

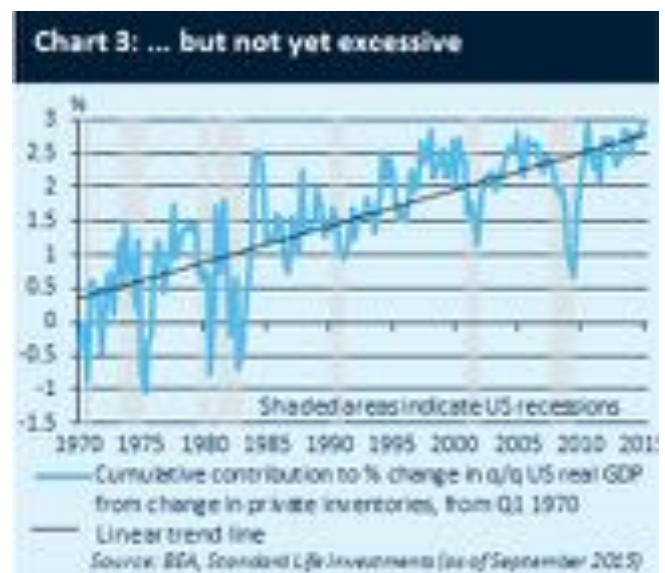


Destocking ahead?

Inventory cycles have long been an important component of the overall business cycle. **Economic expansions - and their early phases in particular - are associated with positive contributions from inventory investment as firms build their stocks in anticipation of stronger demand.** On the other hand, recessions are associated with negative contributions from inventory investment as firms adjust to rapidly deteriorating demand by aggressively cutting stocks. This business cycle has followed a similar pattern. Between Q3 2007 and Q3 2009 inventory investment subtracted some 1.75 percentage points (ppts) from aggregate economic growth. Then, during the first two years of the recovery from crisis, inventories contributed a net 1.35ppts to growth and have added a further 0.5ppts to growth over the past two years. But is there any evidence that inventory investment has been excessive and now represents a threat to the recovery itself?

The most compelling evidence that inventories are stretched comes from inventory-to-sales (IS) ratios in the manufacturing, wholesale and retail sectors. All have increased noticeably over the past two years, and only the retail IS ratio is currently below its pre-crisis business cycle average (see chart 2). The wholesale IS ratio has increased particularly rapidly, though this is partially accounted for by the glut in oil stocks. This data does, however, have to be interpreted cautiously. It is difficult to know what the appropriate IS ratio is because it is subject to structural breaks that prevent it from reverting to its long-term average. For example, academic evidence suggests sustained falls in equipment and software capital goods prices relative to the price of inventories led to a structural decline in the aggregate inventory-sales ratio during the 1990s and 2000s. The shift towards just-in-time inventory management has worked in the same direction. In addition, **once we strip out the positive trend over time, the accumulated contribution of inventories to GDP through the current business cycle has only just erased their drag between 2007 and 2009.** That is in contrast to some previous cycles, where accumulated inventories were as much as 4ppts above trend on the eve of recessions (see chart 3). Meanwhile, inventories simply swing around much less today than they did during first few decades after World War II.

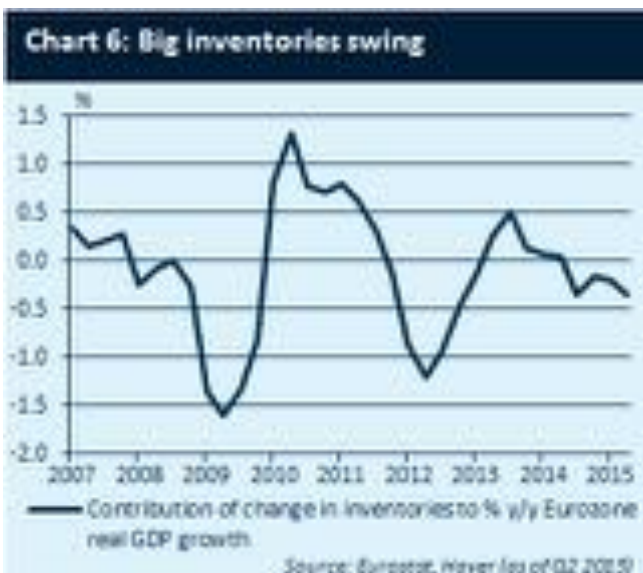
The upshot is that it is not the level of inventories per se that represents the biggest threat to the economic outlook, but the growth rate of sales. While we anticipate that inventories will be a modest drag on growth over the next two quarters (given the size of the positive contribution over the past two years), **the circumstances where we think the drag would be large enough to bring about a recession is if domestic demand in the economy were to slow rapidly.** That would leave firms with unwanted inventories and force them to cut production aggressively. For now, though, there are few signs that such a dramatic turnaround in the domestic growth outlook is in the offing. Much of the drag from lower oil prices on investment is behind us, consumer spending is expanding at a healthy clip and firms outside the manufacturing sector are pointing to buoyant activity and employment conditions.



Time to stock up?

The Eurozone economy has had a tough time in recent years. Any respite from the financial crisis was quickly dashed as the currency union slid back into recession in 2011. This double-dip recession means that the Eurozone is tracking behind many of its developed market peers from a cyclical perspective. The level of GDP in the Eurozone is still below its pre-crisis peak, whereas the UK and USA are currently some 5 and 9 percentage points (ppts) respectively above theirs. **This also means that the Eurozone is currently standing at an earlier stage of its inventory cycle.** The financial crisis triggered large and rapid changes in stocks (see chart 6). At the peak of this adjustment in Q2 2009, inventory cuts were subtracting 1.6ppts from annual growth in the Eurozone, contributing to a 5.6% year-on-year decline in GDP. The initial rebound from this shock was surprisingly powerful. The new orders-to-inventory ratio in the Eurozone manufacturing Purchasing Managers' Index (PMI), which measures business confidence, shot up rapidly from a record low of 0.5 in late 2008 to 1.2 a year later. This rapid rebound in demand encouraged a rebuild of heavily depleted stocks across the region. In mid-2010, inventories were adding 1.3ppts to Eurozone growth, accounting for more than half of the 2.2% growth rate. **This restocking proved premature. The Eurozone sovereign debt crisis pushed the region back into recession in 2011, forcing firms to again reassess their inventory positions.** Inventories provided a drag on growth for five consecutive quarters, subtracting in total 1.2ppts from Eurozone GDP. The strength of the inventory cycle has differed across many of the largest Eurozone member states. Germany, with its large manufacturing sector (accounting for 22% of domestic activity), has seen the largest swings in inventories. At the worst point, the stock adjustment in Germany subtracted 2.3ppts from annual growth rates. These shocks in Italy, France and Spain peaked at a smaller, but still extremely painful, 1.6ppt negative contribution.

The Eurozone moved out of recession in mid-2013 and has now been growing for nine consecutive quarters. However, the pace of this recovery in the early stages was relatively tepid, with the region only having achieved a period of sustained above-trend growth over the past three quarters. We have seen firms remain cautious from an inventory perspective, perhaps reflecting this initially muted upturn (see chart 7). **Since moving out of recession in the middle of 2013, the average impact of inventories on quarterly growth rates has been neutral. Worse, in three of the last four quarters inventories have provided a drag on growth.** This could have been due to upside surprises in demand, which have been met by a forced reduction in inventories. This caution could be storing up good news in the future. If we are right that the Eurozone recovery is sustainable, and that conditions in emerging markets (EMs) do not deteriorate markedly, then Eurozone firms will need to start returning inventories back towards more normal levels. This effect could prove strongest in Germany, where the most recent data show inventories subtracting a full 1.1ppts from annual growth. Firms could be acting particularly cautious given the rise in risks around EMs. This should be at least partly alleviated by rising domestic demand, while at present there are few signs that the deterioration in EMs is materially harming growth, according to the latest PMI and IFO business confidence surveys.



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