GLOBAL ECONOMIC OUTLOOK: INFLATION, DISINFLATION, DEFLATION

"The big story for 2015 is not the Federal Reserve's exit from its monetary policy in the U.S., the European Central Bank adopting quantitative easing, China's hard or soft landing or Abenomics. These are all derivatives of a deeper story: global disinflation. Low inflation slows the Federal Reserve's exit from quantitative easing, speeds quantitative easing in Europe, keeps the Bank of Japan expanding and allows China and India to add stimulus until growth is restored."

– Ethan S. Harris, Co-head of Global Economics

Our view

A specter is haunting the world – the specter of deflation: Low inflation is driving policy across the world. In the U.S., low inflation is allowing the Federal Reserve to make a slow-motion exit from its super-easy monetary policy. In Europe, the threat of deflation is forcing the European Central Bank to steadily expand its balance sheet, and it is deflation that could trigger another debt crisis. In Japan, the pressure to exit deflation drives a likely delay in the consumption tax and further easing by the Bank of Japan. In China, India and other emerging market economies that have slowed recently, low inflation gives policymakers the leeway to push the economy back on track.

The U.S. enjoys delayed gratification: One of the clearest lessons of economic history is that major banking and real estate crises cause deeper-than-normal recessions and weaker-than-normal recoveries. In the latest cycle, all the major economies have outperformed history, but the U.S. has stood out above the others – the recession was smaller and the recovery quicker. With balance sheet repair, reduced shocks from Washington in advance of the presidential election and continued easy Federal Reserve policy, the recent increase in growth should continue in the year ahead.

Muddling through may be the best case in the eurozone: The eurozone has not fully recovered from the great recession, much less the recent debt crisis. For Europe, muddle through is both a baseline forecast and, for the most part, a best-case scenario. Outright deflation is a major risk; if it develops, markets could refocus on Europe's dismal debt dynamics. Even more troubling, there are growing signs of political fragmentation, with rapid growth in populist parties in many countries.

In Japan, Job One is ending deflation: Abenomics remains a work in progress, and it is unclear whether Japan will be able to exit deflation. On the one hand, the Bank of Japan has helped to weaken the currency, strengthen the stock market and boost confidence. On the other hand, fiscal authorities have threatened the recovery with a sharp consumption tax increase and there has been little progress on reform. In 2015, the Abe administration's economic policies are likely to become more stimulative, to try to finally end deflation.

Doing what has to be done in emerging markets: China has been the center of attention in the emerging markets, with several bouts of weak economic data during the past year. However, with moderate inflation allowing room for policy easing, the government is likely to do what it takes to restore normal growth. More broadly, trend-like growth is likely in other emerging markets.

Key calls

- **Inflation to remain low:** The big story for 2015 is inflation or, more precisely, the lack thereof. Low inflation is driving policy across the world, and neutral fiscal policy and easy monetary policy are the forecast for the near-term. Despite the pick-up in U.S. growth in the final three quarters of 2014, core inflation is likely to remain steady at 1.5%, well below the Federal Reserve's 2% target. On the one hand, a recovery in the labor market should generate some increase in wage growth. On the other hand, the global backdrop is very disinflationary, with weak global inflation, falling commodity prices and a strong U.S. dollar.

- **Quantitative easing rotation set to begin:** Continued output gaps and weak inflation give central banks plenty of room to ease policy. Balance sheet expansion in the big four central banks is likely to be faster in the year ahead than it has averaged over the last five years. Both the Federal Reserve and the Bank of England likely will keep their balance sheets flat and not hike rates until the second half of the year. In the eurozone, the European Central Bank will move slowly as inflation remains persistently below its forecasts. The Bank of Japan should continue its aggressive balance sheet expansion, both in terms of size and in branching out into more risk assets. By contrast, emerging markets can be expected to see a mix of small rate hikes and cuts.

- **Risks will be normal now, higher later:** In the near term, the risks to global growth are relatively balanced; however, several risks rise in 2016 and later. While Europe is likely to muddle through in the short term, the markets could refocus on its debt dynamics if outright deflation develops – especially if they lose confidence in the European Central Bank or a populist party takes power in a key country. Other longer-term risks include the challenges China faces in such areas as curbing corruption, getting debt growth under control and shifting toward a more balanced economy, and a failure by Abenomics to restore healthy nominal GDP growth in Japan.