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Policy Debates for 2014

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OVERVIEW

After a year in which U.S. policy dominated the headlines, 2014 should have a more international flavor. Though not predictions, here are five economic themes that could make policymaker's lives difficult in 2014.

1. CATCH A FALLING YEN

"Abenomics" has rejuvenated growth in Japan, but policymakers elsewhere continue to worry about what it means for the yen. Monetary stimulus—and more specifically the commitment to 2 percent inflation—remains the most powerful of the policy's "three arrows" (the others being fiscal and structural policies), and hopes for easier monetary policy were immediately reflected in a weaker yen. Since December 2012, the yen has fallen 17 percent against the dollar and 13 percent on a trade-weighted basis, with the current rate at 105 yen to the dollar.

Pressure is mounting from Congress for exchange rate legislation as part of any trade agreement with Asia or Europe.

While it is possible that the upcoming wage round will provide a durable boost to incomes and inflation, there is growing concern that by mid-2014 the economy could begin to slow and deflationary pressures reemerge. Last month I argued that the Bank of Japan would "do whatever it took" to achieve its inflation target, which in this case means doubling down on its quantitative easing program. Where would that take the yen? A yen-to-dollar rate of 120 or 130 would cause significant stress in finance ministries around the world, given concerns about growth and exchange-rate instability. In addition to a rise in protectionist pressures, the resultant deflationary pulse among Japan's trading partners would intensify incentives for competitive depreciations.

For U.S. policymakers, pressure is mounting from Congress to include exchange rate legislation as part of any trade agreement with Asia (the Trans-Pacific Partnership) or Europe (the Transatlantic Trade and Investment Partnership). A sharp yen decline will intensify this debate. The issue is no less fraught in emerging markets, which are already buffeted by capital outflows over concerns about Federal Reserve tightening. Pressure to impose capital controls or engage in competitive depreciations is likely to mount.

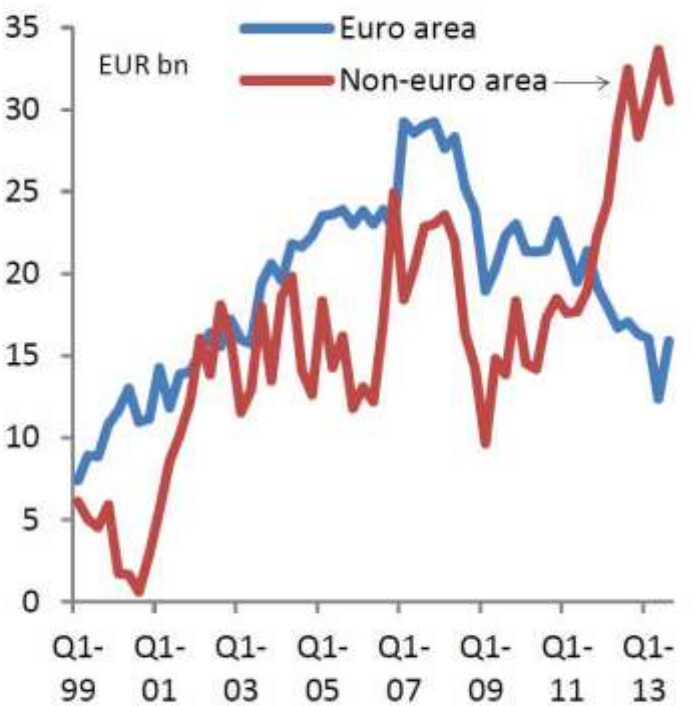
In 2013, the Group of Seven (G7) and Group of Twenty (G20) had a simple mantra: policies should be aimed at domestic objectives, and governments should not purchase foreign instruments (no direct foreign-exchange intervention). It is possible that 2014 will test that consensus.

2. DEBALANCING AND DELEVERAGING

In the economic context, "rebalancing" is not a pivot in U.S. foreign policy to Asia (at least not explicitly). Rather, it reflects U.S.-led efforts since the fiscal crisis in 2008 to encourage policies that will reduce global economic imbalances, most notably reflected in large current account surpluses and reserve accumulation.

After several years of shrinking imbalances, 2014 looks to be the year that external trade surpluses for China and Germany begin to widen again (see Figure 1). This change reflects growth differentials, in part, and in normal times could be addressed through expansionary fiscal policy or an easing of financial conditions by central banks. But these are not normal times. China's early steps toward market liberalization will be tempered by the need to address the challenge of reining in its shadow banking system, and the risks to imports and growth remain on the downside. Meanwhile, Germany benefits from a euro that, while too strong for periphery countries struggling to restore competitiveness, is much weaker than it would be if Germany were not in a monetary union. A muted recovery in the rest of Europe is unlikely to provide a meaningful counterweight. The region continues to deleverage, and tighter credit conditions in the European periphery are likely to provide a substantial headwind to growth. In this context, concerns about global growth may intensify the rebalancing debate.

FIGURE 1. GERMAN TRADE SURPLUSES (IN BILLIONS OF EUROS)



Source: Haver and Bank of America Merrill Lynch Global Research estimates.

3. ARGENTINA FALLOUT

Argentina's standoff with its private creditors is now in front of the U.S. Supreme Court and may not be decided until 2015. Along with an ongoing reassessment of Greece's 2012 restructuring, the dispute has triggered a broader debate over whether the rules of the game for sovereign debt need to change. Some law and economics experts have argued that a decision against Argentina will, by strengthening creditor rights, swing the pendulum excessively toward creditors at a time when political and economic factors already make for restructurings that are "too little, too late." These critics contend that the process for restructuring sovereign debt—primarily through market-based debt exchanges—needs to change to make it easier to get deals done and prevent holdouts from blocking them. These changes could include new language in bond contracts, as well as changes to when and under what conditions the International Monetary Fund (IMF) lends to countries in distress. I am not convinced that the current system needs fixing; however, a full-throated official sector debate in 2014, combined with growing pressure on European policymakers to address official debt relief (OSI) for over-indebted periphery countries, has the potential to create tremendous uncertainty in markets, raising the risk of early runs on countries that are seen as candidates for official support.

> *The dispute between Argentina and private creditors has triggered a broader debate over whether the rules of the game for sovereign debt need to change.*

4. SECULAR STAGNATION, QUANTITATIVE EASING, AND INFLATION TARGETING

Larry Summers created a stir in November with his suggestion that the United States faces long-term secular stagnation. The idea that the weak recovery reflects structural factors—a global savings glut, investment uncertainty, or low productivity—suggests that real interest rates have to fall well below zero to produce an adequate recovery. In today's low inflation, recessionary environment, that is a tough challenge for central banks that cannot lower nominal interest rates below zero. If interest rates remain too high for an extended period, the resultant reduction in investment and increased unemployment has long-term effects: cyclical becomes structural.

> *Summers is telling us that we can't assume a return to above-trend growth, and that central banks may need to rethink how policy should be targeted.*

Fiscal policy can effectively boost demand in these situations—a point Summers elaborates on in the *Washington Post*. In the current U.S. policy environment, fiscal policy is hamstrung and monetary policy will have to carry the burden of supporting demand and reducing real interest rates. This could be done through higher inflation, which would require a change to current central banking orthodoxy (that inflation should be held to around 2 percent). Of course, central bank policy works through channels other than interest rates, including the exchange rate, equity, and housing prices.

The argument also has been advanced by Paul Krugman, among others, and traces back to Alvin Hanson's "stagnation thesis." It contradicts the analysis of Ken Rogoff and Carmen Reinhart, among others, whose work identifies headwinds from a crisis that should recede over time. Somewhat perversely, these economists are looking at the United States at a time when the U.S. economy looks set to grow above trend this year. I find the case for secular stagnation more convincing for Europe. But the bottom line for Summers: one cannot assume a return to above-trend growth, and central banks may need to rethink how policy can and should be targeted.

5. ELECTIONS AND INVESTORS

My colleague Jim Lindsay, CFR's director of studies, has highlighted elections to watch in 2014. Virtually all major emerging market governments face voters in 2014, including the so-called fragile five of Turkey (March and August), Indonesia (April), South Africa (April-June), India (May/June), and Brazil (October). Add in Colombia and Hungary, and 2015 elections in Ukraine and Argentina, and you have upcoming elections in nearly all of the major emerging markets.

With U.S. fiscal and monetary policy on a steadier course following the recent budget deal and the Federal Reserve announcement that it would reduce (taper) its pace of government bond purchases, domestic factors are likely to again become the major drivers of market volatility. All of which could make for an interesting year. And it is even more important that there is strong leadership in the international economic arena, including in the United States, where critical Treasury positions remain vacant.

Looking Ahead: Kahn's take on the news on the horizon

How Much Taper?
Minutes from the Fed's December meeting will provide needed policy insight as Janet Yellen takes the reins.

Europe Quantitative Easing
The European Central Bank is expected to resist pressures to ease monetary policy in January, but odds are rising for more moves during the first quarter. Ultimately, qualitative easing will be necessary to produce above-trend growth.

Emerging Markets Turmoil
Political turmoil in Thailand and Ukraine, and ongoing concern about capital outflows, appear likely to provide a difficult start to the year in emerging markets.