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RESEARCH

BBVA Views

The global outlook, the US and the eurozone

Jorge Sicilia, Chief Economist BBVA

3rd BBVA Seminar for CBs, SWFs and SSAs

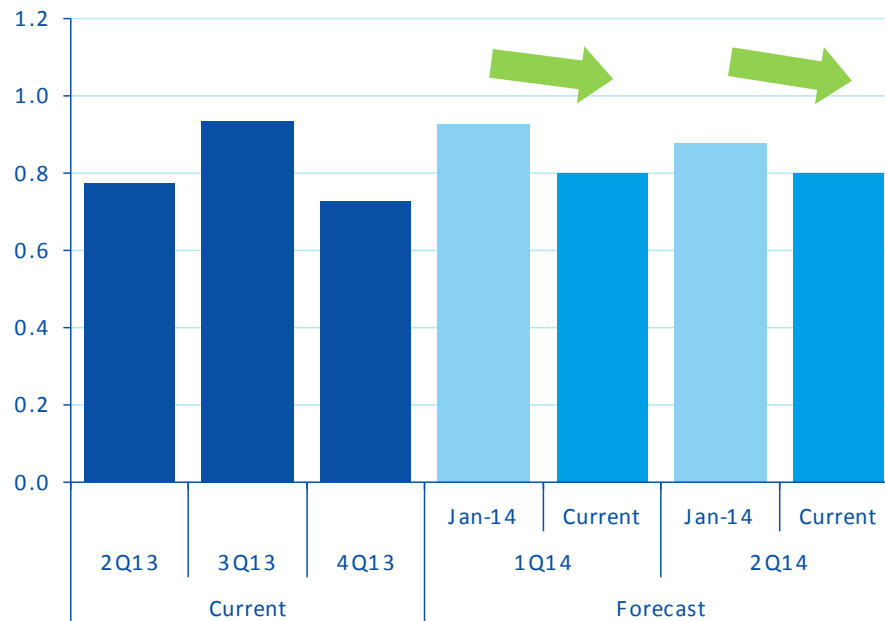
Barcelona, 29 May 2014

Global cycle: growth remains robust at a quarterly 0.8% in the first half of the year

World GDP Growth (% QoQ)

Based on BBVA-GAIN

Source: BBVA Research



Overall, higher growth in developed economies partly offsets lower growth in emerging economies

Growth is still robust and financial conditions have also eased in emerging economies, but incoming information reveal no acceleration in the first half of 2014

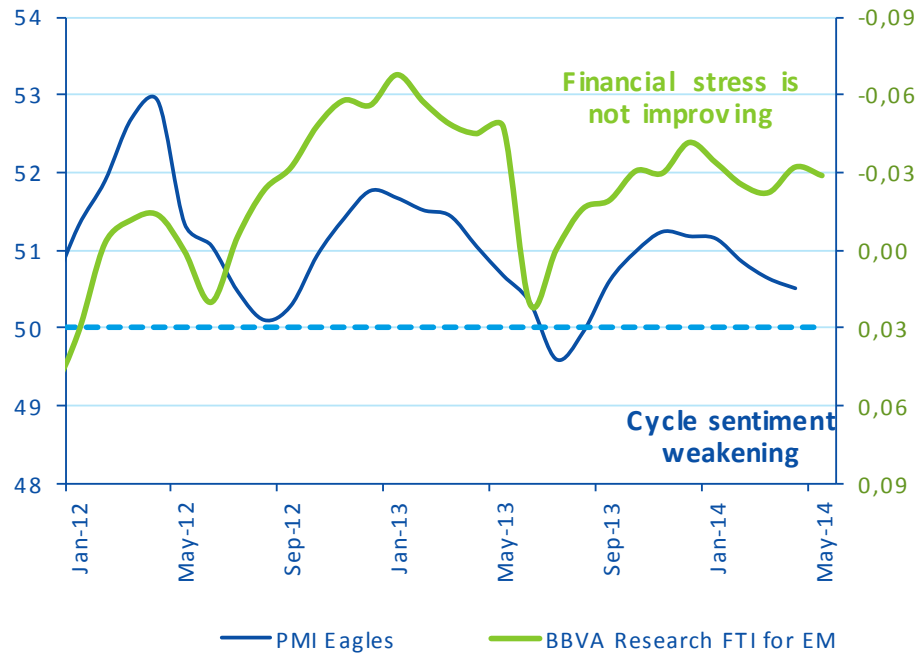
Global cycle: developed economies evolve better than developing countries

Cycle confidence and financial stress

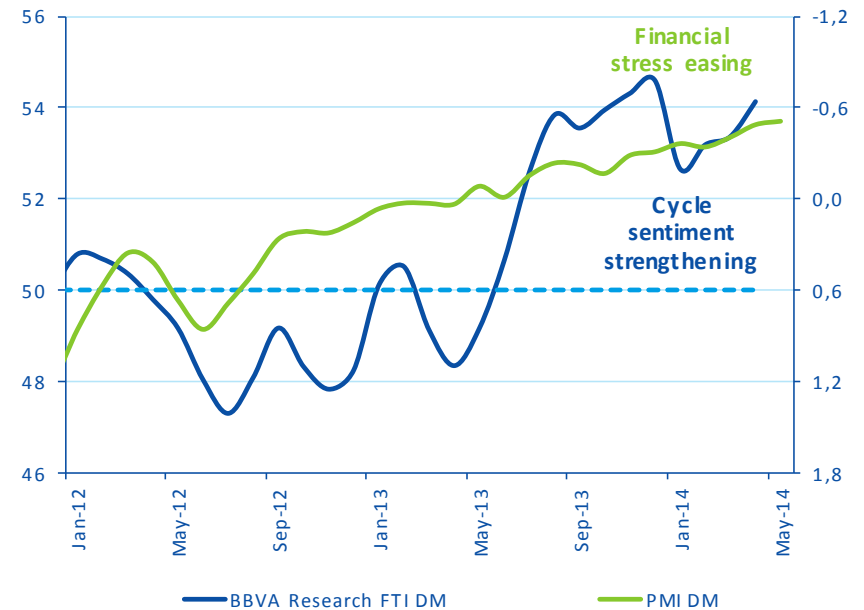
PMI and BBVA Research FTI

Source: BBVA Research

Emerging Markets



Developed Markets



China: growth started weak in 2014

China's indicators are losing momentum, ...

China: industrial production, yoy %

Source: Haver and BBVA Research

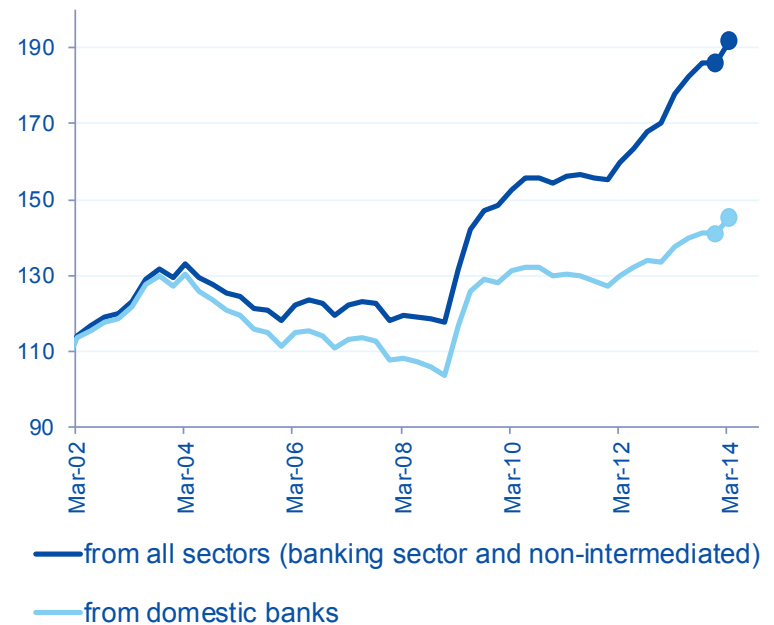


... as the authorities are more focused on medium-term issues and there is less room for manoeuvre in the short term

China: debt in the non-financial private sector

Total debt as % GDP

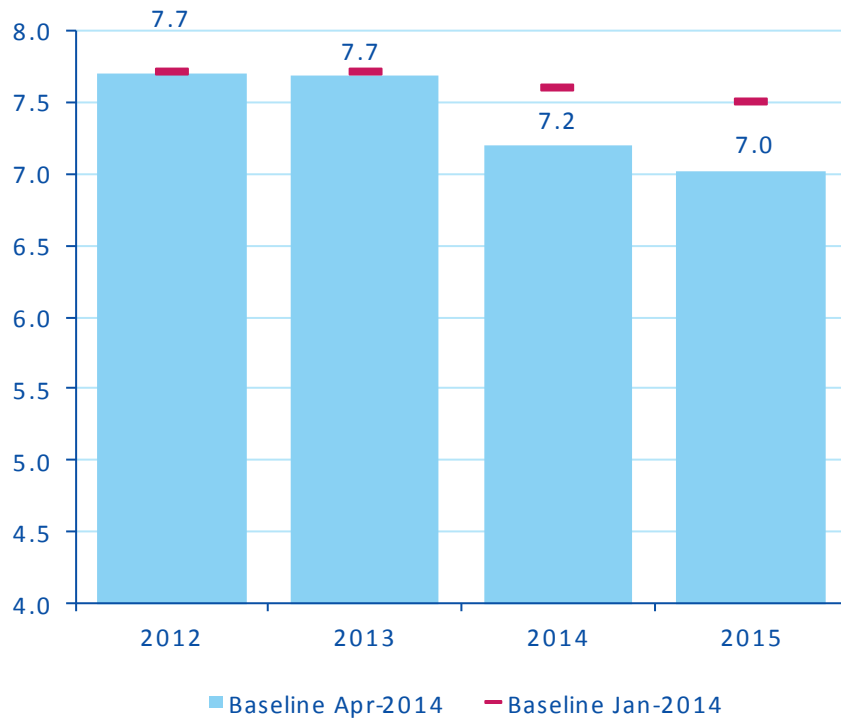
Source: BBVA Research, BIS and OECD



China: towards a “tolerable” 7%

China: GDP growth (% , yoy)

Source: BBVA Research



The government will continue with reforms and will implement measures to reduce financial risks

We expect a higher adjustment in investment than in consumption

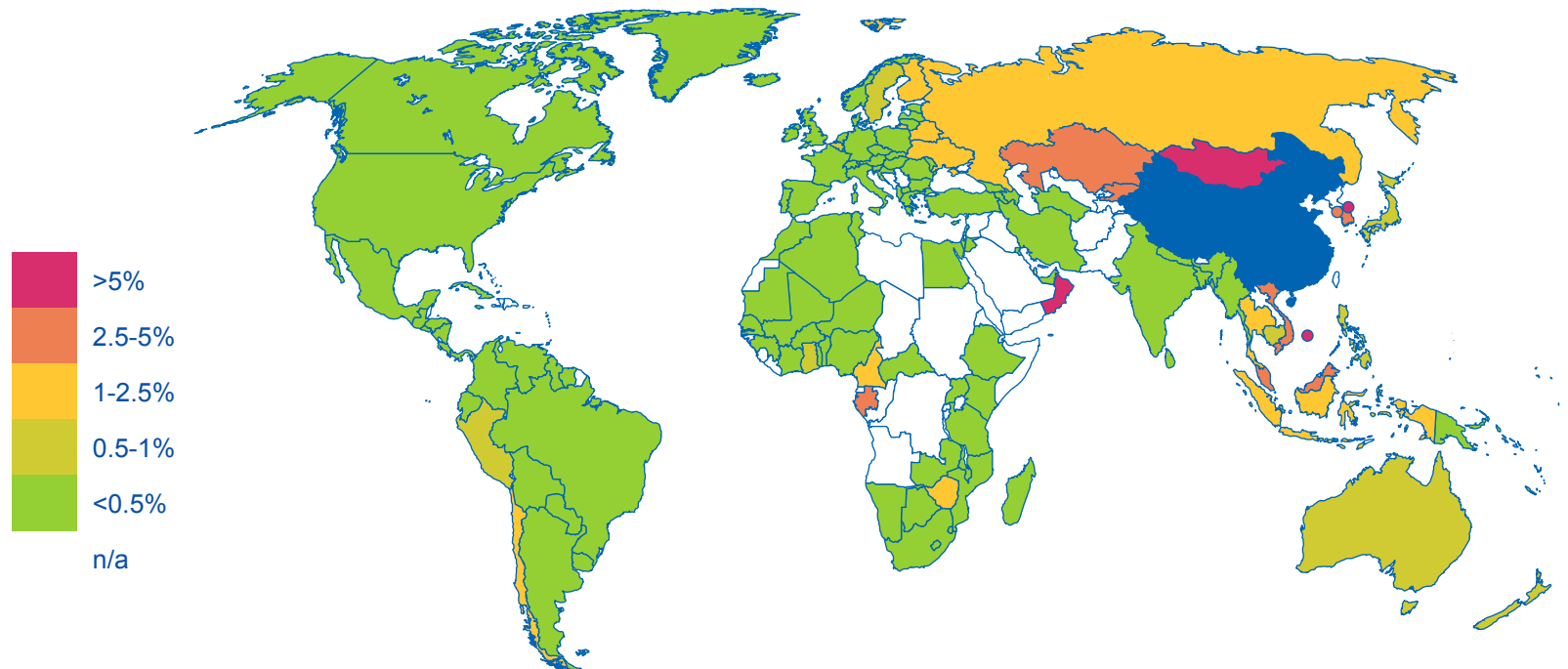
In case of higher than expected deceleration in the economy (below 7%), there is room for public response (investment in infrastructure, fiscal stimulus)

China: What could be the impact of lower growth in China on other economic areas?

The importance of China as source of global demand has increased, but differentiation remains

Exports to China as % of GDP in 2000

Source: BBVA Research, Comtrade and World Bank

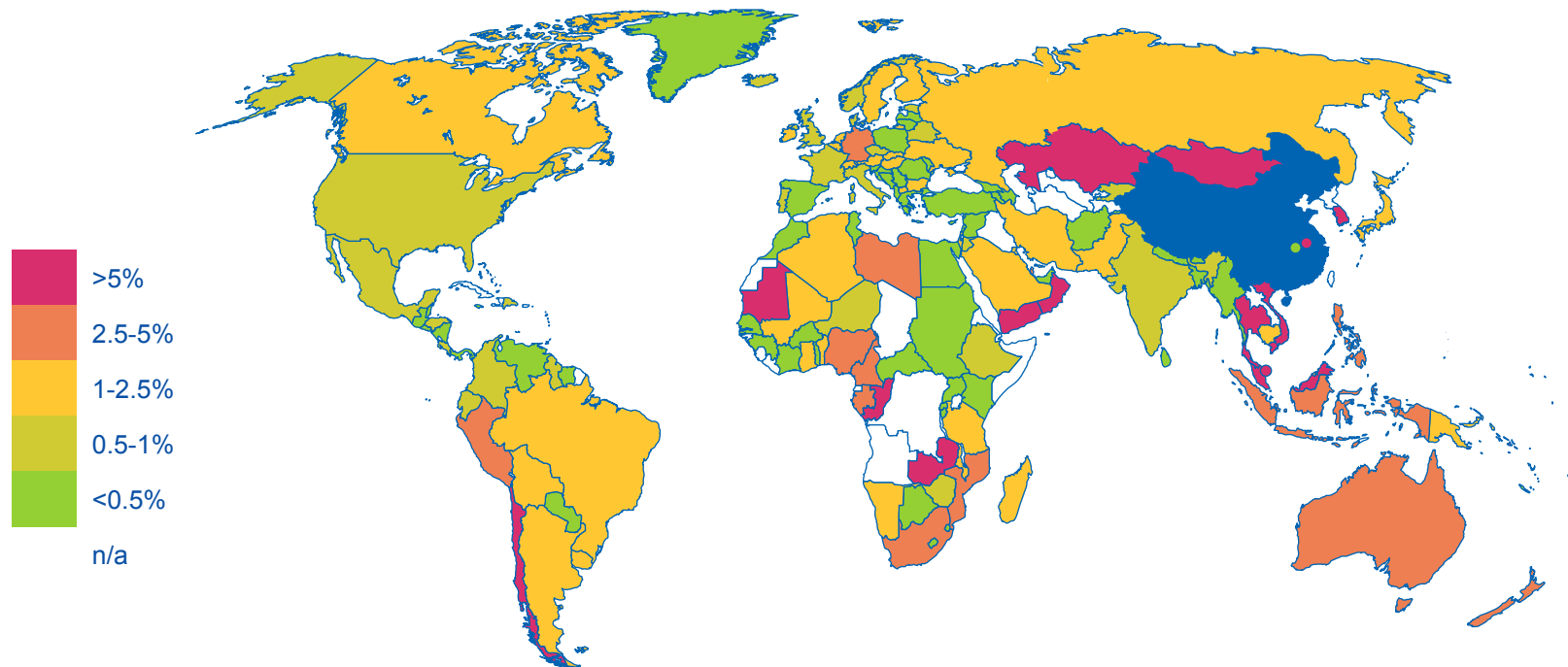


China: What could be the impact of lower growth in China on other economic areas?

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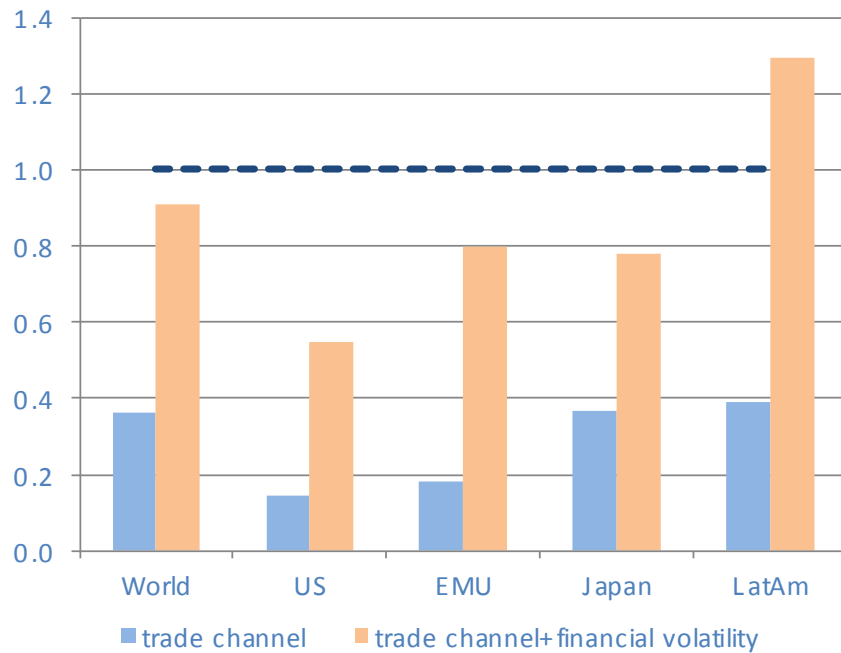
Source: BBVA Research, Comtrade and World Bank



China: What could be the impact of lower growth in China on other economic areas?

GDP growth, impact of an adjustment in China's growth. Ranking from higher to lower impact

Source: BBVA Research



It can be manageable

It will have a major impact

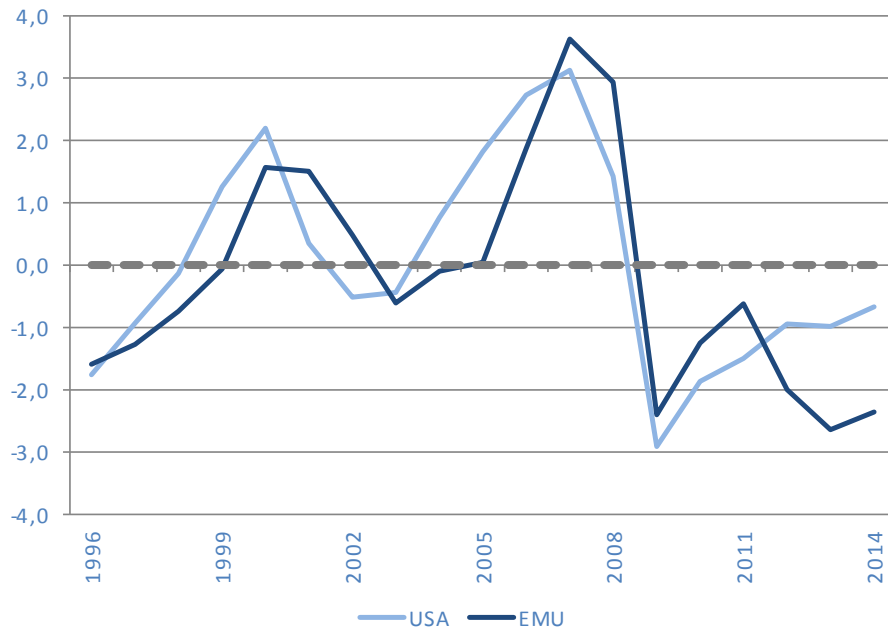
Roughly every pp of lower growth in China reduces global growth by 0.4, mainly in the trade channel (lower demand from China)

All in all, differences will remain on the impact expected between geographical areas

US and the EMU: the eurozone cycle lags behind the US cycle due to differences in shocks and institutions

Output gap (% of Potential GDP)

Source: BBVA Research

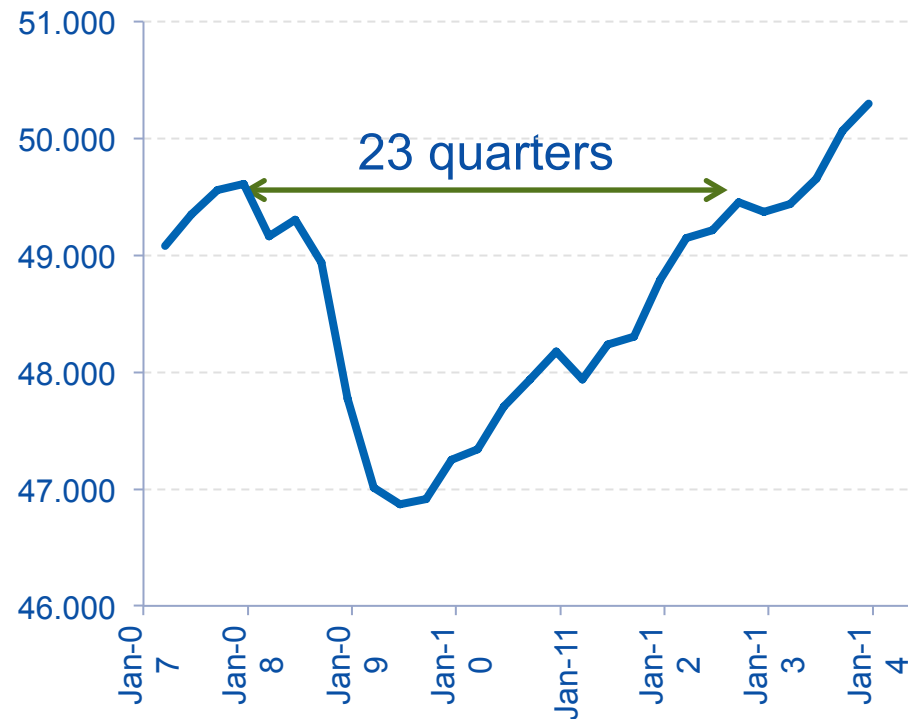


	Shocks	
	Symmetric	Asymmetric
Complete union	USA	
Incomplete union		EMU

US: After a painful deleveraging process, the economy is on better footing to expand at a sustainable pace

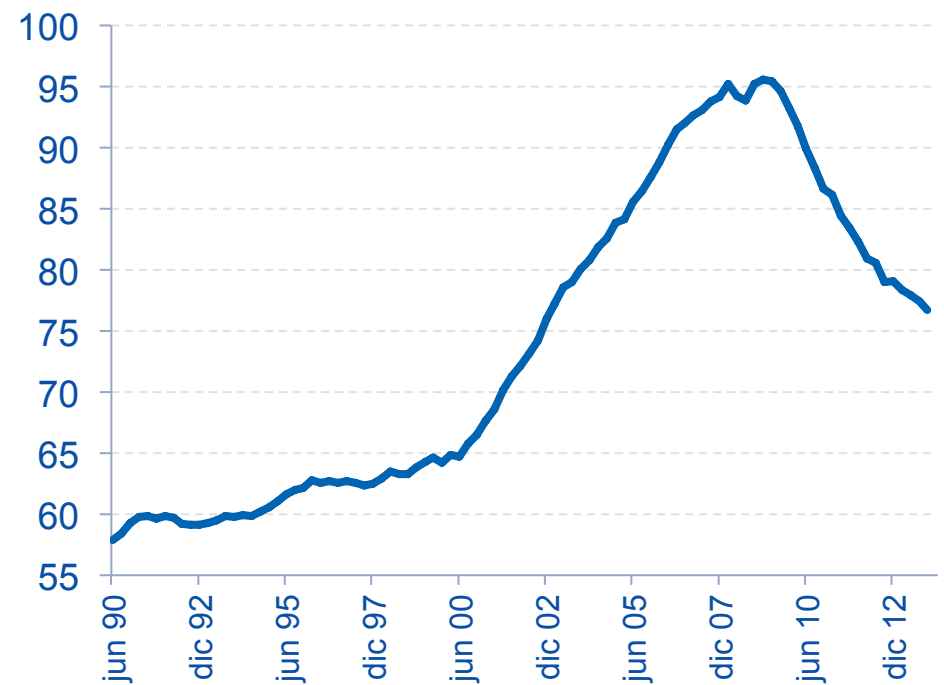
Real GDP per Capita

US\$



Households, liabilities to GDP Ratio

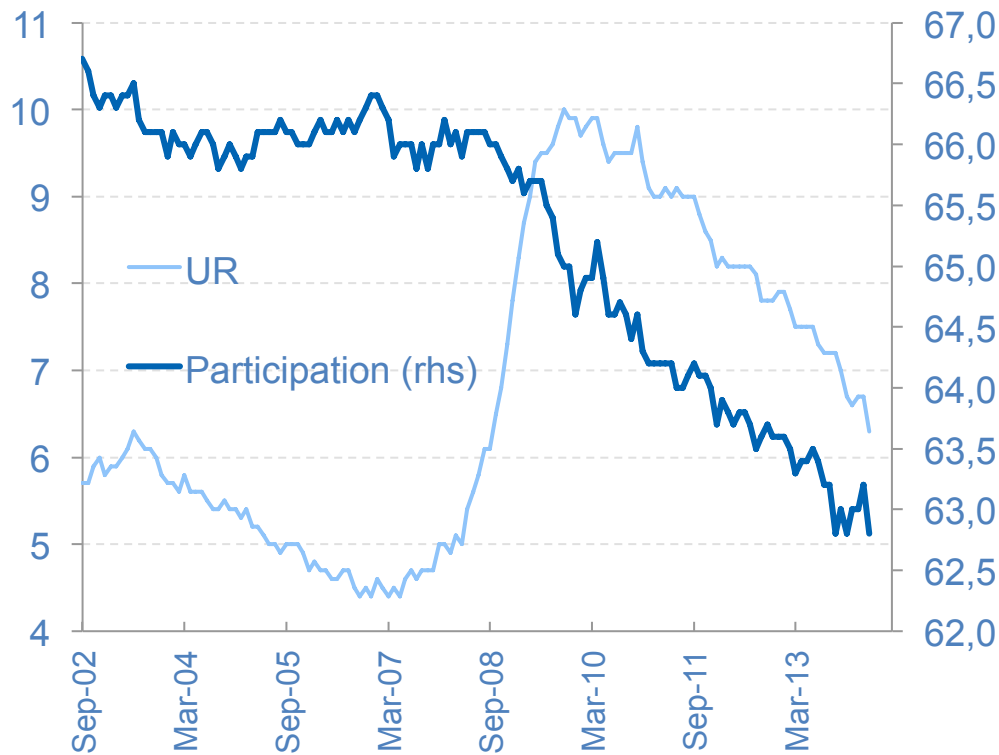
%



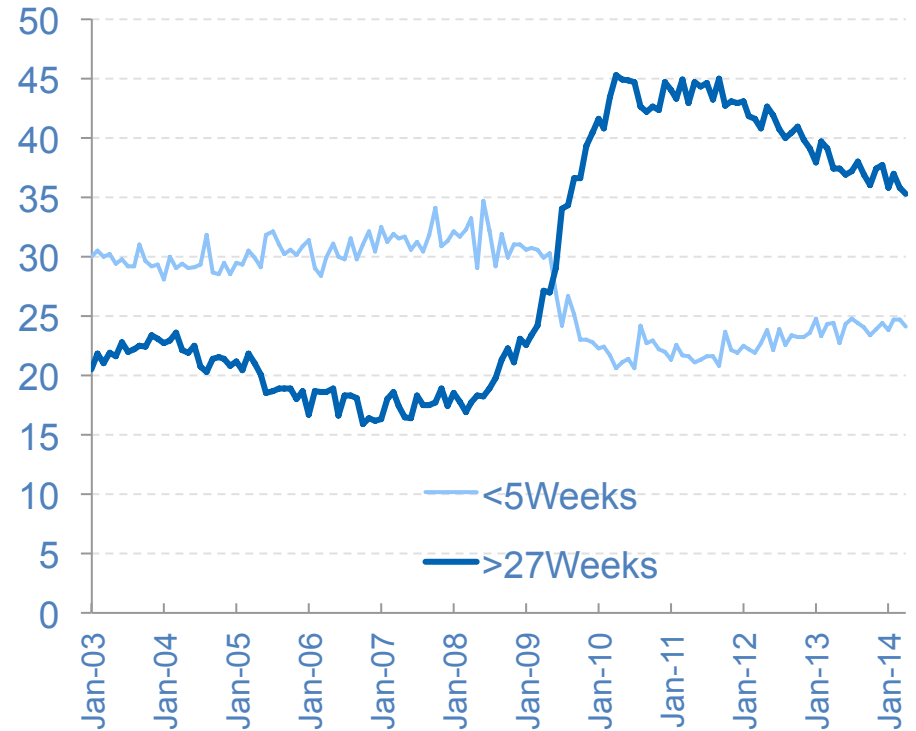
Source: BBVA Research / Haver

US: Despite the improvement in some labor market indicators, conditions remain weak

Unemployment rate and participation rate
%



Duration of unemployment
% share

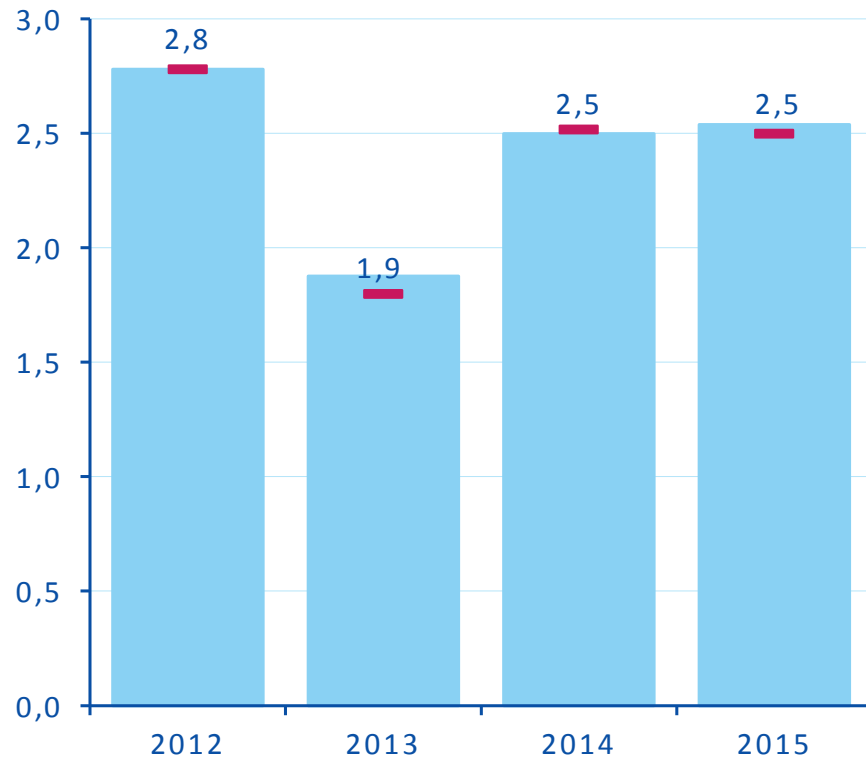


Source: BBVA Research, BLS & Haver

US: all in all, the incoming information fits a moderate rate of growth

US: GDP growth (y/y)

Source: BBVA Research, BEA



■ Baseline Apr-2014 ■ Baseline Jan-2014

We maintain our baseline scenario for growth, the 1Q14 slowdown should be short-lived (bad weather related)

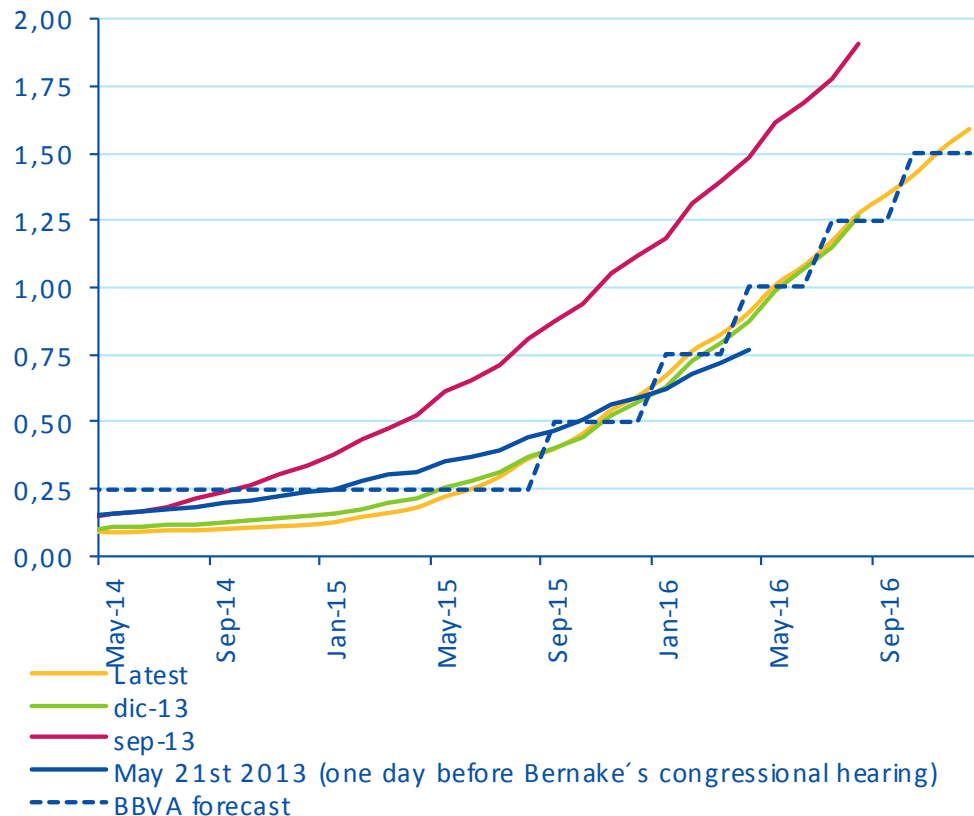
The balance of risks remain slightly biased to the upside

The FED will end tapering by the end of the year and will start increasing the Fed funds rate in 2nd half 2015

US: Expectations on the Fed's "first-hike" remain well anchored but volatility is the norm in the "normalization"

Implicit policy rates in fed funds futures

Source: Bloomberg and BBVA Research



FED's communication in uncharted waters, (after Q1 to Q3) gave a global "tapering tantrum" in May-13

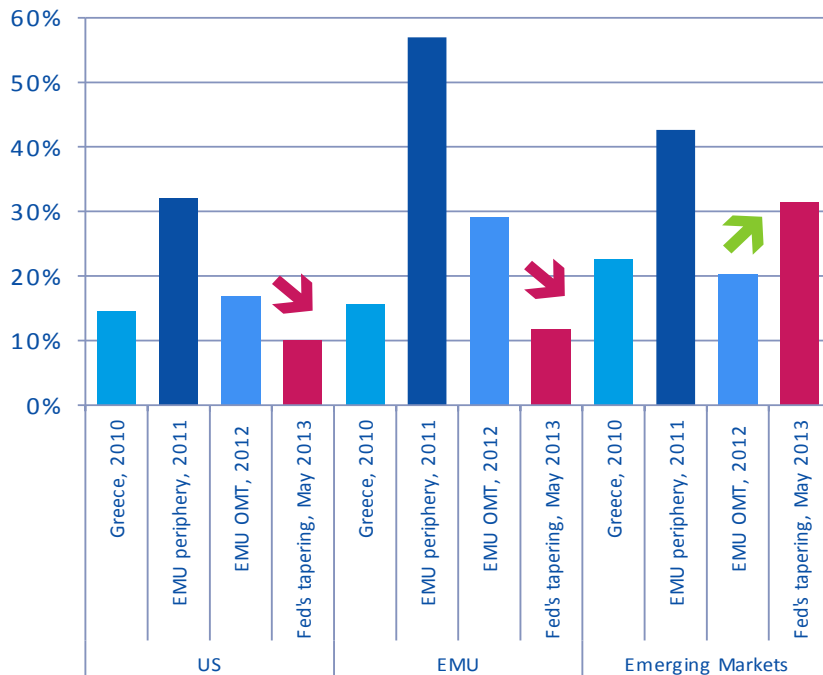
It might be a conflict between the process of tapering of the FED's balance and the tightening of rates

... but the return to normality in the US is an event of potential global impact in financial markets

In May 2013 markets perceived that the end to Fed's balance raise was near, which increased global volatility, especially in emerging markets

Financial tensions vs Lehman

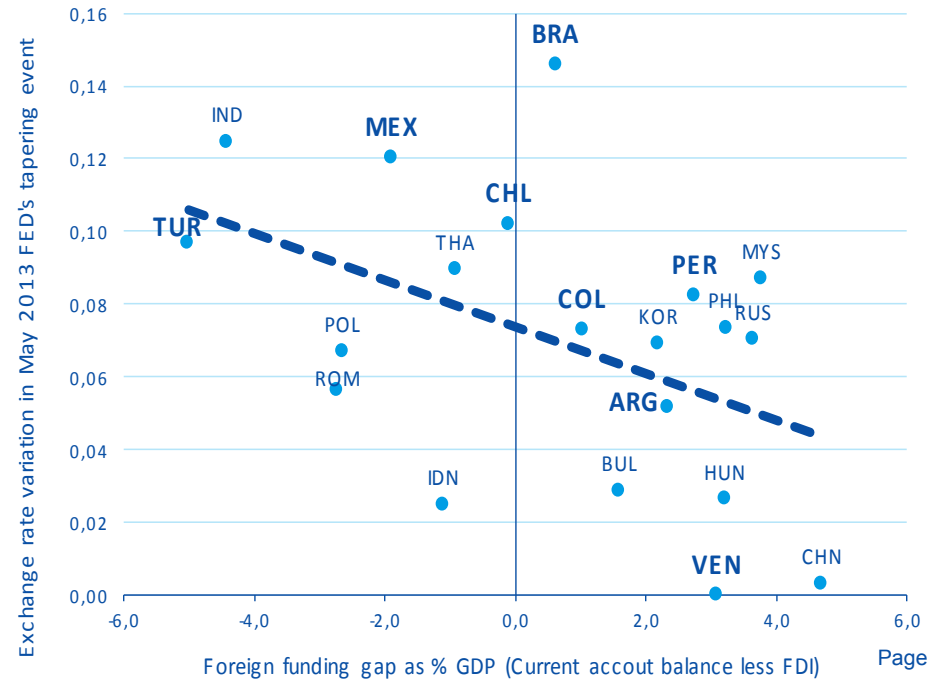
BBVA Research's Financial Tension Index vs Lehman=100%
Source: BBVA Research



Exchange rate volatility was higher in emerging economies with larger external financial dependency

Exchange rate volatility in May-June 2013 and external financial needs

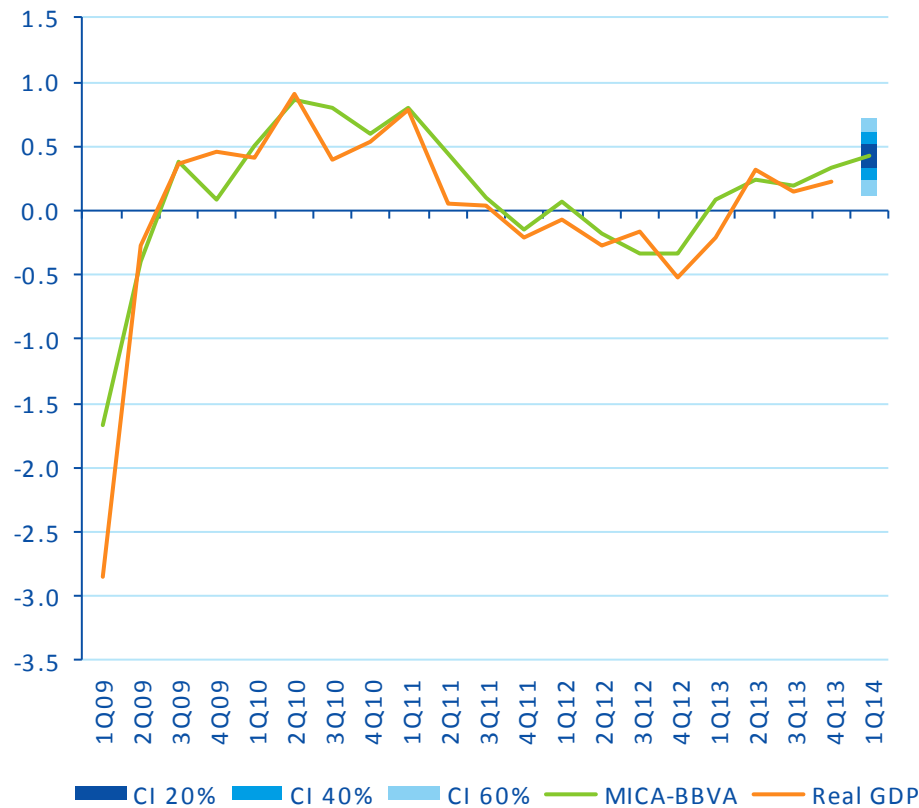
Source: BBVA Research



Eurozone: Incoming data improving

MICA-BBVA model of short term GDP (% QoQ)

Source: Haver and BBVA Research



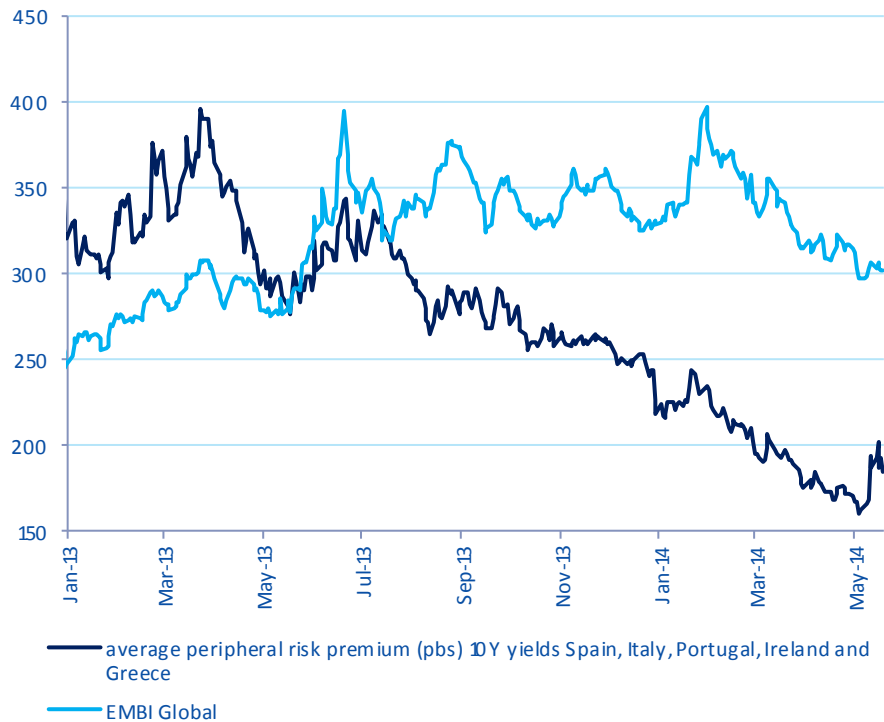
GDP growth projection for Q1 at 0.4% QoQ, above our previous projection (0.3%)

The second quarter has started also more positively than expected (0.2%)

Eurozone: Funding conditions improve and fiscal policy is less restrictive

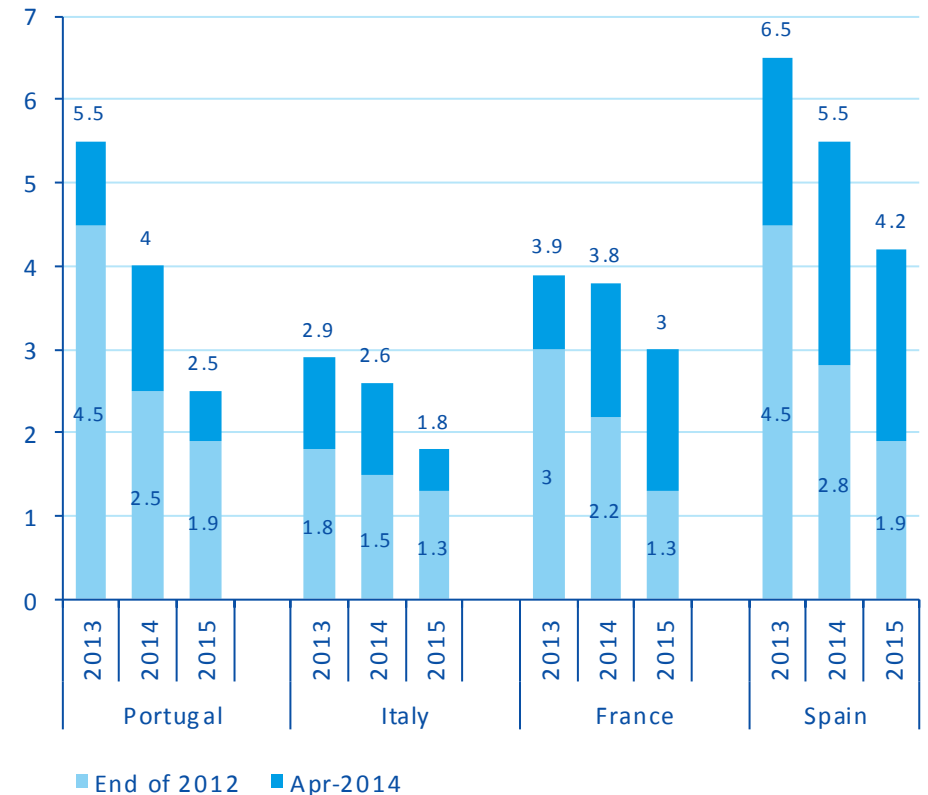
European peripheral risk and EM risk

Source: Bloomberg and BBVA Research



Change in public deficit targets

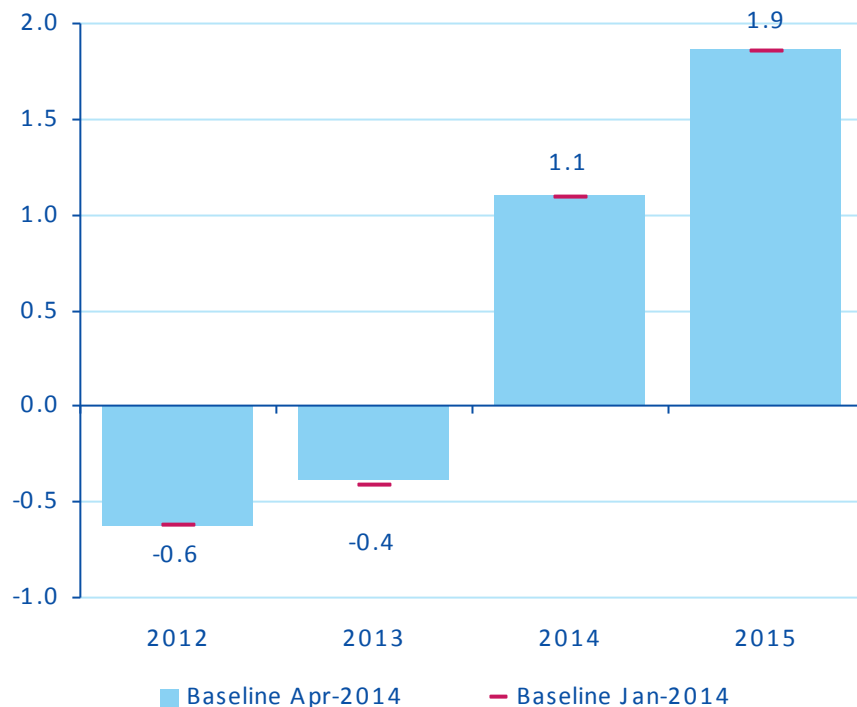
Source: Eurostat and BBVA Research



Eurozone: ... as result of which economic growth gains momentum

Eurozone: GDP growth (YoY)

Source: BBVA Research



Domestic demand will contribute to the recovery in 2014, especially investment, with resilient private consumption

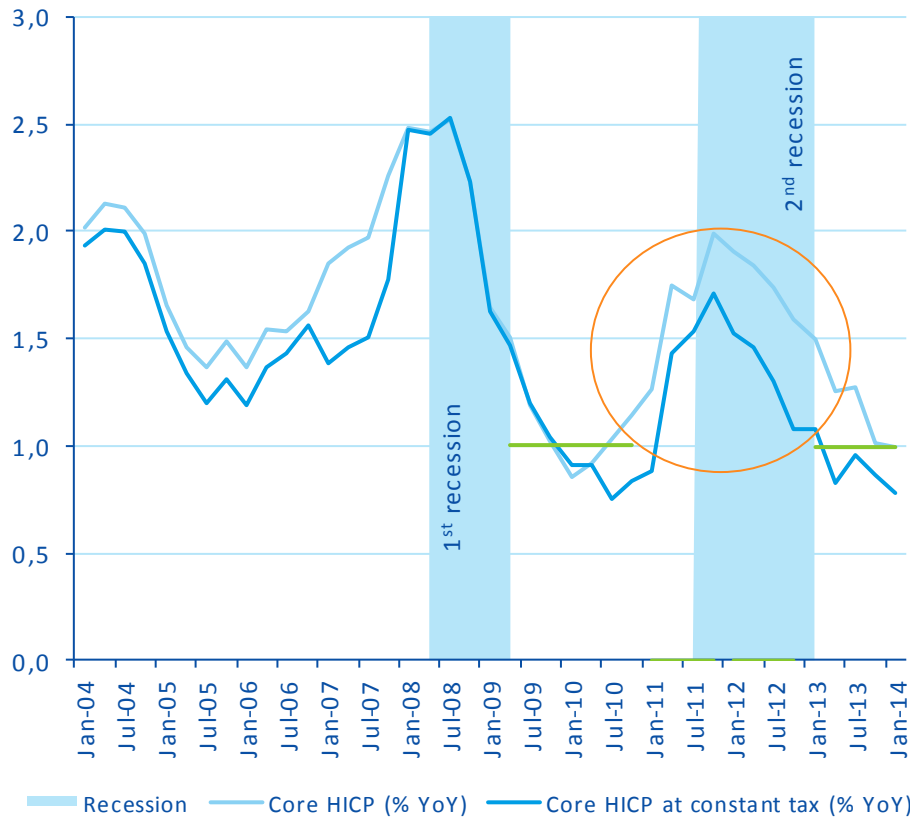
The euro strength will slowdown the contribution of external demand to growth

Ongoing banking union and lower financial stress should support the credit recovery in 2015 signaling the end of the crisis

Eurozone: Strong recession, especially in domestic demand, has weighed on prices since 2009

Eurozone: Core inflation (% YoY)

Source: Eurostat and BBVA Research



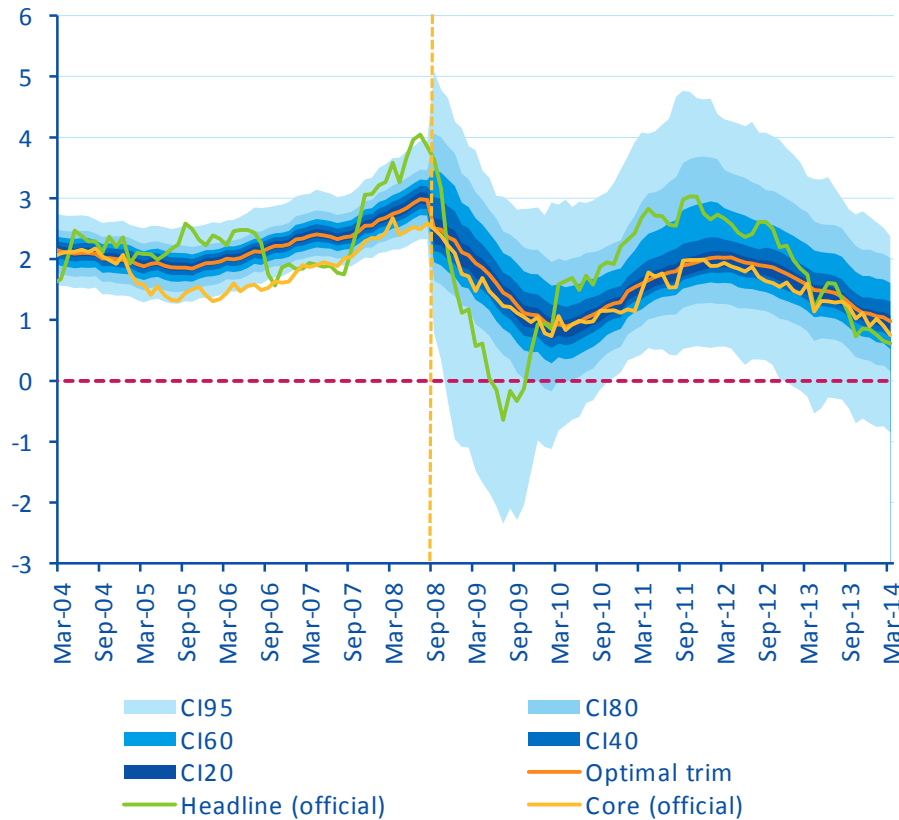
Inflation has declined coinciding with the past recession

The reversing of recent tax hikes has also had an impact on disinflation

Eurozone: ... and very low inflation over a protracted period of time could end up pushing down inflation expectations ...

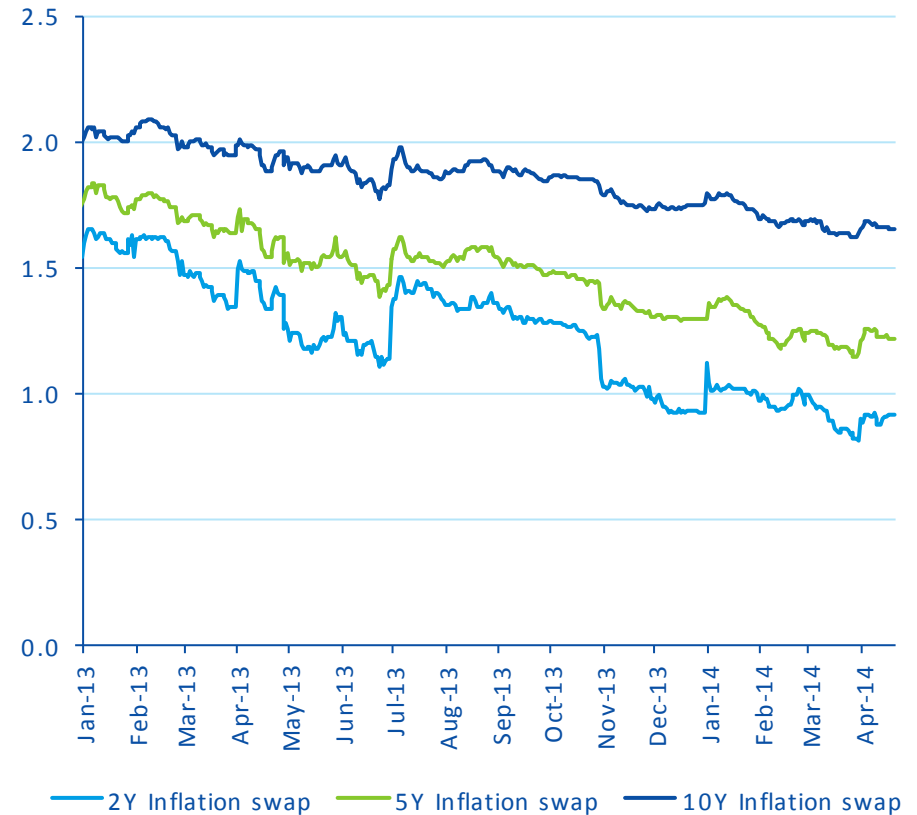
Eurozone: inflation (% YoY)

Source: BBVA Research



Eurozone: inflation swaps expectations (%)

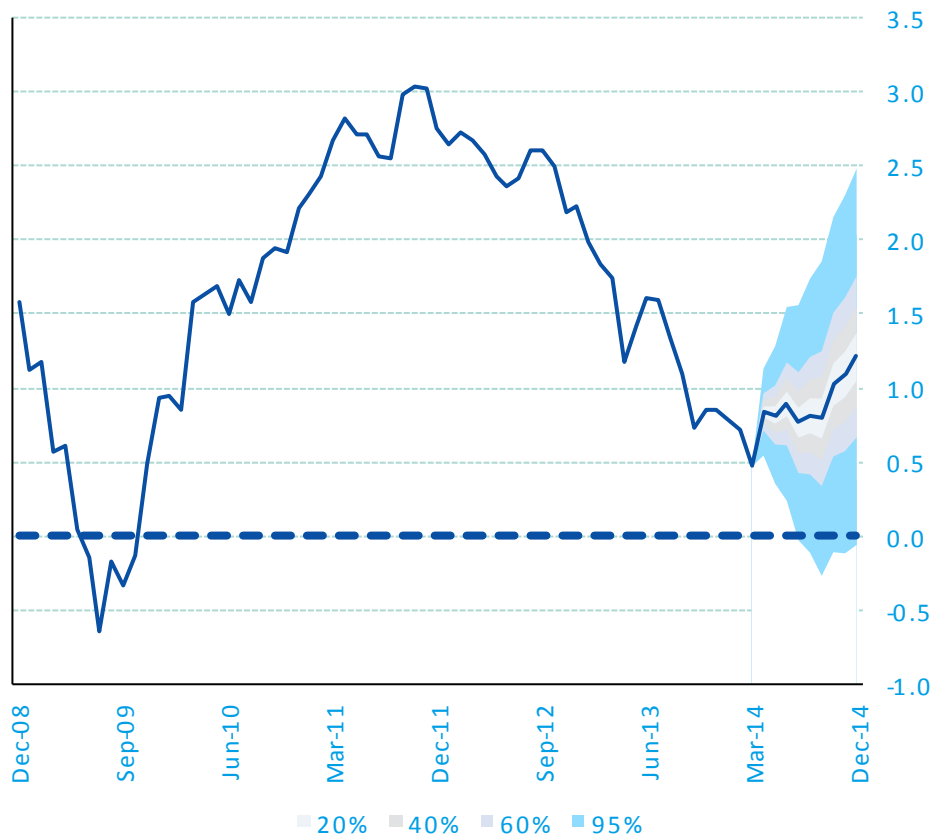
Source: Bloomberg and BBVA Research



Eurozone: the expected cyclical recovery should favor a rise in inflation, but well below the ECB's objective

Inflation in the eurozone: baseline scenario

Source: BBVA Research



The decline in headline inflation over 1Q14 accumulated in the more volatile components; core inflation remained stable

Downward pressures come from the euro appreciation and lower raw material prices

The current recovery in demand, lower financial stress and better bank lending capacity reduce deflation risks

ECB's reaction function: contingencies that would warrant a monetary policy reaction

Contingency	Policy response	What do we expect?
Unwarranted tightening of policy stance	Lower interest rate corridor, negative depo, extension of full allotment, new liquidity injections.	Actions expected to be taken in June: refi rate cut and negative deposit rate
Further impairments in MP transmission	Targeted long-term refinancing operation, ABS purchase.	Announcements of likely actions to be taken in the coming months: extension full allotment, targeted LTRO, abs, non-sterilization SMP
Worsening medium-term outlook of inflation	A more broad based asset purchase programme (QE).	Door open for QE (low probability, not our baseline scenario)

QE: main channels by which QE may alter real rates

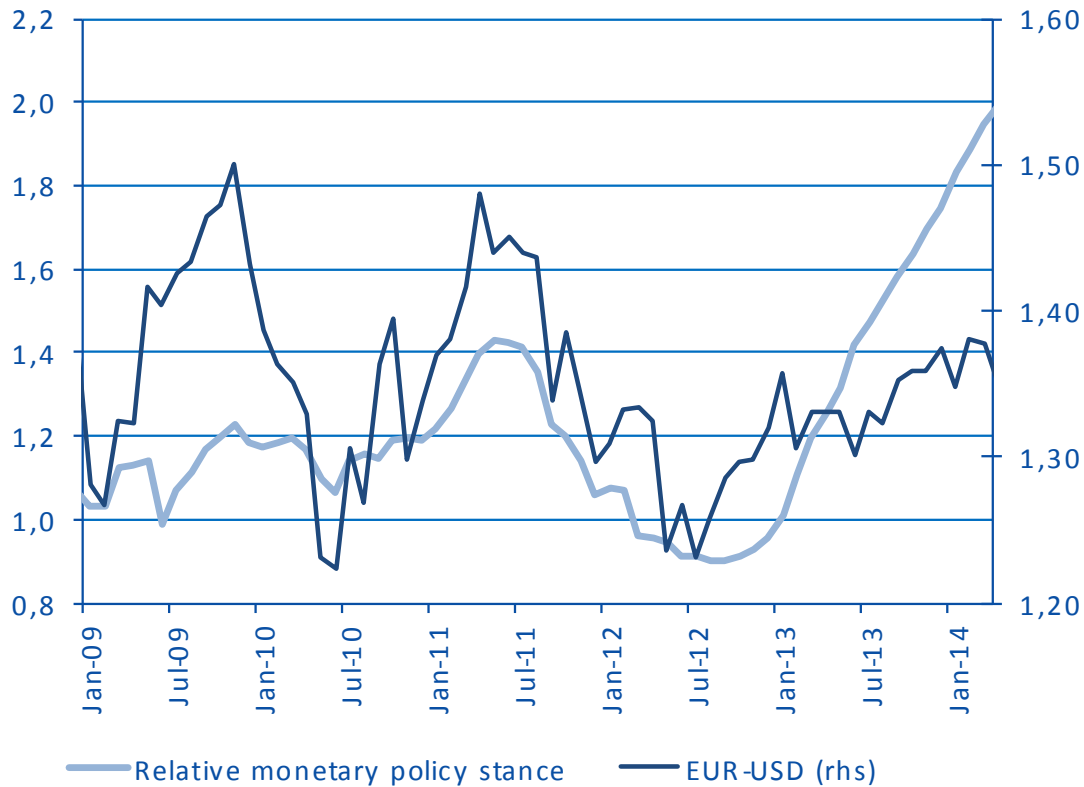
	Conclusions from recent experiences	Main caveats in the EZ
Signalling channel	QE announcements “postpone” date of first rate hike by around 4 to 6 months.	<ul style="list-style-type: none"> • Can it help reduce fragmentation? • How relevant is moral hazard? • Enough support?
Targeting channel	In QE1, it explained between 50% and 70% of the reduction in 10Y Treasury yields.	
Liquidity channel	The only channel to raise rates (liquidity premium).	
Credit channel	Large impact on riskier bonds, with a multiplier effect through the strengthening of the financial sector’s balance sheets.	
Inflation channel	QEs’ efficacy on this front remains a topic of heated debate.	

QE simulation: CB balance sheets have been an important driver of FX

Relative monetary policy stance¹ vs EUR-USD

¹ Relation between Fed and ECB central bank assets, ratio Fed/ECB

Source: Bloomberg and BBVA Research

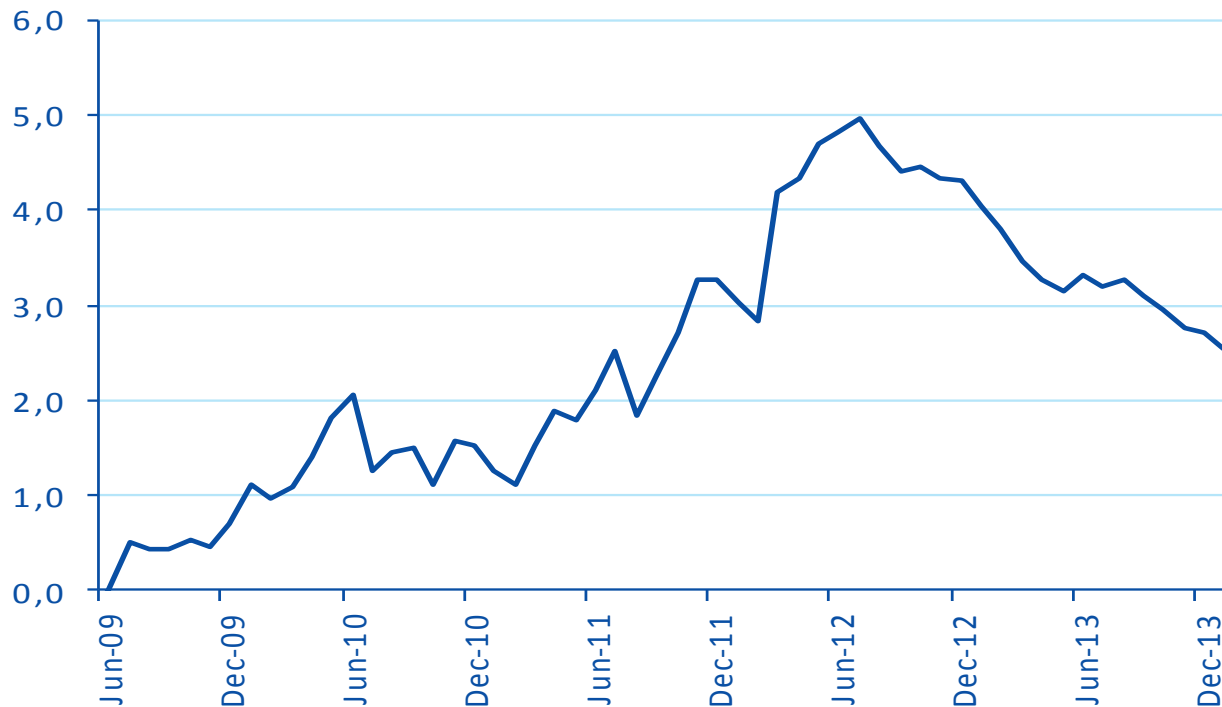


If the ECB embarks in a QE of 1 trillion (one year time program and at the same time the Fed continues with the tapering) this would depreciate the euro by around 8%

ECB's action is too needed to diminish financial fragmentation in the eurozone

Composite measure of eurozone financial fragmentation*

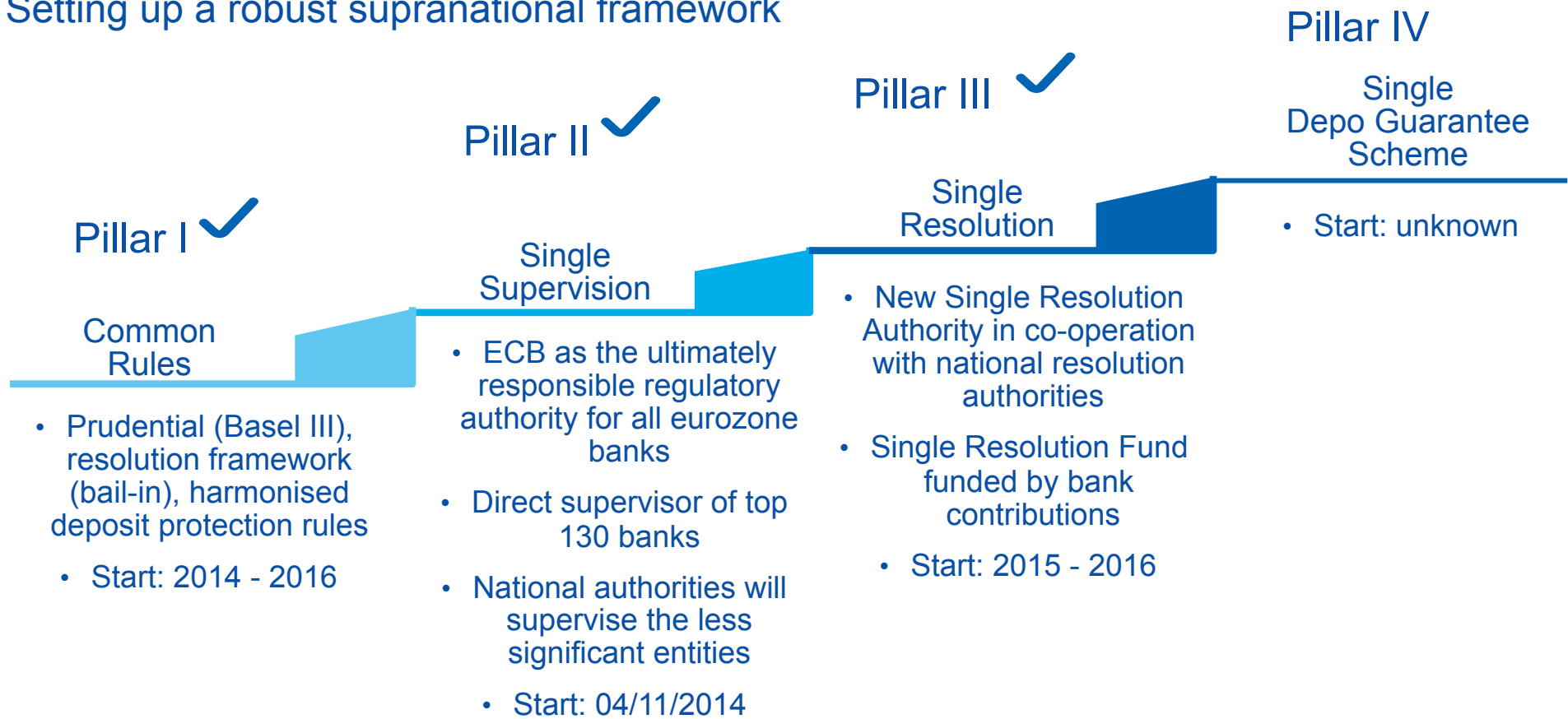
Source: BBVA Research and Bloomberg



* See Annex for more details

Banking union: key to reduce financial fragmentation

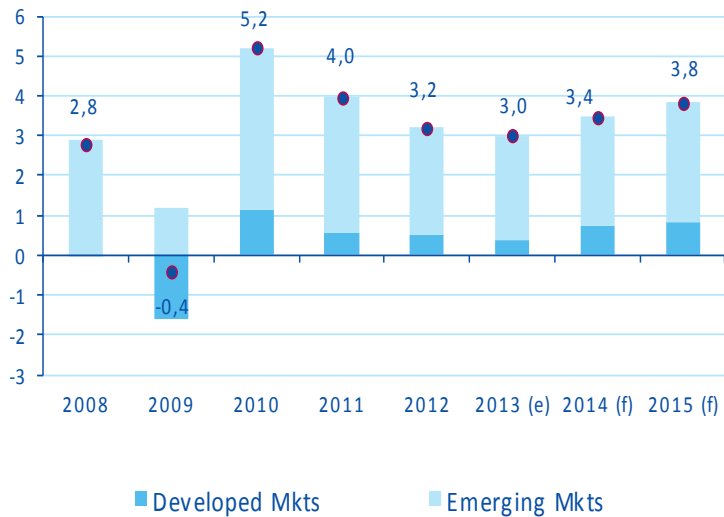
Setting up a robust supranational framework



Main messages

Global GDP growth (%)

Source: BBVA Research



Global Economic Scenario

Global growth remains robust; the sustained recovery in DM offsets the EM slowdown.

Lower growth is expected in China as authorities are focused on tackling vulnerabilities

China's slowdown and the Fed's tightening are the main significant across the board.

The US and the eurozone

US: after a painful deleveraging, the economy is on better footing to expand at a sustainable pace

Eurozone: the economic growth gains momentum but "too low" inflation is a concern

ECB will act against monetary tightening and (if needed) to repair transmission channel and to avoid deflation risk

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The global outlook, the US and the eurozone

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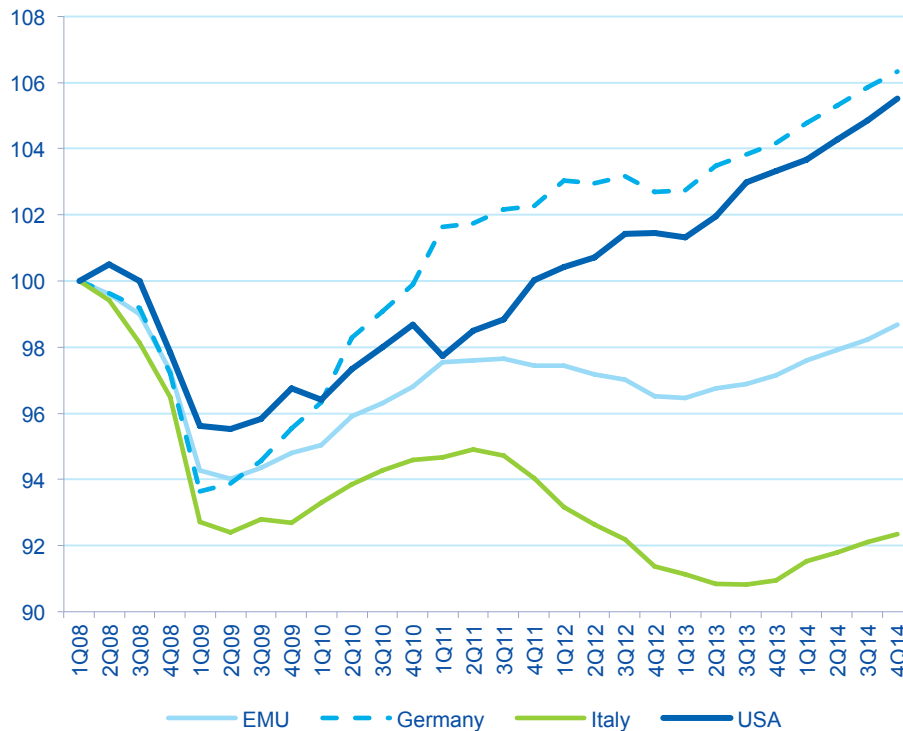
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US and the EMU: the eurozone cycle lags behind the US cycle due to differences in shocks and institutions

GDP per working age population 2Q08=100

Source: Eurostat and BBVA Research



As a result of the imbalances accumulated before and during the crisis, and the lack of banking, fiscal and economic union ...

... EMU countries exhibit large differences in unemployment rates and in GDP per working-age population, ...

... which are correlated with creditor and debtor positions of each country -> consensus on European economic policy is difficult

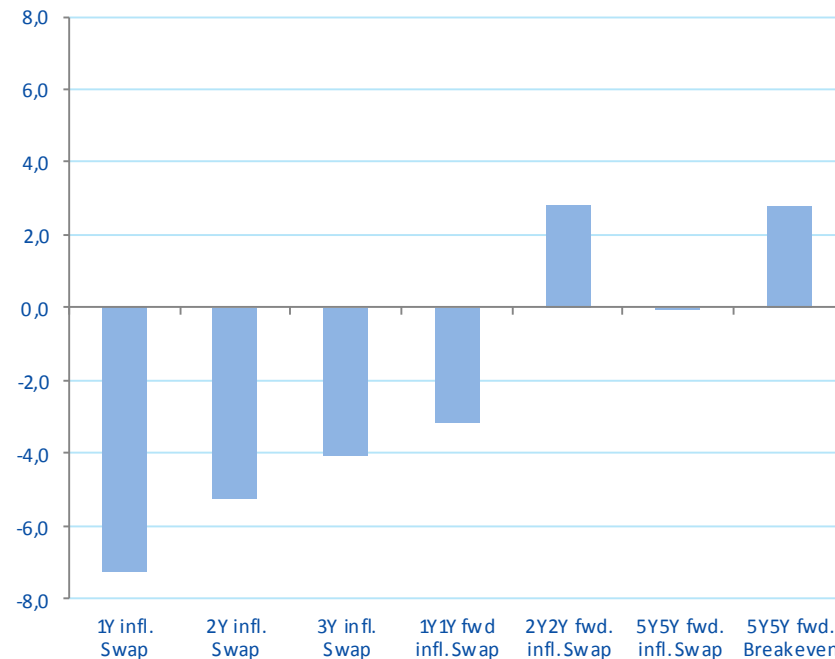
Inflation surprises affect short-term inflation expectations

A simple case study indicates that, on average, market-based inflation expectations react to surprises in inflation, a pattern that is more evident since 2013.

Impact on inflation expectations*
Change in five-day rolling average (daily data, bps)
Source: Bloomberg and BBVA Research

	Downside surprises on Inflation	Upside surprises on Inflation	Inflation surprises Statistical significance**
1Y infl. Swap	-7,2	-0,1	YES
2Y infl. Swap	-5,2	3,3	YES
3Y infl. Swap	-4,1	2,4	YES
1Y1Y fwd infl. Swap	-3,2	6,2	NO
2Y2Y fwd. infl. Swap	2,8	3,1	NO
5Y5Y fwd. infl. Swap	-0,1	-0,8	NO
5Y5Y fwd. Breakeven	2,8	3,0	NO

Impact on Flash HCPI
Change in five-day rolling average (daily data, bps)
Source: Bloomberg and BBVA Research



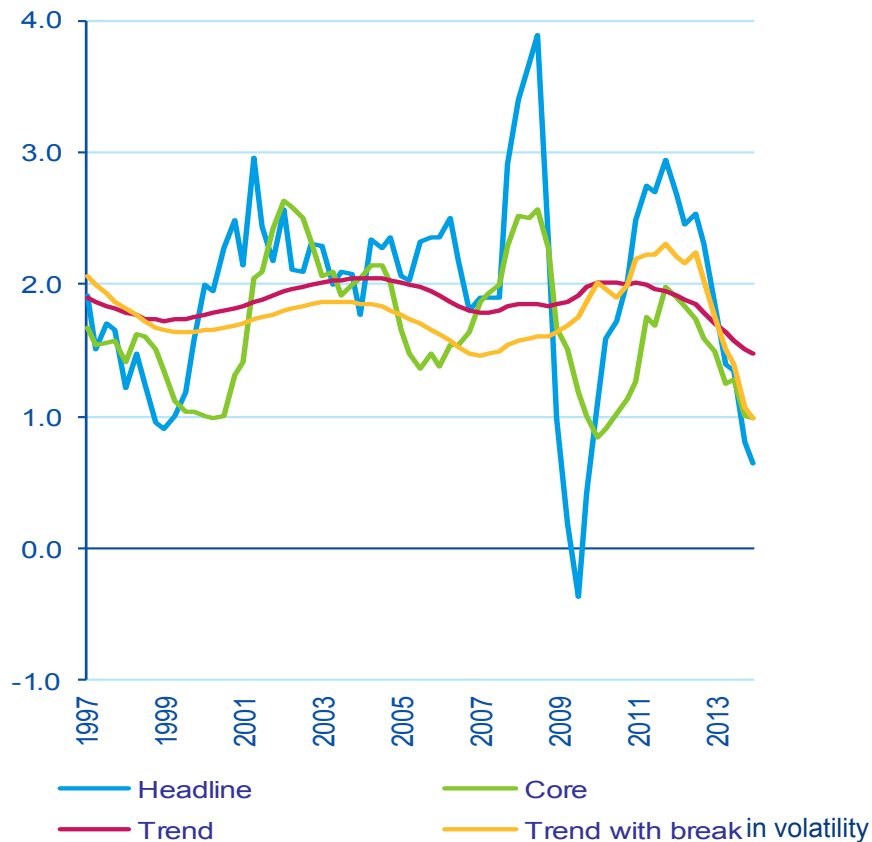
* Simple average of German and French inflation expectations. Sample: Jan 2013 up to now.

** Significance largely driven by a small number of large surprises in inflation

Measuring trend inflation through alternative measures

Eurozone: inflation (% YoY)

Source: BBVA Research



Measuring trend inflation as a latent variable, methodology

1. The model is able to discriminate transitory from permanent deflationary episodes

2. Inflationary pressures are embedded in the performance of some macro variables (GDP, investment ratio, unemployment rate and inflation)

3. In the EZ the main caveat is the limited sample, which implies to take some assumptions: with and without variance change in inflation

Trend inflation in the EZ is trending downwards (more rapidly if a break of inflation volatility is considered) and currently is well below the target, at 1.5% (or 1%).

Fragmentation: implications for monetary policy.

Under “normal”
conditions

Conventional policy is less effective
as the monetary-policy transmission is curtailed.

It generates unwanted (asymmetric) risks

Under the zero-
lower-bound
restriction

Forward guidance (FG) seen as an “optimal
commitment device”
as there is no room left for conventional policy

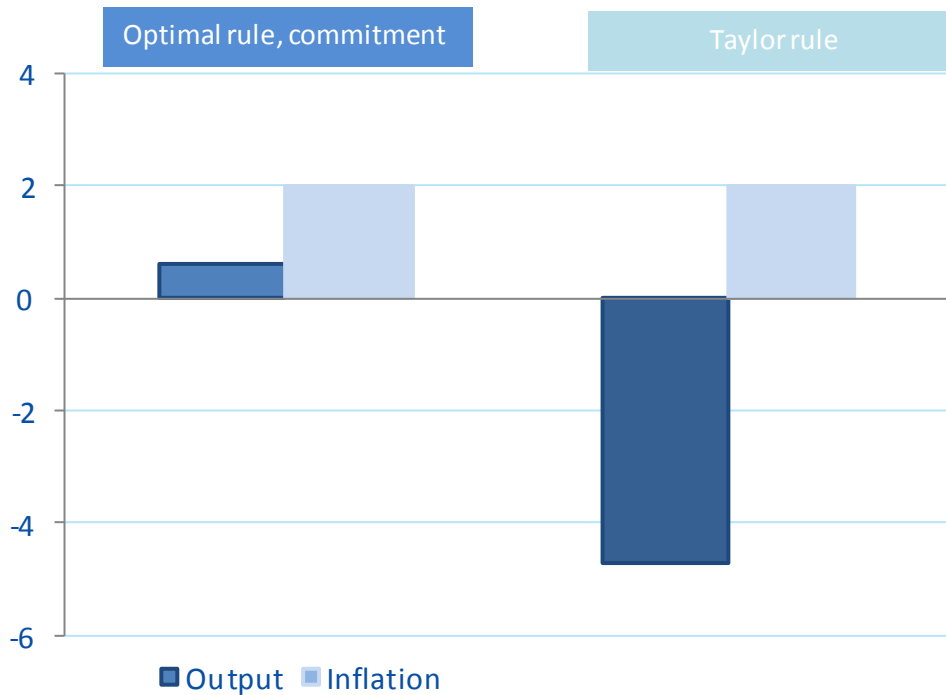
Does fragmentation affect FG?

Fragmentation calls for the strengthening of FG

Under models of optimal policy under commitment, fragmentation imposes the need for lower rates for a longer time: **forward guidance should be reinforced.**

Output gains/losses and inflation in the medium term*

Source: BBVA Research



*Cumulative output gains/losses relative to equilibrium

Interest rates under different policy rules

Source: BBVA Research



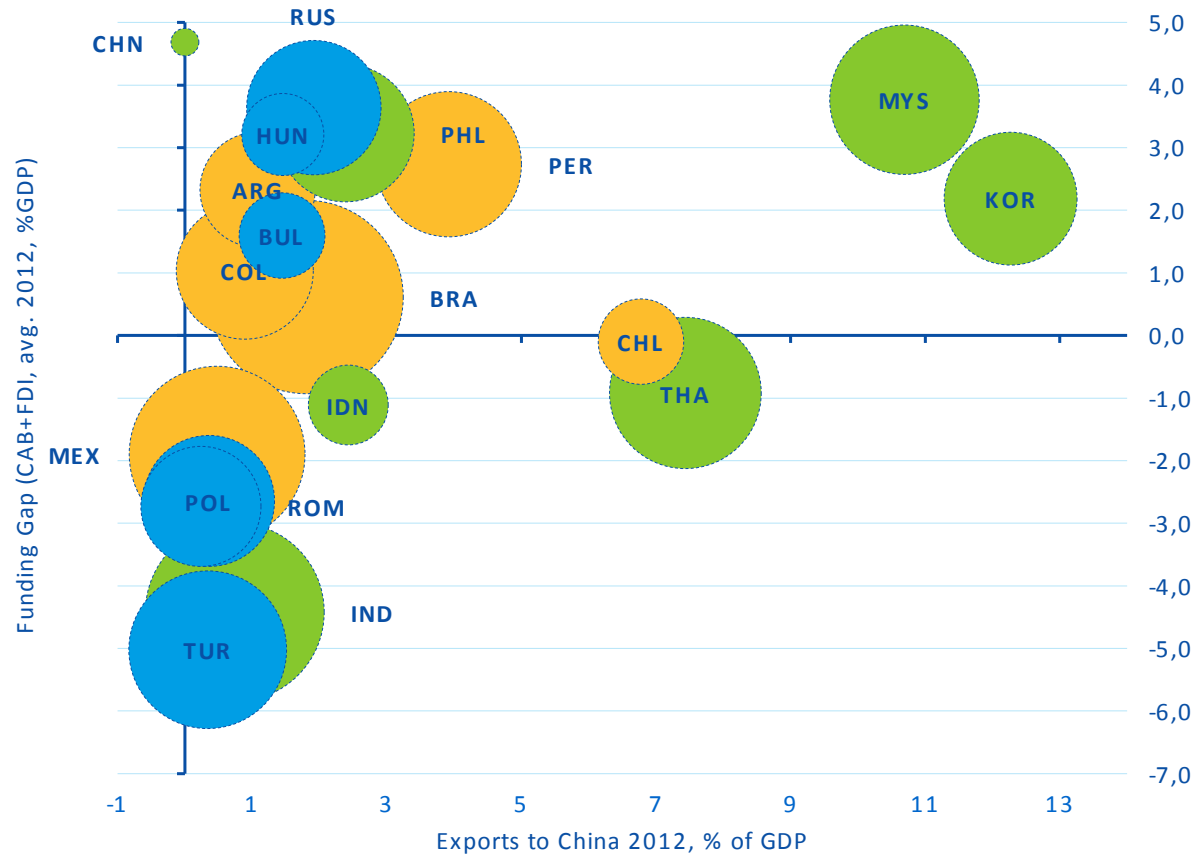
*Fragmentation is modeled by a lower interest rate elasticity in the IS curve

All in all, heterogeneity characterizes the impact of a deceleration in China and interest rate raise in the US

Emerging Markets' exposure to China's slowdown and foreign funding needs

The size of the circle is proportional to the exchange rate volatility in the Fed's tapering episode, May 2013

Source: BBVA Research



Annex: Financial fragmentation index

In order to monitor the financial fragmentation in the euro area, we constructed a composite measure of euro area financial fragmentation. The advantage of utilizing such index is the ability to monitor, on a monthly basis, more accurately the evolution of financial fragmentation.

The FFI is constructed using principal component analysis, a statistical method of extracting factors responsible for the co-movement of several variables. We assume that financial fragmentation is the primary factor influencing this co-movement, and by extracting this factor (the first principal component) we are able to create an index.

The components are:

- the interquartile range of euro area countries* two-year government bond yields ,
- the cross-country dispersion (specifically, the coefficient of variation: the ratio of the standard deviation to the mean) of bank lending rates to corporates and households (average),
- the gross liquidity provision by the Eurosystem as a share of bank assets, and
- the Target 2 balances surplus.

To combine these varied indicators**, we calculate a Z-score for each, and then estimate the first principal component of these Z-scores.

* Ireland, Spain, Germany, Italy, France, Netherlands, Portugal, Greece, Belgium, Finland and Austria.

** Data: monthly frequency. Sources: National Central Banks, ECB and Bloomberg