GLOBAL GROWTH: HEADWINDS OR TAILWINDS?

with Michael Hasenstab, Ph.D.
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Introduction

Excessive pessimism characterizes the current view on the global growth outlook. Many observers see the lowering of global growth forecasts by the World Bank and the International Monetary Fund (IMF) as confirming a loss of global economic momentum. Some of this pessimism also reflects a mistaken interpretation of the reasons behind the recent sharp decline in oil prices, and of its likely consequences. Many analysts and commentators have argued that the plunge in oil prices reflects the slowing down of the global economy, and some believe that the decline in oil prices itself will have a negative impact on global growth, by reducing energy investment and causing deflation in some regions. As for key economic areas, while most observers are more upbeat on the US, many observers seem to expect a major slowdown in China and to view the eurozone as being on the brink of recession.

This paper aims to provide an objective analysis of the main trends that will shape the global economy and to counter this exaggerated pessimism prevailing in the marketplace.

Even the latest IMF forecasts, which have generated so many pessimistic headlines, show the global economy accelerating, not decelerating. The IMF argues that the weakening of global oil demand owes in part to a loss of momentum concentrated in emerging markets, which have a higher energy intensity than advanced economies. But the slowdown in emerging markets overall has been marginal, and, most importantly, China’s oil demand continued to rise through the end of 2014.
With the global economy getting stronger, albeit at a moderate pace, demand factors are unlikely to be the predominate drivers behind the fall in the price of oil. Rather, three major supply adjustments appear to explain the vast majority of this decline. First, markets seem to have underestimated the boost in US oil supply triggered by advances in shale oil extraction, as seen in Chart 1. Second, expected reductions in supply in Libya and Iraq due to political instability failed to materialize. Finally and most importantly, the decision by OPEC (Organization of the Petroleum Exporting Countries) last November to maintain current production levels blindsided market participants. Most expected a reduction to support prices at about US$80 per barrel. Saudi Arabia instead drove the decision to maintain production unchanged, probably with the aim of gaining market share against higher cost producers, to discourage investment in US shale fields, and for regional political reasons.

A positive supply shock that drives down the price of oil provides a significant boost to global growth. It acts as a substantial global tax cut for consumers; it redistributes income from oil exporters to oil importers, the latter of which tend to have a higher propensity to spend; over time, it boosts investment rates in non-energy sectors as capital reallocates from energy-producing industries to energy-consuming industries; and in several countries it creates room to keep interest rates lower than they would otherwise be. It takes a bit of time for these effects to feed through the system, and we therefore think the positive impact on growth should become more evident in one or two quarters. This delay may also have contributed to the pessimism about the growth outlook we mentioned above.

There will be winners and losers, and we will discuss some of them in more detail below. Oil exporters will suffer, and those that are already in a precarious position—like Venezuela and Russia—will likely suffer most. Some oil producers are less vulnerable than markets seem to believe. Malaysia and also Mexico are two such examples, where for the latter we expect the positive spillover of faster US growth to be far more important than the decline in oil prices. And as Malaysia now imports more oil than it exports, the impact should be quite manageable.

The US economy benefits significantly from lower oil prices. While cutbacks in energy-related investment are short-term headwinds to growth, the benefits to industries that consume oil and to the US consumer through lower gasoline prices should turn to a net growth positive over the course of 2015. Investment and employment in the energy sector play a much smaller role in the economy than overall personal consumption, which accounts for about 70% of gross domestic product (GDP). We estimate that, on net, lower oil prices should add about 0.7 percentage points to US growth on an annual basis.

US Surpassed Saudi Arabia as World's Largest Oil Producer

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China, as the world’s largest importer of oil, will also be an important beneficiary of lower energy prices. This should help further mitigate the current mild and healthy slowdown, so that we expect 2015 growth of about 7%, only marginally slower than last year. Importantly, the quality of investment has improved, albeit at a slower rate. This combined with a growing level of consumption as a contribution to growth puts China on a path toward the long sought after rebalancing. We would also observe that as China’s economy has grown substantially over the past decade, even at a more moderate growth rate its total

**Chart 1: US vs. Saudi Arabia Total Oil Supply**

January 2000–September 2014

Barrels per Day (Millions)

contribution to global growth will remain larger than that of the US. If China grows at 7% in 2015, the quantum of demand it produces for world GDP will also be larger than in the prior year.

The market particularly exaggerates near-term growth pessimism for the eurozone. The region’s growth in 2014 was higher than in 2013, and we expect this year to be higher still. The eurozone this year should benefit from three important tailwinds: Quantitative easing by the European Central Bank (ECB) will likely weaken the euro even further, which together with stronger growth in the US and the global economy overall will bolster export growth. This has an important impact on growth, given that exports drive a significant component of overall eurozone growth. Lower oil prices will give a further stimulus to consumption and investment, though not to the same degree as in the US. However, over the longer term, these short-term tailwinds will be challenged by the eurozone’s structural weaknesses ranging from a lack of broad-based product and labor market reform to a lack of greater fiscal and political integration.

The decline in oil prices will have other winners and losers across the world economy, and further accentuate the differentiation between strong and poor performers, notably in the emerging markets universe. Countries like India and Indonesia are taking advantage of the lower oil prices to reduce fuel subsidies and thereby improve public finances. Russia and Venezuela suffer from their undifferentiated growth base. And lower commodity prices are testing the ability of some African countries to strengthen policies and institutions. This variegated environment should provide attractive opportunities for a fundamentals-driven investment strategy.

Bottom line: We see the global growth outlook as significantly healthier than is widely believed. In fact, in 2015 the global economy will benefit from the confluence of some important supportive factors:

• the decline in oil prices should give a much-welcomed lift to global growth;

• monetary easing in Japan and the eurozone will maintain ample global liquidity even as the Fed begins to normalize its policy stance;

• ECB quantitative easing should also alleviate financial market tensions even as the euro area works through difficult policy issues;

• the euro area should get some precious help from liquidity, a weaker exchange rate and stronger exports;

• the health of the US economy, in particular the labor market, should continue to improve; and

• China remains on track for a healthy slowdown in its growth rate while still contributing a greater quantum of demand in 2015 than in 2014.

Importantly, the decline in oil prices will help subdue inflation in the short term. While clearly the impact of oil on inflation will only last temporarily, stronger growth this year without inflation puts the world economy in a sweet spot for 2015. Risks to higher inflation and lower growth beyond 2015 remain and are a topic we will discuss in future pieces.

Uncertainty and risks remain important, and we are not arguing for a return to the booming (overheated) global economy we experienced prior to the global financial crisis. But this overall growth should be sufficiently supportive to allow countries with sound policies to thrive. We will likely see great differentiation in cross-country performances, making fundamentals-based investment strategies critical. Looking further ahead, central banks will have to unwind the enormous interventions of these last few years—and this will set the stage for possible sudden and sharp market adjustments that should be factored into medium-term investment views. This too will be a topic for future pieces.
United States

We believe the US recovery is robust, indeed quite strong by most metrics. Quarterly economic growth reached a 5.0% annualized rate in the third quarter and accelerated to 2.4% in 2014 in the year as a whole from 2.2% in 2013. The IMF has recently revised its 2015 forecast for full-year US GDP up to 3.6%, largely on the back of the positive impact of lower oil prices. The economic recovery is broad-based: Household consumption has proved resilient for some time, and business investment is now also picking up.

The majority of labor market indicators suggest steadily improving labor market conditions. The unemployment rate decreased to 5.7% in January from 6.7% at the end of 2013, while the participation rate has remained steady. Chart 2 illustrates the strengthening employment growth. It accelerated from 239,000 in the first half of 2014 to 281,000 in the second half of 2014. During the three-month period ended in January 2015, employment growth averaged 336,000. Stronger employment creation has played an extremely important role in supporting private consumption.

There has been a lot of focus on the relatively anemic rise in hourly wage growth, and the fact that the participation rate has not yet returned to its pre-crisis levels. The dynamics of average incomes are of course important, as are income distribution issues. But the growth in the total wage bill matters most for aggregate consumption—and this has gone relatively unnoticed. Aggregate private payrolls have increased at a rapid pace due to the growing labor force (see Chart 3). While nominal average hourly earnings (AHE) are flat, aggregate private nonfarm payroll income accelerated to 5.6% year-over-year (y/y) in January from 3.4% at the end of 2013. This is a substantial increase in the overall disposable income that is the relevant driver of aggregate demand in the economy. Aggregate nonfarm payroll income now stands higher than it did before the global financial crisis.

**Average Monthly Gains in Nonfarm Payrolls Accelerated over 2014**

**Chart 2: Change in Nonfarm Payrolls**

January 2008–January 2015

**Aggregate Private Labor Income Growing Much Faster than Average Hourly Wages**

**Chart 3: Aggregate Private Payroll vs. Average Hourly Earnings**

January 2011–January 2015

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Source: US Department of Labor.
Using a broader concept of revenues (including not only labor compensation but also other sources like rents and government transfers) also shows a growing household income (Chart 4).

**Personal Income Growth Accelerated in 2014**

**Chart 4: Nominal Personal Income**  
January 2000–December 2014  
USD (Trillions)

Using a broader concept of revenues (including not only labor compensation but also other sources like rents and government transfers) also shows a growing household income (Chart 4).

**Real Personal Disposable Income Now Above Pre-Crisis Level**

**Chart 5: Real Personal Income**  
January 2000–December 2014  
Real USD (Trillions)

Household spending is supported not only by rising labor income (Chart 5), but also by better prospects of economic growth and healthier balance sheets. Consumer confidence stands at or close to its multi-year highs. Households continue to repair their balance sheets, and net worth has accelerated rapidly. Mortgage interest rate payments remain very low (Charts 6 and 7).

**Household Financial Liabilities Continue to Decline Relative to Disposable Income Driven Largely by Reductions in Mortgage Debt**

**Chart 6: Household Liabilities**  
March 1977–September 2014  
% of Disposable Income


**Average Mortgage Interest Rates Remain Close to Historical Lows**

**Chart 7: Mortgage Interest Payments/Mortgages Outstanding**  
March 1977–September 2014  
Average Rate

Source: Federal Reserve.

Improving economic conditions are boosting confidence, leading to accelerating expenditures, particularly in forward-looking components like household durable goods and business investment. For instance, the annual growth rate of durable personal consumption expenditures was 8.4% in Q4, and the annual growth rate of gross domestic business investment was 9.1%.

More robust economic growth is reabsorbing slack at a fast pace, a process which will eventually lead to stronger pricing power for firms and to higher underlying inflation.
The U.S. Congressional Budget Office (CBO) estimates that GDP remains a little under 2% below its potential level. However, other indicators of economic slack suggest tighter conditions. Using statistical tools such as the Hodrick-Prescott filter yields a positive output gap (i.e., GDP is above its potential level, Chart 8). Manufacturing capacity utilization remains above its 10-year average, and the labor market, in particular, appears to be healing quickly (Charts 9 and 10). The unemployment rate is only slightly above the natural non-accelerating inflation level (NAIRU), also estimated by the CBO. Long-term unemployment is diminishing. The unemployment rate due to those unemployed less than 27 weeks declined to 3.9% in January from 4.2% at the end of 2013 and for those unemployed more than 26 weeks to 1.8% from 2.5% (Chart 11). The divergence from historical norms on unemployment by age and educational attainment is also normalizing rapidly.

Non-CBO Measures Indicate Less Slack in the Economy

Chart 8: Output Gap: CBO vs. Hodrick-Prescott Analysis
March 1950–September 2014

Manufacturing Capacity Utilization Above Its 10-Year Average

Chart 9: Manufacturing Capacity Utilization
March 1950–December 2014

The labor force participation rate remains significantly below pre-crisis levels. Many analysts argue that an eventual increase of the participation rate will hold down wage inflation as the influx of workers reduces wage pressures. However, there is an important offset to this. The chart below shows the relationship between the unemployment rate and the number of job openings, called the Beveridge curve (Chart 12). The last data point in the chart (December 2014) indicates that despite a greater number of job openings than pre-crisis, the number of unemployed has remained at higher levels—indicating a skills mismatch. In other words, an

Unemployment Rate Close to Its Natural Non-Accelerating Inflation Level

Chart 10: Unemployment Rate and NAIRU (Estimated by CBO)
March 1957–December 2014

Chart 11: Unemployment Rates
January 1950–December 2014

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additional structural component to unemployment exists, suggesting that wage pressures could materialize before the unemployment rate reaches previous lows. In addition, demographic shifts suggest that the participation rate is unlikely to return to pre-crisis levels.

The various reports on labor earnings and compensation suggest that wage costs are slowly firming. Average hourly earnings (AHE) grew 2.2% y/y in January 2015. Private employee compensation grew almost 2% in the fourth quarter of 2014. Accounting for the change in composition of the labor force as measured by employment cost index (ECI) data, hourly compensation is growing faster in the fourth quarter (Charts 13 and 14). We conducted a statistical analysis to study the historical relationship between earnings growth, the level of slack in labor markets and labor demand. The results indicate that, based on historical norms, hourly employee compensation will probably accelerate: The models forecast AHE growth to rise toward 3% over 2015.

Headline measures of inflation have declined recently, particularly on softer energy prices, but underlying inflationary pressures have been much more stable, albeit still below the Fed’s 2.0% inflation target (Charts 15–18). Note that core inflation measures still include transportation prices, which tend to decline with lower energy prices.

As with wages, the declining slack in labor markets suggests that companies will have stronger pricing power, leading to higher inflation. Our statistical analysis suggests that the current level of the unemployment rate and the current level of inflation expectations are consistent with a 2.24% core personal consumption expenditure (PCE) inflation rate.

**Accounting for Composition of the Labor Force (ECI), Wages Have Been Rising Faster than 2%**

**Chart 13: Nonfarm Business Compensation per Hour and Private Employment Cost Index**

1990–2014

Y/Y

<table>
<thead>
<tr>
<th>Year</th>
<th>Compensation per Hour</th>
<th>Private Employment Cost Index</th>
</tr>
</thead>
<tbody>
<tr>
<td>1990</td>
<td>1.5%</td>
<td>3.0%</td>
</tr>
<tr>
<td>1995</td>
<td>4.0%</td>
<td>5.0%</td>
</tr>
<tr>
<td>2000</td>
<td>7.0%</td>
<td>7.0%</td>
</tr>
<tr>
<td>2005</td>
<td>9.0%</td>
<td>9.0%</td>
</tr>
<tr>
<td>2010</td>
<td>10.0%</td>
<td>10.0%</td>
</tr>
<tr>
<td>2015</td>
<td>12.0%</td>
<td>12.0%</td>
</tr>
</tbody>
</table>

Source: US Department of Labor.

**Recent Pickup in Inflation-Adjusted Average Hourly Earnings**

**Chart 14: Real Average Hourly Earnings Total Private Nonfarm Employees**

January 2008–December 2014

% Change, Seasonally Adjusted Annual Rate

<table>
<thead>
<tr>
<th>Year</th>
<th>% Change</th>
</tr>
</thead>
<tbody>
<tr>
<td>2008</td>
<td>-1%</td>
</tr>
<tr>
<td>2009</td>
<td>0%</td>
</tr>
<tr>
<td>2010</td>
<td>1%</td>
</tr>
<tr>
<td>2011</td>
<td>2%</td>
</tr>
<tr>
<td>2012</td>
<td>3%</td>
</tr>
<tr>
<td>2013</td>
<td>4%</td>
</tr>
<tr>
<td>2014</td>
<td>5%</td>
</tr>
</tbody>
</table>

Source: US Department of Labor.
We would like to stress this point. The US economy is currently in a kind of “goldilocks” scenario: The financial sector has healed, private debts have been reduced, and the recovery has firmed while receiving a boost from lower oil prices. Even as these low oil prices support growth, they help keep inflationary pressures muted, thus allowing the Fed to maintain very accommodative monetary conditions and very low interest rates. Sometime in 2016–17, however, base effects on energy prices will be much less favorable and, combined with a tighter labor market and faster GDP growth, could result in a meaningful acceleration in inflation pressures. At that point we might see a sudden upward adjustment in bond yields, which are still compressed at an unsustainable level by the distortionary impact of massive Fed purchases over the past few years, even as the federal funds rate remains at the zero bound.

The US has become the world’s largest producer as well as consumer of crude oil (Charts 19–20). In the United States, crude oil production has grown 2 million barrels per day (mb/d) since 2004. More than 3 mb/d of that growth has come from fracking of oil trapped in tight geologic formations. Without shale and other new sources, US oil production would be down more than a million barrels a day over the last 10 years and down 5½ mb/d from its peak in 1970.

As the United States still imports oil and energy on a net basis—net petroleum imports represent about 1.2% of GDP—the US as a whole will ultimately benefit from the drop in oil prices. Within the US, there will be winners and losers. Households stand to gain immediately: They will benefit from the oil price drop much like they would benefit from a tax cut. Household expenditures on energy-related goods and services represent about 6% of total personal consumption expenditures. Likewise, businesses and industries where energy prices are a large cost will also benefit. The main losers from the oil price drop will be those companies that invested heavily in oil and shale-gas expansion.
Investments in the energy sector have reached about 11% of total business investment. Businesses are already scaling back energy-related investments, and if crude prices remain at current levels for a persistent length of time, investment could decline rapidly. In the short term, we estimate that the headwind to GDP growth from lower energy investment may detract about 0.2 percentage points from annualized quarterly growth over a couple of quarters. However, in the medium run, the drop in oil prices should benefit the economy through higher consumption, higher investment and faster potential growth. The effect on GDP should turn positive by the end of 2015 and, over the medium term, boost the level of GDP by about 0.7 percent.

US Remains Large Oil Importer Despite Increase in Domestic Production

Chart 19: Nominal and Real Petroleum Trade Balance
March 1999–September 2014

USD Millions

<table>
<thead>
<tr>
<th>Year</th>
<th>Nominal Petroleum Trade Balance</th>
<th>Real Petroleum Trade Balance</th>
</tr>
</thead>
<tbody>
<tr>
<td>1999</td>
<td>$0</td>
<td>-120,000</td>
</tr>
<tr>
<td>2002</td>
<td>-20,000</td>
<td>-100,000</td>
</tr>
<tr>
<td>2005</td>
<td>-40,000</td>
<td>-80,000</td>
</tr>
<tr>
<td>2008</td>
<td>-60,000</td>
<td>-60,000</td>
</tr>
<tr>
<td>2011</td>
<td>-80,000</td>
<td>-40,000</td>
</tr>
<tr>
<td>2014</td>
<td>-100,000</td>
<td>-20,000</td>
</tr>
</tbody>
</table>

Source: US Census Bureau, US Department of Commerce.

Chart 20: US vs. Saudi Arabia Total Oil Supply
January 2000–September 2014

Barrels per Day (Millions)

<table>
<thead>
<tr>
<th>Year</th>
<th>Saudi Arabia</th>
<th>United States</th>
</tr>
</thead>
<tbody>
<tr>
<td>2000</td>
<td>5</td>
<td>10</td>
</tr>
<tr>
<td>2005</td>
<td>10</td>
<td>15</td>
</tr>
<tr>
<td>2010</td>
<td>15</td>
<td>20</td>
</tr>
</tbody>
</table>


Against this economic background, and based on the latest Fed meeting, the strong presumption should be that the Federal Open Market Committee will begin to normalize policy by raising the federal funds target range around mid-year 2015. A continued improvement in labor market indicators and broader economic conditions remains the Fed’s baseline scenario. Only a relatively large shock would completely derail monetary policy normalization. The Fed will look through the temporary impact of oil prices on the headline inflation rate in setting policy but will monitor the impact of the price drop on the rest of the economy.

This more positive outlook for the US labor market and US growth combined with our view that core inflation looks stable to rising implies higher US Treasury yields. Using a simple economic model, we estimate a relationship between nominal US 10-year yields, US GDP growth and interest rate volatility, based on historical data. The model brings out two important observations. First, current levels of volatility are exceptionally low by historical standards. Second, even abstracting from volatility, we find current US nominal growth would be consistent with nominal yields closer to 4% (Chart 21). With more normal levels of Treasury volatility, our simple model suggests theoretical rates closer to 5%. The main reason why current bond yields are so far below their historical norm is the exceptionally accommodative monetary policy enacted by the world’s largest central banks: Quantitative easing has artificially raised bond demand, and this has been compounded by financial repression creating forced buyers of treasury assets. Moreover, an extended period of zero policy interest rates combined with long-term guidance has compressed volatility. We believe these policies cannot be extended indefinitely, and as they unwind yields should rise. Any rise in inflation would only further escalate this adjustment.

Long-Term Interest Rates Closely Related to Nominal Growth; Nominal Growth Expected to Accelerate

Chart 21: Long-Term Yield vs. Nominal Growth
December 1990–December 2014
Potential Nominal Growth Estimated through December 2020

<table>
<thead>
<tr>
<th>Year</th>
<th>10-Year Yield</th>
<th>Nominal Growth</th>
<th>Potential Nominal Growth (CBO)</th>
</tr>
</thead>
<tbody>
<tr>
<td>1990</td>
<td>-4%</td>
<td>0%</td>
<td>-4%</td>
</tr>
<tr>
<td>1996</td>
<td>0%</td>
<td>4%</td>
<td>0%</td>
</tr>
<tr>
<td>2002</td>
<td>4%</td>
<td>8%</td>
<td>4%</td>
</tr>
<tr>
<td>2008</td>
<td>8%</td>
<td>12%</td>
<td>8%</td>
</tr>
<tr>
<td>2014</td>
<td>12%</td>
<td>16%</td>
<td>12%</td>
</tr>
</tbody>
</table>

As an important corollary of this outlook of stronger growth and higher interest rates, we expect that the current cycle of relative US dollar strength still has longer to run. Historically, dollar strength cycles tend to run for about five to seven years, and in this cycle the real effective exchange rate of the dollar has been strengthening for about three years. We can therefore expect a further strengthening of the US dollar, especially against the euro and the Japanese yen, due to the expansionary monetary stance in those countries. The performance of emerging-market currencies against the dollar will be more differentiated: Countries with weak fundamentals and large financing gaps will likely see their currencies lose ground to the dollar, but countries with stronger fundamentals and especially those with positive cyclical ties to the US economy should see their currencies remain stable and perhaps appreciate somewhat against the dollar.
We would stress at the outset that the eurozone economy as a whole relies to a very important extent on exports. In the case of Germany (accounting for a third of eurozone GDP but over half of all eurozone growth), about 50% of all growth over the last decade has come from the contribution of net exports. Across the eurozone as a whole, the ratio of exports to GDP has been growing and now stands at some 45%. These trends have been accentuated in the period following the global financial crisis as domestic demand across the region collapsed and then struggled to recover. While the impediments to strong growth in the eurozone are well known, ranging from moribund investment to the deep-rooted structural rigidities yet to be addressed, we think that over the coming few years the region should benefit from three strong tailwinds. These have been largely ignored by markets, and we feel they are worth highlighting.

First, as noted in the section on the US outlook, we are anticipating robust growth in the US, with a particularly strong dynamic of consumer demand. This, in turn, will provide solid support for eurozone exports to the US.

Second, the ECB made a commitment on January 22 to embark on a very ambitious quantitative easing program, with the aim of increasing the size of its balance sheet to a level north of its previous peak. The monthly purchases will be similar in size to those made by the Fed when it launched its QE3 program. The ECB intends to continue the purchases until it sees a sustained adjustment in the path of inflation toward its price stability norm of inflation below but close to 2%, making the program effectively open-ended. This will keep interest rates very low for very long, and it will put further downward pressure on the euro, especially if the Fed starts raising rates this year, as we expect. While we are not anticipating that low rates will have a meaningful impact on investment, the weak euro should further boost exports. The charts below show the relationship between exports and the trade weighted exchange rate for both Germany and the eurozone as a whole, illustrating this point (Charts 23–24).

### Euro Depreciation Likely to Benefit Euro Area’s Exports

**Chart 23: Eurozone Nominal Effective Exchange Rate vs. Exports (Year-over-Year)**
Q1 2000–Q4 2013

![Chart 23: Eurozone Nominal Effective Exchange Rate vs. Exports (Year-over-Year)](chart)

**Chart 24: Germany Nominal Effective Exchange Rate vs. Exports (Year-over-Year)**
Q1 2000–Q3 2013

![Chart 24: Germany Nominal Effective Exchange Rate vs. Exports (Year-over-Year)](chart)

Source: Calculations by Franklin Templeton Investments with data sourced from Eurostat.
We have attempted to assess the size of the incremental impact of these two tailwinds on eurozone exports, and from there the potential impact on GDP. While our research does not aim at providing a point forecast for euro area GDP, it suggests that the generally accepted baseline of growth of about 1% (consensus forecasts: 1.15%) seriously underestimates the upside potential coming from these two distinct sources.

**Third,** oil prices have dropped by more than 50% since the middle of last year.\(^5\) The IMF estimates that the incremental impact on euro area growth from such a reduction in oil prices could be as much as 0.5%.\(^1\) The ECB has a more conservative forecast, but we think the key factor remains that the decline in oil prices will support growth—adding to the potential for an upside surprise to expectations of the region remaining mired in stagnation in the year ahead. These factors put us squarely at odds with currently perceived wisdom that sees the eurozone as the source of global growth fears, and thus in part the cause of the collapse in oil prices due to an impending decline in demand.

While this piece focuses on this year and the next, we would note that this short-term outlook does not address some fundamental problems associated with the increasing divergence between the countries of the euro area. These differences are likely to be exacerbated by contentious politics and the fact that many of the factors that brighten the near-term growth prospects reduce the pressure on governments for much needed structural reforms—in turn with negative consequences for the longer-term growth outlook.
Japanese GDP growth should rebound to over 1% this year, above potential, thanks to the expansionary macroeconomic policy and favorable external environment. The IMF estimates that a 50% reduction in oil prices would likely raise Japan’s GDP by up to about 0.5% in 2015. A certain degree of uncertainty accompanies this estimate given the clear increase in oil imports after the Fukushima earthquake in 2011. The positive growth impact will likely be gradual and materialize with some quarters' lags.

Abstracting from the impact of oil prices, we recognize that the efficacy of Abenomics, the Japanese macro policy experiment in place since early 2013, generates some skepticism. Abenomics aims to break Japan out of its multi-decade cycle of deflation, to begin the process of fiscal consolidation, and, perhaps most importantly, to improve Japan’s potential growth rate via structural reforms.

In terms of achievements, it should be acknowledged that Japan does appear to have exited from the cycle of deflation and contraction in nominal growth since the launch of Abenomics, as illustrated in Chart 25. This extremely important step forward has eluded Japanese policymakers for a long time. Furthermore, as illustrated in Charts 26 and 27, both input and output prices have gone up since the start of Abenomics and the increase in output prices has risen faster than input prices. And at the same time, the trend in nominal growth has turned positive.

**Positive Trend in Nominal GDP Growth Since Abenomics**

**Chart 25: Nominal GDP Growth Trend**
Q1 2000–Q3 2014

<table>
<thead>
<tr>
<th>Year</th>
<th>Y/Y</th>
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<tbody>
<tr>
<td>2000</td>
<td>-1.6%</td>
</tr>
<tr>
<td>2002</td>
<td>-1.2%</td>
</tr>
<tr>
<td>2004</td>
<td>-0.8%</td>
</tr>
<tr>
<td>2006</td>
<td>-0.4%</td>
</tr>
<tr>
<td>2008</td>
<td>0.0%</td>
</tr>
<tr>
<td>2010</td>
<td>0.4%</td>
</tr>
<tr>
<td>2012</td>
<td>0.8%</td>
</tr>
<tr>
<td>2014</td>
<td>1.2%</td>
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Source: Calculations by Franklin Templeton Investments with data sourced from the Bank of Japan.

**Output Prices Rising Faster than Input Prices**

**Chart 26: Output Prices Exceeding Input Prices**
January 2012–December 2014

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<thead>
<tr>
<th>Index</th>
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<tbody>
<tr>
<td>104</td>
</tr>
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</table>

Source: Bank of Japan.
The question remains whether this begins a temporary or permanent exit from Japan’s cycle of deflation, rising debt and declining growth. The answer will depend on whether Prime Minister Shinzo Abe’s government manages to make equally decisive progress on other key reforms.

The government has put in place some important supporting conditions: It has triggered positive financial sector dynamics via the augmented quantitative easing and the portfolio rebalancing of the Government Pension Investment Fund (GPIF); these changes should continue to fuel a positive wealth effect, supporting consumption and countering the adverse impact of higher inflation on real wages. Moreover, with last year’s decisive election victory Prime Minister Abe has secured strong legitimacy, which he can leverage to tackle the tougher part of the reform agenda.

With respect to fiscal consolidation, so far the first stage of a two-part increase in the consumption tax has taken effect. While the second stage has been postponed, the government still plans to have it go into effect with a delay. Perhaps more importantly, even with the passage of the entire consumption tax, the sustainability of the fiscal position would still require greater movement on the other goals.

The famous “third arrow” of Abenomics has had mixed results so far, with important actions in the areas of labor and product market deregulation still to come. These will be very important, as they are arguably the most important areas from the perspective of raising productivity and potential growth. Thus far, the progress in the reform of the health care and other high end sectors has been limited. In the electricity sector, there has not been much movement on increasing competition among power producers.

The government has done far better in the area of the financial sector, such as the reform of the pension fund (GPIF) and adopting a code of corporate governance, but labor market reforms, including measures to increase female participation rates, would have a much greater impact on potential growth. Japan now needs decisive action to raise its potential growth path, consolidate the positive inflation dynamics and improve revenue collection. All three conditions are needed to secure stronger growth and debt sustainability. Progress in 2015 will be the key test.
We expect a 2015 GDP growth rate for China of about 7%, and only slightly lower than 2014’s 7.4%. However, any decline in China’s growth rate has been taken to be a significant headwind to global growth by most commentators, which we would not agree with. China is settling on a lower trend growth path compared to the about 10% of past decades, but we think this is playing out as a well-managed and desirable adjustment, and not a hard landing. We see it more as a welcome indication that China’s policymakers are committed to their stated aim of rebalancing the economy and growth model away from such a heavy reliance on fixed asset investment and exports. China’s important progress in reducing some of the excesses that developed during the immediate aftermath of the global financial crisis should be noted: Credit expansion is being brought under control, investment rates have declined, and the real estate market is cooling off.

Separately, some commentators argue that official statistics heavily overstate China’s true GDP growth, which could already be as low as 3% rather than around 7%. We believe this argument simply does not stand up to even a cursory scrutiny. Undoubtedly, in China, as in other emerging markets (and sometimes advanced economies), economic statistics suffer from weaknesses and imprecisions. However, here we highlight just a few of the many indicators that actually support the view that China has indeed been growing at close to or above potential: Labor markets have tightened; while one could argue that these statistics are also flawed, we would highlight the lack of social unrest that would follow deteriorating labor markets. Further support comes from retail sales, which remain robust.

The labor market has tightened somewhat as the pace of urbanization has slowed and as labor supply no longer outstrips labor demand (Chart 28). As a consequence, wages have begun to increase at a healthier pace (Chart 29). The rise in wages in turn has helped accelerate consumption, helping rebalance the makeup of growth. This kind of robust labor market dynamics simply would not be possible without reasonably strong economic growth. The high degree of political stability and absence of violence, as evidenced by the World Bank’s World Governance Indicator (which aggregates political stability indicators from nine different sources) illustrated in Chart 30, supports the view that labor market dynamics are indeed robust.

**Indications of Tightening Labor Market**

*Chart 28: China: Job Vacancy/Job Seeker*

Q1 2005–Q4 2014

80% 85% 90% 95% 100% 105% 110% 115%


Source: China Ministry of Human Resources and Social Security.

**Rising Migrant Workers’ Salaries Should Be Supportive for Domestic Consumption**

*Chart 29: Chinese Migrant Workers’ Monthly Salary*

1979–2014

Real Monthly Wages, 1979 Prices = 100

0 100 200 300 400 500


China's government knows very well that it needs to maintain a healthy pace of growth in employment and living standards to maintain social cohesion and stability, and all indicators suggest this is currently being achieved.

The healthy dynamics of retail sales, which are still growing at double-digit rates, also confirm that rebalancing is underway (Chart 31). It is also worth mentioning that the global impact of China's economy provides additional evidence that the economy is indeed growing at about the reported rate. To give just one example, China now ranks as the world's largest oil importer, and its oil imports have been rising through end-2014, at over 9% year-to-date.8

We also think this rebalancing might already be further along than is commonly believed: Academic work by Wang Xiaolu and Wing Tye Woo suggests that GDP in China was underreported by 10% and consumption underreported by 20%.9 Using these numbers for adjustment, the consumption/GDP ratio in China could well be around 62.5% GDP instead of the official reported 50% GDP (Chart 32). This in turn would imply a lower risk to growth of a sudden slowdown in investment than many think.


Robust Retail Sales Growth Indicates Underlying Strength in Domestic Consumption

Chart 31: China: Retail Sales


China's Official Data Likely Underestimate Consumption as Share of GDP

Chart 32: China Consumption Share of GDP
1997–2013


Labor Market Rebalancing: Tertiary Sector Has Surpassed Secondary Sector in Employment

Chart 33: China: Employment by Industry
1978–2013

Besides consumption, rebalancing seems to be happening in the labor market too. The latest labor market data suggest that the services sector already employs more persons than industry (Chart 33). Finally, amongst the various monthly macro indicators, retail sales have been relatively more resilient compared to industrial production and fixed asset investments.

A healthy rebalancing also characterizes the allocation and use of credit. While overall credit growth slows, financial institutions are directing less credit to state-owned enterprises (SOEs). A number of private sector companies are now benefiting from easier access to credit markets. This in turn helps the private sector become a more important driver of growth in China’s economy. Indeed, private companies already create more jobs than SOEs.

The rebalancing of growth also implies scaling back and headwinds in some areas. These often trigger alarmist comments on the overall growth outlook. Most commentators seem to miss the duality to China’s new growth framework, where different elements fit together, and weaknesses in some areas are just the counterpart to strengths in others.

For example, the reallocation of lending and curbing of credit excesses have reduced fixed asset investment, notably in real estate. And the increases in interest rates, together with the stronger wage dynamics highlighted above, have put pressure on corporate profits. On the other hand, the same wage dynamics are powering consumption and retail sales, providing better profit margins to other parts of the economy.

Moreover, the ongoing urbanization further bolsters wage and consumption growth. As Chart 34 shows, China is still far from being fully urbanized. The extension of growth to more areas within China will require significant additional infrastructure investment.

Therefore, we remain confident that the dynamics at play in this duality of China’s new growth framework can support a gradual rebalancing at this more moderate and more sustainable pace of about 7% for the next year.

**China’s Urbanization Catching Up to the World but Still Lagging Developed Countries**

**Chart 34: Urbanization Rate**

1950–2050 (Estimate)

Source: United Nations, Department of Economic and Social Affairs.
Nonetheless, there remains a great deal of concern that even if GDP growth remains on target while allowing for a healthy rebalancing, this slower pace of growth in China will have a significantly negative impact on global growth. We feel that this concern misses a very important point which has to do with the sheer speed and magnitude of China’s transformation. China’s economy today has doubled in size since 2008. Charts 35 and 36 above illustrate the absolute changes in GDP for some of the world’s major economies in 2014 and projected in 2015. Importantly, China’s contribution to global GDP, even at a slower pace than 2014, will be greater than that of the US.

We have done a simple calculation to simulate the impact of China’s demand on the rest of the world’s growth, using as a proxy Chinese imports. We have calculated the relationship between China’s GDP growth and imports growth across two sub-samples: (1988–2008) and (2009–2014). As Chart 37 illustrates, China’s propensity to import has fallen over the years but at a very gradual pace. Using the coefficients we derive in this fashion, a simple back of the envelope calculation suggests that due to the larger size of its economy, China today has almost double the impact on global demand than it had prior to the global financial crisis.

Finally, we would also note that much like the US, the eurozone and Japan, China benefits significantly from the decline in oil prices. China overtook the US in 2013 as the world’s largest importer of oil, and we estimate that every US$10 reduction in the price of oil results in a 0.2% increase in the trade surplus (or net exports). We have also estimated the impact the reduction in price has on consumption (positive) and investment (negative), and believe that for every 10% decline in the oil price GDP could increase by 0.17%. As in the case of the eurozone, we think that oil prices could act as an important tailwind for Chinese growth.

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China’s Relatively High Marginal Propensity to Import and Large Nominal GDP Bode Well for Global Economic Growth and Demand

China Projected to Be Largest Contributor to Nominal World GDP in 2015

Check 35: Projected Change in Nominal GDP

Check 36: Major Economies’ Share of World’s GDP in 2014

Source: International Monetary Fund, World Economic Outlook, as of October 2014.

Emerging Markets

Markets perceive the sharp reduction in oil prices as a net negative for all emerging markets, rather than a major source of differentiation. The emerging markets world includes some of the world’s largest oil producers, which now face massive headwinds. In particular, some of the largest emerging-market oil exporters also tend to have highly concentrated economies, making them very dependent on oil as a source of fiscal revenues, current account surpluses and GDP growth. On the other hand, some of the world’s largest oil consumers are also emerging markets, and they stand to benefit from the impact of the tax cut implicit in the reduction in oil prices (Charts 38 and 39).

To illustrate, perhaps the most striking example of the former group is Russia, where GDP forecasts have been reduced by between 3%–4%, implying a similar level of outright economic contraction this year. This reflects the fact that the Russian economy was already stagnating on the back of sanctions and tight financial conditions, prior to the collapse of oil prices. Oil has an enormous impact on the Russian economy—oil represents about 25% of GDP, 50% of fiscal revenues and 70% of its exports. Russia’s budget only breaks even at an oil price of about US$98 per barrel, so that the current price of oil puts the budget under significant stress.

On the other hand, China, as noted above stands to gain significantly from the decline in oil prices, but importantly so do most emerging markets. There are far more oil importers than exporters in the world, including within the emerging markets universe. India will likely see a boost to its GDP (albeit smaller than China’s given the limited pass through from global oil prices to the final consumer). Based on our calculations, South Korea, for example, could see as much as a half percentage point boost to its growth rate this year on the back of lower oil—bringing its growth to near the 4% level.

When forecasting the outlook for emerging markets, the need to be nuanced cannot be overstated. Despite superficial similarities, individual countries differ enormously. Mexico, also an oil exporter, maintains a very strong outlook because in contrast to Russia, only 10% of Mexico’s exports are actually oil related. As such for Mexico, the resurgence of the US consumer and US growth is a far more important driver of export and GDP performance than the price of oil. Thus, even all emerging-market oil producers are not in the same boat as Russia—a fact little recognized by most observers.

Share of Oil in Exports and Imports Varies Significantly Across Emerging-Market Countries

![Chart 38: Fuel Exports](2013)

% of Merchandise Exports

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<thead>
<tr>
<th>Country</th>
<th>0%</th>
<th>20%</th>
<th>40%</th>
<th>60%</th>
<th>80%</th>
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Source: The World Bank: World Development Indicators.

![Chart 39: Fuel Imports](2013)

% of Merchandise Imports

<table>
<thead>
<tr>
<th>Country</th>
<th>0%</th>
<th>10%</th>
<th>20%</th>
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Source: The World Bank: World Development Indicators.
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All investments involve risks, including possible loss of principal. Bond prices generally move in the opposite direction of interest rates. Thus, as the prices of bonds in an investment portfolio adjust to a rise in interest rates, the value of the portfolio may decline. Special risks are associated with foreign investing, including currency fluctuations, economic instability and political developments. Investments in developing markets, of which frontier markets are a subset, involve heightened risks related to the same factors, in addition to those associated with these markets’ smaller size, lesser liquidity and lack of established legal, political, business and social frameworks to support securities markets. Because these frameworks are typically even less developed in frontier markets, as well as various factors including the increased potential for extreme price volatility, illiquidity, trade barriers and exchange controls, the risks associated with developing markets are magnified in frontier markets.

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