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Economics Group

Special Commentary

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Where Will Global Growth Come From in 2015?

Executive Summary

Apart from the United States, recent economic data in many major economies have been a bit discouraging. Japan has slipped back into recession again, and economic growth in the Eurozone generally remains anemic. The rate of real GDP growth in China receded to a five-year low in Q3-2014. So, how in the world will the global economy achieve the 3.8 percent GDP growth rate that the International Monetary Fund forecasts for 2015?

The U.S. economy should grow nearly 3 percent in 2015, which would contribute roughly 0.5 percentage points to global GDP growth. Real GDP in China is unlikely to grow at a double-digit rate ever again, but the 7 percent Chinese growth rate in 2015 that the IMF projects, if realized, would still make a meaningful contribution to overall global growth. Developing economies excluding China, which account for roughly 40 percent of global GDP, should grow nearly 5 percent supported, in part, by solid population growth.

Expecting global economic growth to return to the 5 percent per annum rates of 2003-2007, which are an outlier when viewed in the context of the past few decades, may not be realistic anyway. The rates of global GDP growth that we forecast for the next two years are essentially equivalent to the 3.4 percent annual average growth rate that the global economy achieved on average between 1980 and 2013. Maybe the "new normal" of today's slower global growth, at least when benchmarked versus the 2003-2007 period, is actually the old "normal." The experience of 2003-2007 does not appear to be "normal" at all when viewed in a longer-run context.

Positive Contributions From the U.S. and Chinese Economies

Exactly how will the global economy grow 3.8 percent in 2015 and 4.0 percent in 2016?

Recent news about some of the largest economies in the world has been a bit discouraging. The U.S. economy has generally been doing rather well, but the 2.3 percent year-over-year real GDP growth rate that it registered in Q3-2014 is hardly "robust." Real GDP growth in China, the world's second largest economy, slowed to a five-year low of 7.3 percent in the third quarter. Japan, the third largest economy in the world, recently entered its fourth recession since the advent of the global financial crisis in 2008. Real GDP in Germany, the world's fourth-largest economy, has been flat on balance over the past two quarters, and the French economy (No. 5) has been essentially dead in the water for more than a year. With this starting line-up, one could be excused for wondering exactly how the International Monetary Fund (IMF) thinks the global economy will grow 3.8 percent next year and 4.0 percent in 2016 (Figure 1).[1]

[1] The IMF "headline" forecast uses purchasing power parity (PPP) exchange rates to combine growth rates of different countries into a global aggregate. If market exchange rates are used instead in the aggregation, then the IMF looks for 3.2 percent global growth next year and 3.4 percent in 2016. We prefer using market exchange rates for the aggregation because, in our view, PPP exchange rates vastly overstate the size of the Chinese and Indian economies.

Figure 1

IMF GDP Forecast				
	2003-07 Average	2014	2015	2016
World	5.1%	3.3%	3.8%	4.0%
Advanced Economies	2.8%	1.8%	2.3%	2.4%
Developing Economies	7.7%	4.4%	5.0%	5.2%
CIS	8.1%	0.8%	1.6%	2.5%
Emerging Asia	9.5%	6.5%	6.6%	6.5%
Emerging Europe	6.0%	2.7%	2.9%	3.3%
Latin America	4.9%	1.3%	2.2%	2.8%
MENA	6.8%	2.7%	3.9%	4.5%
Sub-Saharan Africa	7.1%	5.1%	5.8%	6.0%

Source: International Monetary Fund

The U.S. should contribute 0.5 percentage points to global GDP growth next year.

Let's start with the United States, the world's largest economy. The IMF forecasts that U.S. real GDP will grow 3.1 percent in 2015 and 3.0 percent in 2016.[2] If PPP exchange rates are used to aggregate the global total (see footnote No. 1), then the United States accounts for 16 percent of global GDP at present. Therefore, the U.S. economy would contribute roughly 0.5 percentage points to global GDP growth next year (0.16 X 3.0 percent) if the IMF's forecast of U.S. GDP growth is realized.[3]

Turning to the second-largest economy in the world, real GDP growth in China clearly has slowed from its double-digit pace a few years ago to 7.3 percent recently (Figure 2), and most analysts do not expect a return to double-digit growth rates anytime soon, if ever. Nevertheless, the IMF forecasts that China will grow 7.4 percent in 2015 and 7.1 percent during the following year.[4] If these forecasts are realized, then China would contribute about 1.2 percentage points to global GDP growth over each of the next two years.[5]

Before we turn to other major economies, we should first discuss what effects the American and Chinese economies have on the rest of the world. As we explained in a special report we wrote last year, the best way to measure the effect that an individual economy has on the rest of the world is to measure the amount that final domestic demand (i.e., final sales to consumers, businesses and government) in that economy has on value added in foreign countries.[6]

[2] At 2.7 percent, our forecast for U.S. GDP growth in 2015 is a bit lower than the IMF's projection. We share the IMF's forecast of 3.0 percent growth in 2016. For details, see our *Monthly Economic Outlook*, which is posted at www.wellsfargo.com/economics.

[3] We showed in a recent report that the U.S. economy has limited direct exposure to the rest of the world. Therefore, it would take a *significant* slowdown/downturn in foreign economies to produce a meaningful slowing effect on U.S. economic growth. See "*Slow Foreign Growth: Should America Worry?*" (Oct. 1, 2014), which is available upon request.

[4] We are not as optimistic about Chinese growth prospects as is the IMF. We look for 6.8 percent real GDP growth in China for 2015 and 6.5 percent in 2016. See our *Monthly Economic Outlook* for details.

[5] Under PPP exchange rates, the Chinese economy accounts for 17 percent of global GDP at present, making it larger than the American economy. As discussed in footnote No. 1, we think that PPP exchange rates overstate the actual size of the Chinese economy. If market exchange rates are used to aggregate global GDP, then China currently accounts for 13 percent of the global economy versus 22 percent for the United States.

[6] See "*How Much Does Slower Chinese Growth Matter?*" (July 10, 2013), which is available upon request.

Figure 2

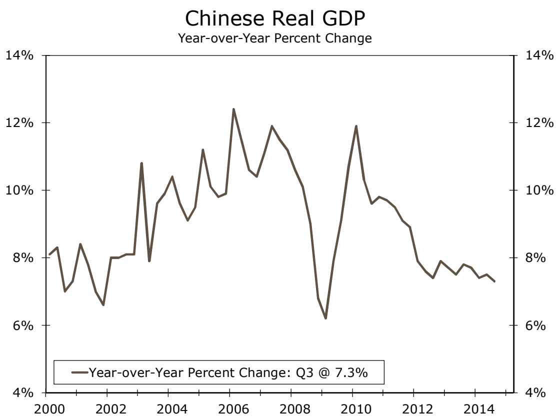
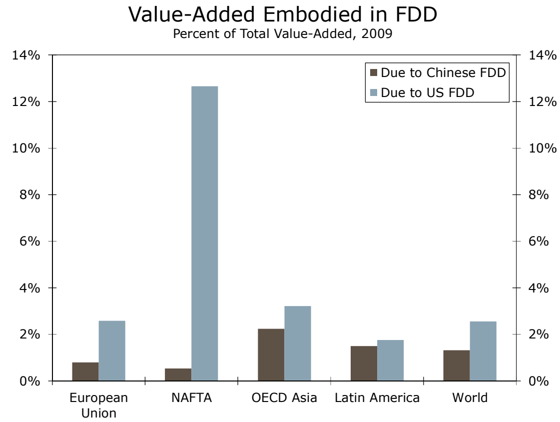


Figure 3



Source: Bloomberg LP, OECD and Wells Fargo Securities, LLC

Both the U.S. and China should contribute positively to growth in other economies over the next two years.

Final domestic demand in the United States clearly has an outsized effect on the NAFTA economies of Canada and Mexico, accounting for more than 12 percent of value added in those countries (Figure 3). The American economy should be able to provide some locomotive power to Canada and Mexico over the next two years if, as we project, growth in final domestic demand in the United States remains solid. Although much has been made of the growing importance of China to other Asian economies as well as to Latin American countries, the United States still has a larger effect on value added in those regions than does China. Although China has half as much effect on the rest of the world than the United States—China accounts for 1.3 percent of global value added versus the 2.6 percent ratio for the United States—the former likely will grow twice as fast (or more) than the latter over the next two years. In other words, both the United States and China should continue to contribute positively to growth in other economies over the next two years.

What Other Regions Will Grow?

As noted above, the German and French economies have been more or less flat over the past few quarters. More broadly, economic activity in the 18 countries that form the Eurozone has been sluggish recently as shown by the year-over-year real GDP growth rate of only 0.8 percent in Q3-2014 (Figure 4). Although the sequential rate of growth in the overall euro area has slowed in the past two quarters, the Eurozone has been able to avoid another recession, and we look for continued growth, albeit at a sluggish pace, in coming quarters. Economic growth should be shored up in the coming quarters by financial conditions, which are becoming less restrictive. In that regard, bank lending, which has been trending lower for three years, may be beginning to stabilize, and the depreciation of the euro, which has weakened about 5 percent on a trade-weighted basis since May, should help to support export growth. Fiscal policy is not as restrictive today as it was a few years ago.[7] If, as we project, Eurozone GDP grows roughly 1 percent next year, then the euro area would make a positive contribution to global GDP growth that would be equal to about 0.1 percentage points.

Japan made headlines recently on news that the economy had entered its fourth recession since the global financial crisis of 2008 (Figure 5). That said, we expect real GDP growth in Japan to turn positive again in 2015. For starters, growth in consumer spending is positive again, following its tax hike-induced collapse in the second quarter, and the sizeable drop in inventories in Q3 lays the groundwork for a bounce-back in production in the coming months. Japan accounts for only 4 percent of global GDP, so weak Japanese economic growth next year will contribute only marginally to global GDP growth.

[7] The IMF estimates that the structural budget deficit in the Eurozone will decline by 0.2 percentage points of GDP in 2015, which is down from the fiscal drag worth 1 percent or more of GDP per annum in 2011 through 2013.

Figure 4

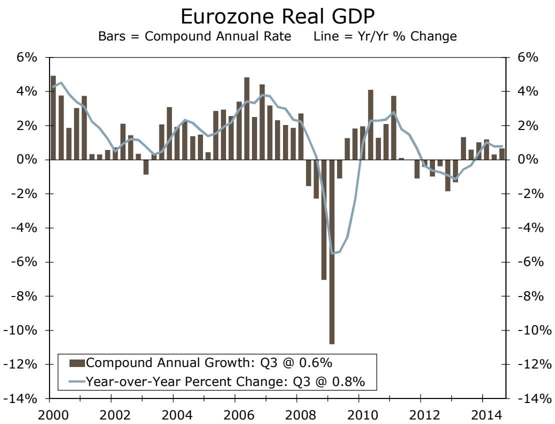
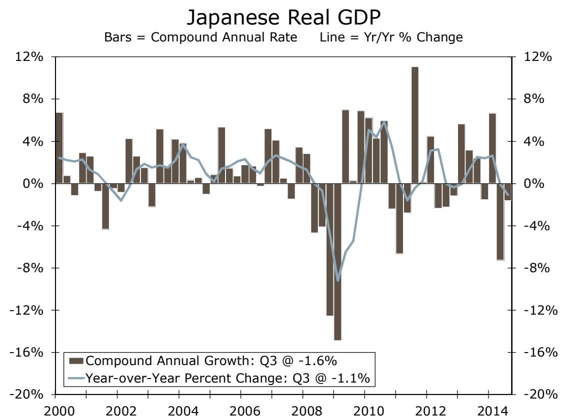


Figure 5



Source: IHS Global Insight and Wells Fargo Securities, LLC

So that leaves the developing countries of the world. Excluding China, which we discussed previously, developing countries in aggregate account for 40 percent of global GDP.[8] As shown in Figure 1 on page 2, the IMF expects that real GDP in the developing world will grow about 5 percent per annum over the next two years. However, if developing countries are completely dependent on exports to advanced economies to drive economic growth, how can real GDP in the developing world possibly grow 5 percent per annum over the next two years if growth in many advanced economies, such as the economies of the euro area and Japan, continue to grow at a slow pace?

The popular perception may be that developing countries are dependent on economic growth in advanced economies to drive their own GDP growth. The reality, however, is that developing countries generally rely on growth in their own domestic demand to power their GDP growth rates. As shown in Figure 6, real GDP growth in developing economies (excluding China) was driven entirely by growth in domestic demand in those economies between 2010 and 2012 (latest available data).[9] Net exports actually exerted a modest drag on growth in those countries during those years.

Excluding China, developing economies should grow about 5 percent per annum over the next two years.

Real economic growth in developing economies has been (and will continue to be) driven, at least in some measure, by population growth. In simplistic terms, more mouths mean more demand for goods and services, many of which are produced domestically. As shown in Figure 7, the population of the developing world grew in excess of 1 percent per annum in recent years, well above the population growth rate of the advanced economies, and this solid population growth in the developing world likely will continue for the foreseeable future. Technological improvements and continued strong growth in capital spending in many developing economies should lead to solid growth in labor productivity that will also contribute to economic growth in the developing world. In our view, the 5 percent per annum growth rates that the IMF forecasts for developing economies over the next two years are not unreasonable. If 40 percent of the global economy grows roughly 5 percent in both 2015 and 2016, then the contribution of those economies to overall global GDP growth would be about 2 percentage points each year.

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[8] If market exchange rates, rather than PPP exchange rates, are used to aggregate GDP of individual countries, then the percentage of global GDP that is accounted for by developing countries (excluding China) drops to 25 percent.

[9] To minimize data requirements, we considered only the largest 25 developing economies (excluding China) in the calculations made in Figure 6. These 25 economies account for 80 percent of GDP in the developing world (excluding China).

Figure 6

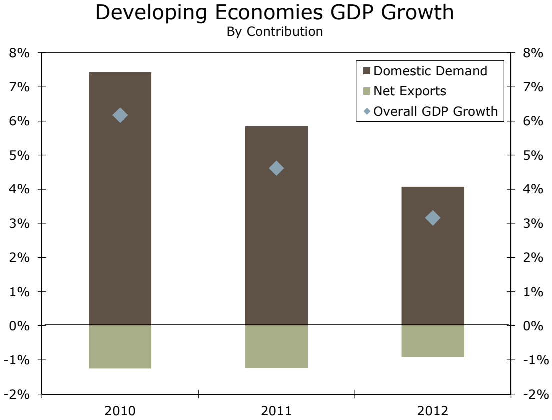
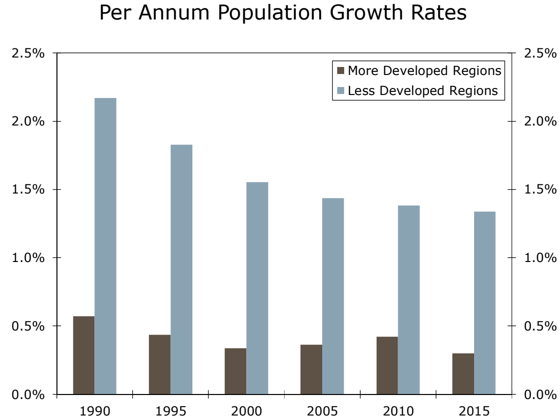


Figure 7



Source: United Nations and Wells Fargo Securities, LLC

The Global Economy Is Not Going Back to 5 Percent GDP Growth

Global GDP growth is not going back to 5 percent anytime soon.

The good news is that the bottom-up approach we employed above finds that the IMF's forecast for global GDP growth in 2015 and 2016, which is more or less our own forecast, is not far-fetched. The bad news, however, is that global economic growth is not going back to the 5 percent per annum rate that it averaged between 2003 and 2007, at least not anytime soon. Many major economies have some structural problems today that will make a return to the supercharged growth rates of the middle years of the past decade difficult to re-attain in the foreseeable future.

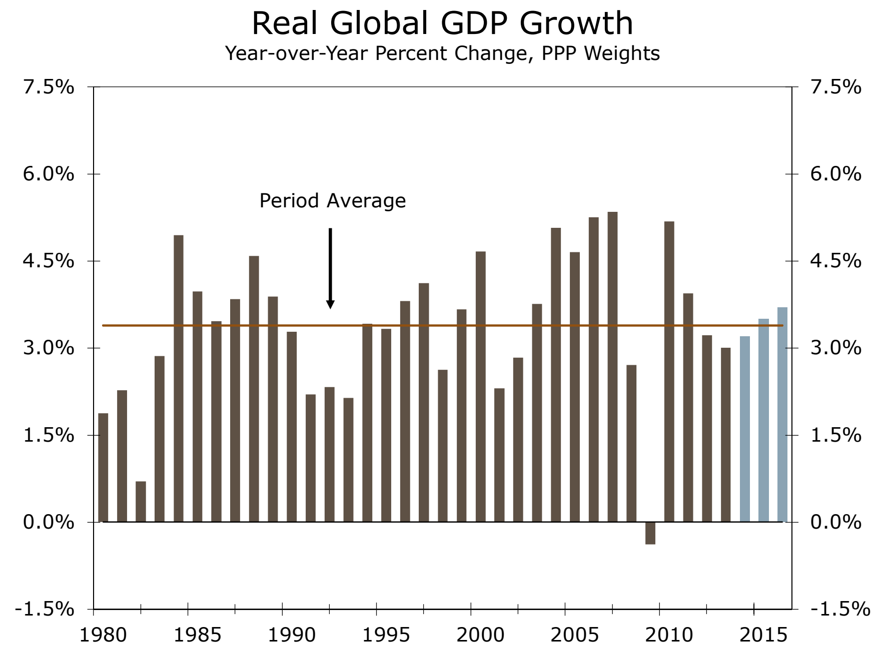
Let's start with the United States. Real GDP growth in the United States was boosted in the past decade by loose credit standards that are not likely to reappear soon. Moreover, many analysts estimate that the long-run economic growth rate of the American economy has downshifted in recent years as labor force growth has slowed due, at least in part, to the aging of the population. At least the United States has the advantage of positive population growth. Many other advanced economies (e.g., Germany, Italy and Japan) will see their populations either top out or begin to decline in the next few years. In addition, high debt levels in many advanced economies, especially in Europe and Japan, likely will constrain growth as well in those countries for the foreseeable future.

As noted above, the IMF forecasts 5 percent economic growth in the developing world in both 2015 and 2016. Those rates, however, are nearly 3 percentage points slower than the 7.7 percent annual average rate that developing countries in aggregate were able to achieve between 2003 and 2007. The Chinese government is attempting to rebalance the economy away from excessive investment spending, which means that China is unlikely to return to the double-digit growth rates that characterized the past two decades. Supply bottlenecks in India will prevent that economy from re-attaining in the next few years the 8 percent to 9 percent growth pace that it achieved between 2003 and 2007. Brazil is presently in recession and economic growth in Russia is very weak. Neither country will bounce back soon to the robust rates of economic growth they both enjoyed prior to the global financial crisis.

The "new normal" may actually be the old "normal."

Expecting global growth to return to 5 percent per annum may not be realistic anyway. As shown in Figure 8, a global GDP growth rate of 5 percent per annum is an outlier when viewed in the context of the past few decades. The rates of global GDP growth that we forecast for the next two years are essentially equivalent to the 3.4 percent annual average growth rate that the global economy achieved on average between 1980 and 2013. Maybe the "new normal" of slower global growth, at least when benchmarked versus 2003-2007, is actually the old "normal." The experience of 2003-2007 does not appear to be "normal" at all when viewed in a longer-run context.

Figure 8



Source: International Monetary Fund and Wells Fargo Securities, LLC

Could the global economy grow faster than most analysts, including ourselves and the IMF, expect over the next two years? Sure. Global monetary conditions are quite accommodative at present. The combination of ultra-low interest rates and signs of pent-up demand for durable goods and investment spending in some countries could conceivably lead to more robust spending on "big ticket" items than currently expected.[10] Further declines in energy prices, if brought about by increased supply, would be positive for global economic growth on balance.

A return to the "good old days" of 2003-2007 does not appear to be in the cards.

Of course, there are some downside risks to keep firmly in mind as well, but economies usually do not stall on their own accord. Rather, some shock is generally needed to bring about a significant slowdown or downturn. In that regard, an open conflict between Russia and Ukraine could raise uncertainty as well as energy prices. House prices in China have declined in recent months. A property price collapse in China, should one occur, would lead to a sharp slowing in the world's second largest economy. Not only would slower growth in China have a direct effect on overall GDP growth, but the knock-on effect that China would exert on its major trading partners would also cause global growth in 2015 to be weaker than expected. In sum, we are generally constructive about the global economic outlook over the next two years, but readily acknowledge that a return to the "good old days" of 2003-2007 does not appear to be in the cards.

[10] See "*Outlook for 'Big Ticket' Spending in the Eurozone*" (Sept. 25, 2014) for a discussion of potential pent-up demand in the Eurozone. This report is available upon request.

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