

JOURNEYS INTO THE UNKNOWN

Strategy and economics

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This is the time of year that economists start to do some navel gazing and contemplate the outlook for the year ahead. A word that we can expect to hear more over the next few months is 'decoupling'. In truth, there has been increasing divergence in economic performance for a few years. However, it looks set to become more obvious during 2015. In this month's article, I look forward to some of the key features we expect to see in Western economies.

The economy that looks to be establishing the best momentum is the US. Following a difficult, mainly weather-related, start to 2014, activity has improved and we expect growth to be close to 3.25% next year. The US has benefited from the early recapitalisation of its banking system, which has allowed it to provide better support to the recovery. In addition, the economy has had a lift from the development of shale oil and gas. Even so, despite a history of self-renewal in the US, the recent recovery has been underwhelming compared to recoveries following previous recessions. This brings us to the issue of what is normal. While an economy may be capable of short bursts of growth above what might be considered its long-term sustainable rate, especially when there are spare resources in the labour market, the long-term trend should be based on the underlying trend rate of improvement in productivity, adjusted for anticipated changes in the size of the employed labour force. When growth rises above the sustainable rate for a prolonged period, there will be an associated increase in debt and increasing signs of excess demand – most obviously in a widening trade deficit.

I believe the new normal for the US encompasses a sustainable growth rate of little more than 2.5%. That does not mean that growth above 3% in 2015 should sound an immediate alarm, but in causing a further tightening in the labour market and forcing up labour costs, it will increase inflationary risk. In doing so, we suspect that it will prompt a

reasonably swift reaction from the Federal Reserve, which we expect to start increasing interest rates, most likely during the second quarter.

The contrast to the US within Western industrial economies will be seen in the eurozone. Immediately following the recession, the German-led recovery in eurozone activity was similar to that seen in the UK. However, as the eurozone crisis emerged and deepened, the bloc fell back into recession, a position from which it has struggled to emerge.

While 2014 should show growth of around 1%, there are few signs that momentum is about to pick up. Indeed, we believe that the constraints imposed by a common currency will be reflected in an extended period of sub-optimal growth. For 2015, we are looking for only a marginally improved increase in activity over that in 2014, and without significant structural reform in economies such as Italy and France, growth will struggle to top 2% with any consistency.

While the US is not heavily exposed to the eurozone, the UK certainly is. Time was when the US was the more important export market for the UK. Now, however, some 44% of the UK goods exports go to the Economic and Monetary Union (EMU) members and only 13% to the US (based on 2013 data). As a result, in terms of UK export growth, the sluggish nature of the recovery in the eurozone far outweighs the benefit of a stronger expansion in the US. Hence, the UK has remained heavily reliant on momentum in the domestic economy to drive growth.

The pick up in activity seen in 2014 has flattered to deceive. Yes, the economy here is on a sounder footing, but temporary and one-off factors (including help-to-buy and PPI compensation) have given household demand a temporary boost. We believe 2015 will see a decline in growth from 3% to around 2.75%. Within this, however, we expect to see signs of a more sustainable expansion. In particular, we are looking for improved productivity gains.

While this will take some pressure off the labour market, it should also support stronger increases in employee incomes. How the Bank of England reacts to this will be interesting. Despite slightly slower growth in the wider economy, activity will continue to expand faster than our estimate of the UK's sustainable rate of 2.25%. We believe this will persuade more members of the Monetary Policy Committee to argue for a rate increase, and it seems likely this will become the majority view at some stage during the second half of the year.

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