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Economics Group

Special Commentary

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Which Way Will the Global Economy Go in 2018?

Executive Summary

The global economy has been growing for seven years, and we forecast that the expansion that is underway will remain intact through 2019. Inflation has been benign in most economies, but inflation rates should edge higher as spare capacity diminishes. Expectations of eventual monetary tightening in many foreign economies should lead to modest dollar depreciation vis-à-vis most foreign currencies. Overzealous tightening of monetary policy represents a potential downside risk to the global economic outlook as does a potential debt crisis in China. However, geopolitical events represent the most credible downside risk in the foreseeable future to our base case scenario that the global economy will continue to grow at a modest pace.

Global Expansion Likely Will Remain Intact

It appears that global economic activity has accelerated this year.

There has been an economic expansion underway in the global economy for the past seven years (Figure 1). That said, the 3.1 percent real GDP growth rate that the global economy registered in 2016 was the slowest rate of economic growth since the global financial crisis caused global GDP to contract in 2009. But global economic activity appears to have accelerated in 2017 if the upturn in global industrial production (IP) growth is any indication (Figure 2).[1] Although the turn-around in IP growth is most apparent in advanced economies, IP has also accelerated in developing economies. We estimate that global GDP growth has strengthened in 2017, and we forecast that the global economic expansion will remain intact in 2018 and 2019. (See Figure 1 and the table at the end of the report.)

Figure 1

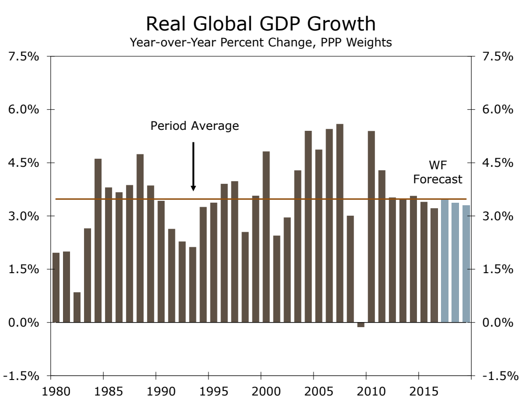
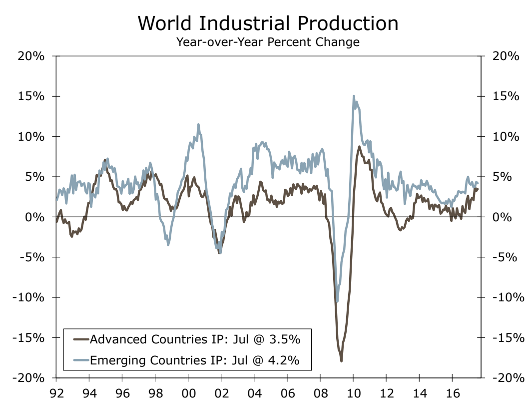


Figure 2



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

[1] **GDP measures production of all goods and services in the economy whereas IP simply measures production of goods in the industrial sector. We use the narrower concept of IP to discuss economic developments in 2017 because we do not have a high frequency measure of global GDP.**

Real GDP in the United States, the world's largest economy, has grown at a modest pace since mid-2009, and we look for real GDP to continue to grow between 2 percent and 2.5 percent through 2019 (Figure 3). Significant fiscal stimulus in the United States, should it occur, could boost real GDP growth higher, but we are skeptical that Congress will actually approve significant fiscal easing due, at least in part, to budget realities.[2]

The expansion in the Eurozone is becoming increasingly self-sustaining.

The Eurozone has surprised many observers this year with the acceleration in economic activity that has occurred. Indeed, real GDP in Q2-2017 was up 2.3 percent, the strongest rate of year over year GDP growth in more than six years (Figure 4). The expansion in the Eurozone is becoming increasingly self-sustaining, and we look for it to continue over the next two years. The Canadian economy has thoroughly recovered from its mild downturn in early 2015 as real GDP was up nearly 4 percent on a year-ago basis in the second quarter. Even the often comatose Japanese economy has gotten into the growth act with real GDP growing at a respectable rate of 1.4 percent (year-over-year) in Q2.

Figure 3

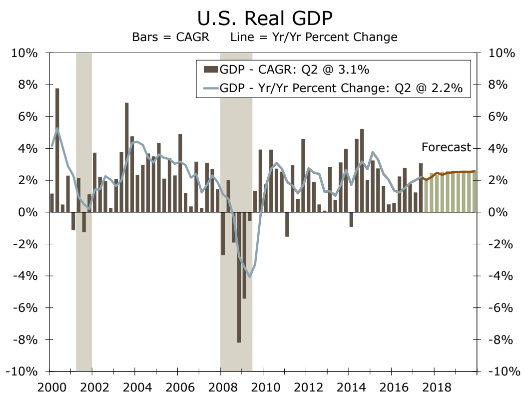
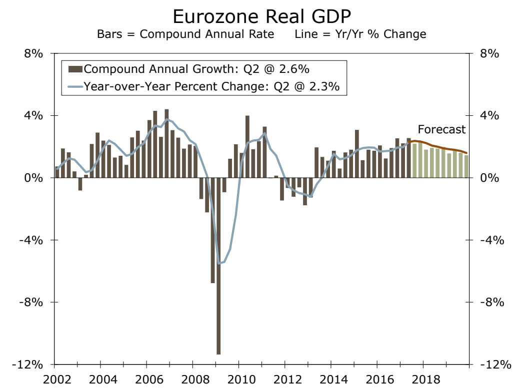


Figure 4



Source: U.S. Department of Commerce, IHS Global Insight and Wells Fargo Securities

Some deceleration appears to be underway in the Chinese economy.

Turning to the developing world, the year-over-year rate of real GDP growth in China has stabilized between 6.5 percent and 7.0 percent in recent quarters (Figure 5). But recent economic indicators suggest that some deceleration is underway again in China as authorities have eased up on policy stimulus. We look for growth in China to slow further over the next two years. That said, we do not believe that a debt-inspired collapse of the Chinese economy is likely because, in our view, the very real debt problem in China is manageable. As we note below, however, debt issues in China do represent a downside risk to the global economic outlook.

Real GDP in India continues to grow at a solid rate, although a few policy changes over the past year have introduced distortions that have caused some wiggles in the economic growth rate.[3] Looking forward, we expect that real GDP growth in India will strengthen from the 6.6 percent rate that we forecast for the fiscal year (FY) that began on April 1, 2017, to 7.2 percent in the FY that begins next April. The Brazilian economy suffered through two years of deep recession, but economic growth has resumed again in Latin America's largest economy (Figure 6). We look for growth to strengthen in coming quarters, but a return to the supercharged growth rates of the past decade do not look likely anytime soon. Likewise, the Russian economy was flat on its back in 2015 and 2016, but is growing again and likely will continue to do so, albeit at a modest pace.

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[2] **See our *Monthly Economic Outlook* for further details on our U.S. economic forecast. See our *Capitol Hill Update* for details regarding our fiscal policy assumptions. Both reports are posted at https://www.wellsfargo.com/com/insights/economics/.**

[3] **The surprise de-monetization that was implemented last November caused economic activity to go through an air pocket for a few months. The Byzantine tax system was rationalized into a national goods and service tax on July 1.**

Figure 5

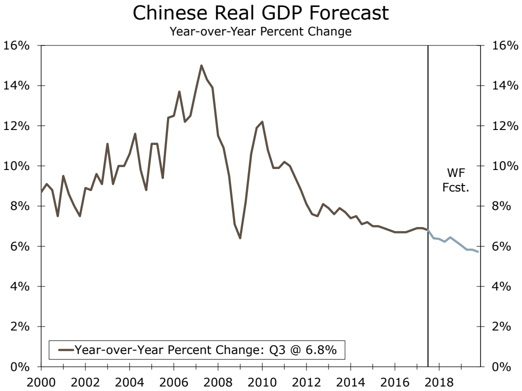
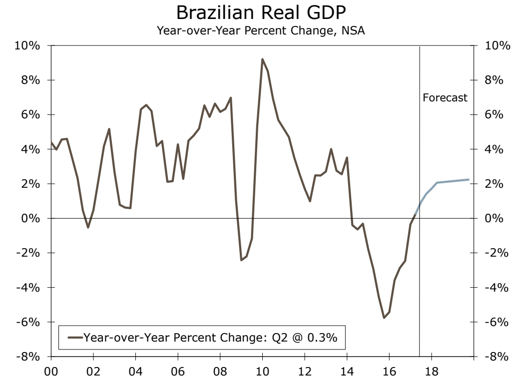


Figure 6



Source: Bloomberg LP, IHS Global Insight and Wells Fargo Securities

A return to the supercharged global growth rate of 2003-2007 do not look likely.

As already noted above, incoming data suggest that global GDP growth has strengthened somewhat this year relative to 2016 and we look for global growth to edge even higher in 2018 (Figure 1). That said, a return to the supercharged growth rates of 2003-2007, when global GDP grew in excess of 5 percent per annum on average, does not seem likely anytime soon. Demographic factors are holding back potential economic growth rates in aging advanced economies and in some important developing economies such as China. Speaking of China, that economy is no longer capable of growing 10 percent per annum on a sustained basis, as it did a decade ago, because the indebted business sector needs to de-lever or it could eventually face a crippling debt crisis.

Some Removal of Monetary Accommodation is Likely

Central banks in many economies eased their respective policy stances in 2015 and 2016 as economic growth rates slowed and inflation rates collapsed. In many cases, central banks slashed their policy rates to zero percent—some central banks cut rates into negative territory—and quantitative easing (QE) programs were adopted or expanded. But growth is now strengthening and overall rates of consumer price inflation have edged higher again. Consequently, some central banks are beginning to dial back policy accommodation.

Like the Fed, the Bank of Canada is raising rates now.

The Federal Reserve has led the pack in that regard. The Fed stopped buying bonds altogether in late 2014, and it has raised its target range for the fed funds rate by 100 bps since December 2015 (Figure 7). We expect that the Fed will hike again by 25 bps at the December 13 FOMC meeting and we look for two more rate hikes in 2018. The Bank of Canada (BoC) got into the rate-hiking act this year by raising its main policy rate by 50 bps in Q3-2017 (25 bps on two separate occasions). We suspect that the BoC will refrain from raising rates again this year, but we look for two 25 bps rate hikes in 2018.

The Bank of England (BoE) cut its main policy rate from 0.50 percent to 0.25 percent when the near-term U.K. economic outlook became opaque in the immediate aftermath of the Brexit referendum last year. Although GDP growth has slowed somewhat this year, the economy has not slid into recession. Furthermore, CPI inflation has been running consistently above the Monetary Policy Committee's (MPC) target of 2 percent. Consequently, the MPC has hinted that policy likely will be tightened in coming months, which supports our call for two 25 bps rate hikes next year.

The ECB likely will be removing policy accommodation.

The European Central Bank (ECB) has had a QE program in place since early 2015 (Figure 8). It dialed back its monthly rate of bond purchases earlier this year from €80 billion to €60 billion, and we look for the Governing Council to announce another reduction in this monthly rate at its next policy meeting on October 26. In our view, the ECB will wrap up its QE program by mid-2018 and begin a slow process of hiking its policy rates in the second half of 2018.

Figure 7

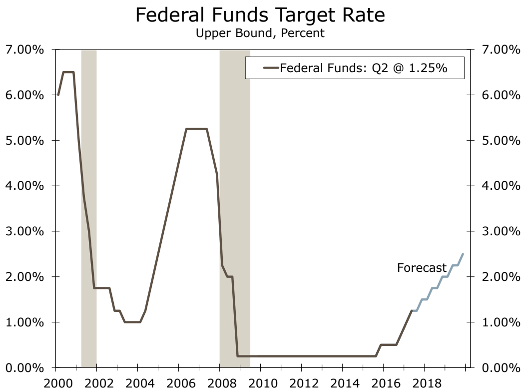
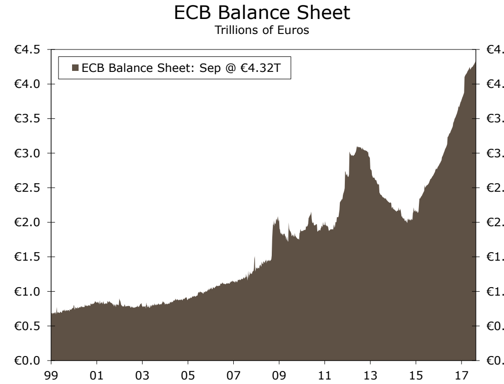


Figure 8



Source: IHS Global Insight, Bloomberg LP and Wells Fargo Securities

The U.S. Dollar Should Trend Lower

The Fed's "Major Currency" index, which measures the trade weighted-average value of the U.S. dollar against other major currencies, rose about 40 percent between mid-2011 and late 2016 (Figure 9). The greenback was supported during this period, especially starting in mid-2014, by expectations of diverging monetary policy stances among the world's major central banks. That is, market participants expected that the Fed would be removing accommodation while they looked for further accommodation by other major central banks. Consequently, interest rate differentials rose in favor of the United States vis-à-vis other major economies, thereby supporting the greenback.

We look for the dollar to depreciate as foreign central banks remove policy accommodation.

However, expectations are starting to shift toward monetary policy convergence. In other words, the Fed is no longer seen as the only game in town in terms of less accommodative monetary policy. As discussed above, other major central banks are beginning to dial back QE programs and/or hike rates, and expectations of less accommodative policy going forward in foreign economies have already caused the U.S. dollar to weaken marginally versus many major currencies this year. We look for the greenback to move lower against most major currencies in coming quarters as foreign central banks turn to less stimulative policies. We also forecast that the U.S. dollar will depreciate versus the currencies of many developing economies in the foreseeable future.

Figure 9

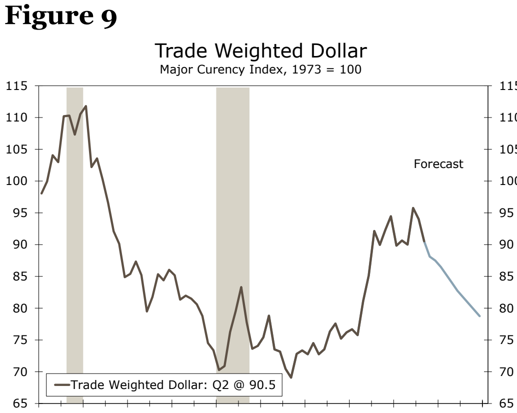
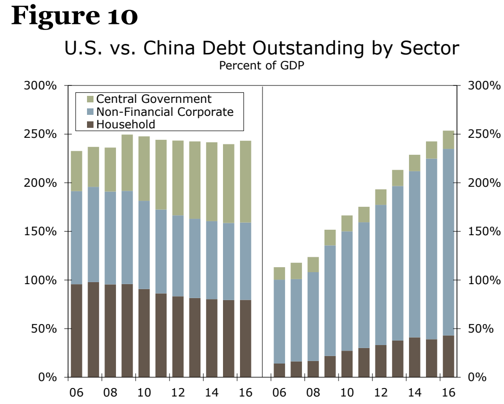


Figure 10



Source: IHS Global Insight, CEIC and Wells Fargo Securities

Risks: What Could Go Wrong?

In sum, it appears that global GDP growth has edged higher this year relative to 2016, and we look for it to continue to grow near its long-run average of 3.5 percent per annum over the next two years. What could potentially go wrong with this outlook? A downside risk that springs to mind is the leveraged nature of the Chinese economy. The debt-to-GDP ratio in China has more than doubled over the past decade with much of this increased leverage occurring in the non-financial business sector (Figure 10). China is the second largest economy in the world, and a sharp economic slowdown that is caused by a debt crisis in that country clearly would have global economic implications. In our view, the debt issues in China are largely manageable, and we do not look for a marked deceleration in that economy. However, China is not as transparent as many other economies, and we readily acknowledge that the debt problems in China could be more serious than our analysis suggests, which poses a potential downside risk to our outlook.

Inflation has been benign for the past few years in most economies. As noted above, inflation is starting to edge a bit higher in most economies. If inflation should start to move markedly higher, then inflation expectations could become unmoored. In that event, central banks could tighten faster than most market participants currently expect. A sharp move higher in interest rates, especially if it were to occur rapidly, could lead to a meaningful slowdown in global economic growth. That said, inflation rates largely remain depressed, and a significant rise in inflation does not look likely in the immediate future.

In our view, the most credible downside risks to our outlook arise from potential geopolitical events. For example, a conflict between the United States and North Korea, should one occur, could darken the economic outlook significantly, depending on the severity of the conflict. So too could a widespread conflict in the Middle East or further Russian aggression against some of its neighbors. Of course, it is very difficult to forecast these geopolitical events, so we make the simplifying assumption that they will not occur. If in fact they do, then we will need to change our economic forecasts.

The most credible downside risks to our outlook arise from potential geopolitical events.

Conclusion

The global economy in 2016 grew at its slowest pace since the worldwide recession of 2009, but there is clear evidence that global economic activity has accelerated this year. We expect that the expansion will remain intact through 2019, but a return to the supercharged global GDP growth rates of the last decade does not seem likely. A debt crisis in China or significant monetary tightening by the world’s major central banks could cause global economic growth to slow sharply, but the most credible downside risks to our outlook at this time seem to arise from potential geopolitical events.

If our base-case scenario of continued global growth comes to pass, then inflation rates should edge higher in most countries in coming quarters. Consequently, we look for most major central banks to slowly remove policy accommodation via tapering and eventual cessation of QE programs and/or rate hikes. Many foreign currencies have strengthened vis-à-vis the U.S. dollar this year as market participants have started to expect policy tightening by foreign central banks, and we look for the dollar to trend lower versus most foreign currencies in coming quarters.

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WELLS FARGO SECURITIES

Wells Fargo International Economic Forecast

(Year-over-Year Percent Change)

	GDP			CPI		
	2017	2018	2019	2017	2018	2019
Global (PPP Weights)	3.5%	3.4%	3.3%	3.1%	3.4%	3.4%
Global (Market Exchange Rates)	3.2%	3.2%	3.1%	3.1%	3.4%	3.4%
Advanced Economies[1]	2.3%	2.3%	2.2%	1.8%	1.8%	1.9%
United States	2.1%	2.4%	2.5%	2.1%	2.0%	2.1%
Eurozone	2.2%	2.1%	1.7%	1.5%	1.7%	1.9%
United Kingdom	1.6%	1.8%	1.6%	2.6%	2.2%	2.0%
Japan	1.9%	1.1%	0.7%	0.4%	0.8%	0.3%
Korea	2.8%	2.8%	2.7%	2.1%	2.0%	2.4%
Canada	3.0%	2.0%	1.9%	1.6%	1.9%	2.0%
Developing Economies[1]	4.6%	4.4%	4.4%	4.4%	5.0%	5.0%
China	6.7%	6.3%	5.9%	1.6%	2.4%	2.2%
India[2]	7.1%	6.6%	7.2%	3.2%	4.2%	4.3%
Mexico	2.1%	2.3%	2.4%	6.0%	5.0%	5.1%
Brazil	0.6%	2.0%	2.2%	3.5%	3.4%	3.7%
Russia	1.9%	2.0%	2.2%	4.0%	4.2%	4.5%

Forecast as of: October 11, 2017

[1]Aggregated Using PPP Weights [2]Forecast Refers to Fiscal Year

Wells Fargo International Interest Rate Forecast

(End of Quarter Rates)

	3-Month LIBOR						10-Year Bond					
	2017	2018				2019	2017	2018				2019
	Q4	Q1	Q2	Q3	Q4	Q1	Q4	Q1	Q2	Q3	Q4	Q1
U.S.	1.65%	1.65%	1.90%	1.90%	2.15%	2.15%	2.49%	2.57%	2.66%	2.71%	2.78%	2.82%
Japan	-0.03%	-0.02%	-0.01%	0.00%	0.01%	0.02%	0.03%	0.05%	0.07%	0.09%	0.12%	0.14%
Euroland[1]	-0.37%	-0.30%	-0.20%	0.05%	0.20%	0.40%	0.45%	0.60%	0.75%	0.85%	1.00%	1.10%
U.K.	0.40%	0.60%	0.70%	0.85%	0.95%	1.10%	1.40%	1.50%	1.65%	1.80%	1.90%	2.00%
Canada[2]	1.50%	1.65%	1.75%	1.90%	2.00%	2.15%	2.10%	2.25%	2.40%	2.50%	2.55%	2.60%

Forecast as of: October 11, 2017

[1] 10-year German Government Bond Yield [2] 3-Month Canada Bankers' Acceptances

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