Rising East, emerging West

By Marios Maratheftis

Expect a better 2014. World economic growth should pick up and inflation should stay benign. But the way growth will play out will depend largely on policy changes in the US and China, the two largest economies in the world. Will the US Federal Reserve under incoming Chairperson Janet Yellen get its taper timing right, or could it pull the trigger to unwind its five-year-old quantitative easing (QE) programme too soon, hurting the fragile recovery? Can Premier Li Keqiang execute the boldest set of economic reforms in three decades to turn China into a more sustainable, consumer-driven economy? We think the answer is ‘Yes’ to both questions.

All signs point to a stronger year for the world economy, with global growth expected to accelerate to 3.3% from this year’s 2.7% thanks to improvements in the US and Europe. A recovering West is excellent news for world trade and for the continued outperformance of emerging markets.

The expected ending of QE will be a significant event, even if QE was never the answer to all the challenges the developed world, particularly the US, is facing. With policy rates hovering close to 0%, QE was unlikely to raise growth and encourage job creation. And it did not. It did, however, play an important role.

QE helped the Fed manage interest rate expectations. A central bank that is implementing QE is highly unlikely to hike interest rates anytime soon. As a result, long-term market interest rates remained low, and this helped some parts of the economy, particularly the housing market, recover.

Yellen’s most important decision once she takes charge of the Fed would be to time that moment to unwind QE. We expect the Fed to start tapering by June 2014, a bit later than the market currently expects. Yellen and the other Fed policy makers will need to see strong evidence that the economy is about to accelerate before it tapers, and that evidence is likely to show up by the second quarter of next year.

With QE being tapered and eventually ending, the Fed is likely to rely mostly on forward guidance to influence market rates, which may not be as effective. As a result, expect market interest rates to move higher in 2014. Inflation still remains benign, with the exception of a few emerging markets; commodity prices are stable; and labour markets, both in the US and Europe, remain substantially slack. Meanwhile, the Fed is likely to raise its benchmark policy rate only in 2016.

Where does this leave Asia and the other emerging markets? The acceleration in US activity and Europe’s return to growth after two years of contraction are pleasant changes for Asia, which for the past five years has been relying mostly on domestic demand and trade with other emerging markets to power the global recovery.

China should be particularly pleased with the upturn in the West as it tries to usher in the most ambitious package of reforms since it opened up to the world in the 1980s. In fact, reform and rebalancing will be in focus across Asia in the coming year. Premier Li has been tasked with overseeing China’s economic rebalancing, with consumption growing in importance relative to investment. This is moving along nicely, and the recently concluded Third Plenary Session provided the clearest sign that President Xi Jinping and his colleagues in the all-powerful Politburo of the Chinese Communist Party are leading the ambitious agenda for economic and social reform.
Starting next year, expect a stronger push for land and state-owned enterprise reform, a further opening of the capital account, and less intervention in the currency markets. These reforms are necessary for the sustainability of China’s growth, but short-term volatility cannot be ruled out.

Meanwhile, economies in Southeast Asia are likely to benefit from their growing competitiveness with China as a manufacturing centre, enabling them to attract increased foreign direct investment. Urbanisation, a strong driver of growth in the region, has a long way to go with the build-up of infrastructure and increased industrial activity.

As in Asia, the resource-rich Gulf Co-operation Council (GCC) countries in the Middle East can look forward to a strong year ahead. Oil prices are likely to remain above levels that would boost the coffers of GCC governments, enabling them to use their fiscal strength to drive near-term growth and diversify their economies away from energy industries. However, oil importers in the Middle East and North Africa face slower economic activity, rising fiscal pressures and increasing youth unemployment. Thus, the Middle East remains a tale of two worlds.

Meanwhile, Africa is likely to outperform world growth in 2014 as it has for the past decade. Resource exploration remains important, and commodity output gains should compensate for weaker prices in terms of the impact on growth. However, domestic demand remains the fundamental driver of growth across the continent. The rise of the African consumer – spurred by an improved policy environment, stable inflation, greater savings and a more open embrace of the private sector – is being reinforced by large-scale infrastructure and resource investment as seen most recently in eastern Africa, where governments are keen to commercialise new oil and gas discoveries.

All in all, 2014 should be a better year than 2013. The global economic recovery, so far shouldered by the emerging economies, is likely to broaden with the West joining in. However, the growth gap between G7 and the emerging markets is unlikely to close anytime soon. Challenges lurk as the Fed forays into unchartered territory yet again, this time trying to undo its QE programme. Meanwhile, China is about to enter its most decisive phase of reform as it strives to become a consumer-driven, middle-income economy.

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