Our Top Ten Predictions for 2014

US GDP growth to accelerate
The US economy is expected to gain momentum in 2014, with growth reaching a 3% annual rate by H2 2014 as solid job growth, reduced fiscal restraint and greater political certainty help lift consumer spending. Further expansion in the housing sector will also help, although the recovery in this sector will be more subdued than normal given the impact of tapering and rising mortgage rates. Some risks will remain, including the danger of policy errors, and the US will probably also not be as much of an engine for world growth as in previous global upswings. But amongst the advanced economies, the US will look strongest.

Eurozone to flirt with renewed recession
With GDP growth at just 0.1% in Q3 2013 and survey data suggesting a similar or lower outcome for Q4, there is a risk that the Eurozone could slip back into technical recession next year, although growth is expected to slowly improve later in the year. Renewed recession would raise the danger of a slide into deflation and reignite concerns about debt sustainability in Eurozone member states.

Inflation to remain subdued in the advanced economies
Growth in the advanced economies next year is unlikely to be fast enough to close still-significant negative output gaps, and with wage growth also subdued and global export prices declining due to sharp market competition, inflation is unlikely to be a problem in the advanced economies next year. Indeed, in the Eurozone at least concerns about a slide into deflation are likely to predominate.

Another patchy year for the emerging markets
We expect Chinese growth to level off in 2014 at just over 7%, modest by recent standards, as the authorities attempt to rebalance growth away from exports and investment. Relative growth performance will be even worse in the other BRIC economies – Brazil, Russia and India – with GDP expanding at well below trend rates. US tapering will tend to attract capital away from emerging markets, leaving those with weak external positions at risk of renewed currency weakness. Overall, 2014 is likely to see increased segregation in the emerging world between the more successful countries and the more vulnerable. Political risks will also be in focus with important elections in Brazil, India, Turkey, Indonesia and South Africa.

Diverging monetary policies – more stimulus in Japan, tapering in the US
US economic performance is likely to be strong enough to persuade the Fed to begin ‘tapering’ its asset purchases in January of next year. But while the US is reducing the degree of monetary stimulus, Japan will continue its aggressive stimulus – and even increase it to offset the negative effects of a rise in the consumption tax. The ECB meanwhile will come under pressure to loosen policy further in the face of low inflation and weak growth.

Yen and euro to decline, dollar to gain
Rising US growth and a widening differential between US interest rates and rates elsewhere will mean the dollar will gain around 3% on a trade-weighted basis next year, with notable gains against the euro and the yen.
UK to be the fastest growing major economy in Europe

The UK will grow by 2.4% in 2014, the fastest pace of growth among the major European economies as consumers benefit from rising incomes and house prices and the recovery broadens out to exports and investment also.

Equity market rally to cool

After big gains in equities in 2013, the onset of US tapering will result in much more modest equity market increases in 2014 – by the end of the year, annual increases in equity prices will have fallen to around 5-6% in the US, Eurozone and UK. Monetary policy settings will still be very expansionary in most advanced economies, reducing the danger of a sharp sell-off.

Oil prices to decline

We expect increased supply (helped by reduced disruption in key producers) plus modest demand growth to see oil prices edge down to US$103.9 per barrel in 2014 from US$108.6 per barrel in 2013, a modest flip for the world economy.

Wild cards –

- China moves to weaken its currency
- Greece to default again
- Financial crisis in Argentina, danger of civil uprising in Venezuela
- Geopolitical tremors in Asia – tensions in Korea and between Japan and China
- Middle East risks – Iran, Egypt and Syria all remain serious potential flashpoints with the capacity to disrupt commodity markets
- Bursting of housing bubbles, possibly linked to US tapering – Canada, Australia, Hong Kong all possible candidates
Assessment

2014 – a year of widening monetary divergence

The Fed’s December decision marks a change in active monetary policies. It is a natural consequence of the divergence in global growth that was one of the key developments of 2013. Over the course of the year, US and UK activity strengthened, remarkably so in the case of the UK where six months ago the talk was of a triple-dip recession. Chinese activity held up, if below the stellar growth rates of the pre-crisis years. Japan is beginning to see some dividend from Abenomics, but rather less than expected; while the Eurozone economy is slowing again after showing some brief strength in Q2, and may fall back into recession. Diverging growth was clearly signalled by diverging broad money growth earlier in the year. Recent broad money developments imply that this divergence will not just continue but widen in 2014.

2013 – the year when growth diverged

The performance of the major world economies diverged substantially in the second half of 2013. US and UK output growth was stronger than expected. By contrast, the Eurozone’s performance disappointed. In China, the 7.5% growth target for the year looks within reach; while Japanese activity has been weaker than expected, if better than in 2012.

A result of differing broad money trends

Diverging growth was signalled earlier on by diverging broad money trends. These were partly the result of different monetary policies. The Federal Reserve maintained its quantitative easing over the course of 2013, while the Bank of Japan ramped it up. The Bank of England ended its asset purchase programme, but instigated forward guidance to reassure financial markets that interest rates would stay low. And the ECB eventually eased rates but has not introduced QE. By contrast the People’s Bank of China tried, with limited success, to dampen the growth of broad money.

Recent broad money developments imply that this divergence will not only continue but widen in 2014. That also points to monetary policy actions diverging for the first time in years.

Fed: two expected decisions, one surprise

This trend has already begun with the Fed’s December announcement that QE tapering would start in January 2014. The Fed’s statement contained two expected developments; and one unexpected. The expected developments were the decision to begin to taper QE from January 2014; and the notice that interest rates would remain unchanged even after unemployment has fallen below the previous 6.5% threshold. No new unemployment threshold was given, probably to give the Fed increased flexibility instead of tying policy to a number – a (welcome) retreat from ever-more detailed forward guidance. It probably also indicates uncertainty and an intra-Fed debate about exactly where the US natural rate of unemployment currently is.

The surprise was the dissent by Eric Rosengren, President of the Federal Reserve Bank of Boston, who felt that the decision to taper was premature. What was surprising was not so much Mr Rosengren’s views, which

![Graph of US: Broad money and credit](image)
are well-known but that this was the first time since December 2011 that a dove has dissented from the majority. The implication is that there remains substantial opposition within the FOMC to the taper decision. It signals that markets cannot take for granted that QE is a one-way street. Economic developments suggest that it should be; but the Fed is clearly prepared to ramp up QE again if economic data indicate otherwise.

**US broad money growth holding up…**

Looking at monetary developments, US broad money growth has held up reasonably well over the past year, generally oscillating around 5%. Assuming a US trend real growth rate of 2-2.5%, an inflation target of 2% and a long-term decline in the velocity of money of somewhat more than 0.5%, 5% annual broad money growth is barely consistent with medium-term trend rate GDP growth. Over the longer term, broad money growth should ideally be stable at between – say – 4% and 6%. However, the US economy is still exiting from a deep crisis; in Q3 the level of real GDP was 5.5% above its pre-crisis peak. If GDP had grown at 2.5% every quarter since (and arguably this is still a below-trend rate, given that our estimate of trend growth in the early 2000s was in the 2.5-3% range), it would today be 15% above its level in Q4 2007 and close to 9% above its current level. It would therefore be better if US broad money growth were stronger than 5%, perhaps in the 7-10% range for the next six to twelve months.

…but the taper effect is a concern

However, the outlook for US broad money growth is currently muddled by issues related to the Fed's eventual tapering of its quantitative easing. On the one hand, recent credit data show that American households are taking on more debt, including re-mortgaging loans to take advantage of higher house prices. On the other, banks are constrained by regulatory insistence that they hold fewer risk assets. Banks have been able to expand their balance sheets (which increases broad money through credit growth) by amassing large amounts of cash. However, if the Federal Reserve begins to taper, that starts to turn off the cash tap for banks. Which of these two forces is the strongest is the key to the outlook for the US economy in 2014. While this is difficult to judge, recent non-monetary data have generally been stronger than expected, implying that, although growth in the current quarter is likely to be weaker than it was in Q3, US economic activity should improve further in 2014.

**PBoC failed to dampen M2 growth**

In contrast to the US, the Chinese authorities have attempted to dampen broad money and credit growth in 2014. This has at best met with limited success. The People’s Bank of China has a 13% target for M2 growth in 2013, down from 14% in 2012. In 2012, M2 growth averaged 13.5%, and ended the year at 13.8%. By contrast, in 2013, the average 12-month growth rate between January and November was 15%; while November M2 was up 14.2% on a year earlier. It therefore looks likely that broad money growth for the whole year will overshoot the central bank’s target. The overshoot is not particularly large – around 1% – but what is significant is that it occurs at all and that money and credit growth accelerated in 2013 instead of the intended slight easing.

**Japanese M3 growing – but not enough**

The current 13-15% broad money growth is slower than average of the pre-crisis 2000s, when it exceeded 16%. However, it is probably enough to be consistent with the likely 7% GDP growth target for 2014, which is also probably China’s current trend growth rate. While China has a medium and long-term growth issue related to the economic reforms the leadership is trying to implement, the near-term outlook is still relatively positive. In a recovering world economy, China too will benefit.
Even though the main thrust of Japan’s qualitative and quantitative easing has been to boost the monetary base, broad money growth has benefited somewhat. M3 grew by 3.4% in the year to November, the fastest rate since August 1999, primarily sustained by credit growth. M3 growth has been above 3% since last May. This should be enough to power Japanese growth around trend (estimated at around 1%); the problem for Japan is that it needs growth above trend in order to ignite inflationary pressures. The downward revision of Q3 growth from 1.9% to 1.1% implies that the Japanese economy has yet to achieve ‘escape velocity’. In the absence of stronger growth, the weak yen becomes crucial to achieving the Bank of Japan’s 2% inflation target for 2015.

**UK M4 growth is faster but slowing**

UK broad money growth is somewhat less positive than Japanese. Not because it is slower. In fact, it is faster, at around 4.5%. However, where Japanese broad money growth is accelerating, the growth of British broad money has eased slightly in recent months, from around 5% per annum to between 4.5% and 5%.

In contrast with the Japanese situation, British broad money growth – supported by a Bank of England policy specifically aimed at increasing the stock of M4 – has not been accompanied by stronger credit growth. Or, more correctly, credit has gone from contracting to being unchanged year-on-year. Weak credit growth is not necessarily surprising; central banks’ myopic fixation on credit growth was always misguided. A debt-induced crisis cannot be solved by making the private sector take on more debt. However, as in the case of the United States, British broad money growth is probably enough to power trend-rate growth in the medium term, assuming, as we do, a trend growth rate in the 1.75-2.25% range and an inflation target of 2%, with a small fall in the velocity of money. In another parallel with the United States, recent data have confirmed that there is now a clear recovery, and that this is likely to accelerate somewhat in 2014.

That was the good news. Now, the Eurozone

So far, the countries we have covered are seeing broad money growth at rates which, if not stellar, are at least decent and indicative of activity around trend. This is most emphatically not the case with the Eurozone. What is deeply worrying in the Eurozone is the continued deceleration of twelve-month broad money growth, from above 3% at the end of 2012, to between 1% and 2% in the first half of 2013 and below 2% since then. In October, Eurozone M3 grew by 1% from a year earlier; November and December may well be down from late-2012.; by the end of the year, we may well find money supply contracting again.

**Regulatory pressure holds back M3 growth**

This is partly due to Eurozone banks continuing to shrink their balance sheets, mostly for regulatory reasons. Difficulties agreeing a European banking union are likely to exacerbate this trend. The ECB has said that some banks will fail its impending asset quality review (AQR). It therefore makes sense for banks to shed bad loans and accelerate the building up of buffers. (A case in point is Spain, where the Financial Times on 18 December 2013 reported that private sector bankruptcies are increasing as banks foreclose on doubtful and bad loans in order to improve their balance sheets prior to the AQR). But this means that broad money growth will be further constrained in 2014.
The Eurozone trend growth rate is likely to be around 1%. Given an inflation target of 2% and a slight long-term fall in the velocity of money, the broad money trend growth rate consistent with medium-term trend GDP growth is likely to be in the 4-6% range. As noted for the US, the UK and Japan above, in this phase in the cycle, it should ideally be considerably faster. The fact that it is not suggests that euro area growth is likely to disappoint in 2014 – as is also the message from recent data. The Eurozone recovery has already been weaker than the US recovery. US GDP is 5.5% above its pre-crisis peak, but Eurozone GDP remains 3% below its level in Q1 2008 (UK GDP is 2.5% below its pre-crisis peak). This relative weakness will remain the pattern in 2014.

Monetary policy will begin to diverge…

Diverging monetary trends also mean that monetary policy is likely to diverge in 2014. The Federal Reserve will start tapering its quantitative easing in January and will most likely conclude it before the end of next year. The People’s Bank of China is likely to continue its attempts to gently dampen M2 growth. Bank of England policy is likely to remain on hold, with the date for the first interest rate increase moving forward from 2016 to 2015 or possibly even late 2014. By contrast, the Bank of Japan will continue its monetary policy; and the ECB will attempt to ease policy further, whether by cutting interest rates to zero or by introducing negative interest rates of reserves or by other means.

…while fiscal policy (broadly) converges…

If monetary policy is likely to diverge – or diverge further – in 2014, fiscal policy looks like converging. The budget deal in the US Congress means that the headwinds from fiscal policy will largely dissipate in 2014 and possibly be replaced by some tailwinds. In the Eurozone, the acceptance of fiscal austerity has reached the end of the road – and is likely to be one factor that will boost the vote of euro/EU-sceptic parties in the elections to the European Parliament in May next year. By contrast, the British government expects its structural deficit to narrow by more in 2014 than in 2013.

..but not in East Asia

The outliers here are Japan and China. The Japanese government will raise consumption tax from 5% to 8% in April 2014 (although there will be some offset from other taxes). In China, the authorities are moving ahead on cleaning up local government debt as part of their general economic reform. Since local government has financed much of its activity through borrowing, this too will involve at least some fiscal tightening.

To sum up

Broad money trends point to continued growth divergence in 2014. For the US and the UK, the message is one of steady but unspectacular growth. That should at the very least mean no further easing of monetary policy; and the ultimate withdrawal of the US monetary stimulus. Chinese growth is also likely to hold up, but the authorities will try to tighten policy to deal with an incipient housing boom. By contrast, although Japanese broad money growth has picked up, the economy is still likely to disappoint, at least until the second half of the year, meaning possible further easing by the Bank of Japan. And the greatest disappointment seems to be in store for the Eurozone, where the ECB only recently seems to have taken on board the risks of deflation and the near-certainty of growth weakening again.