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Overview — Marginal Revolution

As 2013 draws to a close, the global economy looks to be exiting the slowdown of the past three years and entering a new phase of modest recovery and growth. Global real GDP growth measured at market exchange rates looks poised to strengthen, from about 2½% this year to roughly 3¼% next year, with further modest increases in 2015 and 2016. But even if this relatively good news materializes, substantial spare capacity (particularly in the advanced economies) is likely to persist.

Yet what is revolutionary about 2014 is that the likelihood of severe downside tail events, which could paralyze the global economy, seems to have diminished significantly (though not disappeared). Granted, the euro-area is still work in progress, China presents meaningful question marks, Congressional gridlock in the US could still throw sand in the federal fiscal wheels and geopolitics can always surprise. But, enough progress has been made that all of these issues seem less threatening today than 12 months ago.

We expect 2014 to be marked by progress in three major areas of economic policy. Although it is difficult to find perfect synchronicity across the world, we think that monetary and fiscal policies, plus structural reforms, will deliver some moderate adjustments, and that these changes will be broadly supportive of global growth and stability. More specifically, although monetary policy in some countries may turn less accommodative, the pace of tightening of fiscal policy among the world's advanced economies is expected to slow. Structural reforms are also likely to continue in several corners of the world (including the euro area periphery, China, and Mexico), although these reforms are likely to remain, in most cases, incremental.

Is monetary policy on its way to normalization?

US monetary policy is likely to continue being highly accommodative. Even after the Fed begins to taper its securities purchases, most likely early in 2014, Federal Reserve policy will remain expansionary. And even if tapering commences as anticipated, the size of the Fed's balance sheet (the key variable determining the resulting stimulus) will likely expand through most of next year. And it has become clear from the confirmation hearings of the likely next Fed Chair, Janet Yellen, that policymakers don't see rate hikes as a serious possibility until well into 2015.

Japan continues to pursue the cyclical targets of ending deflation, moving to 2% inflation, and closing the output gap. To date, the major instruments used have been a temporary fiscal stimulus and, more notably, an unprecedented expansion of the Bank of Japan's balance sheet and the monetary base (which is slated to double from its end-2012 level by the end of 2014). While this aggressive policy mix can make headway in defeating the deflationary demons that have long plagued Japan, even more stimulus may be required. In particular, the 3 percentage point sales tax increase scheduled for April 2014 and the further 2 percentage point increase expected for October 2015 could kill the budding recovery. Our assessment is that the Bank of Japan is prepared do more, likely next summer, but we worry that the necessary support from fiscal policy may not be forthcoming.

In the euro area, besides structural and fiscal headwinds, the recovery has received less support from monetary policy than has been the case in many other advanced economies. The recent drop in inflation to around ¾%, well below the ECB's below-but-close-to 2% objective, prompted a modest rate cut at the central bank's November meeting. But the ECB has failed to use all its policy tools to aggressively counter the disinflationary — even deflationary — risks that appear to be taking hold. Even if outright deflation is avoided, the ECB's stance seems too restrictive.

Unemployment is running high, at 12.2%, and there is excess capacity in most individual member states. (Germany, of course, is a notable exception.) Yet the ECB has allowed its balance sheet to shrink significantly since the end of 2012, and was unwilling until last month to cut the refi rate. Perhaps more worrying, policymakers seem hamstrung regarding the use of additional policy tools, with little consensus regarding another LTRO (with an eye toward boosting bank liquidity and lending) a cut in the deposit rate into negative territory (which might help weaken the external value of the euro) or credit easing measures aimed directly at lowering the cost and increasing the availability of credit for SMEs, especially in the periphery.

Monetary policy in EMs was disproportionately affected by external conditions during 2013. We expect a similar situation for 2014. Despite the mild hysteria in financial markets, the Fed's "taper talk" through the late spring and summer does not appear to have done significant damage even to the worst-affected EMs. Indeed, as financial shocks imported from the US go, this one was rather mild — which reflected two factors: First, the US financial shock was rather small. Unlike previous shocks, which typically have brought a triple whammy of bad news (higher official US policy rate, higher US long rates, and lower US growth), the news in this case was more mixed (higher long rates but also higher US growth). Second, despite some fragilities, EMs were in a better position to respond to it and live with it than in the past. No doubt when tapering is actually implemented (and when US rates are ultimately hiked), there will again be some financial arrhythmia and another rush out of EM securities and currencies. But the effects of this on the real economies will likely be minor, partly muffled by the use of monetary policy. The countries to watch remain those with: (1) a prior domestic credit boom/bubble; (2) an open capital account; and (3) external vulnerability through a large current account deficit and a large stock of foreign currency liabilities. The so-called 'fragile five' — India, Indonesia, Brazil, Turkey and South Africa tick all three boxes. Some progress has been made in a few of these countries to strengthen their economies (mainly in India), but electoral cycles unfortunately make prompt action unlikely.

On the road to fiscal sustainability?

The US economy has had a rather disappointing 2013, with growth likely to come in at around 1.6% — well below the 2.8% achieved in 2012. This is due in large measure to front-loaded fiscal tightening the US inflicted on itself, through the 'fiscal cliff' at the beginning of the year and the March sequestration. This premature burst of fiscal austerity also suffered from poor composition and may have cost roughly 1.5% of GDP. But this tightening is unlikely to be repeated, assuming that between now and March 2014, Congress and the White House can engineer a continuing resolution to fund the government and reach an agreement to raise the debt ceiling. Our central view is that this fiscal minefield will be navigated more successfully than in 2013, with US growth next year rising to 2.6%.

On the other hand, in Japan, the (permanent) sales tax increases scheduled for April 2014 and October 2015 are likely to be met with some temporary fiscal stimulus and, if necessary, some further monetary stimulus. Apart from the tax package, there are no signs of a long-term strategy for dealing with Japan's unsustainable public debt and deficit. Thus far, the markets are happy to hold 10-year JGBs at nominal yields near 60 bps, but we see risks that even sleepy bond-market vigilantes may eventually wake up. It is therefore time for Japan to design a medium- to long-term strategy for closing the deficit and reducing the debt-to-GDP ratio. Clearly, restoring fiscal sustainability would be much easier if the growth rate of potential output could be raised significantly.

The European economy is once again showing that it has a pulse — indeed quite a vigorous one in countries like the UK. The euro area (EA) economy is performing better, but is still sluggish. Growth is expected to close 2013 mildly negative, and we

anticipate 0.9% growth for 2014. The reduction in the severity of fiscal austerity that has taken place has been one of the contributors to this modest recovery.

However, the vigor of the EA recovery remains challenged by persistent question marks regarding fiscal sustainability and sovereign solvency in the periphery. Bail-ins of official creditors (official sector involvement or OSI) remains a frequent occurrence. The sovereign debt of Greece, Ireland and Portugal held by the EU or EA member state governments, through the Greek Loan Facility, the EFSF and the ESM, has been the subject of repeated maturity extensions, coupon reductions, and deferrals of interest payments. This debt is quickly becoming indistinguishable from a zero coupon perpetuity — a promise to pay nothing forever, with full face value and zero net present value. Writing down the face value of the officially held obligations of the Greek, Irish and Portuguese sovereigns would be cleaner than the current version of "extend and pretend" now offered to program countries.

In addition, it is still possible that more OSI/PSI (official/private sector involvement) may be needed in the EA. Greece and Portugal remain vulnerable. And Italy, Spain, and Ireland could be threatened if sustained GDP growth remains elusive.

Meanwhile, fiscal policy in EM continues to loosen. The response to the global financial crisis brought a generalized expansionary change in fiscal stance which has not been reversed since. As growth in EM has slowed — partly due to cyclical factors but also partly in response to structural challenges — governments throughout EM have maintained a bias towards expansionary fiscal policies. As we move into 2014, the fiscal anchor is expected to drift further. The electoral cycle, slow growth and continued availability of funding are driving governments from Chile to Mexico, India to Turkey to open their purse, increasing the risk of a sudden stop in external funding.

Incremental progress on structural challenges

Structural reforms, while acutely needed in both AEs and EMs to speed-up growth, remain gradual and incremental in nature. Properly sequenced and executed structural reforms that are needed to resolve supply side difficulties, even in regions with wide output gaps, could boost domestic demand and assist the recovery. Nevertheless, from China's reform agenda to Europe's bank reforms, progress is likely to be slow.

We believe that sustained recovery in the EA (i.e., growth that closes the output gap) will require (1) much stronger actions than those to date to clean up and recapitalize the banking system, and (2) dealing with the sometimes excessive indebtedness of other sectors — including sovereigns in the periphery and households in a range of countries (for example, Ireland, Spain, Portugal and the Netherlands). Fortunately, European policymakers have recognized the importance of restoring the banking sector to health and of breaking the perverse feedback loops between weak sovereigns and weak banks. We expect that the proposals currently under discussion — for a bank recovery and resolution directive at the level of the EU and for a single resolution mechanism at the EA level — will be implemented in time to allow the ECB to don the mantle of the EA banking supervisor in November 2014 and to permit capital shortages identified by the stress tests to be filled during 2015.[1] Structural reforms aimed at producing a higher growth rate of potential output are likely to continue to be uneven across countries and on balance disappointing.

In Japan, the third arrow of Abenomics, supply-side reform aimed at increasing the growth rate of potential output, has yet to deliver an agenda that raises much hope of success. Boosting the effective supply of labor through immigration policies,

[1] For more details, see the accompanying essay by Buiter and Rahbari.

encouraging the labor force participation of women, and ending lifetime employment in large corporations may look like low-hanging fruit economically. But, the politics of their implementation places them close to the top of the tree. The same holds for trade liberalization in agricultural products and tradable services, deregulation of Japan's low productivity service sectors, and opening up the non-traded service sectors to FDI. Without such reforms, the Japanese economy will, after a couple of years of cyclical recovery, be consigned to resume its anemic growth.

China's path to reform stemming from its plenary session also emphasizes gradualism. Yet, the country faces a triple challenge. It has to bring its credit and housing bubbles under control without causing a financial crunch and a significant cyclical slowdown in economic growth. It also needs to redesign its countercyclical fiscal stabilization policy in such a way that neither its composition nor its funding are in direct conflict with its medium- and long-term rebalancing objectives. Finally, it has to achieve a change in its growth model (a rebalancing), from an investment-led model concentrated on high-visibility infrastructure and on SOEs, to growth that is driven by private and public consumption and investment in the service sectors (including health and utilities) and private corporates.

The outcome of the Third Plenum of the Communist Party provides a broad roadmap toward these objectives, but the available specificity does not provide clarity as to whether the long-term rebalancing challenges will be met. In particular, although the medium- and long-term reform agenda appears ambitious, its gradualism and focus suggest that, in some cases, it could fall short of the needed changes to achieve rebalancing. As regards avoiding a cyclical downturn, the Chinese authorities have legacy central planning instruments and institutions that may give them more control over the exit process from the financial excesses of the past five years, but there remains a material risk of a sharp correction.

Conclusion

It is almost never quite true that one year resembles the previous one. Still, we expect 2014 to resemble in many dimensions a slightly improved version of 2013. Global growth is likely to be somewhat higher with a better grounded recovery. We do not expect monetary policy to turn dramatically in advanced economies, nor is fiscal policy set to tighten to the point of threatening growth. Structural reforms are not likely to be earth shattering in 2014. Thus, we see the next year bringing a gradual return to normalcy.

Of course, normal also implies surprises and some risks. Geopolitics can always surprise, though 2014 seems leaner as regards threats than has typically been the case in recent years. National politics, with presidential elections in several EM nations and a midterm contest in the US, could also throw a curve ball, but such shocks rarely are large enough to materially affect global economic performance over the course of a year. Sovereign accidents in Europe, a fiscal mishap in the US, or a bursting bubble in China are also possibilities, but seem either less likely than this year or, should they happen, of less global systemic significance. The initiation of tapering by the Fed and some macroeconomic vulnerabilities in a few systemically important EMs could create a bit of a jolt. But, once again, it is unlikely that 2014 will bring an EM crisis like those of yesteryear.

Moderate risks, moderate recovery. The trademark of 2014 appears to be that of incremental improvements. Yet, consistent, marginal improvement is, for this day and age, revolutionary.