



Chief Economist Richard Hoey presents his outlook for 2014

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We continue to expect an acceleration in global economic growth in 2014. Global GDP growth should accelerate by one-half of one percent to three-quarters of one percent from the prior pace near 3% in both 2012 and 2013. The acceleration in global growth should be led by the developed world, in continued recovery from past economic weakness. We believe that the four main causes of faster growth should be: (1) past and ongoing monetary ease, (2) reduced fiscal drag, (3) moderation in the post-crisis deleveraging of the private sector and (4) moderate energy prices, given the expansion of new

sources of energy supply, especially in the U.S. A key theme for 2014 is that aggressively easy monetary policy in most developed countries should support an acceleration of global economic growth.

While we are optimistic about the cyclical outlook for the world economy, we believe this will occur in a longer-term context of a lower path for potential GDP reflecting both a one-time downshift due to the effect of the Great Recession plus a slowing potential GDP growth rate in the future due to: (1) deteriorating demographics and (2) suboptimal economic policy. The growth rate of the working-age population is decelerating in many parts of the world, with absolute declines in some countries. That is not a significant cyclical problem due to high current unemployment rates in many countries. However, it should contribute to a downshift in trend economic growth in the long run. Little can be done to modify these demographic trends, especially in the short run.

In contrast, the drag on potential GDP growth from suboptimal economic policies is different. For each country, suboptimal economic policy is a choice, not a destiny. A key swing factor in the economic outlook is whether the medium-term credibility of economic policy in each country improves or deteriorates. There are numerous opportunities for economic reforms which could improve the outlook for long-term growth in each country, but the political difficulties to reforming policy are substantial. Some progress has been made. At the price of short-term economic weakness, short-term budget deficits in Europe, the U.K and the U.S. have been reduced, even as long-term debt and budget trends remain challenging. We

believe there are favorable opportunities for difficult structural reform in China and Japan. The appointment of a well respected reform-oriented economist to head the Reserve Bank of India is encouraging. Protectionism has been dormant and the negotiations to further open trade channels through the Trans-Pacific Partnership (TPP) and the U.S.-EU trade deal could prove a motivator of economic reform efforts.

A notable aspect in most developed countries has been strong asset inflation combined with low consumer price inflation. Central bank policy tends to target consumer price inflation. Consumer price inflation remains below target in key countries, motivating central banks to maintain aggressive monetary policy ease. Wage inflation has remained low due to: (1) a cyclical excess in labor supply in the aftermath of the Great Recession, (2) substitution of technology for labor and (3) a prolonged period of global labor arbitrage between high-wage and low-wage countries. Since the aftermath of the Great Recession brought a combination of excess capacity and tightened financial regulation, inflation has remained low, permitting persistently stimulative monetary policy in these inflation-targeting regimes. With the global economy likely to accelerate higher in 2014, we expect that the recent disinflationary trend will reverse into a very gradual upward drift in inflation in most developed countries, a shift too slow to motivate increases in central bank policy rates.

In the developed world, monetary policy is stimulative, fiscal restraint is easing and private sector deleveraging is less intense. With inflation quiescent, markets can discount a prolonged period of stimulative monetary policy, especially given conditional central bank promises of low policy rates in the form of forward guidance.

We believe that the U.S. has passed the midpoint of what should prove to be a seven year economic expansion. Because the initial years of expansion were so slow, inflationary pressures have not built up and U.S. monetary policy can remain stimulative for an extended period of time. After more than four years of subpar economic growth near 2%, we expect a "three for three" pattern of roughly 3% real GDP growth in the U.S. for the next three years. Stagnation in the U.K. has given way to a sustainable expansion and the outlook is favorable. In Europe, the good news is that the euro should remain intact, the double-dip recession has ended and a sustained but muted expansion has begun. The bad news is that the pace of economic growth in Europe over the coming years is likely to be modest, given a combination of high debt burdens, challenging demographics, and only hesitant movement towards reducing north/south imbalances within the Eurozone. Following two decades of stagnation, Japan is experiencing a fast pace of growth in the early phases of Abenomics. After a volatile pattern of pre-buying, then payback, due to the hike in the Value Added Tax scheduled for April 2014, moderate expansion should persist.

The outlook in 2014 for emerging countries is more challenged and differentiated, both by initial conditions (current account, interest rates, credit growth) and by questions about the credibility of some countries' economic policies over the medium term. Countries with large current account deficits remain sensitive to swings in financial market sentiment. However, the actual taper of U.S. QE3 that we expect to occur in 2014 may prove less disruptive than the mid-2013 sell-off on "taper talk" since the gap between current QE-suppressed Treasury yields and free-market levels has already been reduced.

The double-dip recession in the European economy has ended and we believe that Europe has begun a period of sustained but sluggish expansion. The euro is a single currency with a single monetary policy for a group of very disparate countries. While there is a political commitment to preserve the euro, the disparities within the Eurozone persist. The peripheral countries were forced to make substantial

adjustments to their fiscal deficits by tax increases and spending cuts, but progress on reforms to increase their growth potential has been limited. We expect a Eurozone growth rate of 1% to 1.5% in 2014. This should only be strong enough to stabilize the Eurozone unemployment rate, but not to reduce it. The growth rate in the overall European Union should be about one quarter of one percent higher.

One way to think about the Eurozone is to regard it as having 17 different currencies locked together at fixed exchange rates. From that perspective, the euro-deutschmark is undervalued and the euro-drachma is overvalued. If changes in the nominal exchange rates are prohibited, the euro-deutschmark could adjust its real exchange rate by a powerful inflation, while the euro-drachma could adjust its real exchange rate by a deflation. Given the distribution of power within Europe, the adjustment has largely been pushed onto in the periphery. The result has been economic pain, elevated unemployment and political stresses. Given that wages tend to be somewhat inflexible on the downside, in the past countries with overvalued currencies have tended to foster rebalancing via a devaluation rather than by prolonged economic weakness. Our expectation is that the euro will remain intact but that the consequences of a one-size-fits-none monetary policy for disparate countries should contribute to a sluggish pace of expansion.

Japan has been caught in a stagnant equilibrium for two decades. Despite Japan's adverse demographics, we are optimistic that Abenomics will make some contribution to improving Japanese economic performance. Japanese deflation in recent years had multiple causes: (1) long delays in the recovery of its financial system after the Nikkei and real estate bubbles burst, (2) a strong yen, due in part to preferences among risk-averse Japanese investors for domestic investments, (3) global labor arbitrage from lower wage countries and (4) a liquidity trap, as deflation at the zero bound for nominal interest rates prevented a sufficient decline in real interest rates (nominal interest rates minus inflation).

We regard the new policies of weakening the yen and quantitative easing with a 2% inflation target as shock therapy designed to engineer a shift to a new set of more positive expectations in Japan. We expect that both realized inflation and inflation expectations will shift higher, lowering real interest rates. Corporate profits have already risen and the result should be an improvement in domestic capital spending. The "third arrow" of Abenomics is an attempt to reduce some of the growth-hostile rigidities in the Japanese economy. Change is likely to prove politically difficult. If talks on the Trans-Pacific Partnership trade deal can be brought to a successful conclusion, we believe that it would increase the odds of relaxing these rigidities. We expect an average real GDP growth rate of about 2% in Japan over the next two years, in a very volatile pattern.

The outlook for the Chinese economy is one of the crucial uncertainties for 2014. We expect a growth rate near 7.5% in 2014. We believe that the deceleration in Chinese economic growth is not cyclical but rather is structural. A slowdown in the growth in its blue-collar labor force has contributed to wage inflation, which has eroded its competitiveness, especially for less complex products. We believe that China is beginning a transition from a double-digit trend growth rate in the past to a sustainable growth rate near 6% in future years due to eroding demographics and the need for greater discipline in its investment in infrastructure, property, plant and equipment.

We disagree with those who anticipate a financial meltdown in China, since we believe that the government has the financial resources to amortize financial losses over a period of years. China is adopting a major long-term program to rebalance its economy away from excess or misdirected investment towards consumption. However, this should prove a complex multiyear process and we would

expect actual implementation to be gradual. Over the next several years, the deceleration of investment may occur more rapidly than the acceleration of consumption spending.

In the early stages of the U.S. economic recovery, many mainstream economists argued that the U.S. should take credible steps to reduce the long-term problem of rising entitlement spending resulting from the coming retirement of baby boom workers, but should avoid or limit tightening short-term fiscal policy, since that might restrain the economic recovery. The political dynamics were such that exactly the opposite occurred: there was little progress on long-term entitlement reform but substantial short-term fiscal tightening. The political left achieved some of its objectives of increased taxes and the political right achieved some of its objectives of restraining discretionary non-entitlement spending. The result was a rapid reduction in the current budget deficit, but practically no progress on the long-term entitlement problem.

The short-term fiscal tightening helped hold back the pace of U.S. real GDP growth in the first four years of recovery to about 2%, well below normal. The current budget deficit as a share of GDP has now dropped sharply. This creates the opportunity for less fiscal tightening and faster economic growth for the next several years. Having paid the price of slower growth to reduce the current deficit, the fiscal drag should now drop, permitting an acceleration of U.S. economic growth. Note that, even after quantitative easing ends, the remaining budget deficit should be easy to finance over the next several years in a context of low inflation and low short-term interest rates.

There is an ongoing political war in the U.S. over the Federal role in the U.S. economy in two aspects: (1) the relative share of Federal spending and private sector spending and (2) the distribution of decision-making power between the Federal government, the states and the private sector. Many of the recent budget conflicts are battles in that ongoing political war. The general background of the politics of the war over the U.S. budget has been described in the book "The Price of Politics" by Bob Woodward.

We believe that future budget battles will end in a low level status quo stalemate rather than repeating the recent pattern of disruptive major clashes over budget policy. There is currently an effective double veto in the U.S. political system. Nothing can become new law unless it is passed by the Republican House, the Democratic Senate, and then signed into law by President Obama. In effect, both the Democrats and the Republicans have a veto. The results of the 2011 debt ceiling battle, the 2012 fiscal cliff battle and the 2013 debt ceiling battle have generated public opinion increasingly opposed to major disruption over budget issues. We believe that the U.S. budget battles have moved from a World War II phase of rapidly moving front lines to a World War I phase of static front lines and trench warfare. Rather than some "grand bargain," we expect minor budget compromises with little policy change and substantially less disruption than in the last several years.

What about U.S. monetary policy? Janet Yellen, a well-respected economist with knowledge of both monetary economics and labor market economics, has been nominated chairman of the Federal Reserve. We expect her to be confirmed by the Senate. She supports the mainstream Federal Reserve view of monetary policy, but she has a reputation as an easy money "dove" due to her past views and her current positions. She sees minimal near-term inflation risk and believes that high unemployment is predominantly due to weak demand and not any major structural reduction in labor supply. Based on her "optimal control" analysis, she sees advantages in an aggressively easy monetary policy in order to reach full employment more quickly. It is notable that recent research by senior Federal Reserve staff supports that thesis. She has noted that the Fed's 6.5% economic threshold is not an automatic trigger for

tightening. We believe that she is likely to hold the Federal funds rate at zero even after the unemployment rate hits 6.5% and to emphasize that the initial taper of the quantitative easing should not be interpreted as a leading indicator of any early rise in the Federal funds rate.

We believe that the implication of "Yellenomics" is that monetary policy will be very supportive of economic expansion for the next several years. With inflation below the Fed's target and the labor market far from full employment, both parts of the Fed's dual mandate support stimulative monetary policy. We categorize monetary policy into five stages: (1) aggressively stimulative, (2) stimulative, (3) neutral, (4) restrictive and (5) aggressively restrictive. Since we believe that the U.S. economy is not currently very inflation-prone, we would expect a monetary policy supportive of economic expansion in 2014, 2015 and 2016, with truly restrictive policy postponed until 2017 or 2018, after the Presidential election of 2016.

We believe that the three-decade-long secular bond bull market is over. The U.S. has benefited from declining interest rates for about three decades. We outlined the logic for a persistent decline in long-term yields in our May 25, 1981 Forbes column, entitled "Last Chance This Century." The actual long-term secular decline in bond yields lasted nearly 31 years, with 10-year U.S. Treasury yields peaking intraday at 16% on September 30, 1981 and troughing intraday at 1.37% in late July 2012, a decline of 1463 basis points over a period of more than three decades. Such an extreme low yield below 1.4% in July 2012 was only reached because the markets feared a total collapse of the European financial system last year, a risk which has faded.

As described in our September 12, 2013 report entitled "Interest Rate Normalization", we expect a three-phase normalization of bond yields over a half-decade period: (1) a rise, much of which has already occurred, from artificially depressed bond yields to free-market bond yields as markets discount the end of QE3, (2) a prolonged gradual upward drift over the next two years in response to normal cyclical forces and (3) a late spike in interest rates when Fed policy turns restrictive in 2017 and/or 2018 following seven years of economic expansion.
