June 04, 2015

Economics Group

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Special Commentary

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# Economic Prospects in Emerging Asia

## Executive Summary

In a recent report, we provided a general overview regarding economic prospects in six regions of the developing world.[1] In the first of our series of individual regional reports, we drill down into seven countries in emerging Asia to examine economic opportunities and risks in those specific economies. Among the six regions of the developing world, emerging Asia has posted the strongest rates of economic growth over the past two decades.

China and India, the two largest economies in the region, have been important drivers of economic growth in emerging Asia, but some economies, such as Indonesia and the Philippines, which are less directly tied to these two behemoths than some of their regional neighbors, have also posted impressive growth rates over the last decade or two. Many of the region's economies can attribute their success to their high savings rates, which have allowed those countries to finance robust rates of investment spending without racking up crippling current account deficits. Strong demographic trends have also boosted economic growth rates in many emerging Asian economies over the past few decades.

Emerging Asia will likely continue to post faster economic growth rates than most other regions in the developing world for the foreseeable future. However, the region will likely not be able to achieve the same robust rates of economic growth as it did in the last two decades. The working age population in China is cresting, and the country has arguably overinvested in the last decade. Mongolia, Thailand and Vietnam also will likely post slower rates of real GDP growth in coming years than they did during the last decade. Favorable demographics mean that Indonesia, the Philippines and India could all experience some economic acceleration in the next decade or two. However, in our view, a number of reforms will need to be undertaken in these economies for them to realize their true economic potential.

## Seven Countries Account for Vast Majority of GDP in Region

As shown in the appendix, the International Monetary Fund (IMF) includes 29 countries in its classification of "Emerging and Developing Asia." A detailed analysis of all 29 economies is beyond the scope of this report. Therefore, we will concentrate on 7 countries that collectively account for 95 percent of the region's GDP and 90 percent of its population.

## China: Further Slowing Ahead

Three decades of very rapid GDP growth have transformed China, the most populous country in the world, from an economic backwater in the early 1980s to the world's second largest economy today.[2] Real GDP growth in China averaged 10 percent per annum between 1980 and 2010, but growth has slowed over the past few years and the IMF looks for further deceleration between

**[1] See "General Growth Prospects in the Developing World" (May 27, 2015), which is available upon request.**

**[2] If purchasing power parity (PPP) exchange rates are used to compare GDP among countries, then China surpassed the United States as the world's largest economy in 2014. In our view, however, PPP exchange rates vastly overstate the "true" size of the Chinese economy.**

now and the end of the decade (Figure 1). That said, the 6 percent per annum growth rates that the IMF forecasts later in this decade would be the envy of most economies in the world.

***China's elevated national savings rate has been the wellspring of the country's robust economic growth.***

China's elevated national savings rate over the past three decades has been the wellspring of the country's robust economic growth rate over that period (Figure 2).[3] Ample savings can finance strong investment spending, which in turns drives economic growth. Investment spending, which includes residential investment as well as non-residential investment (commonly referred to as "capex spending"), has accounted for roughly one-half of China's overall GDP growth rate over the past three decades. The IMF's projections of slowing economic growth in the year ahead reflect the recent reversal in the country's investment rate as well as its slowing population growth rate, which we will discuss in more detail in the next section.

**Figure 1**

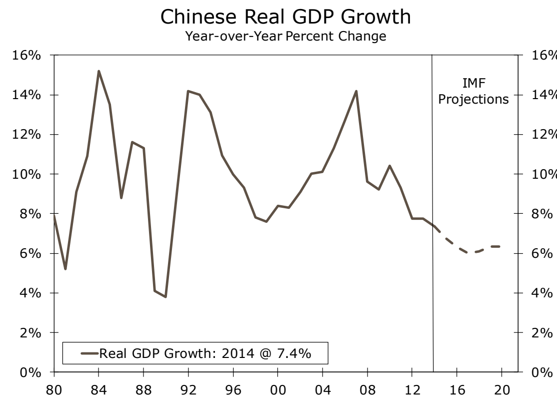
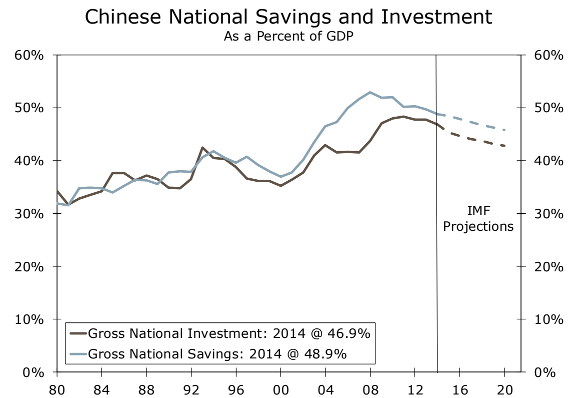



**Figure 2**




**Source: International Monetary Fund and Wells Fargo Securities, LLC**

As noted above, robust investment spending helps to deliver strong economic growth. The downside of robust investment spending is that overinvestment, should it occur, can ultimately lead to a spike in non-performing loans and a sharp economic downturn. The recent decline in Chinese house prices (Figure 3) has some analysts worried that a collapse in residential investment may be underway, and that Chinese economic growth will slow sharply, if not turn negative, over the next few years.

***The Chinese economy likely will grow slower in coming years than it has over the past few decades.***

While acknowledging that growth in Chinese investment spending will likely slow further in coming years, we think the risk of an investment-led collapse in Chinese economic growth is overstated. The debt-to-GDP ratio of the central government is only 15 percent, and the country's foreign exchange reserves total nearly $4 trillion. Even in the worst-case scenario of a spike in non-performing loans, we feel the Chinese government has the financial ability to recapitalize the banking system. And in our view, Chinese authorities would not hesitate to clean up any mess in the country's banking system. In sum, we believe that the Chinese economy will grow at a solid rate for the foreseeable future, but probably not as robustly as it did over the past few decades.

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**[3] A country's national savings rate represents the savings of its household, business and government sectors, expressed as a percent of GDP. The national savings and investment rates of the United States over the past few decades have been roughly half of the comparable rates in China.**

**Figure 3**

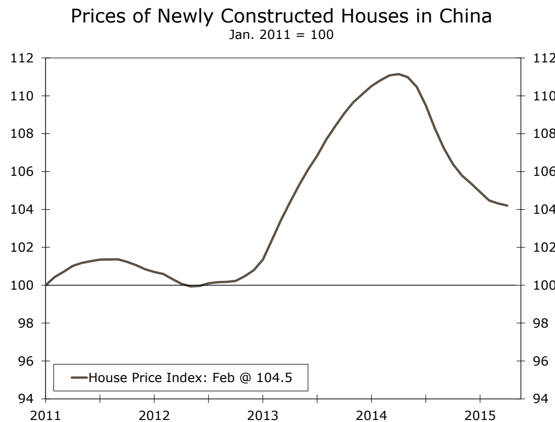
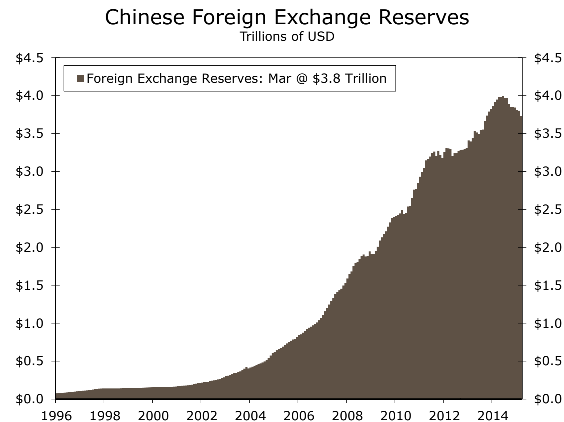



**Figure 4**




**Source: CEIC, IHS Global Insight and Wells Fargo Securities, LLC**

## India: Will the Country Fulfill Its Potential?

Real GDP in India has grown in fits and starts over the past few decades, but the rate of economic growth has generally trended higher over that period (Figure 5). Throughout most of the 1980s and 1990s, the savings and investment rates in India were significantly below comparable rates in China, which helped to restrain the rate of economic growth in India. However, the savings and investment rates in India rose sharply about a decade ago, and both exceed 30 percent of GDP at present.

**Figure 5**

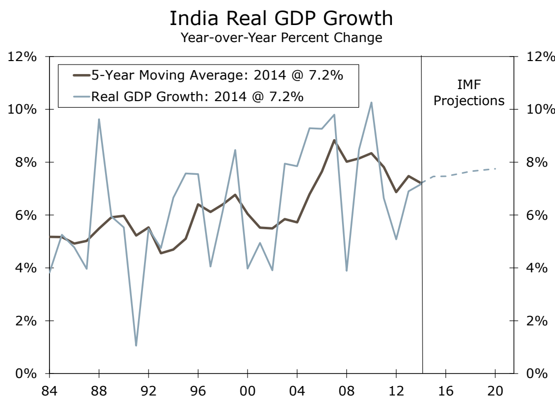
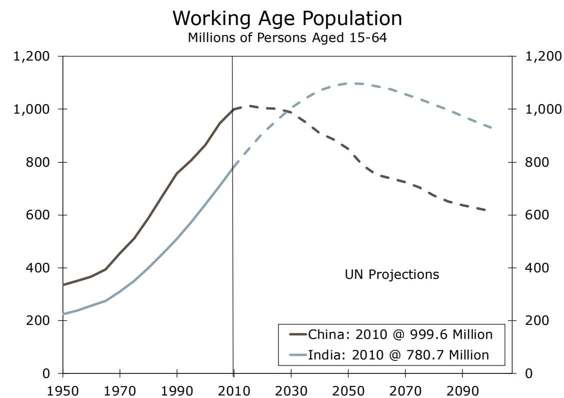



**Figure 6**




**Source: International Monetary Fund, United Nations and Wells Fargo Securities, LLC**

***The working age population in India is growing at a strong rate.***

Strong growth in the working age population (i.e., individuals between 15 and 64 years of age) has also tended to support Indian economic growth over the past decade or so.[4] The working age population in India grew at an annual average rate of 1.8 percent over the past decade, and the United Nations (UN) projects that the number of potential workers in the country will increase even further over the next few decades (Figure 6). In contrast, the working age population in China is currently topping out, and the UN projects that it will contract by roughly 15 percent by the middle part of the century. Favorable population dynamics and strong investment growth,

**[4] As noted in our overview that was referenced in footnote #1, a country's potential economic growth rate is roughly equal to the sum of the growth rates of its labor force and its labor productivity. Growth in the number of working-age individuals is obviously highly correlated with labor force growth, and capital investment helps to lift labor productivity.**

assuming it continues, should translate into an elevated rate of economic growth in India for the foreseeable future.

***A number of challenges could prevent India from reaching its true economic potential.***

There are a number of challenges, however, that could keep the country from realizing its full potential in coming years. India remains a poor country despite its rapid economic growth over the past decade or so, as per capita GDP (measured in current dollars) is less than $2,000/year.[5] Attempting to meet countless human needs presents governing challenges to authorities. Second, the Indian education system is mediocre, at best. The World Economic Forum ranks the quality of primary education in India as 81st among 144 countries, and only 63 percent of eligible students are enrolled in secondary education.[6]

**Figure 7**

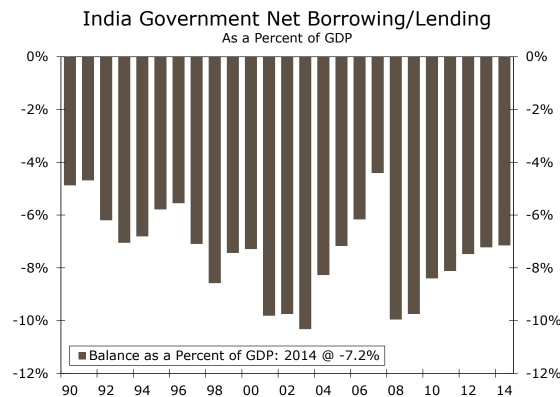
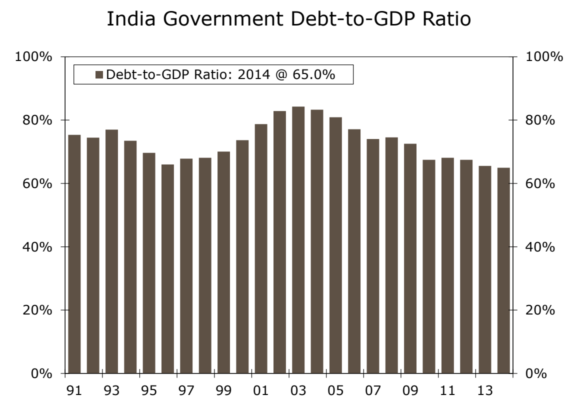



**Figure 8**




**Source: International Monetary Fund, United Nations and Wells Fargo Securities, LLC**

Third, the government has incurred sizeable fiscal deficits for decades (Figure 7). Although strong rates of nominal GDP growth has led to stabilization of government debt as a percent of GDP (Figure 8), the ratio could start to swell if economic growth were to unexpectedly stall. Given high debt and other fiscal needs, the government may be hard pressed to finance infrastructure spending which is desperately needed.

In that regard, businesses rank inadequate infrastructure as “the most problematic factor for doing business” in India.[7] Prime Minister Modi is accelerating the approval of some infrastructure projects that have been long stalled, and the government is trying to implement other economic reforms. However, the political system in India is fragmented, and the pace of reform remains modest. The Indian economy has enormous potential, but the jury is deliberating over the question of whether the country can reach its full potential or not.

## Indonesia: Some Imbalances Remain

Indonesia is the fourth most populous country in the world, although it ranks much further down the scale in terms of per capita GDP.[8] As shown by real GDP growth in Figure 9, the Indonesian economy has gone through a number of economic transition periods over the past few decades. Very rapid economic growth rates in the 1980s and especially in the 1990s glossed over a number of structural problems that included widespread corruption and a lack of faith in contract enforceability that discouraged foreign direct investment. Moreover, credit growth was robust

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[5] **If GDP is measured at the purchasing power parity (PPP) exchange rate, then per capita GDP jumps to more than $6,000/person. In our view, however, PPP exchange rates vastly overstate the size of the Indian economy and, by extension, per capita GDP.**

[6] ***The Global Competitiveness Report 2012-2013*, The World Economic Forum, Geneva, 2012**

[7] ***Ibid.***

[8] **Only China, India and the United States exceed Indonesia, which has a population of about 250 million. At roughly $3,500/person, Indonesia’s per capita GDP places it in the bottom half among the world’s economies.**

during this period, and the country had to finance its chronic current account deficits via inflows of portfolio capital and bank lending. When financial market instability swept through the emerging Asia region in 1997-1998, the Indonesian economy and currency collapsed. Real GDP nosedived by an incredible 13 percent in 1998.

***Indonesia has enacted some meaningful reforms in recent years.***

The silver lining to that very stormy period was that it ushered in needed changes that allowed Indonesia's economic growth to become more sustainable. Financing through a series of IMF funding packages in the late 1990s and early 2000s was conditional on Indonesia meeting a number of governance targets that helped weed out corruption, restored faith in public institutions and stabilized external and government debt ratios, both of which ballooned in the immediate aftermath of the crisis.

**Figure 9**

**Figure 10**

**Source: International Monetary Fund, Bloomberg LP and Wells Fargo Securities, LLC**

GDP growth in Indonesia has trended down from 6.4 percent in 2010 to 5.0 percent in 2014. Slower growth in fixed capital formation is largely to blame for the overall slowdown in the economy, although net exports have been a drag on headline GDP growth in two of the past three years. Oil and natural gas account for roughly 20 percent of the country's exports. Unlike some countries in the region, Indonesia is not overly dependent on trade with China. Indeed, Japan is Indonesia's single largest export destination, and the country's exports to China and the United States are roughly equal in value. Looking forward, the IMF forecasts that real GDP in Indonesia will strengthen a bit this year and in 2016 before settling out around 6 percent per annum in the latter years of the decade.

***Indonesia is not without its economic problems.***

Despite the stability that is evident in real GDP growth in recent years, Indonesia is not without its microeconomic and macroeconomic problems. Although corruption may not be as endemic as it was a few decades ago, businesses continue to list it as one of the most problematic factors for doing business in the country.[9] In addition, the Indonesian government retains all petroleum and mineral rights which it develops through private partnerships with domestic and foreign petroleum companies. The country continues to export crude oil, but output from Indonesia's oil wells has been in decline since the 1990s. With oil prices still low relative to 2014 highs, it is unlikely that drilling and extraction equipment outlays will increase enough to reverse that long term decline, at least not in the foreseeable future.

Another legacy of the historical tie up with oil is that the government subsidized oil and gas consumption by consumers, which reduced the amount of the budget that could be devoted to badly needed infrastructure spending. The new government of President Widodo reduced energy subsidies last autumn, which should allow it to spend more on development needs in coming years.

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[9] ***The Global Competitiveness Report*, op cit.**

Underdevelopment of energy resources squanders some of the country's export potential. Indeed, the country continues to record modest current account deficits, which makes it dependent on foreign capital inflows. The Indonesian rupiah has come under significant downward pressure in recent years, falling to its lowest level vis-à-vis the U.S. dollar since the currency's collapse in 1998 (Figure 10). Currency depreciation has helped to push up the country's inflation rate, which averaged less than 5 percent per annum between 2010 and 2012, to more than 7 percent at present.

## Thailand: Road to Recovery Looks Rocky

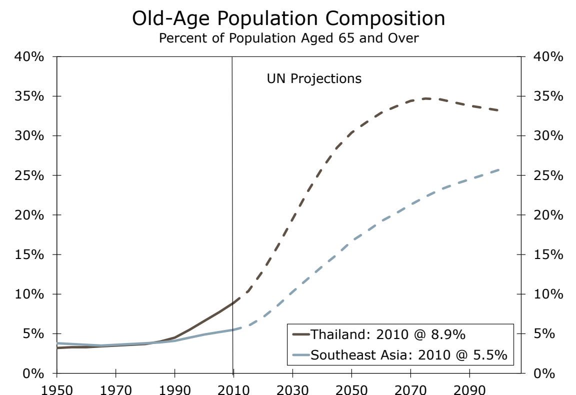
Despite Thailand's history of political turmoil, the country is generally considered a development success story, having made impressive strides in improving its socioeconomic landscape over the past few decades. Thailand enjoyed solid economic growth during the 1980s and early 1990s, and its poverty rate has fallen to about 10 percent from nearly 60 percent in 1990. However, real GDP in Thailand contracted sharply during the 1997-1998 Asian Financial Crisis and again during the 2008-2009 global recession. In 2011, a severe flood caused real GDP growth to stumble again. The IMF projects moderate acceleration in real GDP over the next few years, but the economic growth rates it forecasts do not come close to matching the rates that were achieved during the 1980s and the early 1990s (Figure 11).

***Thailand's economic performance has recently lagged behind that of its neighbors in SE Asia.***

More recently, Thailand's economic performance has generally lagged behind that of its neighbors in Southeast Asia. In particular, the country's growth prospects were restrained by its most recent political crisis, which culminated in a military coup and the establishment of martial law in mid-2014. To be sure, real gross fixed capital formation and real private consumption expenditures are both below 2012 levels. Another key factor holding back growth in Thailand has been its challenging external environment. Exports are equivalent to nearly 75 percent of Thai GDP, and the slowdown among its top two trading partners, Japan and China, combined with a strengthening domestic currency have exerted headwinds on the country's growth performance.

**Figure 11**

**Figure 12**




**Source: International Monetary Fund, United Nations and Wells Fargo Securities, LLC**

Thailand faces a number of challenges over the next few years. Although the military coup brought an end to mass protests and martial law has recently been lifted, the political situation in Thailand remains uncertain. The military government's referendum on a new constitution and democratic elections has been delayed until next year, and private investment and consumption are unlikely to recover meaningfully until uncertainty subsides. The tentative political situation also adds risk to the outlook for the government's ambitious infrastructure investment plans.

If infrastructure investment does not pick up meaningfully in the near future, Thailand will likely have a difficult time achieving the growth rates the IMF is currently forecasting, particularly given the nation's challenging demographic landscape. The UN projects that the population in Thailand will age at a significantly faster rate than in the general region of Southeast Asia (Figure 12).

Moreover, the UN expects that the working age population in Thailand will start declining as early as 2020, and that it will continue to shrink through the end of the century. In sum, while Thailand seems to be taking measures to reform its economy and political system, a rebound to the heady growth rates of the 1980s and early 1990s will likely be difficult to achieve.

## Philippines: From Laggard to Leader?

Just as many of its neighbors in emerging Asia seem to be losing economic steam, the Philippines appears to be hitting its stride. Although it has lagged behind the rest of emerging Asia in terms of real GDP growth for decades, the gap has narrowed markedly in recent years, and the IMF projects that the Philippines will finally catch up next year (Figure 13). As a consumption-driven economy, the Philippines has been less exposed to the slowdown among its top trading partners, China and Japan, than have some other economies in emerging Asia. That said, good macroeconomic policymaking has contributed to the Philippine's strong economic performance in recent years.

***The Philippines has enjoyed rapid economic growth in the past few years.***

**Figure 13**

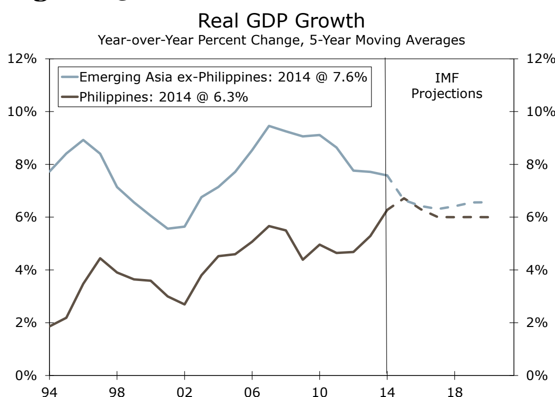
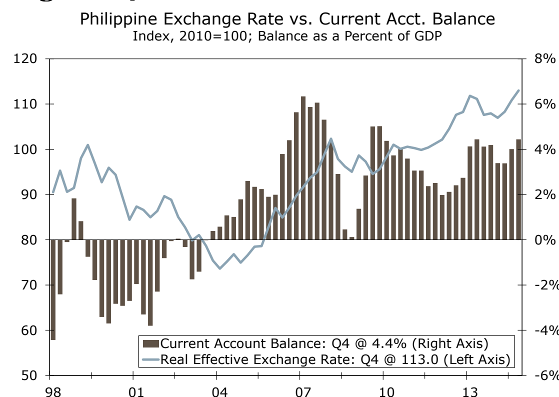



**Figure 14**




**Source: International Monetary Fund, IHS Global Insight and Wells Fargo Securities, LLC**

For starters, the government, which incurred chronic fiscal deficits in decades past, has more or less balanced its books in recent years. Consequently, the government debt-to-GDP ratio has retreated from nearly 70 percent in 2003 to less than 40 percent in 2014. In addition, the Central Bank of the Philippines has had success in bringing down the CPI inflation to the 3 to 4 percent range in recent years, well below the double digit rates observed in the 1990s. The combination of lower government debt and receding inflation expectations has led to a marked reduction in long-term interest rates in the Philippines.

The country has also managed to turn around its current account position from chronic deficit to sustained surplus (Figure 14). The country's success in establishing and sustaining a current account surplus has largely been driven by impressive growth in exports of services, which includes its all-important call center industry. The turnaround in the current account has contributed to the appreciation of the Philippines peso over the last decade or so.[10] Current account surpluses also entail less foreign borrowing, and the country's external debt, which was equivalent to more than 70 percent of GDP at the turn of the century, has declined to about 30 percent.

From a demographic perspective, the Philippines' outlook looks more favorable than that of Southeast Asia as a whole. The UN forecasts that the Philippines will continue to outpace the rest of Southeast Asia in terms of working age population growth for decades (Figure 15). The working

**[10] In nominal terms, the Philippines peso has strengthened about 25 percent vis-à-vis the U.S. dollar since 2005. In real trade-weighted terms, the peso is up 50 percent over that same period due, at least in part, to its sharp appreciation against the Japanese yen.**

age population in the Philippines is projected to peak around 2085, 40 years after the peak in the region as a whole.

**Figure 15**

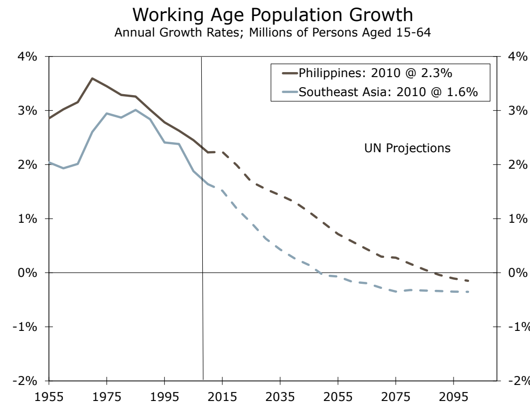
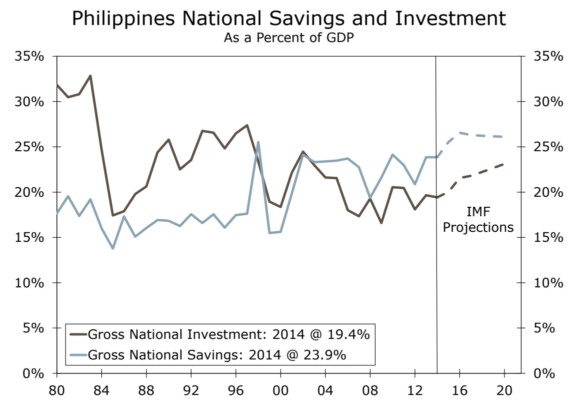



**Figure 16**




**Source: United Nations, International Monetary Fund and Wells Fargo Securities, LLC**

While the Philippines has undoubtedly proven itself as a robust economy in recent years, there are some factors that could stymie the country's growth prospects. First, the Philippines remains a poor country, as its per capita GDP places it in the lower half among the world's individual countries. Therefore, the government has many human development needs crying out for budgetary attention, which limits the amount of infrastructure investment it can undertake. Lack of adequate infrastructure has been cited as a key obstacle for businesses attempting to conduct business within the country's borders.[11]

***The investment rate will need to rise further to achieve rapid economic growth on a sustained basis.***

Speaking of investment, the country's ratio of investment spending-to-GDP remains low by the standards of some of its Asian competitors. In order to achieve the high growth rates that have been registered in India and especially in China over the past few decades, the Philippines needs to invest more. The good news is that the savings rate has edged up over the past few years, which allows the country to increase its investment rate without incurring large current account deficits again. The bad news is that the IMF does not project a dramatic increase in the country's savings and investment rates in the foreseeable future, although it does believe that both rates will trend modestly higher over the next few years. The combination of strong labor force growth and significant acceleration in investment spending, should it occur, would make the Philippines a contender for heavyweight status in terms of potential economic growth.

## Vietnam: Living in the Shadow of an Investment Slowdown

The Vietnamese economy grew at a heady pace in the 1990s and throughout most of the past decade, but real GDP growth has slowed in recent years (Figure 17). Looking forward, the IMF forecasts that the rate of economic growth in Vietnam will generally remain solid, but that it will not return to the 7 percent average rate that was achieved between 1990 and 2010.

***Growth in Vietnam has slowed in the wake of a burst credit bubble.***

Some of the economic deceleration in Vietnam in recent years reflects slower global growth that has weighed on the country's export growth. However, sharp deceleration in investment spending appears to be the major reason behind the economic slowdown in Vietnam. As shown in Figure 18, the investment spending-to-GDP ratio rose sharply in the 1990. Not only did the ratio remain above 30 percent for much of the past decade but it also exceeded the national savings rate, implying that the country was incurring sizeable current account deficits during those years. Strong investment spending went hand in hand with robust credit growth that averaged about 35 percent per annum between 2004 and 2010. When the inevitable bust came, investment spending slowed sharply. Credit growth remains weak today, at least relative to the boom years, as banks continue to clean up their balance sheets.

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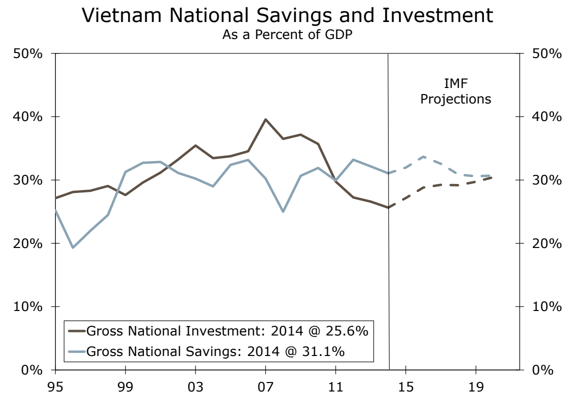
[11] ***The Global Competitiveness Report*, op cit.**

**Figure 17**

**Figure 18**




**Source: International Monetary Fund and Wells Fargo Securities, LLC**

The Vietnamese economy has some positives working in its favor. First, the savings rate remains high, which can continue to finance solid rates of investment spending. In addition, the working age population of the country is currently growing in excess of 1 percent per annum, although this growth will slow somewhat in coming years. Solid growth rates of investment spending and labor force growth should make the 6 percent per annum real GDP growth rates that the IMF forecasts for the next few years achievable.

***Government debt in Vietnam is high.***

Vietnam, which has 66 million working age individuals, is just not in the same league as Indonesia (170 million), not to mention the behemoths of India (850 million) and China (1 billion), in terms of population. There are a few other drawbacks to keep in mind. The government has been incurring large budget deficits on the order of 5 percent to 6 percent of GDP over the past few years, and its debt-to-GDP ratio has risen from less than 40 percent prior to the global financial crisis to nearly 60 percent today. This increase in debt gives the government less ability to respond to a negative economic shock, should one occur. Speaking of the government, state involvement in the economy has trended lower over the past few decades but state-owned enterprises (SOEs) still account for roughly 30 percent of GDP. SOEs tend to be less efficient than their private-sector counterparts.

## Mongolia: Robust Growth Recently but Fortunes Tied to China

The land-locked country of Mongolia, which is tucked away between Russia and China, may not be a top-of-mind location when discussing growth opportunities in Asia, but it does boast some impressive growth figures. In the past 20 years, the Mongolian economy has more than tripled in size. Moreover, the country boasted an annual average real GDP growth rate of more than 15 percent between 2010 and 2013, making it the fastest growing economy in the world over that period.

***Investment in copper mining has driven economic growth in Mongolia recently.***

The torrid pace of GDP growth in recent years is a function, at least in part, of investment spending largely attributable to one major project: the Oyu Tolgoi copper mine. While the mine was under construction in 2010 through 2013, total investment spending in Mongolia represented more than 50 percent of GDP, although it slowed last year when the mine was completed. Consequently, the current account deficit narrowed substantially in 2014 as import growth needed to build the mine subsided. The surge in the volume of copper exports, which have doubled over the past few years, also contributed to the narrowing that has occurred in the current account deficit.[12]

**[12] The current account deficit-to-GDP ratio exceeded 25 percent in each year between 2011 and 2013. It fell to 8 percent in 2014, which is still a sizeable deficit.**

Although the real GDP growth rates that Mongolia has achieved in recent years may be impressive, it helps to keep a level head about just how small the Mongolian economy still is at present. The total size of the economy in 2013 was only $12.5 billion, less than half the size of the economy of Vermont, the smallest state economy in the United States. With less than 3 million individuals, Mongolia has a tiny population as well.

***Mongolia remains dependent on economic growth in China.***

Mongolia's close economic ties with China—nearly 90 percent of Mongolia's exports go to China—and its dependence on copper production raise some concerns about the sustainability of the country's growth prospects. Copper has not been immune to the broad commodity price declines of the past few years. The price of copper is off about 40 percent from its 2011 high, and this price decline has restrained growth in the overall value of the country's exports. The IMF forecasts that real GDP growth in Mongolia will slow to 4 percent or so per annum over the next few years before firming a bit toward the end of the decade. Given our expectations about economic growth in China that we outlined above, we believe that the IMF's forecasts for Mongolian real GDP growth in coming years are not unreasonable. That said, these forecasted growth rates are not as robust as the actual rates of growth that the Mongolian economy achieved a few years ago.

## Other Countries in Emerging Asia

As noted above a detailed discussion of the other 22 economies that comprise emerging Asia is beyond the scope of this report. The IMF maintains an extensive database of economic variables for these economies and for the seven economies that we discuss in this report, and we direct interest readers to this database which can be found at http://www.imf.org/external/pubs/ft/weo/2015/01/weodata/index.aspx.

## Conclusion

Among the six regions of the developing world that we are analyzing in this series of reports, emerging Asia has posted the strongest rates of economic growth over the past two decades. China and India, the two largest economies in the region, have been important drivers of economic growth in emerging Asia, but some economies such as Indonesia and the Philippines, which are less directly tied to these two behemoths than some of their regional neighbors, have also posted impressive growth rates over the last decade or two. Many of the region's economies can attribute their success to their high savings rates, which have allowed those countries to finance robust rates of investment spending without racking up crippling current account deficits. Strong demographic trends have also boosted economic growth rates in many emerging Asian economies over the past few decades.

As we plan to show in future reports, emerging Asia will likely continue to post faster economic growth rates than most other regions in the developing world for the foreseeable future. However, the region will likely not be able to achieve the same robust rates of economic growth as it did in the last two decades. The working age population in China is cresting, and the country has arguably over-invested in the last decade. Mongolia, Thailand and Vietnam also will likely post slower rates of real GDP growth in coming years than they did during the last decade. Favorable demographics mean that Indonesia, the Philippines and India could all experience some economic acceleration in the next decade or two. However, in our view, a number of reforms will need to be undertaken in these economies for them to realize their true economic potential.

## Appendix: Countries in Emerging Asia

Bangladesh

Bhutan

Brunei Darussalam

Cambodia

China

Fiji

India

Indonesia

Kiribati

Lao P.D.R.

Malaysia

Maldives

Marshall Islands

Micronesia

Mongolia

Myanmar

Nepal

Palau

Papua New Guinea

Philippines

Samoa

Solomon Islands

Sri Lanka

Thailand

Timor-Leste

Tonga

Tuvalu

Vanuatu

Vietnam

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