THE G4:

UNDIMINISHED EXPECTATIONS

ROOM TO RECOVER

MAY 2015

PREPARED FOR PROFESSIONAL CLIENTS ONLY

Executive Summary

After the economic upheaval of recent years, many commentators now seem resigned to an era of subdued growth. The world economy looks likely to underwhelm us, they argue, even if crises now look unlikely to overwhelm us. Christine Lagarde of the IMF has warned that the world economy risks settling into a "new mediocre", an era of relative stability without great prosperity. Larry Summers of Harvard worries that lackluster demand in the mature economies will persist, even as rapid growth in China and India does not. According to this view, global economic prospects are not unnerving. But they are disappointing.

This glum consensus, however, gives rather little weight to some of the things that have gone right over the past couple of years. In particular, four of the world's biggest economies - Japan, America, China and India - are now in the midst of recovery, reform, or both. Under Shinzo Abe, Japan now has the most stable government since Junichiro Koizumi [1] and a central bank that has twice surprised jaded onlookers with its determination to defeat deflation. In America, unemployment has dropped surprisingly quickly as firms have added jobs at the fastest pace since the dot-com boom [2]. China's President, Xi Jinping, has consolidated power faster than his predecessor, stepped on powerful toes with his anti-corruption campaign, and staked his personal authority on economic reform [3]. And in India's 2014 election, Narendra Modi won the first single-party majority in thirty years, promising to restore the country's economic momentum.

Author

Simon Cox

Managing Director and Investment Strategist

BNY Mellon Investment Management Asia Pacific

1 Since returning to power in December 2012, Shinzo Abe has already been in office longer than the previous six prime ministers (which included himself in his first stint in the role). He need not call another lower house election until - December 2018. If he survives until then, he would be Japan's longest-serving prime minister since Eisaku Sato who - served from 1964 until 1972. -

2 According to the Bureau of Labor Statistics, America's non-farm payrolls increased by 3.227 million in the 12 months ending February 2015, the biggest 12-month increase since May 2000.

3 http://www.hoover.org/sites/default/files/uploads/documents/CLM43BN.pdf

This is an unusual confluence of events. The United States is enjoying a durable recovery just as all three of Asia's big powers boast secure, confident governments committed, at least in word, to economic reform. The region's stars rarely fall into alignment in this way.

This combination raises the tantalizing possibility that all four of these giant economies might stop floundering and start flourishing at roughly the same time. That, simply put, is the scenario we will explore in a series of four white papers this year.

What does flourishing mean, exactly? The scenario assumes that Japan's growth revives to roughly **2** percent a year on average for the remainder of this decade, America's remains at about **3** percent, China's averages **7** percent and India's **8** percent. This is an optimistic scenario but not a utopian one. It is contrarian, in some cases, without being crazy.

Nonetheless, if this scenario were to materialize, the consequences would be profound. China, America, India and Japan are the four biggest economies in the world, measured at purchasing-power parity (PPP), accounting for almost 45 percent of GDP [4]. They consume a similar proportion of global energy and contributed well over half of last year's global economic growth. We call them the G4.

The G4 series

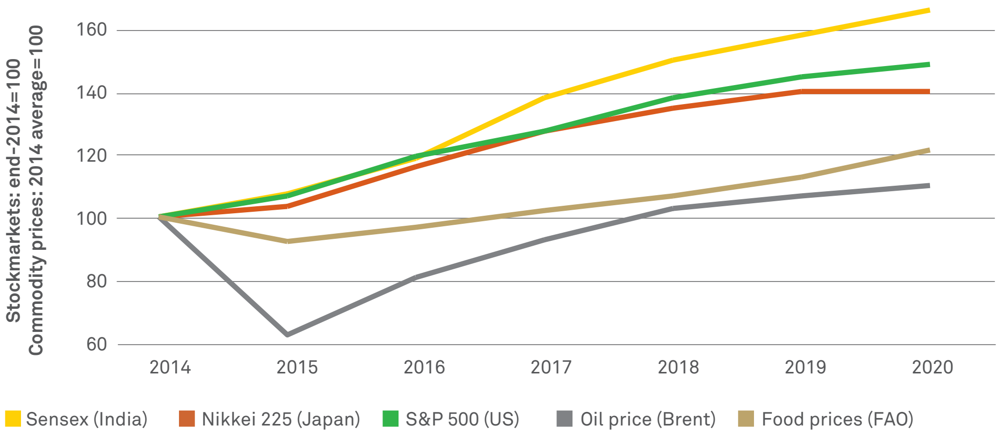
Our white paper series will examine why the G4 economies might prosper, and what would happen if they did. Future papers will look at:

- The "supply-side" sources of G4 growth - the combination of productivity improvements, labor mobilization and capital accumulation required to sustain the growth rates envisaged in our scenario
- The investment opportunities that might arise from the G4's joint success
- The geopolitical implications of four self-confident, assertive powers all operating in the region at the same time.

This first paper, "Room to Recover", compares our scenario to other projections of future growth and official estimates of potential GDP. It also reports the results of a modelling exercise by The Economist Intelligence Unit, which simulated the impact of these four economies' growth on each other, the rest of the world, commodity prices and stock markets.

That impact would be significant. Our optimistic scenario would add over $10 trillion to the four economies' combined GDP in 2020, holding prices and exchange rates constant. According to the EIU's global economic model, it would also add $8 trillion to the rest of the world's GDP outside these four. This combined growth would be enough to restore $100 oil within three years and lift global food prices by over 40 percent from their level in March 2015. It would help the Nikkei 225 surpass 24,400, the Sensex exceed 45,000 and the S&P 500 reach 3,000 by the end of the decade.

G4 scenario: Oil, food and share prices



Figures refer to projected end-2020 prices for stockmarkets, and projected 2020 average prices for commodities

Source: EIU simulation based on BNY Mellon assumptions.

Commodity and Share Prices [5]	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020
Oil price (Brent)	79.6	110.9	112	108.9	98.9	62.2	80	92.2	101.5	105.3	108.6
Global Food Price Index (FAO)	188	229.9	213.3	209.8	201.8	186.5	195.3	205.8	215.9	227.6	244.6
India Sensex	20509	15455	19427	21171	27499	29578	32564	37818	41133	43338	45495
Japan Nikkei 225	10229	8455	10395	16291	17451	18104	20229	22156	23520	24359	24416
US S&P 500	1258	1258	1426	1848	2059	2203	2452	2624	2834	2974	3060

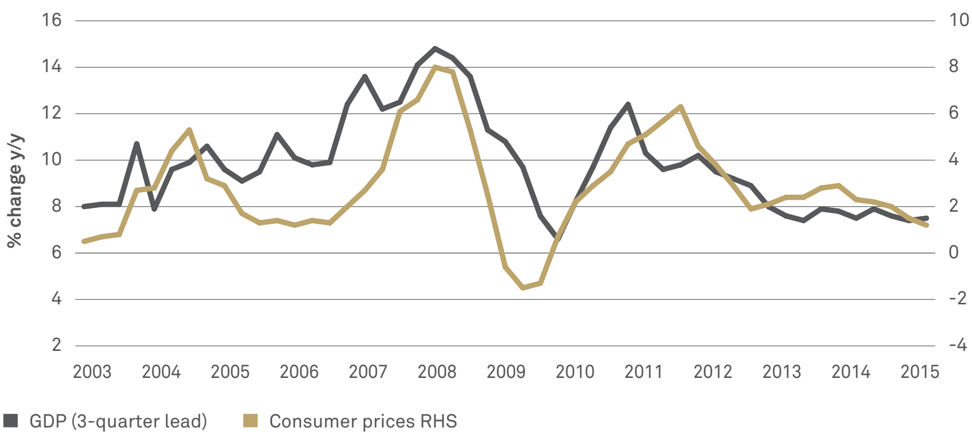
Source: EIU simulation based on BNY Mellon assumptions.

How likely is the G4 scenario?

In our view, recent economic weakness has left the G4 economies with substantial "slack". Their GDP has fallen short of their potential, leaving them substantial room to grow without generating unwelcome inflationary pressure. Take America for example. The gap between its actual GDP and its potential GDP adds up to a cumulative $5.3 trillion over the past seven years [6]. And the aggregate number of hours worked in America last year fell short of full employment by the equivalent of 638,000 years.

Japan also seems to have substantial room to grow - perhaps more than official estimates imply. Based on past evidence, its GDP would have to greatly exceed the Cabinet Office's estimate of its full potential in order to push inflation up to the 2% target. It seems clear that China could also expand significantly faster than its current rate without inflation exceeding its official ceiling of 3% (see chart).

China's growth and inflation



Source: BNY Mellon; Thomson Reuters Datastream

We believe that the G4 economies could live up to this unfulfilled economic potential within the next few years. Policymakers in China and India still have scope to revive demand through lower interest rates, cuts in reserve requirements and, in China's case, fiscal stimulus. Japan's monetary easing, which was reasonably successful in reviving spending until the April 2014 tax hike, now has two more years to work without another such fiscal interruption. In America, government spending and employment have stopped shrinking [7], and the recovery in demand is already strong enough for the Fed to contemplate raising interest rates.

For our scenario to come true, these four economies would all have to perform better than the IMF and other forecasters now expect. But (with the exception of Japan) our scenario is in keeping with what the IMF and others foresaw a few years ago. Forecasters have lowered their sights in recent years in the belief that recent economic setbacks reflect a new trend. We are not so sure. We cannot say with any certainty that the G4 *will* grow as fast as we have outlined. We are saying that they *could*. And we prefer to view these four economies with undiminished expectations.

4 India's GDP is the 9th biggest in the world at market exchange rates, according to our calculations. But it is forecast to make the third biggest contribution to global growth this year (according to the IMF) and it is already the world's third biggest economy measured at PPP, according to the same source.

5 EIU simulation based on BNY Mellon assumptions. The EIU, quite sensibly, chose not to simulate the impact of growth on China's stockmarkets, "given the absence of a credible relationship between economic fundamentals in China and the performance of local shares."

6 BNY Mellon calculations, based on Congressional Budget Office estimates of potential GDP and actual GDP figures from the Bureau of Economic Analysis.

7 The number of government employees in the US reached its post-crisis trough in January 2014, according to the Bureau of Labor Statistics. Real government consumption and investment spending grew by 0.8% in the year to the first quarter of 2015, according to the Bureau of Economic Analysis.

Issued as at 6 May 2015 GA13 6 Nov 2015 (6M)

BNY MELLON