CALM BEFORE THE STORM?

Don't start feeling too comfortable about the world economy, warns Rob Wood. There will still be pockets of trouble in 2014

The world economy seems to be settling down on the sofa for a movie and some comfort food. The US Federal Reserve is still buying tonnes of bonds, the UK is engineering another housing boom, and some emerging markets continue to gorge on cheap credit. The trouble with comfort food, however, is that it can sometimes leave you feeling unwell.

That will be the case for some exposed emerging economies in 2014. The problems of the past few years are fading, especially in the developed world. Monetary policy is getting traction, eurozone austerity is easing and the periphery is starting on the long road to recovery. Much of the world should see growth accelerating as confidence gradually returns, but there will be pockets of trouble.

Those countries that gorged on cheap money to finance large current account deficits will have a difficult 2014. The problems of summer 2013 will re-emerge as the Fed reins in its largesse. The impact this time is likely to be smaller than in the summer because investors have had more time to get used to the idea. It won't derail the world recovery, but uncertainty could re-emerge.

The Fed's non-decision on tapering delayed the day of reckoning. As the Fed signalled over the summer that it might reduce its asset purchases, global bond yields rose. Countries with high current account deficits and thus external financing needs were hit particularly hard. Currencies from the Indonesian rupiah to the Brazilian real fell sharply as liquidity flows reversed course.

Tapering will come eventually. Some of the trouble subsided following the Fed's non-decision in September 2013 and the focus on the bickering in Washington. But tapering will come back on the agenda, probably after the next rendition of the debt ceiling fandango in February 2014. Countries such as Brazil, India, Indonesia and Turkey could be hit hard again.

Most emerging markets should escape relatively unscathed, though. Many look healthier and more mature than five or 10 years ago. They have built defences against shifts in market sentiment, with substantial FX reserves the rule rather than the exception now. They are less reliant on foreign currency borrowing. Not all have enormous current account deficits.

Importantly for the world economy, China can stay above the fray. Of course, it has big challenges of its own. They range from a banking sector saddled with many dud loans, through an overheating property market to a need to rebalance the economy towards consumption and away from investment. But these are domestic problems that can be addressed with domestic solutions.

China accounts for almost two-fifths of emerging-market GDP and can use all levers of policy to stay clear of trouble. Inflation is low, FX reserves are high and it is not dependent on hot money inflows. The latter point is important. China's problems are all within the authorities' gift to manage.

The coming adjustment will be painful for the vulnerable countries. But with the US, Europe and China looking up, we expect the world economy to cope. The good news from the developed world far outweighs the collateral damage that the end of overly easy money may cause in some markets.

Emerging-market wobbles are one of the many problems that will arise as central banks move closer to exiting from their extraordinary policy settings. That is going to require a lot of signalling and careful adjustment. But, ultimately, the world economy will be in a better place when it is no longer reliant on a tsunami of cheap liquidity. With major economies improving and large emerging markets relatively well placed, the transition should be successful, if not smooth.

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