Economic Viewpoint

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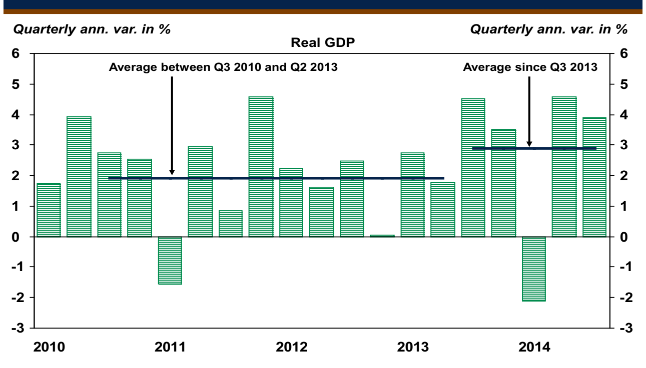
Can the United States prevent the global economy from slowing down?

Before and during the crisis of 2008–2009, the concept of “decoupling” suggested that the emerging countries and the global economy had less need to depend on the U.S. economy in order to grow. But in the past year, the United States has seen acceleration in its production, while the other major economic zones, in particular the euro zone and the BRIC[1] countries, have been struggling. In this new “decoupling,” is the United States fated to take back its role as economic driver? Acceleration in the U.S. economy would appear to be a necessary condition for better global growth, but it is not enough, because the United States no longer has sufficient weight to bear that burden all by itself.

It has taken a while, but the economic recovery in the United States now appears to be robust. After several false starts, GDP growth has made strong advances since mid-2013, if we exclude the problems caused by last year’s harsh winter. From the summer of 2013 to that of 2014, the average annualized increase in real GDP has been 2.9% (including the 2.1% contraction in the first quarter of 2014). From the summer of 2010 to the spring of 2013, that average was 1.9% (graph 1). Clearly, we can feel a change of velocity in the U.S. economy.

Graph 1 – The U.S. economy is clearly picking up steam



Sources: Bureau of Economic Analysis and Desjardins, Economic Studies

LITTLE SUPPORT FROM OTHER ADVANCED ECONOMIES

The current improvement in the U.S. economy is all the more remarkable in that few other economies are currently exhibiting strong growth. The euro zone is still anemic, Japan has fallen back into recession, and many emerging countries are in a slowdown phase. The good news currently comes mainly from the Anglo-Saxon countries: the United Kingdom, Canada and, to a lesser extent, Australia and New Zealand have shown healthy real GDP growth since 2013. Apart from the United Kingdom, these economies are not large enough to make any real difference to global economic development; taken together, Canada, Australia and New Zealand account for no more than 3% of global GDP.[2]

The current picture of the euro zone economy is in stark contrast with that of the United States. The euro zone has not experienced any contraction of real GDP since the winter of 2013, but its performance is far from impressive. The average annualized quarterly growth has been a mere 0.7% in the past year, i.e. one quarter of that recorded by the United States. But we must also take into account the growth potential, which for various reasons is lower in the euro zone (0.9%, compared with 1.8% in the United States).

[1] Brazil, Russia, India and China. Some include South Africa in the BRIC (BRICS), but given the lesser weight of this country in the global economy (0.7%), we prefer to use the initial definition.

[2] Throughout this article, the weights used date back to 2013 and are calculated based on data from the World Bank, based on purchasing power parity. These weights do not change much over a short span of time.

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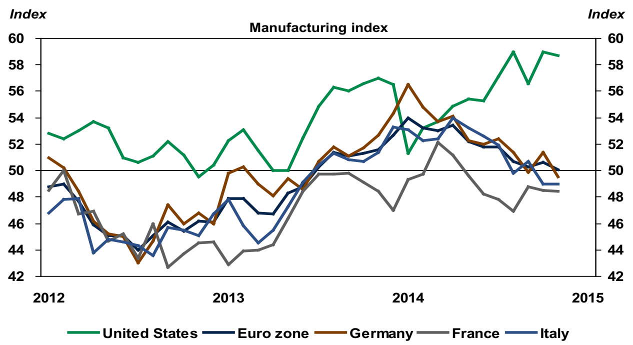
The tepid growth in the euro zone obviously has a significant impact on global real GDP, as it represents 14% of global GDP. Therefore, a 1% slowdown in the euro zone economy subtracts 0.1% from global real GDP growth.

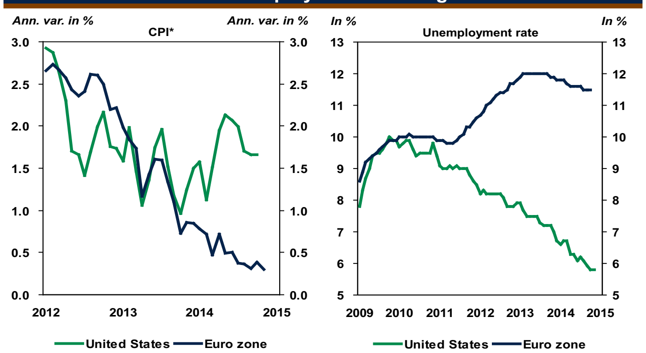
The growth gap between the euro zone and the United States is likely to continue, because few factors suggest any imminent acceleration of the euro zone economy. The recent trend in European PMI indexes contrasts sharply with that of the U.S. ISM index (graph 2). Risks of deflation are still far stronger in Europe than in the United States, and the unemployment rate in the euro zone has barely fallen (graph 3).

Graph 2 – The U.S. ISM index is in contrast with the PMI indexes of the euro zone



Sources: Institute for Supply Management, Markit, Bloomberg and Desjardins, Economic Studies

Graph 3 – Inflation is weaker in the euro zone, while unemployment is far higher



* Consumer price index.
Sources: Bureau of Labor Statistics, Eurostat and Desjardins, Economic Studies

Many factors account for this difference, in particular the actions of the two central banks. The European Central Bank is just beginning to take a more active role, while the Federal Reserve recently brought its sizeable asset purchase program to a close, and key interest rate hikes are expected in 2015.

Economic growth in the United Kingdom is comparable to that of the United States. Since the summer of 2013, its average real GDP growth has been 3.1%. It also provides support to the global economy, since it represents 2.7% of it. However, the size of its trade (45% of exports) with the euro zone, its partner in the European Union, renders the British economy less immune to the sluggish growth in the other countries of Europe.

Japan is also standing on shaky ground; its economy has fallen back into recession. The consumption tax hike that was imposed on April 1 has generated a great deal of volatility in the economic indicators. The third-quarter data wiped out any hope of a quick rebound in growth, after the 6.7% contraction that was recorded in the spring. In fact, real GDP has contracted once again, this time by 1.9%. Since the summer of 2013, Japan's real GDP average growth has been -0.5%. Of course, with growth potential of just 0.7%, it is normal for the Japanese economy to grow slowly, and to frequently show periods of stagnation. Still, the recent performance is no less disappointing. The Japanese economy represents 5.2% of global GDP, so it too is dragging the world's economy down.

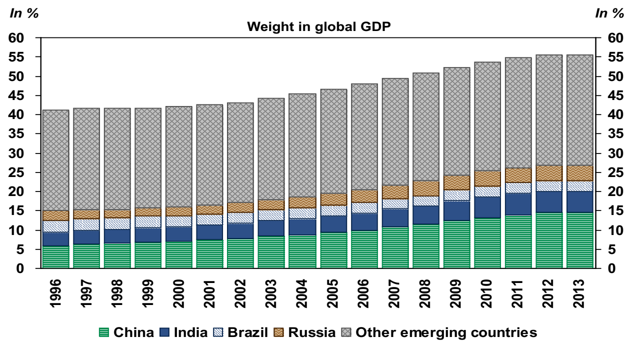
THE PARADOX OF THE EMERGING COUNTRIES

The major, advanced economies are not the only ones going through a rough patch; the same holds true for many of the emerging countries. Due to their growing weight in the global economy, their growth is increasingly sensitive to the ups and downs of the major economies. Over a period of several years, the emerging countries have accustomed us to a very fast, even frantic, pace of growth; but they too are not completely immune to more challenging economic conditions. On average, between 2000 and 2008, the emerging countries' real GDP posted annual growth of 6.1%. The rate of growth fell to 1.5% in 2009, at the worst point of the global recession. Growth rebounded to 7.1% in 2010 and 6.0% in 2011, but since then the pace has slowed. In 2013, the emerging countries' real GDP growth was just 4.3%, and a similar number is in the offing for 2014.

The size of the emerging economies is expanding. Their total weight has increased, from 42.2% in 2000 to 55.4% in 2013. This predominance is largely attributable to the BRIC countries. The combined weight of those four countries has expanded, from 16.0% to 26.7% of the global economy (graph 4 on page 3).

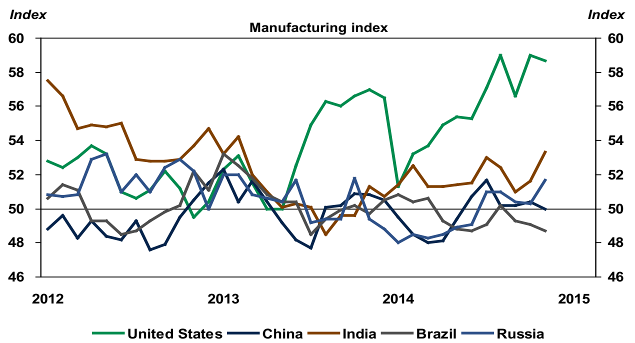
However, the current climate is more challenging for these economies, and here too, the PMI indexes show no sign of an imminent rebound (graph 5 on page 3). China's growth has been more subdued in recent years, now that the authorities are trying to reform some past excesses in the areas of credit and investment. They are also attempting to slowly shift the economy away from a focus on exports, to greater reliance

Graph 4 – The weight of the emerging countries in the global economy has grown considerably



Sources: World Bank and Desjardins, Economic Studies

Graph 5 – The U.S. ISM index is also higher than the PMI indexes of the BRIC countries



Sources: Institute for Supply Management, Markit, Bloomberg and Desjardins, Economic Studies

on domestic demand. During the 2000s, China's economy grew by an average of 10.3%. The government is now aiming for real GDP growth around 7.5%. The slowdown in China's real GDP growth is likely to continue in the years to come, especially since the demographic situation there is not very favourable.

In India, the situation appears to be improving in the short term, but this economy has seen its share of problems in recent years. India is faced with many imbalances (budget and trade deficits) and with structural constraints (cumbersome bureaucracy and regulation, inadequate infrastructures) that discourage investment. The arrival of a new, reform-minded government should spur stronger growth in the years ahead, although that growth is unlikely to sustainably match the peaks of the 2000s.

Brazil and Russia have been flirting with recession for a year now, and outlooks there are not very positive. Both are suffering from weak demand for commodities. Russia's case is obviously exacerbated by the political situation and the economic sanctions that followed the Ukrainian crisis. The Russian economy will probably stagnate in the years to come, as it did in 2014. In Brazil, growth should regain the upper hand, but without any huge rebound.

While the U.S. economy is accelerating, deceleration will remain the name of the game in the BRIC countries. They will not be the drivers of growth that they were in the second half of the 2000s. Other emerging countries might pick up the torch, but there too the rate of economic growth will not be as great as what was seen in the previous decade, and their low weight will prevent them from having significant global influence in the short term.

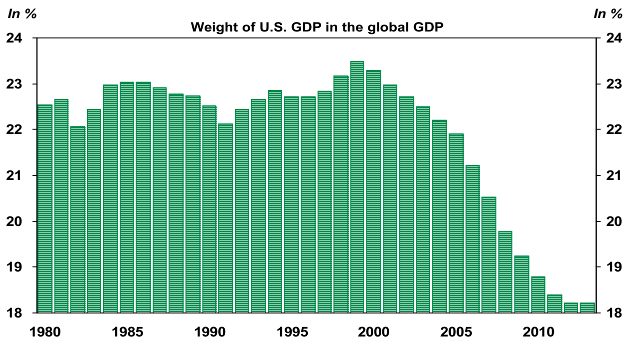
THE U.S. ECONOMY TO THE RESCUE

Fortunately, several factors argue in favour of vigorous growth in the U.S. economy. During the recession and the slow recovery that followed, the Americans have managed to repair many of the imbalances that had caused the crisis. For instance, the household debt rate has been brought down to a healthier level, and the housing market has purged itself of the excesses that characterized the 2000s. The confidence indexes are on an upwards trend, and businesses are now in a better position to increase their investments and their hiring. The recovery and budget constraints have enabled the federal government to reduce its deficit considerably. The trade balance has also improved, and the current account deficit is now, proportionally speaking, at its lowest level since 1998.

When combined with factors of a more cyclical nature, such as the significant slump in gasoline prices and the low interest rates, these factors should support economic growth in the forthcoming quarters and years. The U.S. economy is not completely repaired, and we still note several problems, including significant underutilisation of production capacity, insufficient growth in real income and a destabilizing political divide. However, contrary to the experience of most of the other major economies, the situation there is quite encouraging. While potential GDP growth is fluctuating around 1.8%, according to the Congressional Budget Office, we note that real GDP is currently growing at closer to 3%. Given the hardships of the recession and despite growth that is now stronger, the output gap is still very broad; this limits inflationary pressures and suggests that the United States is still nowhere near the end of another cycle.

We have waited a long time to be able to rely on the U.S. economy getting back on its feet. The tribulations of recent years have weighed heavily on the global economy, and the improving conditions in the United States can only be beneficial. The weight of the United States in global GDP is 18.2%. Therefore, each 1% of variation in U.S. GDP generates slightly less than a 0.2% fluctuation in the global economy, all other things being equal. Of course, the direct influence of U.S. GDP on global GDP used to be greater: in 2000, its weight was 23.3% (graph 6).

Graph 6 – The weight of the United States in the global economy has shrunk



Sources: World Bank and Desjardins, Economic Studies

Beyond the direct effect of U.S. real GDP on the calculation of global growth, we must take into account the size of that country's final demand. Americans produce a lot, but their consumption and their investment require an enormous amount of work, production and resources from the rest of the world. One of the main reasons why China has been producing so much in the past decade is because it has succeeded in exporting vast quantities of goods to the United States, surpassing Canada as the top "supplier" to that country. Also, China has a great need of resources in order to produce goods for export, a large share of which is headed for the United States. Thus the "spin-offs" of healthy U.S. growth go beyond that economy's mere weight in global GDP.

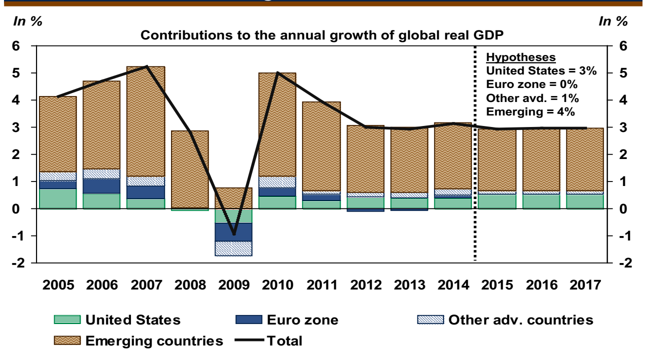
In the longer term, the weight of the U.S. economy will probably continue to decline. First, the United States will eventually approach a pace of growth closer to the potential. Second, even during a slowdown, the main emerging countries will generally keep recording higher rates of growth: their weight within global GDP will therefore keep increasing. Since the two economic drivers, the United States and China, are expected, for demographic reasons, to grow more slowly, we can also predict that global GDP will follow a more subdued trend.

CONCLUSION: NECESSARY, BUT NOT SUFFICIENT

While Europe is stagnating, Japan is sinking and China is slowing, the acceleration of the U.S. economy comes at just the right time. It will help to stabilize global GDP, and even give it a little boost. Thus the United States is resuming its role of economic driver, which it has been unable to perform since its real estate bubble burst, in the second half of the 2000s.

By growing at around 3%, U.S. real GDP is helping to make up for the weakness of the European economy, which keeps threatening to fall into a triple-dip recession. But the U.S. economy does not have as much influence as it did in the past. In itself, it would be unable to counterbalance the combined effects of hypothetical sharp pullbacks in the other advanced countries and in the main emerging countries, especially since the financial markets, more than the commercial trade channel, could affect American confidence and production. At best, the United States could help stabilize global growth at around 3% in a plausible alternative scenario in which the euro zone continues to stagnate (0% change in real GDP), the other advanced countries disappoint (1% variation in real GDP) and the emerging economies slow further (4% variation in real GDP) (graph 7). Thus the decoupling between the United States and the rest of the world must not be too long, nor too pronounced.

Graph 7 – Improved U.S. growth does not guarantee acceleration in global real GDP



Sources: World Bank, Datastream and Desjardins, Economic Studies

In conclusion, improved growth in the United States is a necessary condition for acceleration in the global economy, but cannot guarantee it.

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