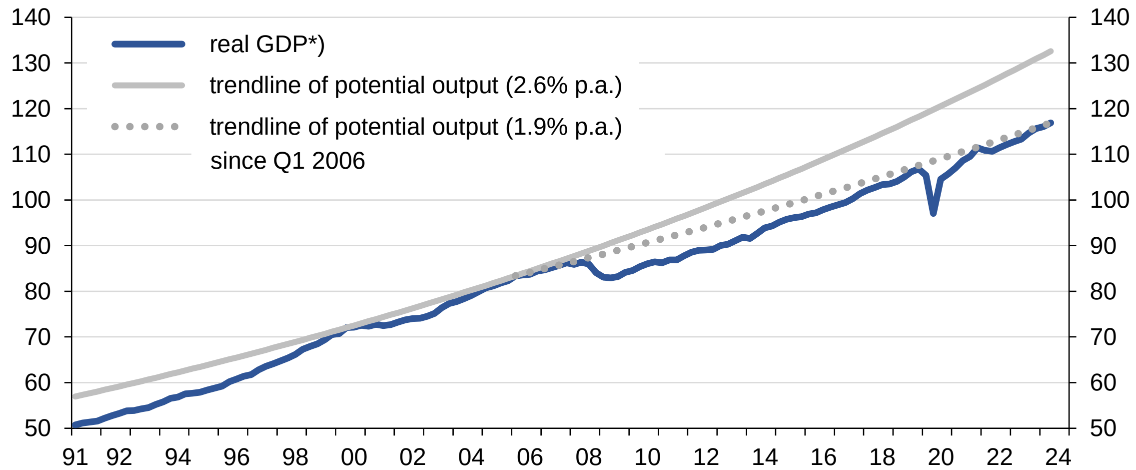
*) quarterly data, seasonally adjusted

sources: Eurostat; own calculations:design & research: Uwe Richter ©UR

The **US economy** is presently characterized by fully employed capacities if I let the potential GDP trendline go through the first quarter of 2006 (1.9% p.a.) – which means the inflation outlook is not particularly favorable. Things look different if I use the second quarter of 2000 as the left-hand peak for my trendline (2.6% p.a.). In that case I would implicitly assume that there hadn‘t been a structural break around the years 2007/2008 – today’s output gap would be about 12% (comparing 117 with 133 in the following graph), suggesting inflation might fall a lot from here on.

real GDP and potential growth in the US

2017=100



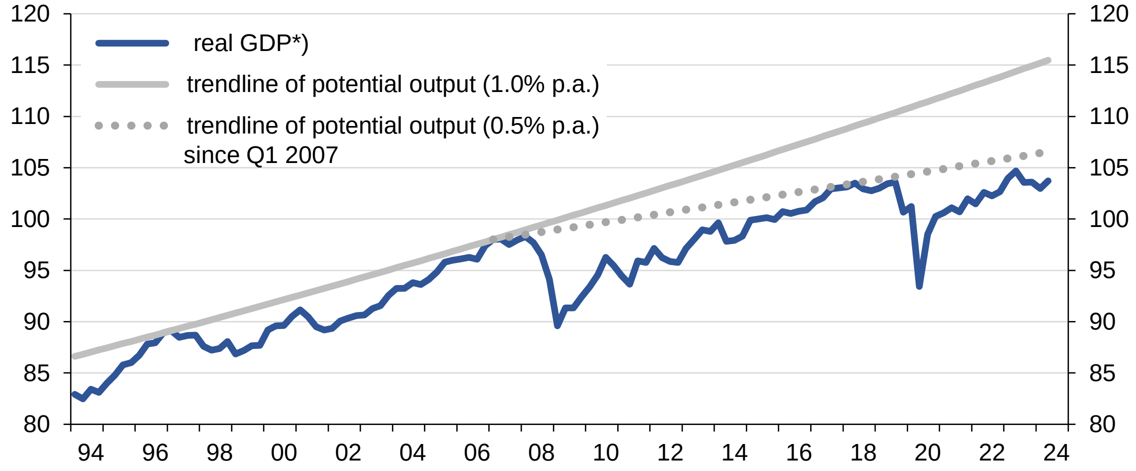
*) quarterly data, seasonally adjusted

sources: BEA; own calculations; design & research: Uwe Richter ©UR

Japan's economy seems to operate far below potential as well. Since real GDP has been stagnating since 2018, almost six years by now, it is presently about 5% below potential. The end of the long years of deflation, with actual inflation rates of more than 2%, does not necessarily mean that inflation is back for good.

real GDP and potential growth in Japan

2015=100



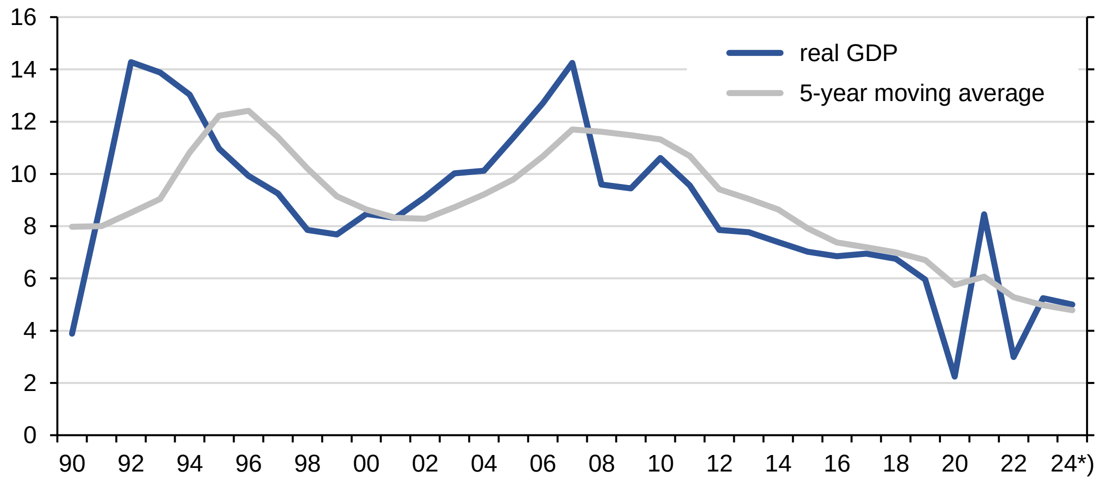
*) quarterly data, seasonally adjusted

sources: ESRI; own calculations;:design & research: Uwe Richter ©UR

Finally **China**: back around the year 2005, real GDP growth rates were in the order of more than 10%, a result of an ambitious government growth strategy, a large catch-up potential and an investment ratio which was about twice as high as in the OECD area. In the meantime, growth rates of around 5% have become the new normal. Put differently, there must be huge capacity reserves which in turn will prevent an increase of inflation and interest rates. The main risk is actually deflation.

Chinese economic growth slows

real GDP (yoy, %)



*) IMF projection

sources: IMF; own calculations, design & research: Uwe Richter ©UR

And the bottom line? The combined output gap of the euro area, the US, Japan and China – which, in purchasing power terms, account for 50% of global GDP – is so large that inflation is no risk at all, especially in the next two or three years. I guess the main problem will soon be to prevent deflation. Monetary policies may become more expansionary than generally expected, just as fiscal policies. Moreover, a crash of stock and real estate markets is a distinct possibility as market participants realize that future earnings growth will probably disappoint. Investors should keep this in mind.

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