GLOBAL ECONOMICS 2017 YEAR AHEAD: REGIME SHIFT

"With modest fiscal expansion in a number of countries, we expect a pick-up in global growth this year, as aggregate demand begins to outstrip the feeble aggregate supply. This also could put upward pressure on global core inflation. The risks for 2017 center most of all on U.S. policy: either a big fiscal stimulus to the upside, or a big anti-globalization push to the downside."

– Ethan Harris, head of Global Economics

Our view

Growth: The intersection of supply and demand
2016 was the fifth straight year of modest downside disappointment, with global economic growth stuck at about 3 percent. Despite this, there was a pick-up in inflation, reflecting higher core inflation in the U.S. and the stabilization of commodity prices. The increase in inflation suggests that weak growth mainly stems from the supply-side of the economy (weak demographics and productivity) rather than the demand side (an unwillingness to spend).

In our view, economists and investors need to pay more attention to the supply side of the economy. Yet each year, forecasters have found a new demand-side explanation for weak growth and only reluctantly cut trend growth estimates. Given the stability of core inflation, more cuts may be needed: 3 percent global growth may be the new normal.

Inflation: Core call
Two of our out-of-consensus calls are on core inflation. As we have argued since the start of 2016, the Fed can, will and should allow inflation to overshoot its 2 percent target. It can because the economy has hit full employment; it will because averaging 2 percent inflation requires overshooting when the economy is hot; and it should because both the U.S. and the world need a period of modestly above-target inflation to help heal the wounds of recent years.

Our two key inflation calls: First, with many measures of core prices and wages accelerating, we see U.S. core PCE inflation nearly reaching 2.0 percent by end of 2017. Second, we expect Japan to achieve sustained 1 percent-plus inflation. Outside of the U.S. and Japan, we see steady but below-target inflation.

Policy: Finally fiscal
Our inflation call is linked to our fiscal forecast. We expect modest fiscal easing in developed market economies and mixed easing and tightening in emerging markets. In the U.S., President-elect Trump has proposed massive fiscal stimulus, but still must deal with a fiscally conservative Congress. Moreover, with the U.S. economy already at full employment, a big stimulus could eventually trigger a faster Fed hiking cycle.
Japan also has crafted a big stimulus package; however, fiscal plans in Japan always include a lot of "old water" versus real incremental spending or "fresh water," and therefore could disappoint.

Fiscal constraints in Europe have eased, but the Eurozone is likely to see ongoing, rather than increasing, stimulus next year. Hence, it is a region that needs stimulus but probably will not get it.

The slow monetary policy divergence is likely to continue. The Fed is likely to continue slow hikes in the near term, raising rates this December and once again late next year. It could deliver three hikes in 2018 if fiscal stimulus kicks in. In Europe, maintenance of very easy policy seems more likely than more experimentation with negative rates. We expect some easing of monetary policy in countries with high policy rates such as Brazil and Russia, but we expect monetary policy to be on hold in most of EM.

Rotating risks

The main risk to global growth in 2017 comes from the U.S. The Trump presidency presents two different risks. First, a big fiscal push could cause the economy to overheat. Second, aggressive populist measures on trade, immigration and the Fed could hurt confidence and growth.

Outside the U.S., a number of risks remains. Chinese debt continues to grow as a share of GDP. Populist pressures are building in Europe. The Middle East is an ongoing source of concern, especially if the Iranian nuclear deal fails. Emerging markets are vulnerable to sharp shifts in U.S. fiscal and trade policy.

Key calls

- **U.S.** – After a slow start to the year, growth should pick-up in the second half as fiscal stimulus kicks in. However, a big fiscal stimulus could trigger an acceleration in Fed hikes.
- **Euro Area** – We expect slightly stronger growth and steady core inflation, as quantitative easing is extended. But the risk of a premature normalization of policy is now high.
- **U.K.** – The worst fears of Brexit have so far not materialized. The next two years will likely see only weak expansion while sterling-driven inflation should peak around 3.0 percent.
- **Japan** – We are upbeat on Japan's outlook and think consensus is under-estimating the strength of 2017 GDP and inflation. We expect solid 1.4 percent growth in Japan. For the first time since 2013, policy makers are working together to stimulate growth with easy monetary and fiscal policy. Fiscal policy is poised to turn expansionary, as earlier stimulus measures kick in, and the Bank of Japan will likely keep policy settings on hold.
- **China** – Without further policy easing, Chinese GDP growth should inch down to 6.6 percent in 2017. The 2017 baseline scenario is muddling through, to pave the way for the 19th Communist Party Congress election in November 2017.
- **Russia** – Slowing inflation should support domestic demand and drive a modest 1.1 percent recovery.