

## IMF/WB annual meeting 2014 – Divergent monetary policies, geopolitical risks and disruptive technologies

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- The IMF/World Bank annual meeting took place in Washington, D.C. this past weekend
- We believe that the most important topics discussed this year were:
  - (1) The normalization of the US Fed monetary policy and the ample divergence in these policies among the central banks of DE's, particularly given the prospects of low growth and deflation risks in the Eurozone;
  - (2) The impact of such divergence in emerging economies in a context of low growth; and
  - (3) Geopolitical issues in different regions of the world, particularly the tensions in the Middle East
- In addition, more structural issues were discussed:
  - (1) Disruptive technologies and the financial system; and
  - (2) The increase in the levels of inequality in advanced countries

### Gabriel Casillas

Chief Economist and Head of Research  
gabriel.casillas@banorte.com

### Delia Paredes

Executive Director of Economic Analysis  
delia.paredes@banorte.com

### Katia Goya

Senior Global Economist  
katia.goya@banorte.com

**Relevance of IMF/WB annual meetings.** A delegation of Banorte-Ixe attended the 2014 International Monetary Fund (IMF) and World Bank (WB) annual meeting in Washington, D.C. Next year, these meetings will take place in Lima, Peru, as it is the case every three years, when the venue is changed. In our opinion, attending these meetings imply taking part of the discussions of the most important issues discussed globally.

**Global growth prospects.** Prior to the meetings, the IMF published its *World Economic Outlook* (WEO), in which it downgraded its estimates of global growth for both 2014 (to 3.3%, from 3.4%) and the coming year (to 3.8%, from 4%). We highlight the downward revisions to the IMF's growth prospects in the Eurozone (0.8% vs. 1.1%) and Japan (0.9%, from 1.6%). In the case of emerging economies, growth estimates in Brazil were reduced by 1%-pts to 0.3%. In 2015, growth in the Eurozone is estimated at 1.5% (vs. the previous estimate of 1.3%), while the expansion of the Japanese economy is expected in the area of 0.8% (vs. previous 1%). In the case of the United States, 2014 forecast was lifted to 2.2% from 1.7%, while the estimate for 2015 remained at 3.1%. In the case of the Chinese economy, growth estimates remained unchanged at 7.4% for 2014 and 7.1% in 2015. Finally, according to the IMF, the Mexican economy will grow 2.4% in 2014 unchanged from previous estimates, while it is expected to expand 3.5% next year.

**The most relevant issues discussed at the meetings.** In our opinion, the following issues were the most discussed in the meetings: (1) The normalization of the US Fed monetary policy and the ample divergence in these policies among the central banks of DE's, particularly given the prospects of low growth and deflation risks in the Eurozone; (2) the impact of such divergence in emerging economies in a context of low growth; and (3) geopolitical issues in different regions of the world, particularly the tensions in the Middle East. In addition, there were also some structural issues discussed in the meeting agenda: (1) Disruptive technologies and the financial system; and (2) the increase in the levels of inequality in advanced countries.

**Fed's monetary policy normalization.** Consensus is that the U.S. economy is gaining momentum and, as a result, we are getting close to the next stage of monetary policy normalization in the US. In this context, there have been several discussions about potential GDP in the aftermath of the 2008-2009 crisis. It is worth noting that some analysts argue that potential GDP growth in the US has not declined from pre-crisis levels. In fact, they believe it never really increased. They believe that the perception of higher potential growth was explained by the credit bubble but that, in fact, potential GDP never increased. In this context, the overall view is that the FOMC is going to adopt a cautious approach when starting to normalize monetary conditions, mainly because there is still uncertainty about the level of slack remaining in the economy and because once the process starts, it will be very difficult to reverse. In addition, given the potential effect of normalization on emerging markets, it would be important to devise a careful communication strategy. In this context, most private sector analysts see the beginning of a Fed's rate hike cycle in June 2015.

**Divergent monetary policies.** While the consensus is that the Fed is closer to normalizing its monetary policy, the common denominator in most of the meetings was that the ECB should increase the level of stimulus amid weakening growth prospects in the Eurozone and the risk of a deflation scenario. In this context, we highlight that growth prospects in the U.S. –where estimates point to a more vigorous growth in 2015–, and the Eurozone –where geopolitical risks are undermining economic confidence while the dynamics of consumer prices continues to approach a scenario of deflation–, are also divergent. These differences are even clearer if we compare the performance of nominal GDP in both regions. Here, the general feeling is that the ECB should take more action –it is widely argued that so far efforts have been relatively timid vs. the magnitude of what is needed–, but there is also the need of structural changes like fiscal measures (*e.g.* tax cuts, increased spending on infrastructure, etc.).

**The ECB should step up efforts.** In addition to structural reforms and fiscal policy actions, such as widening fiscal deficits –analyst and academics' suggestion is that the ECB should embark in a large-scale asset-purchase program (*a.k.a.* *Quantitative Easing* or *QE*) à-la-Fed, but central bank officials showed no particular inclination for this strategy.

The main problem is that, despite all the measures already implemented (LTRO's, OMT's, benchmark rate at the zero-bound, negative rate of deposits, etc.), the credit channels are still not working (*i.e.* banks are not lending). Members of the ECB, commented that monetary policy actions implemented so far are adequate. In this sense, they argued that this is because the measures were necessary to remove obstacles to commercial banks to carry out their work, especially at a time of restrictive bank regulation. For the first time, the ECB –that will soon be responsible for regulating banks-, is carrying out *stress tests* on banks, which include the process of reviewing the quality of its assets. Nevertheless, they also commented that the effectiveness of these measures is questionable. The general perception so far is what it has been done is "*too little, and too late*".

**Impact on emerging economies.** While divergent monetary policies in major central banks are not particularly challenging for flows in emerging economies, the normalization of monetary policy in the U.S. in particular is an issue that concerns both analysts and authorities. In this context, it was emphasized that the impact of normalization in emerging markets depends on three factors: (1) Changes in the global environment, specifically, the level of risk aversion and the rate of global growth; (2) economic environment in the United States and the Fed's communication strategy with regard to the normalization of monetary conditions; and (3) macroeconomic fundamentals in each country.

**Chinese economy rebalancing needs.** A key issue for growth prospects in emerging markets has to do with the performance of the Chinese economy. In this sense, we cannot ignore the fact that this economy needs to face a rebalancing process –in order to become a consumption driven economy from an investment driven one (the ratio of investment to GDP of the Chinese economy is significantly higher than in other countries). Nevertheless, although the risk of a *hard landing* remains reduced –even if the economy expands less than 7%, which would facilitate the process of rebalancing-, the high level of housing sector leverage is an important downside risk. In fact, some analysts believe that the construction industry should adjust down by around 20% to 30% in the next two or three years.

**Latin America: Growth is the name of the game.** Although Latin American economies are vulnerable to an environment of lower growth coming from the Chinese economy and the U.S. Fed normalization process, for the first time in many years, one of the key issues discussed was how to generate more growth and not just how to deal with external shocks. In this context, Latin American economies are in an environment of relative macroeconomic stability, stable credit ratings and bright growth prospects, which allows them to tap international financial markets. We refer here to Brazil, Colombia, Chile, Peru, Mexico, Paraguay, Uruguay, and some economies of Central America and the Caribbean, as unfortunately the kind of policies that have been implemented in Venezuela, Argentina, Ecuador, and Bolivia have shifted away global investment funds.

**Important challenges for the Brazilian economy.** A special case within the universe of emerging markets (and Latin America) is Brazil. This country faces significant challenges ahead in a scenario in which there is still great uncertainty in the political arena (the second round of the presidential election will take place on October 26). In this context, the new administration resulting from the election will have to deal with several issues: (1) Social demands of unions and other social movements; (2) macroeconomic policy –achieving greater interaction between the public and private sectors; and (3) low growth combined with inflationary pressures. Unfortunately, Brazil has ahead a very complex scenario, with no precedents in textbooks, with an economy in recession, high inflation and full employment –despite having gone through a cycle of monetary tightening-, making it more complex to have a mechanism to cope with shocks derived from Fed’s normalization.

**Mexico, a different emerging market.** Analysts, academics and authorities acknowledged the efforts of structural change in Mexico and agree in that these reforms will eventually generate more growth ahead. In addition, some tailwinds must be added such as the recovery of the construction sector and the dynamism of the U.S. economy. In terms of the impact of the Fed’s normalization on the Mexican economy, it is worth noting that such process comes because of a more buoyant economic activity, which should help offset, at least partially, the negative shocks that these process could have on the Mexican economy. Among the questions that investors directed towards policymakers and analysts in the meetings, was the likelihood of a minimum wage increase, as well as by how much and when this could happen. In this context, we perceived that for several government officials, this is “a done deal”, and as long as links with speeding tickets and government-sponsored mortgage loans –among others-, are cut, and it is specifically for workers that earn one minimum wage (*i.e.* at the end we all earn a multiple of the minimum wage), the impact on inflation will be limited.

**Geopolitical issues.** Geopolitical tensions are among the most important risks to the global growth scenario. These include not only tensions between Russia and Ukraine, but particularly the ones in the Middle East. Before arriving to Washington D.C., our perception of geopolitical conflicts was that the *Russia-West* conflict was to be the highest rated in most of the discussion groups, but this was not so. In fact, the number one issue by far was the situation in the Middle East, where even some global portfolio managers said they had never been so concerned about the situation in the Middle East.

**The ISIS threat.** No doubt that the threat of ISIS (*Islamic State of Iraq and the Levant*) is the issue that occupies the minds of investors, public officials, academics and analysts. In particularly, this has to be added to the civil war in Syria, the terrorist problems in Lebanon and Israel -coupled by armed Israeli incursion in the Gaza strip, and the traces left by the "*Arab Spring*" in many other countries. Many of these cases are circumscribed to ISIS.

One of the biggest concerns that were widely commented is that the military actions carried out by the U.S. government and other allies are still insufficient, thereby increasing the likelihood that ISIS is strengthened considerably by conquering Baghdad and other major cities.

**Mid-term elections in the United States.** This is another geopolitical factor to take into account. Next November 4, the House of Representatives will be renewed along with 36 Senate seats (a third of the Senate and three legislators who withdrew or died) and eight local governments. This is relevant, not only having an eye in 2016 presidential election, but also given the fact that the Senate could shift to a Republican majority, which could make the last years of President Obama's administration (Democrat) more difficult. In particular, the discussion on the debt ceiling could be in the limelight once again in March 2015. Even though we do not expect tensions to reach last March's levels, Republicans are likely to once again, extend negotiations until the very last moment.

#### *More structural topics*

**Virtual currencies.** While financial institutions have been dealing with increasingly restrictive regulation and, on the other side of the spectrum, new technologies, another innovation disrupts the market: Virtual currencies. The most known example is bitcoin. Skepticism about the use of bitcoin and other so-called "digital cryptocurrencies" is all over the place with comments such as "stay away from bitcoin...It is a mirage" or "it's a terrible store of value", sponsored by Warren Buffet and Jamie Dimon, respectively. Nevertheless, this time the topic showed up in different agendas during the meetings in a much more constructive way. Nobody believes bitcoin or any if these will take over the world as the next global currency. In this context, some compared this to what happened with Esperanto, taking over the world's language of choice, which as we all know, has not happened at all. However, the digital protocol that gave birth to cryptocurrencies might be an initial "layer" in which platforms or even full-blown payment systems can be built upon. The main nicety is that this protocol conducts real-time operations, in which value is transmitted, instead of the current use of corresponding banking, representing a liability for one of the counterparties, in both, simple money transfers and FX operations. This reduces transaction costs and counterparty risk. All in all, instead of perceiving a full rejection of cryptocurrencies, we observed a much more constructive assessment of these around its operational aspects to build more secure and cheaper-to-use payments systems.

**Increasing inequality in developed economies.** For the first time in a long time –or at least since we have been attending these meetings–, inequality in DE was addressed. In our view, recent empirical evidence, and Piketty's highly influential book (*Capital in the Twenty-first Century*, Belknap Press, 2014), fostered the topic to be included in the meetings' agenda. Former policymakers and academics mentioned that inequality is bad from both, morally and selfishly standpoints. From a moral standpoint, recent studies about the differential impact of biomedical advance in life expectancy among socio-economic groups.

In this context, in the past 20 years life expectancy for the richest 10% in the US has increased six years, while it has only grown one year for the poorest 10%. From a so-called selfish point of view, they mentioned that “an extra dollar that goes to the richest 10% goes to a savings account”, while “an extra dollar to the poorest 10% is used for consumption”, boosting aggregate demand, in a world in which savings have not necessarily translated into investment. It is worth noting that since the policies a government could implement to reduce inequality are quite controversial -mainly due to the intrinsically non-market orientation of these-, the acknowledgement of the issue should not be eliminated from the high-level discussions in the first place. More so if there is a will to find a solution.

*In sum...*

**Recovery continues with important challenges ahead.** In sum, the world economy continues in this long recovery phase after the 2008-2009 global financial crisis, and is facing quite important challenges. In particular, the normalization of the US Fed ultra-lax monetary policy –in a quite uncertain economic environment, in which basic issues such as US potential GDP growth rate are being challenged-, as well as the impacts of the increasing geopolitical tensions. In this context, the asynchronies between the economic cycles of the US and the rest of the developed economies are quite worrisome, particularly due to the divergent monetary policies that need to be implemented, and the impacts this might have on emerging economies, particularly in the ones with no so solid macro fundamentals. On the other hand, the speed and impacts of disruptive innovation, particularly in DE’s is gaining ground in the agenda of high-level policymakers and politicians.

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**GRUPO FINANCIERO BANORTE S.A.B. de C.V.**
**Research and Strategy**

Gabriel Casillas Olvera	Chief Economist and Head of Research	gabriel.casillas@banorte.com	(55) 4433 - 4695
Raquel Vázquez Godínez	Assistant	raquel.vazquez@banorte.com	(55) 1670 - 2967

**Economic Analysis**

Delia María Paredes Mier	Executive Director of Economic Analysis	delia.paredes@banorte.com	(55) 5268 - 1694
Julieta Álvarez Espinosa	Assistant	julieta.alvarez@banorte.com	(55) 5268 - 1613
Alejandro Cervantes Llamas	Senior Economist, Mexico	alejandro.cervantes@banorte.com	(55) 1670 - 2972
Katia Celina Goya Ostos	Senior Global Economist	katia.goya@banorte.com	(55) 1670 - 1821
Julia Elena Baca Negrete	Economist, U.S.	julia.baca.negrete@banorte.com	(55) 1670 - 2221
Livia Honsel	Economist, Europe	livia.honsel@banorte.com	(55) 1670 - 1883
Miguel Alejandro Calvo Domínguez	Economist, Regional & Sectorial	miguel.calvo@banorte.com	(55) 1670 - 2220
Rey Saúl Torres Olivares	Analyst, Mexico	saul.torres@banorte.com	(55) 1670 - 2957
Lourdes Calvo Fernández	Analyst (Edition)	lourdes.calvo@banorte.com	(55) 1103 - 4000 x 2611

**Fixed income and FX Strategy**

Alejandro Padilla Santana	Head Strategist – Fixed income and FX	alejandro.padilla@banorte.com	(55) 1103 - 4043
Juan Carlos Alderete Macal	FX Strategist	juan.alderete.macal@banorte.com	(55) 1103 - 4046
Santiago Leal Singer	Analyst Fixed income and FX	santiago.leal@banorte.com	(55) 1670 - 2144

**Equity Strategy**

Manuel Jiménez Zaldivar	Director Equity Research Analyst - Telecommunications / Media	manuel.jimenezza@banorte.com	(55) 5004 - 1275
Victor Hugo Cortes Castro	Equity Research Analyst	victorh.cortes@banorte.com	(55) 5004 - 1231
Marissa Garza Ostos	Senior Equity Research Analyst – Conglomerates/Financials/ Mining/ Chemistry	marissa.garza@banorte.com	(55) 5004 - 1179
Marisol Huerta Mondragón	Senior Research Analyst – Food/Beverages	marisol.huerta.mondragon@banorte.com	(55) 5004 - 1227
José Itzamna Espitia Hernández	Equity Research Analyst – Airports / Cement / Infrastructure / Fibras	jose.espitia@banorte.com.	(55) 5004 - 1266
María de la Paz Orozco García	Analyst	maripaz.orozco@banorte.com	(55) 5004 - 5262

**Corporate Debt**

Tania Abdul Massih Jacobo	Director Corporate Debt	tania.abdul@banorte.com	(55) 5004 - 1405
Hugo Armando Gómez Solís	Analyst, Corporate Debt	hugoa.gomez@banorte.com	(55) 5004 - 1340
Idalia Yanira Céspedes Jaén	Analyst, Corporate Debt	idalia.cespedes@banorte.com	(55) 5268 - 9937

**Wholesale Banking**

Marcos Ramírez Miguel	Head of Wholesale Banking	marcos.ramirez@banorte.com	(55) 5268 - 1659
Luis Pietrini Sheridan	Managing Director – Private Banking	lpietrini@ixe.com.mx	(55) 5004 - 1453
Armando Rodal Espinosa	Managing Director – Corporate Banking	armando.rodal@banorte.com	(81) 8319 - 6895
Victor Antonio Roldan Ferrer	Managing Director – Transactional Banking	vroidan@ixe.com.mx	(55) 5004 - 1454
René Gerardo Pimentel Ibarrola	Managing Director – Asset Management	pimentelr@ixe.com.mx	(55) 5268 - 9004