Three percent GDP growth for next three years: BNY Mellon

By Editorial Staff *Thu, Sep 26, 2013*

The Fed will fall "behind the curve" in its monetary policy, creating pressure for a major upward spike in interest rates in 2017 or 2018, following the Presidential election of 2016, predicts economist Richard B. Hoey.

Monetary easing—both past and ongoing—in the world's wealthiest countries should continue to increase the pace of economic growth worldwide in 2014, according to the September 2013 Economic Update from BNY Mellon's chief economist.

"Fears of a developing market crisis appear overdone and continued expansion at a moderate rate can be anticipated in most of them," wrote economist Richard B. Hoey, adding that there will be a mixed pattern among emerging market countries.

According to his Update:

The U.S. outlook. We believe the U.S. economy has moved into the second half of what we expect will be seven consecutive years of economic expansion. U.S. real GDP has grown at about 2% over the past four years, but we expect an acceleration to three years of 3% real economic growth in 2014, 2015 and 2016. This should be due largely to the fading of several drags, such as the federal fiscal drag and the state and local downsizing drag. The U.S. is not very inflation-prone, so monetary policy can remain stimulative. The dovish stance of monetary policy was reinforced by the Fed's recent decision to postpone the first taper of QE3.

The outlook for Europe. Europe entered 2013 in a double-dip recession which was caused by the slow pace of financial stabilization in Europe. Aggressive policies and promises from the European Central Bank have, with a lag, calmed these financial stresses. Our view has been that the European recession would end by mid-2013 and be followed by a very weak economic expansion. Recent data have supported that thesis. The swing from a double-dip recession to a modest economic expansion in Europe should contribute to faster global economic growth in 2014 and beyond.

On the East Asian front. The Japanese economy has been stagnating for two decades, but Abenomics has brought about a dramatic change to a more stimulative policy. Despite uncertainties about the hike in the value-added tax planned for the spring of 2014, confidence and economic activity have improved in Japan, led by a very strong gain in corporate profits which should contribute to future strength in investment spending and wage income.

There was a cost-of-capital shock to many emerging market countries due to volatility in the perceptions of U.S. monetary policy. For countries whose policies are regarded as appropriate, these stresses should calm overtime.

China is a separate case. With its capital controls, financial conditions are dominated by domestic decisions rather than by the spillover effects of U.S. economic policy. China is not experiencing a temporary cyclical slowdown. Rather, it is adjusting down to a slower pace of sustainable growth. There has been mal-investment and an accumulation of vulnerable loans in China, but we believe that the Chinese government has both the financial resources and the will to amortize these losses over a number of years, rather than permitting a contagious financial meltdown. We expect an orderly deceleration of trend growth in China.

Interest rates: A major spike after the 2016 national election. The Federal Reserve surprised money market participants by deciding to postpone the first taper of its QE3 program of buying $85 billion a month of Treasury and mortgage securities. One reason was that the Fed is "data-dependent" and U.S. economic data have been mixed rather than definitively strong.

In addition, the Fed appeared concerned about the risk of a fiscal shock. We believe a major motive for the adoption of QE3 in September 2012 was concern about the "tail risk" of a large year-end 2012 "fiscal cliff." In the end, the fiscal tightening was significant but not severe. A year later, we believe that one element in the Fed's decision not to taper in September 2013 was the "tail risk" of disorderly fiscal negotiations over funding the Federal government and the debt ceiling.

We believe that the odds of permanent damage are quite low, but there certainly could be some very tense moments between now and early November 2013, when it should all be resolved. We believe that, both in September 2012 and September 2013, the Fed was motivated in part by the desire to take out some monetary insurance against potential fiscal shocks.

We continue to expect a three-phase upward adjustment of bond yields over a half-decade period, as outlined in our report entitled "Interest Rate Normalization" dated September 12, 2013. The first phase is an adjustment to free-market levels from artificially low bond yields, which reflect an artificial scarcity of bonds due to large scale bond purchases under QE3. This adjustment is underway, but in a choppy pattern, due to the Fed's "Hamlet syndrome" about beginning the tapering down of QE3. To taper or not to taper? That is the question.

We regard the Fed's failure to start the taper as a leading indicator of a central bank which will eventually end up "behind the curve" in its monetary policy, slowly building up the pressure for a major upward spike in interest rates in 2017 or 2018, following the Presidential election of 2016. While the first Fed taper has been postponed, we expect the first taper to occur within the next two to six months.