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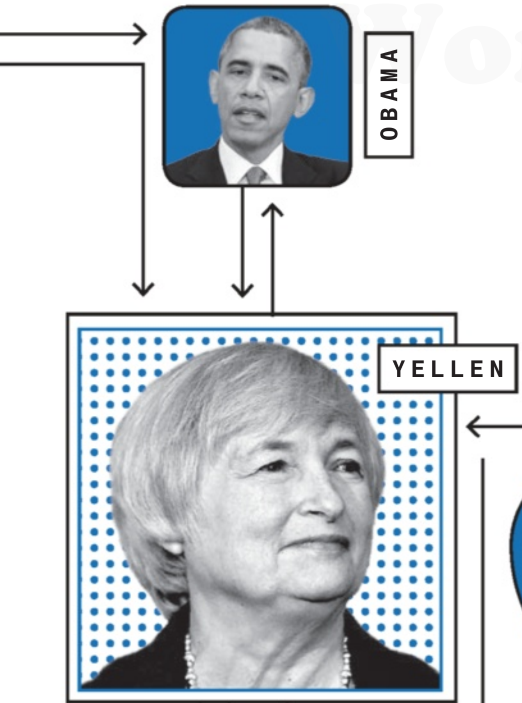
A sluggish U.S. recovery. Volatility in China. Uncertainty in Europe. The global economy is struggling to pick up steam—but the year ahead may still turn out better than you think. Here's why. By Peter Coy



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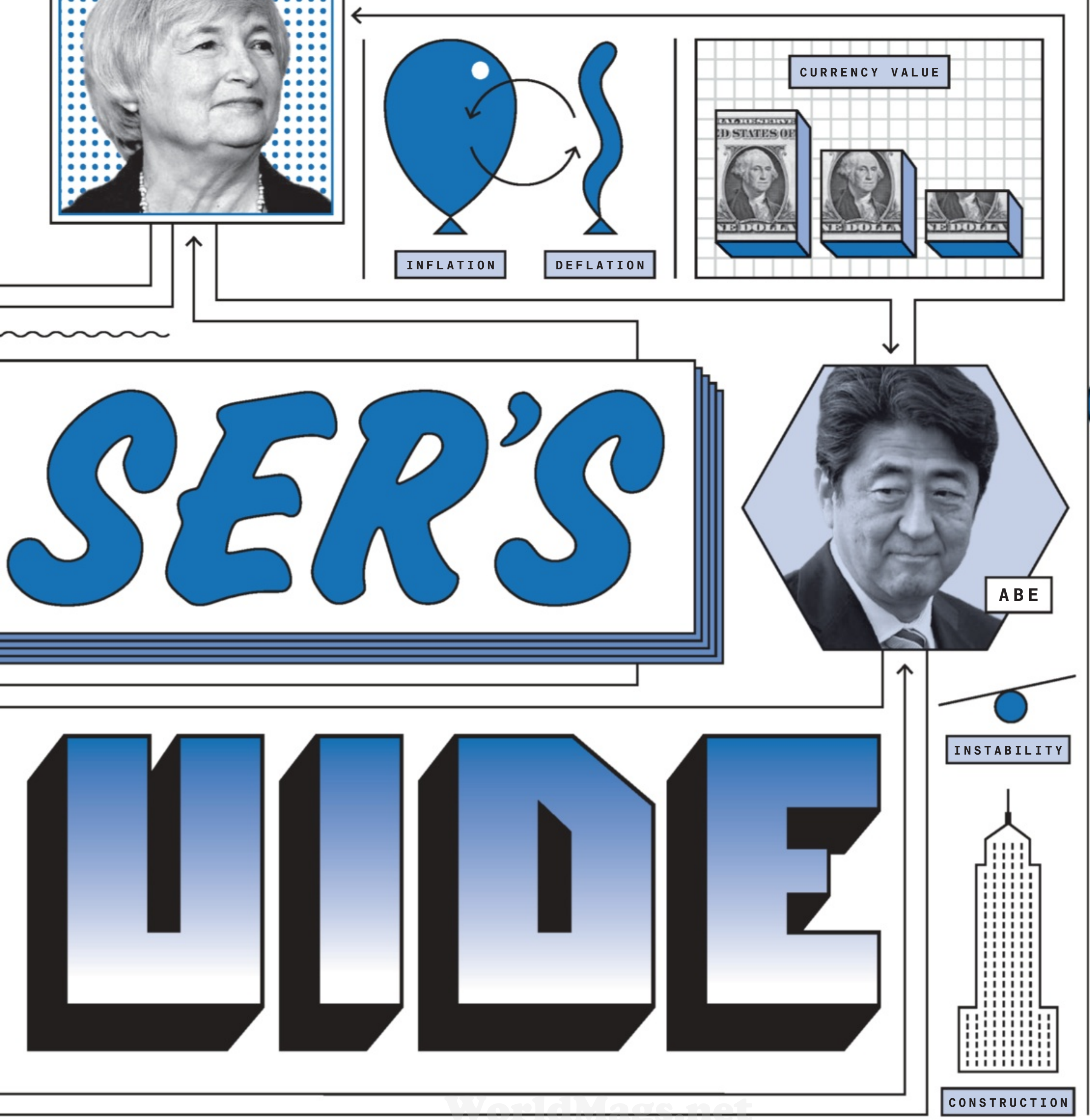

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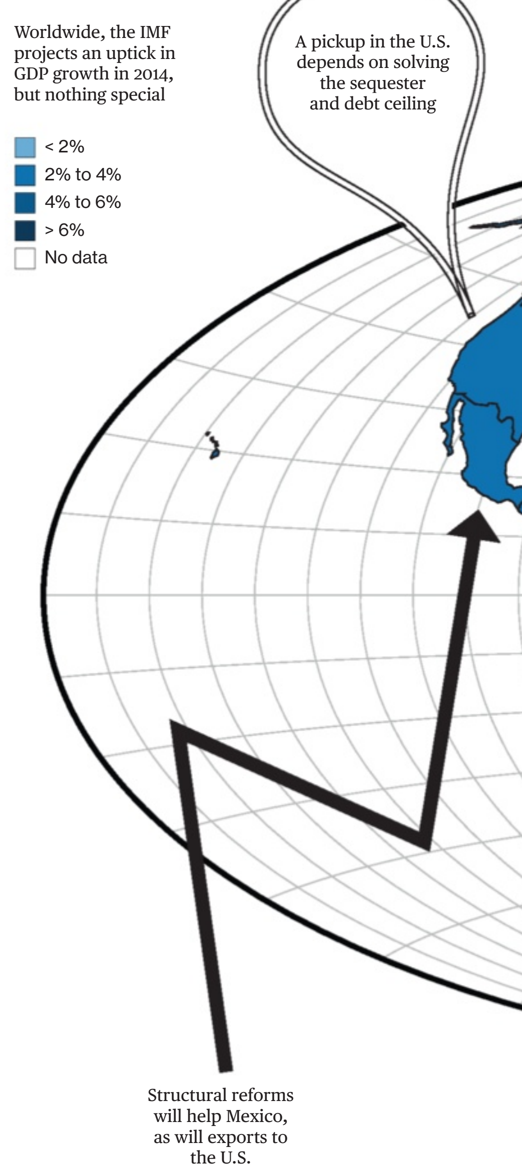


On Jan. 1, 2014, Latvia will adopt the euro, and its lats currency will be no more. Farewell to the fulsomely bearded Krišjānis Barons, the collector of folk songs who graces the 100-latu note. Goodbye to images of sailing ships and maidens, oak trees and the Daugava River. The little Baltic nation is shucking a piece of its national heritage because its leaders think that joining Europe's somewhat troubled common currency zone will lead to more trade, investment, and prosperity. "We are looking to growth," Finance Minister Andris Vilks told reporters in June.

There aren't many other events in 2014 that we can forecast with as much confidence as Latvia's scheduled adoption of the euro. For decision-makers in global business, some big unknowns await. Things you'd like to know: Will the U.S. economy add jobs or asset bubbles with Janet Yellen as the next chairman of the Federal Reserve? Will German Chancellor Angela Merkel become more generous toward Southern Europe if she forms a coalition with the Social Democrats? Can Chinese President Xi Jinping and Premier Li Keqiang defeat the forces of reaction and repair the slowing engines of the world's second-largest economy? And how about Shinzō Abe, the iconoclastic Japanese prime minister: Can he shrink budget deficits without pushing the economy back into deflation?

This article sets the economic and geopolitical stage for our special issue, The Year Ahead: 2014. In the pages to follow, we'll provide a preview of 2014 for 55 global industries, from tech to banking and energy to retail. We don't claim to be prescient, but we do believe that by wrestling with the hardest questions of the day we can help executives make decisions about where and when to deploy people and capital.

Worldwide, 2014 should be better than 2013 but not great. Inflation and interest rates are low in most of the world, oil prices are expected to fall (page 22), companies are sitting on cash, and there's plenty of pent-up consumer demand. A Barclays measure of global business confidence reached a 31-month high in October. But the world is having trouble accelerating after the 2009 global downturn. The International Monetary Fund projects global growth in gross domestic product of 3.6 percent in 2014. That's up from 2.9 percent this year, although not back to the 5 percent growth rates of 2005 to 2007. The IMF's theme for 2014 is "transitions and tensions," which sounds anxious. "Global growth is in low gear, the drivers of activity are changing, and downside risks persist," the organization reports.

The best place to start our *tour d'horizon* is Washington. That's partly because the U.S. is the world's largest economy and partly because two of the most important uncertainties on the global scene involve the Fed and Congress. Business executives from Shanghai to São Paulo are praying that Congress and the White House will reach deals with a minimum of additional fuss in January and February to fund the federal government for the rest of the fiscal year and raise the debt ceiling. And they're hoping that Yellen can taper stimulus measures as adroitly as Ben Bernanke layered them on.

Success in both missions could lift 2014 growth in the U.S. above the middling 2.6 percent rate foreseen by economists surveyed by Bloomberg News. Failure threatens not only the U.S. but also the entire world. In 2014 "the biggest risk for us would be homemade troubles" coming out of Washington, says Jan Siegmund, chief financial officer of Automatic Data Processing, the payroll giant.

"Right now we're living in this uncertainty. The thing that business hates the most, maybe after taxes, is uncertainty," says Harold Sirkin, a senior partner at Boston Consulting Group. The U.S. is emerging as one of the world's low-cost manufacturing centers, but politicians could still screw things up by keeping executives on pins and needles, Sirkin says. "Companies aren't making the same level of investment," he says. "They don't want to hire people. If you tell them what the rules of the game are, they're more likely to respond."

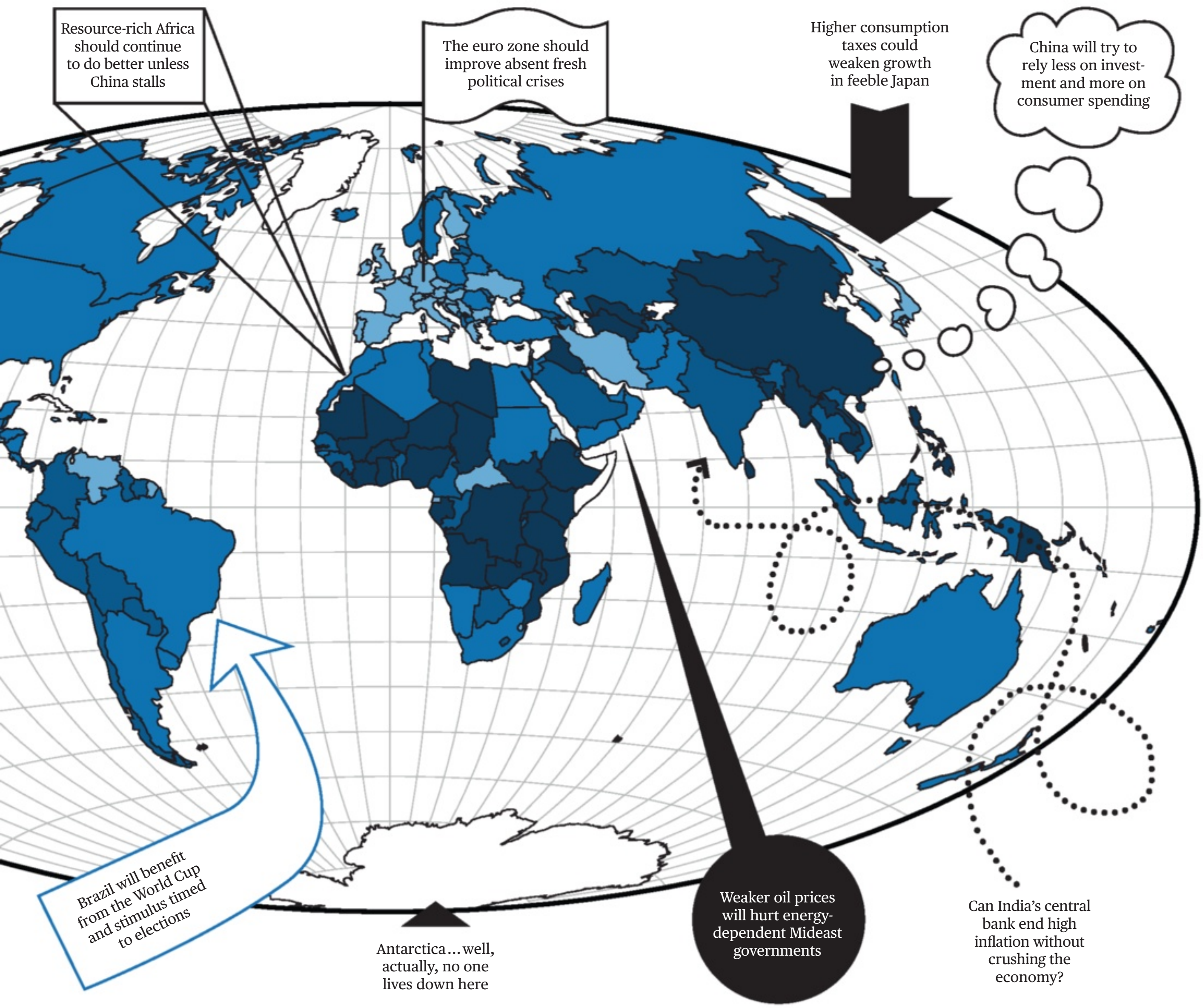
One reasonable scenario goes like this: Fiscal policy becomes less of a drag on the U.S. economy in 2014. Republicans approve a debt-ceiling increase in February in exchange for some hard-to-predict concession from the White House. By spring, President Obama wins continuing resolutions that replace some of the scheduled budget caps and sequestration with smaller cuts in other areas. In the November 2014 congressional elections, the GOP loses some seats but retains control of the House. Divided government means less contraction because the Republicans can't win big spending cuts and the Democrats can't get tax increases. There's little progress, though, on restraining the long-term growth in entitlement spending.

Over at the Fed on Constitution Avenue, Yellen will face anguishing decisions as soon as she replaces Bernanke as Fed chairman on Feb. 1, assuming she wins confirmation. Years of near-zero interest rates and aggressive Fed bond-buying have failed to engender strong economic growth. Monetary hawks say easy money will create bubbles in assets ranging from housing (again) to farmland to junk bonds. The Fed is near a tipping point at which stimulus becomes "an agent of financial recklessness," and "none of us really know where that tipping point is," Richard Fisher, the president of the Federal Reserve Bank of Dallas, said in October. In 2014, Fisher becomes a voting member of the Federal Open Market Committee—and a thorn in Yellen's side.

Bubbles are only one risk. The expansion could lose what little momentum it has next year if Yellen, to prove

World of Economic Growth

Projections of the International Monetary Fund's October 2013 World Economic Outlook



GRAPHIC BY BLOOMBERG BUSINESSWEEK. DATA: INTERNATIONAL MONETARY FUND

her inflation-fighting bona fides, goes along with premature withdrawal of stimulus. The decline of the unemployment rate since 2009, to 7.3 percent in October, is misleading because it's largely the result of people giving up and not being counted among the unemployed, says Scott Clemons, chief investment strategist at Brown Brothers Harriman Wealth Management.

The last recession ended in 2009, so by next summer this run of growth, modest as it is, will have lasted longer than the average post-World War II expansion. To keep it alive, says one investor, it's almost as likely that the Fed will increase stimulus as that it will finally begin its long-anticipated taper. "Low demand for credit, low inflation, and other indicators are signaling that deflation remains a serious threat," Daniel Arbess, a partner in the investment and advisory firm Perella Weinberg Partners, wrote in an e-mail.

The Fed's next move matters to everyone because it remains the world's de facto central bank. Other nations complained when low U.S. rates sent hot money flooding their way in 2008, and they complained again this year when hints of higher U.S. rates reversed the tide. Yellen won't focus too much on that turmoil, though. Serving the U.S. economy is complicated enough. The latest expectation of many market watchers is that the central bank will start tapering bond purchases around March. But the Fed's own rate setters don't foresee nudging up the federal funds rate until 2015. That's because the U.S. economy remains too weak to withstand it.

All of which argues for caution. At the sprawling Port of Long Beach, Calif., work is proceeding on a $4 billion expansion that by 2019 will increase capacity by one-third. Port officials aren't so bullish about the coming year, though. They're projecting only 3 percent volume growth for Long Beach and the neighboring Port of Los Angeles combined, the same as this year. Says Noel Hacegaba, the chief ▶

◀ operating officer: "We see no clear sign that the recovery is picking up steam in the immediate future."

China, the world's No. 2 economy, won't grow at its customary pace in 2014, either. Western drugmakers, whose Chinese sales rose 40 percent a year as recently as 2011, might have to settle for 14 percent to 15 percent growth next year, estimates London-based GlobalData (page 162). Economists surveyed by Bloomberg are looking for China's deceleration to continue in the year ahead, with growth of 7.4 percent, vs. 7.6 percent in 2013. That may look boringly steady, but the seeming ability of China's leadership to hit its targets masks economic and political volatility. "Nothing in China is as it appears," says Gary Burnison, chief executive officer of recruiting company Korn/Ferry International. He lived in Shanghai this past summer.

To judge whether President Xi and Premier Li are gaining the upper hand, keep an eye on a few key events in 2014, advises David Hoffman, who lives in Beijing as managing director of the Conference Board's China Center for Economics and Business. One is the 12th National People's Congress's plenary meeting in March. The other is a plenary session of the 18th Central Committee of the Communist Party of China, probably in September or October. Li wants to move China from investment to consumption as a source of growth, but the pop in growth this fall was achieved the old-fashioned way, by heavy lending that fueled investment in plants, equipment, and infrastructure. The municipality of Beijing is planning a financial district with 80 skyscrapers, even though its existing Financial Street is only about 15 years old. "We're seeing tremendous inertia on the reform front, and the factional divides are very pronounced," Hoffman says.

Xi and Li have declared war on corruption. The *South China Morning Post* says Xi has taken a personal interest in allegations of graft against Zhou Yongkang, who was the head of internal security until he retired last year. The trouble is that the leadership isn't just cracking down on crime; it's suppressing legitimate dissent by arresting professors and executives who defy it, says Regina Abrami, co-author of a new book *Can China Lead?* "The whole economy is built on a foundation of moral hazard," says Abrami, director of the Lauder Global Program at the University of Pennsylvania's Lauder Institute.

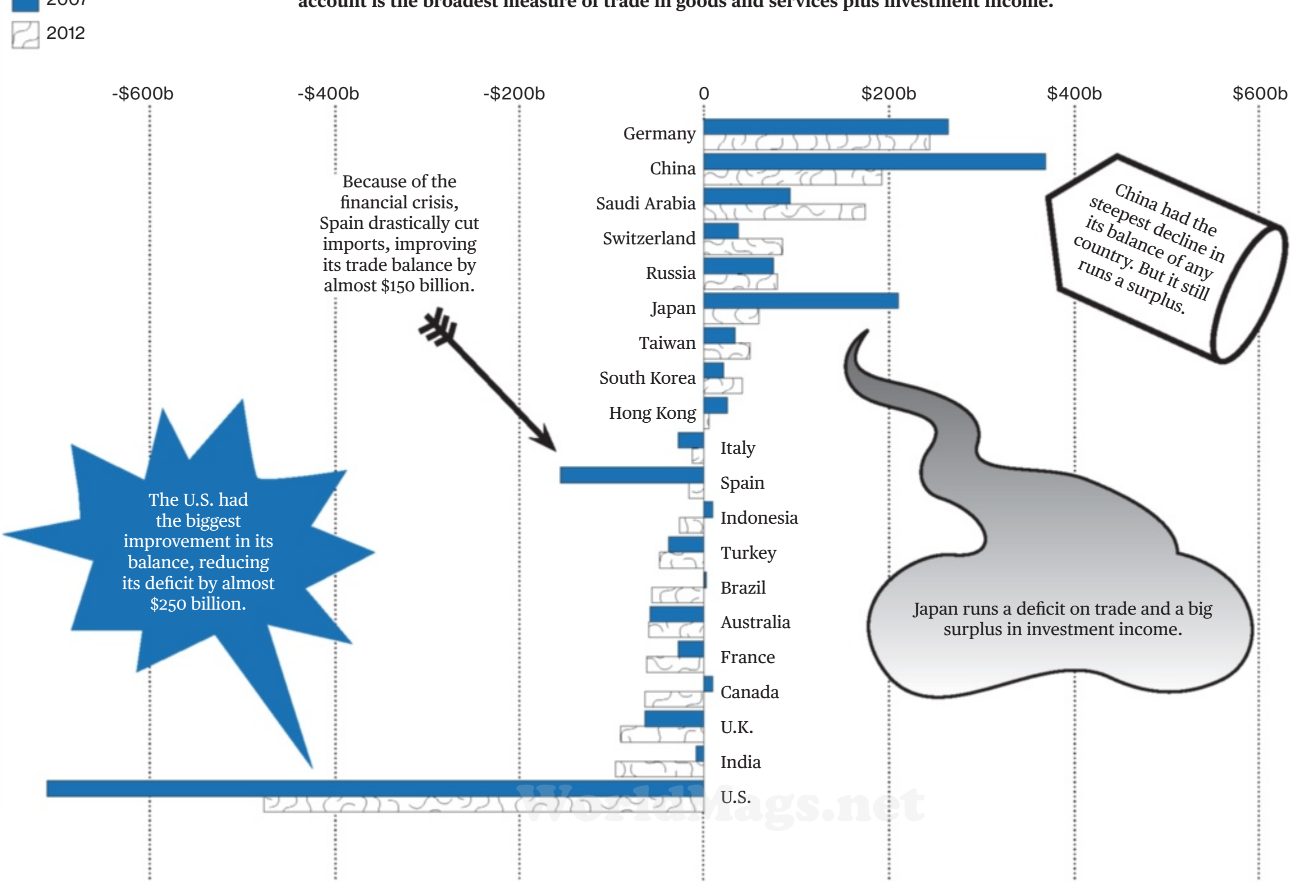
China looks considerably healthier to Michael Silverstein, who, like Sirkin, is a Boston Consulting Group senior partner. "There are 300 bureaucrats that basically run China as a meritocracy," he says. They're already starting work on the next Five-Year Plan, which will cover 2016 to 2020. "It'll just blow you away," Silverstein says. "I think they're going to get highly specific about the technologies they really want to try to own." Corruption? "The current government is very intent on knocking that out," he says.

No one knows for sure who's right. In China and elsewhere, predictability is a thing of the past. For a few good years, roughly 2000 to 2007, life was easy for global investors, according to a recent presentation in New York by David Bloom, global head of foreign exchange strategy at HSBC. Practicing the time-honored carry trade, they would borrow in countries with low interest rates, such as Japan, and invest in those offering higher returns, such as New Zealand. After the global financial crisis hit in 2008, the game became "risk on/risk off." In months when "risk on" was in fashion, money flowed into risky, high-yielding securities; other months investors would flee for the safety of U.S. Treasuries.

The latest trend, which will continue in 2014, says Bloom, is for some investment money to travel the carry-trade ▶

GOOD NEWS: TRADE IMBALANCES HAVE NARROWED

This chart shows the change in current-account balances from 2007 through 2012. The current account is the broadest measure of trade in goods and services plus investment income.



GRAPHIC BY BLOOMBERG BUSINESSWEEK. DATA: HSBC route, some to seek geopolitical safety in the likes of the euro and the British pound (but not the suddenly scary U.S. dollar), and some to go toward places such as Hong Kong, Taiwan, and South Korea whose currencies look promising because they have fat trade surpluses. "The FX world has gone from the simple to the complicated," Bloom wrote in an e-mail.

One piece of good news on the currency front is that imbalances in global trade have been shrinking. American deficits and Chinese surpluses have fallen dramatically since 2007. But even that positive development will cause unnerving reverberations in 2014, predicts Stephen King, HSBC's global head of economics and asset allocation.

The recently dubbed Fragile Five—Brazil, India, Indonesia, South Africa, and Turkey—became addicted to inflows of hot money caused in part by the Fed's easy monetary policy. They ran up trade deficits. Now those deficits are getting smaller, which is healthy in the long run. But they're dwindling too rapidly and in a sickly way, i.e., through currency depreciation that makes imports unaffordable and through high interest rates that chill demand, says King.

Mathematically, if the Fragile Five are reducing their deficits, some other countries must run bigger deficits or smaller surpluses. If they don't want to, the risk is a beggar-thy-neighbor currency war.

A big question for 2014: Which country will break out of a mercantilist mindset and accept smaller surpluses? China is moving slowly toward an overall balance in trade despite its huge surplus vs. the U.S. Then come Japan and Germany. Japan's Abe is in a pickle. He needs to boost growth but can't afford a big stimulus and is promising a sales tax hike in April. So Abe is counting on igniting growth through higher inflation. That weakens the yen, which suppresses imports. "It is hard to see any solution to Japan's problems that does not involve a significantly weaker yen," Julian Jessop, chief international economist for Capital Economics, wrote in a note to investors.

That leaves Germany, which has run large trade surpluses throughout the European crisis. Merkel won election to a third four-year term as chancellor in September, but her Christian Democratic Union party failed to garner enough votes to form a government by itself. Her most likely partner is the more Eurocentric Social Democratic Party. European growth could accelerate in 2014 if a new German coalition government provides more financial aid to the rest of Europe and agrees to contribute more to recapitalizing weak banks in Spain and Italy. "This is not far-fetched," says Andre Sapir, an economist and senior fellow at Bruegel, a Brussels-based think tank. "Germany doesn't want to go for the major clash and the end of the euro."

On the other hand, ordinary Germans aren't feeling a lot of *gemütlichkeit*—warm fuzzies—toward the people of Southern Europe, whom some describe as freeloaders. Conservative Germans say that if they make life too easy for Greece, Portugal, Italy, and Spain, the pressure on them to reform will be removed. If Germany gets too hard-nosed, though, its policies could intensify a populist backlash in debtor nations. A key event to watch is the elections to the European Parliament in May, where anti-European parties threaten a strong showing. A surprise rate cut by the European Central Bank on Nov. 7 should boost growth. On balance, Sapir is mildly optimistic: "I would see 2014 as a year of transition. But hopefully not a wasted year of transition."

Once you get past the world's top four economies, you're down to countries that are not fully masters of their own fates. The rest of Europe takes its cue from Germany, although Britain, France, and Italy are players, too. The economies of Russia and the Middle East depend on energy prices. Africa, primarily a commodity producer, lives and dies by the swings in prices of raw materials. Ditto for most of South America, although Brazil is a major manufacturer as well. Southeast Asia and Australia are in China's orbit, while Canada and Mexico depend on the U.S. India is big but insular. Then there are the trouble spots that could blow up in 2014—or not: the South China Sea, Kashmir, Yemen, and so on.

The U.S. matters the most of all. If it grows, the world will, too. In the eastern U.S., railroad CSX is running more trains laden with housing construction materials, cars, and even crude oil from North Dakota. "We are feeling more optimistic," says CEO Mike Ward (page 36). "If you look at some of the broad indicators in the economy ... we're really seeing some positive signs." If more CEOs climb on board Ward's optimism train, 2014 could be a strong year after all.

Cheaper Oil, a Lubricant

GRAPHIC BY BLOOMBERG BUSINESSWEEK. DATA: COMPILED BY BLOOMBERG

ALMOST EVERY COUNTRY WANTS TO GROW BY EXPORTING MORE THAN IT IMPORTS. MATHEMATICALLY, THOUGH, THAT'S IMPOSSIBLE