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## Introduction and Summary

Barring a significant negative economic or financial shock in the week ahead, the long-awaited turn toward the normalization of US monetary policy should finally get under way before the end of this year. The 25-basis-point fed funds rate hike now widely anticipated at the Fed's December meeting would be the first such move since June 2006. In the year ahead, we could also see signals that the monetary spigots in Europe will begin to close as well. While such signals are probably more than a year away in Japan, we don't expect the BoJ to add to its asset purchases, implying a gradual easing of stimulus there. In a world that has been awash with central bank liquidity for most of the past decade, there is both great curiosity and great concern about how the global economy and financial markets will react as the tap is finally shut on that liquidity. This question is a central focus of our World Outlook for 2016.

The pivot away from this great monetary experiment is unprecedented and will not be without risks. However, we expect both the world economy and global financial markets to weather this turn in policy reasonably well, partly because major central banks -- and the Fed in particular -- have made it abundantly clear that they will be moving far more cautiously than they have in the past as they withdraw accommodation. Markets appear so far to have settled comfortably into the expectation that the Fed will be moving very slowly, expecting only about half the pace of hikes as the median Fed expectation, which is, in turn, about half the pace of historical Fed hiking cycles.

The economic backdrop should allow for this gradual pace of policy normalization, at least initially. Global growth has been slowed by significant headwinds on both the demand side and the supply side of major economies. While moderate consumer spending growth has increasingly been the principal driver of a sluggish recovery, capital spending has been very slow to advance. A result of weak business investment has been that labor productivity growth has slowed to historically low rates in advanced economies. The inevitable slowing of China's economy to a more sustainable pace has also been a significant headwind to growth with dramatic implications for the world economy. China's slowdown has been a major factor underlying the weakening of commodity markets, trade flows, business investment, and manufacturing activity globally.

But the slow growth of supply—or decline in potential growth—has also meant that sluggish recoveries in demand have been able to achieve considerable progress in removing economic slack. The US and Japanese economies are already nearing full employment, and even Europe's labor market has shown gains. The progress to date in reducing unemployment will help, along with the stabilization of energy and other commodity prices, to push inflation higher in the year ahead from recent extreme lows. The prospective pickup in wage and price inflation, as well as the continuing improvement in the labor market, is what is inducing the Fed to commence policy normalization. Spillovers from the Fed's move will help the ECB and the BoJ to achieve their inflation targets, as prospective rate increases in the US further strengthen the dollar against the euro and the yen.

This raises the question of how far this policy divergence can go. Economic slack is declining enough to push Europe's core inflation close to its historical average by end-2016. Stable and eventually rising commodity prices, supportive currency developments, and rising inflation expectations could lead the ECB to start talking before year end about tapering in 2017. In this light, the recent extension of its QE program, while disappointing to the markets, could prove to have been unnecessary. For the BoJ, any change in policy stance seems unlikely until well after the April 2017 consumption tax increase.