The global economy is on the threshold of a major shift in macro economic policies. The world will shift from easy monetary policies and tight fiscal policies to tighter monetary policies and looser fiscal policies. Of course monetary policy will be relatively loose throughout this year and fiscal austerity programs will be operative in Europe and in the US, but they will be less loose and less tight than they were in 2013 and before.

Easy Money

Since the start of the great recession the world has relied on monetary policy to mute the negative effects of the downturn and to restart economies that had been damaged by the recession. Central banks lowered interest levels to near zero, provided billions of dollars in liquidity to banks and non-bank institutions, created dollars to facilitate FX swap lines, and purchased the distressed financial assets from financial markets.

Fiscal Austerity

Governments, particularly in Europe and later in the US, believed austerity and budget reduction would be the key to reducing the mis-placed incentives that were believed to be the underpinning of their poor financial condition. After years of austerity, tighter fiscal policies became a major drag on their economies causing unemployment to rise to threatening levels in Europe and driving potential workers out of the labor market in the US.

EU Unemployment is Too High for Too Long
Big Profits little employment

Economic growth finally emerged after a long recession but the recoveries in the west were very sub par especially with respect to employment. Corporations in the US were extremely profitable in the first years of the recovery as they operated with significantly fewer workers than before. Unfortunately, business confidence did not match their profitability and therefore they did not invest their cash flow in big projects and instead were content to accumulate massive pools of unused capital.

Corporations Underinvesting Cash Flow ($ Bils)

Fiscal Policy becoming less Restrictive

As the recoveries progressed in the West, tax revenue in the developed countries began to rise and with rising revenues budget deficits began to fall back into acceptable ranges. With smaller budget deficits conservative legislatures have less reason to demand more austerity.

Federal Deficits Contracting to less than 3% of GDP

A widespread voter backlash in the US convinced conservatives in congress to modify their budget reduction agreement and postpone most restrictive provisions into 2015. Smaller federal deficits and more voter backlash should cause additional rounds of postponement, or at least serious compromise of these spending cuts and shift some of them further into the future. This would reduce the intended fiscal drag from budget policies in 2015. Consequently, governments are now more open to the ideas of supporting economic growth.

A sea Change in Governments’ Thinking

The latest G-20 meeting is a testimony to this change of policy intent. The meeting in Sydney produced a promise by all 20 attending governments to pursue policies that over the next 5 years would raise global GDP 2% above the present estimated path given current macro policies. Of course member governments did not agree on specific policies, but this is a sea change in thinking from the austerity crazed days of the past few years.
The end of easy money

While faster growth was materializing in the US the Federal Reserve began to consider reducing its monetary stimulus. First, the chairman warned markets that they would begin to taper their purchases of securities. Second several months later they did reduce their purchases. Given continued improvement in the economy, I expect that they will continue reducing the size of their monthly purchases at each FOMC meeting and exit the security purchase program before the end of this year. Finally, the FOMC members are now discussing the problem of how to change the policy statement about leaving the target fed funds rate exceptionally low for long and specifying under which conditions they would start the process of raising the funds rate to some normal level.

For the moment they are using a combination of qualitative and threshold based language to determine when to end the exceptionally low level of the funds rate. Their threshold targets are: a 6 1/2% unemployment rate, a projected inflation rate ¾% above 2%, and if long term inflation expectations continue to be well anchored. However, the FOMC wanted some wiggle room by including additional measures on labor market conditions and inflation pressures and financial developments. Thus, an automatic adjustment in policy to the data thresholds is not guaranteed.

How High will Fed funds rate go

What level is normal and how fast would the FOMC raise rates back to that level is probably going to be the subject of debate among FOMC members over the balance of the year now that the tapering decision has been agreed to.

One guide to answer the question of the normal level is provided by the Taylor rule. This former FOMC governor formulated a rule that stated that the fed funds rate should be: 2% plus an adjustment for economic growth above or below potential and inflation above or below a target rate. Both adjustments are weighted equally. The FOMC has forecast that economic growth would accelerate to 3% in 2014 and 3.2% in 2015. Both are above the economy’s presumed potential rate of growth of 2.3% using the FOMC’s estimate. Their core inflation forecast however is slightly below their 2% target. If we use the midpoints of the FOMC’s latest estimates for economic growth and inflation for this year and the next then the policy rate should be 2.275% by the end of 2015 assuming that their forecasts are realized.

Evolution of Fed Funds Expectations: May 2013 to present
Difference expectations between Fed and the Market

The FOMC’s latest survey of its participants on the timing of a change in the funds rate 15 of 17 stated it should change in 2015. And, the appropriate rate for the funds rate at the end of 2015 would be: the mean estimate 1.1% and the median 0.75%. Interestingly another measure of the normal fed funds rate is the FOMC members’ long run estimates. They indicated that the median, long-run Fed funds rate would be at 4%. This presumably would be: if the economy were growing at potential and inflation were 2%; their long run estimates. It is in marked contrast to the Taylor Rule, which would imply a 2% Fed funds rate if economic growth and inflation conditions were at potential and at target.

In comparison, the evolution of market expectations of the timing and extent of the FOMC raising the Fed funds rate is quite different from FOMC members’ estimates. As shown in the chart, the market now believes the FOMC will raise the funds rate in mid 2015 and push it up to 70bp by end 2015; and 1.7% by end of 2016.

ECB always follows the FED

Recent history has shown that the ECB has usually followed the Federal Reserve in the direction of their policy decisions. Therefore some time before the end of 2015 the ECB can also be expected to raise their basic lending rate.

Asia and the less developed economies

The developing economies in Asia that were less affected by the developed world’s recession benefitted from a huge inflow of capital and extremely low interest rates. This drove asset prices (especially real estate) significantly higher than they otherwise would have been. Investors, particularly Asian investors, choose real estate over corporate equities.

Those countries that were dependent upon foreign markets to finance their balance of payments debts were damaged by the FOMC”s initial discussion about tapering their purchases. FX values in India and Indonesia were depreciated, stock markets roiled, and sovereign interest rate levels climbed. Subsequently, the actual reduction in the Fed’s security purchases has had less negative impacts than the rumors did.

Governments in Asia trying to close down asset inflation
Many governments in Asia have recently taken corrective measures to reduce some of the asset inflation that has occurred over the past several years. For example, the government of Singapore has imposed much stricter lending standards on real estate financing and automobiles and imposed new taxes for short-term asset holders. In just a few months these new policies have already arrested the increase in real estate prices.

**China Restructuring**

The new regime in China has embarked on a major refocus of policy away from supporting high economic growth to adjusting the structure of the Chinese economy. Their unstated tolerance for annual growth appears to be 7%, or slightly higher, down from the average annual double-digit growth of the past two decades. The government is also seeking to address the problem of growing unserviceable debt in Chinese banks and imposing more stringent lending controls on banks to brake the bubble in real estate prices. Slower economic growth in China will affect the net trade contribution for all South Asian economies and slow the potential growth rates for all of Asia.

**Problems in original tiger economy South Korea**

In South Korea, one of the first Asian tigers, economic growth has slowed considerably to less than 3% per annum. The new government seems to have come to the same conclusion as the Chinese that its economy needs to rebalance. That is, to emphasize domestic spending instead of relying on export growth. The government promises to spend $4.7 billion over the next 3 years to promote start-ups and new housing. However, there are several prominent headwinds to overcome. First, South Korea has a rapidly mounting aging population problem; second, the household sector is massively over leveraged. Its household debt is 140% of disposable personal income, one of the highest in the world and higher than the US was at the peak of the US crisis. Third, export growth is likely to diminish as the big chaebols are rapidly building more manufacturing facilities overseas. It is difficult to imagine South Korea’s economy expanding by more than 3% over the next several years.

**End of Easy Money in Asia**

The end of easy monetary conditions is near. Tighter macro policies in Asia and diminishing monetary flows from the west will increase the inter-dependence among all SE Asian economies for their own growth. Thus, there will be increased emphasis in SE Asian economies on internal growth in spite of tighter domestic monetary policies and higher global interest rates. And it will increase their dependence on the west for growth in external export demand. These crosscurrents will likely
produce no acceleration in total Asian growth rates over the next two years.

**New World Order**

In the new world order for global economic growth developing Asia will continue to outperform the developed world, but by a much smaller margin than in the past several years. The growth gap is forecast to narrow to 3% this year from double that of 5 years previous. Therefore, the investment flows will probably diminish along with the easy money making it difficult for Asian equities to outperform. Developed world economic growth will get a boost from less fiscal drag in the US and EU, and the developing Asia economic world will slow as external monetary ease ends and internal monetary policy tightens.

*For more information, please contact camri@nus.edu.sg*
### Key Indicators Table (As of 21 March 2014)

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Source: Bloomberg

### Appendix

**Glossary of Key Terms (Source: Bloomberg, with tickers in parenthesis. In US$ where applicable)**

- **S&P500**: capitalization-weighted index of the prices of 500 US large-cap stocks (SPX)
- **FTSE**: capitalization-weighted index of the prices of the 100 largest LSE-listed stocks (UKX)
- **NIKKEI**: capitalization-weighted index of the largest 225 stocks of the Tokyo Stock Exchange (NKY)
- **HANG SENG**: capitalization-weighted index of companies from the Hong Kong Stock Exchange (HSI)
- **STI**: cap-weighted index of the top 30 companies listed on the Singapore Exchange (FSSTI)
- **EUR**: USD/EUR exchange rate: 1 EUR = xx USD (EUR)
- **YEN**: YEN/USD exchange rate: 1 USD = xx YEN (JPY)
- **CMCI**: Constant Maturity Commodity Index (CMCIMI)
- **Oil**: West Texas Intermediate prices, $ per barrel (CLK1)
- **3MO LIBOR**: interbank lending rate for 3-month US dollar loans (US0003M)
- **10YR UST**: 10-year US Treasury yield (IYC8 – Sovereigns)
- **10YR BUND**: 10-year German government bond yield (IYC8 – Sovereigns)
- **10YR SPG**: 10-year Spanish government bond yield, proxy for EU funding problems (IYC8 – Sovereigns)
- **10YR SGS**: 10-year Singapore government bond yield (IYC8 – Sovereigns)
- **US ISM**: US business survey of more than 300 manufacturing firms by the Institute of Supply Management that monitors employment, production inventories, new orders, etc. (NAPMSPMI)
- **EU PMI**: Purchasing Managers’ index for the 17-country EU region (PIMTPMEZ)
- **JP TANKAN**: Bank of Japan business survey on the outlook of Japanese capital expenditures, employment and the overall economy, quarterly index (JNTGALLI)
- **CHINA IP**: China’s Industrial Production index, with 1-month lag (CHVAIOY)
- **LC**: Local Currency

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