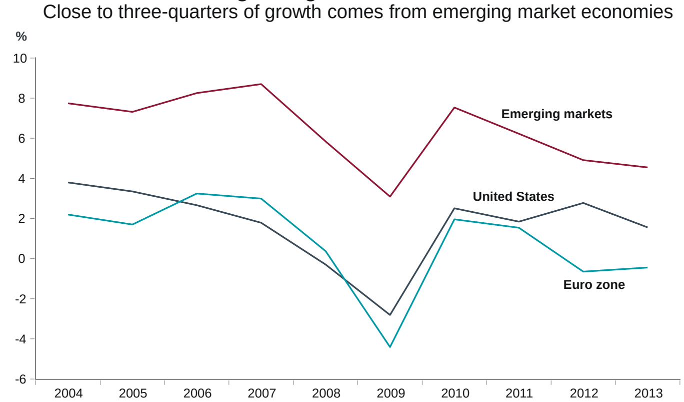
THE GLOBAL ECONOMY:
PROGRESS, BUT CHALLENGES REMAIN

The past four years have been particularly eventful for the global economy. During much of that period, the United States and Europe focused on correcting the imbalances that had developed in their economies before and during the financial crisis of 2008, mainly the excessive levels of debt that were limiting their growth. The United States relied on a series of unprecedented monetary policy measures, which reduced the long-term interest rate to a historically low level and supported the prices of risky assets, both in the United States and elsewhere. This strategy worked well and enabled it to make significant progress in solving its problems. In December 2013, the U.S. Federal Reserve (Fed) was able to begin reducing its stimulus program. Europe, in contrast, favoured an approach based on fiscal austerity which, far from having the desired effect, resulted in the euro zone's most severe recession since its inception, followed by only a timid improvement in the economic situation.

In the meantime, the emerging market economies, which recovered more quickly from the crisis in large part because of an extraordinary stimulus program introduced by China in 2009, took over as the engine of global growth. They accounted for nearly three quarters of global economic growth between 2010 and 2013. Over the past two years, however, several emerging economies experienced a marked slowing of economic activity, owing to capacity constraints exacerbated by a lack of structural reform. In addition, the signal by the Fed in May 2013 that it might soon reduce its program of asset purchases, prompted investors to reconsider their risk tolerance in relation to these markets and exposed the vulnerability of some countries.

Modest global growth from 2010 to 2013
Close to three-quarters of growth comes from emerging market economies



Sources: CDPQ – Economic Analysis and Asset Allocation Strategies, FMI

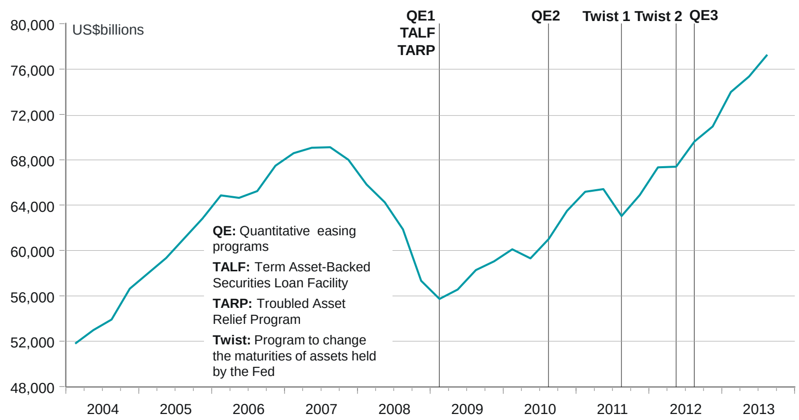
In sum, a global economic recovery is under way, but the economic situation varies widely by geographic area and country.

In this context, we are monitoring three themes that will shape the global economy in the coming years:

1. Normalization of monetary policy in the United States

After the steep recession in 2008-2009, the U.S. economy grew at an average annual rate of 2.3% between 2010 and 2013, a reasonable performance given the severity of the financial crisis it experienced. This result illustrates the appropriateness of the bold monetary policy measures that were adopted. Moreover, the government took the right approach to fiscal policy, waiting until the economy returned to a stronger growth path before reversing the easing of policy implemented in 2009-2010.

U.S. household net wealth reaches new heights



Sources: CDPQ – Economic Analysis and Asset Allocation Strategies, Datastream

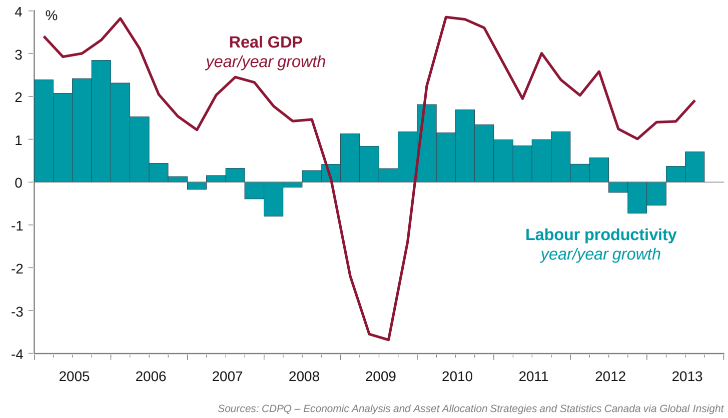
This approach helped revitalize the economy, pushing up housing prices and generating strong increases in equity prices. As a result, U.S. households improved their balance sheets significantly; net worth now exceeds the level before the crisis by about 12%, which has recently led to an increase in consumption.

The United States also benefited from increased domestic energy production as a result of technological innovations, as well as the lower prices of electricity and natural gas that ensued. The strengthening of private domestic demand enabled private sector output to grow by 3.1%, on average, over the past two years, despite the tightening of fiscal policy in 2013 equivalent to about 1.75% of real GDP. As a consequence, the federal deficit fell from 8.5% of nominal GDP in 2010 to 3.3% in 2013. The improvement in the U.S. economy permitted the Fed to start the process of normalizing monetary policy in December.

This process, which is taking place after several years of unprecedented monetary policy stimulus, could lead to surprises not only in the United States – even if the growth dynamic is stronger – but also worldwide.

The strengthening of the world's largest economy is good news for Canada as it is becoming increasingly clear that the Canadian economy must be reoriented towards exports. Between 2010 and 2013, economic activity in Canada grew at an estimated annual rate of 2.3%, the same rate as in the United States. Canada emerged from the recession faster than most other developed countries. However, in the past two years, it has entered a regime of slower growth. This is attributable to the effects on growth of weak trend productivity growth and the development of certain imbalances that have limited the increase in domestic demand. In particular, the dramatic increase in Canadian household debt has forced consumers to reduce the growth of their spending.

Canada's economy has slowed since 2010 mainly because of slower growth in productivity

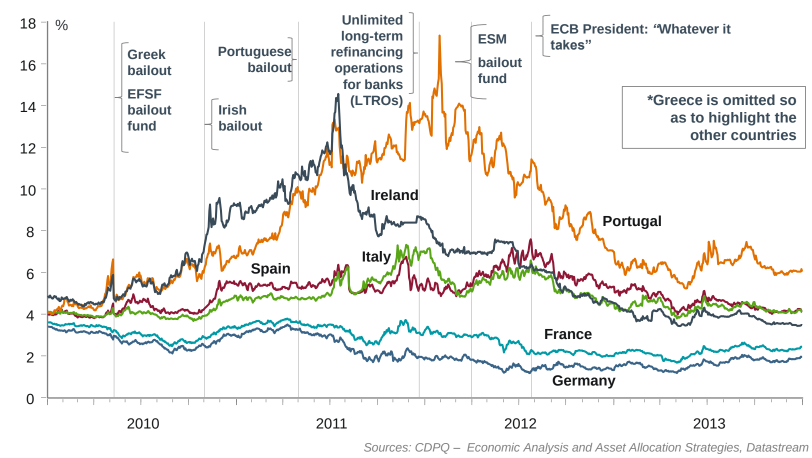


In addition, the stagnation of commodity prices reduced the growth of investment in infrastructure. At the same time, the high Canadian dollar, reflecting the high prices of resources, weighed on exports of Canadian manufactured goods, which created a large current account deficit of 3.2% of GDP, on average from 2010 to 2013.

2. Evolution of the economic situation in Europe

In response to the series of crises in the euro zone between 2010 and 2013, EU leaders adopted an approach based on fiscal austerity, which had the effect of making the euro zone economy more fragile, without solving most of the fundamental problems that afflict it. They did not introduce the institutional reforms required to make their monetary union function well, or the structural reforms that, together with an aggressive easing of monetary policy, would have helped the countries in difficulty perform better economically and better control their debt levels. The European Central Bank (ECB) flooded the banking system with liquidity, but did not cut interest rates to a minimum and refused to take additional risks onto its balance sheet. Instead, the authorities relied on a process of internal devaluation to compensate for the lack of competitiveness of countries with significant current account deficits. As a result, the euro zone entered a severe recession.

A series of crises in the euro zone
10-year bond yields in six countries*



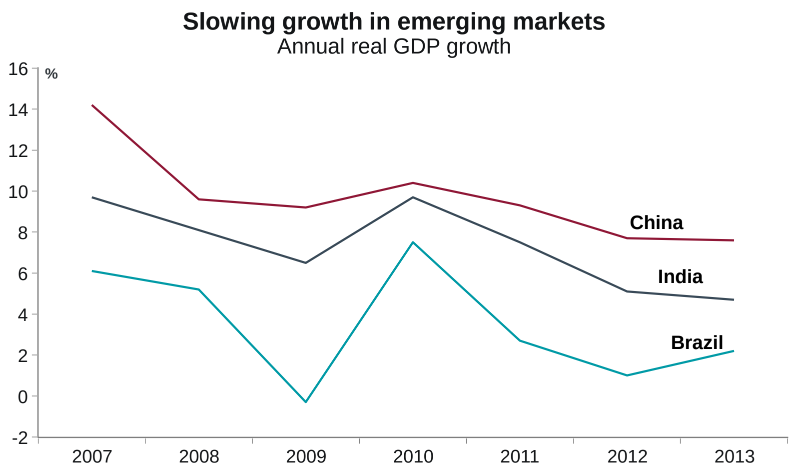
The recession ended in the spring of 2013, after European leaders agreed to soften the fiscal austerity and after the uncertainty related to the debt crisis had cleared. The decisive moment was undoubtedly the declaration by the President of the ECB in the summer of 2012 that he was ready to do whatever it took to preserve the euro zone. Thus far, it has been mainly the strong performance of the German economy that has allowed the euro zone to return to growth, although recently, some indicators point to a strengthening of economic activity in other euro zone countries. Nonetheless, the recovery remains weak and fragile, and there is the specter of deflation.

In this context, we believe the ECB will eventually have to further ease monetary policy, member countries also need to strengthen their institutions and move forward with structural reforms to eliminate the dysfunctions that are undermining the potential of the euro zone. In this regard, the impending elections in Europe may manifest a rejection of European integration by many citizens, which would make it more difficult to adopt the needed reforms.

3. Policy in emerging markets

The turbulence in emerging markets in the wake of the Federal Reserve's signal in May 2013 that it would most likely reduce its program of asset purchases, demonstrates that these countries do not form a homogeneous group and that it is necessary to consider each country individually.

After the recession of 2008-2009, emerging economies rebounded strongly as a result of highly expansionary policies at the global level, a large influx of capital and the absence of serious imbalances. In 2011, however, several countries, including China, Brazil and India, began to encounter capacity constraints and inflationary pressures became evident. They responded by tightening monetary policy, which, together with the slow growth of productive capacity, owing to a lack of structural reforms in recent years, resulted in a deceleration in growth in emerging markets generally through 2013. The weak demand in developed markets for their exports further complicated the situation.



Sources: CDPQ – Economic Analysis and Asset Allocation Strategies and Oxford Economics

Countries with large current account deficits financed by portfolio investment were particularly affected by the Fed's announcement, and their currencies depreciated significantly. To avoid an acceleration of inflation, central banks responded by raising interest rates, which will result in slower growth. The fact that emerging markets have strong commercial links between them will likely exacerbate the situation.

While the long-term potential of these countries remains intact, their performance will depend on the willingness of their leaders to undertake the reforms necessary to improve the functioning of their economies. Moreover, the reorientation of the Chinese economy towards greater reliance on domestic demand will affect other emerging countries, as well as countries that produce raw materials, such as Canada.