BBVA RESEARCH

Global Economic Outlook

Third Quarter 2014
Economic Scenarios Unit

- Global growth will improve after the pause seen in the first half of 2014, accelerating in the US and the eurozone and gradually decelerating in China.
- Complex global scenario. The risk of a hard landing in China is low and the Fed has anchored financial volatility, but geopolitical risks are emerging everywhere.
- What is the outlook for the global economic scenario? The still pending balance-sheet adjustment could slow the recovery in the medium term.

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Closing date: 4 August 2014

1 A slower global recovery in a complex environment

The global recovery never really took off in the first half of 2014, with growth either restricted or in decline in some of the heavyweight economies such as China and the US. Thus, according to our estimates, global growth moderated by nearly one percentage point from the 3.2% registered in the second half of 2013. The surprisingly sharp drop in US GDP growth in 1Q14 was the principal cause of the slowdown which **moderated but did not interrupt global growth**, which we still think will reach 3.8% next year. The indicators of confidence in activity and financial volatility are consistent with a gradual improvement, although **uncertainty remains biased to the downside,** given the resurgence of geopolitical risks and concerns regarding the impact on global financial flows and asset prices of the upcoming higher interest rates in the US.

Our positive outlooks for the advanced economies (AEs) remain unchanged for 2015. The fall in US GDP in the first quarter of 2014 was mainly due to transitory factors (bad weather, the destocking process), as reflected in the most recent data. All in all, the **severity of the adjustment has led us to reduce our growth outlook for FY14 from 2.5% to 2.0%**. In the case of the **eurozone,** although we have left our previous growth forecasts unchanged (1.1% in 2014 and 1.9% in 2015), the risk is now **moderately to the upside given the measures announced by the ECB** in June. The ECB is trying to anchor interest rates, lower the cost of funding for the banks and, at the same time, ease credit availability for households and companies. In addition, we think it has reduced the risk of more intense disinflation by strengthening the banking channel for the transmission of monetary policy.

As regards **China**, our outlook is unchanged: a **very contained deceleration** from 7.7% in 2013 to 7.0% in 2015. This movement would be supported by economic policy tools on the demand side (increased infrastructure investment, easier credit for privately-owned SMEs), as well as opening-up the access to the private sector and risk management of the shadow-banking sector. That is, by supply-side measures which suggest that although credit will continue to grow, when the adjustment occurs, it will be mild. The probability of success of these measures is also supported by the substantial scope for manoeuvre available given the high level of foreign currency reserves, the low level of public debt and the control over the current account.

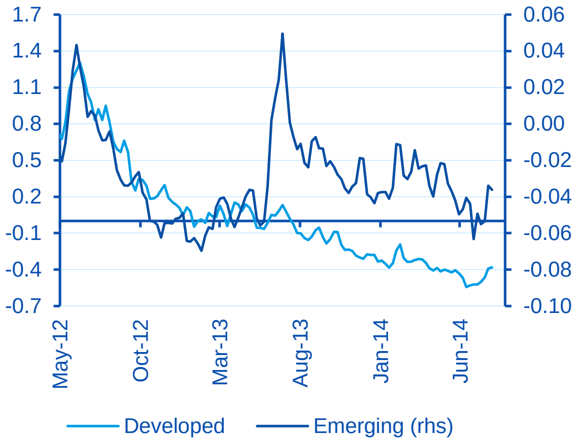
Finally, note the **characteristics of the economic scenario that weigh on the recovery and on the risks it faces,** namely the combination of: i) a high level of debt, which taking public-sector and private-sector liabilities together is no lower in the AEs; ii) comparatively low growth compared to other recoveries given the extent of economic policy stimulus; iii) even lower inflation in some of the most-developed economies; iv) interest rates at all-time lows, and even close to zero, which restricts the scope for central bank action, particularly those that have already expanded their balance sheets. **Debt service is a heavy burden on some AEs,** which is limiting expenditure decisions, particularly if the bank credit channel is still under repair. **According to our base-case scenario, the pending adjustment of economic agents' balance sheets will come with a combination of stronger growth and some inflation,** supported by a better functioning financial system since the reforms undertaken as a result of the 2009 financial crisis. However, the acceleration of economic activity is not the only possible outcome, notwithstanding the complicated geostrategic situation (Middle East, Ukraine, Iraq): even without reaching the point of being disruptive, this could start to affect the agents' expectations.

All in all, this could result in a **scenario of prolonged global stagnation,** particularly if no progress is made on the reforms that could increase productivity and encourage investment. In such a scenario, without higher interest rates either due to weak growth or to central bank action in the advanced economies, this would distort decision-making regarding debt and investment and the risk/reward ratio, which could lead to significant misalignments in financial asset prices. This hypothetical situation would pose an important challenge for economic policy management, especially in the emerging economies.

2 The global scenario is improving, but more slowly than expected

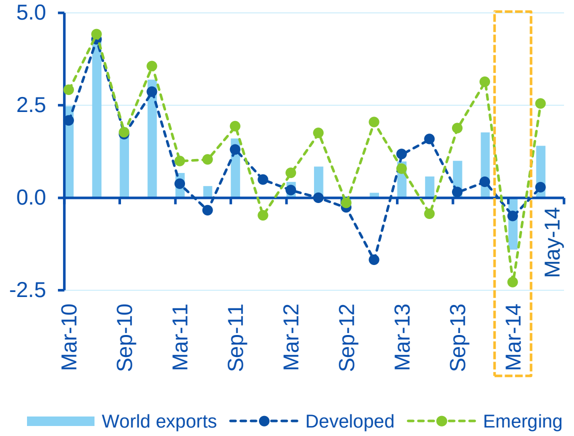
The global leading indicators are consistent with a favourable scenario for growth. First, tensions in financial markets remain low, according to our indicators, in both emerging[1] and developed markets (Figure 2.1). Second, in the year to May, worldwide industrial activity continued to grow at around 3.4% YoY, above the 3% mark reached by the end of 2013, while global trade also recovered in the same period from the intense and geographically extensive downward correction in the first quarter of 2014 (Figure 2.2).

Figure 2.1
BBVA Research's Financial Stress Index



Source: BBVA Research

Figure 2.2
Trade in goods
QoQ %



Source: BBVA Research

All of this is taking place in a global environment in which **geopolitical risk events, while not causing outright disruption to economic activity, are cropping up everywhere,** and as such increasing uncertainty. It is hard **to assess the economic impact of geopolitical occurrences,** and not only because of the inherent difficulty in predicting their outcome, intensity and scope of influence. We also have to take into account the **different means of action** this type of risks have on decision-making by economic agents. These range from **future growth and savings expectations** to **effective interruptions of the flows of goods and services,** including **financial contagion** to assets and geographies that in principle are less directly linked to an outbreak of tension. For the moment, financial volatility is at historically low levels, since **the factor dominating the behaviour of global financial markets is the Fed**, and this institution is carefully managing a very gradual exit from the exceptional monetary measures implemented in the last few years, helped by moderate growth in the US economic cycle and well-anchored inflation expectations.

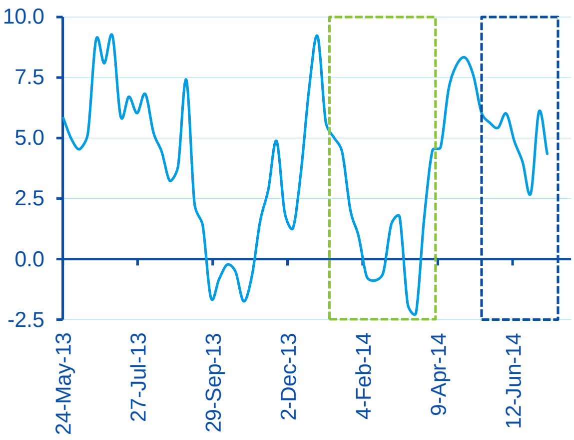
The risk of a hard landing in China, predicted by some a few months ago, is receding, thanks to the improvement in exports and in fiscal and monetary support measures. Increased external demand and the brake put on the appreciation of the yuan have helped exports to recover, while monetary policy has been relaxed by cutting the bank reserve ratios, thus favouring credit. Shadow banking controls and plans to liberalise the more regulated part of the banking sector are enabling most of this new financing to be provided by the latter segment. This combination of supervisory measures and simultaneous liberalisation to

1: The recent upturn of financial tensions in emerging markets (second half of July) is limited to Russia, which has a heavy weighting in the indexes.

help traditional banking entities compete (freedom to set interest rates, easing the entry of private investment, promoting lending to private companies over those in the public sector) should enable the deleveraging process to take place in an orderly manner, without any sharp corrections. Finally, more focused fiscal policy measures than on other occasions have also been introduced, above all in relation to the increase in infrastructure spending.

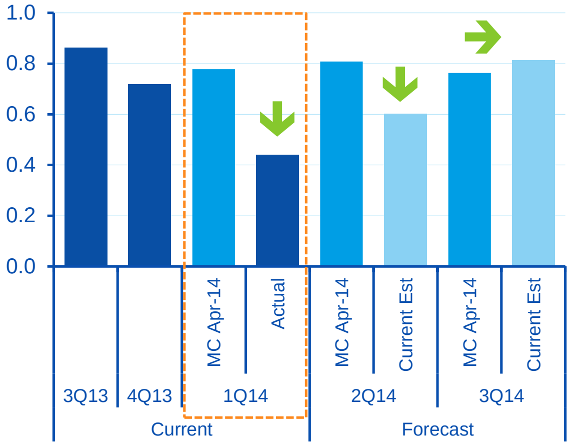
All in all, **our outlook is for a very controlled deceleration, with growth easing to 7% in 2015, from 7.7% in 2013**. Furthermore, this movement is linked to a long-term trend of an increase in household consumption over business investment, while at the same time the Chinese currency returns to its previous appreciation trend against the dollar. In short, an **economic rebalancing, with a moderate increase in debt**, for which the authorities have the room for manoeuvre provided by their high level of reserves and control of their current account, together with high levels of private savings and relatively low public-sector debt.

Figure 2.3
US BBVA Research's Weekly Activity Index



Source: BBVA Research

Figure 2.4
Global GDP growth
QoQ %

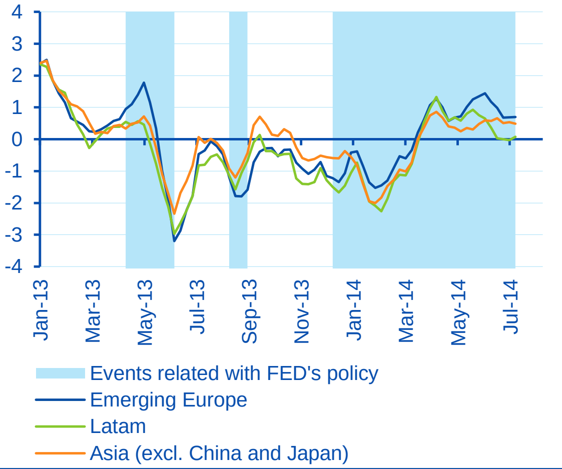


Source: BBVA Research

The fall in US GDP during the first quarter of 2014 was mainly due to transitory factors, but the intensity of the correction made us revise our growth forecast downward for 2014 from 2.5% to 2%. The 2.1% quarterly drop, in annual terms, of US GDP is the sharpest of the historical series in a cyclical growth phase. The most recent information on the situation (Figure 2.3) shows that the US economy has recovered from the intense, but transitory, effect of the bad weather and from the steep fall in the accumulation of stocks. A good demonstration of the negative surprise caused by US 1Q14 GDP can be seen in the impact it had on our estimates and short-term forecasts for world growth (Figure 2.4)

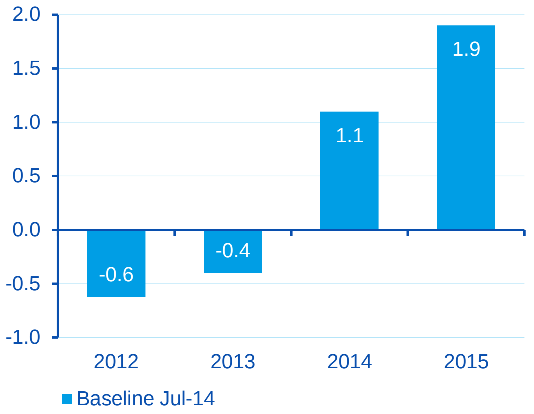
There is greater uncertainty about the perspective of monetary tightening by the Fed and, in particular, about the global impact this will have on financial markets. The Fed will stop expanding its balance sheet in October, starting a phase in which rates and monetary measures will be determined based on the incoming information about the strength of the economic cycle and the anchoring of inflationary outlooks. In our most likely scenario, the first rise in the Fed funds rate will be in 3Q15, with a bias towards this happening closer to the middle of that year. In this scenario, the US central bank's communication policy on its view of the economic situation will become more important; as such, an increase in global financial market uncertainty is also a possibility. While the measures taken to avoid economic depression have been exceptional in terms of their intensity and duration, their withdrawal may also have effects that have not been seen before on both global capital flows and on asset prices, especially in the case of emerging economies. We have already seen an example of the impact that changes in the Fed's policy could have - however likely it is that monetary policy is going to be tighter in future - between April and May 2013. The change in tone of the US central bank's communication policy then, with a reference to the likelihood of higher interest rates on the horizon, caused a reallocation of global flows from emerging markets (Figure 2.5) to developed markets with the consequent volatility, currency depreciation and higher interest rates in the former.

Figure 2.5
Portfolio capital flows to emerging markets
% of AUM, moving 4-week average



Source: EPFR and BBVA Research

Figure 2.6
Eurozone, GDP growth
YoY%



Source: BBVA Research

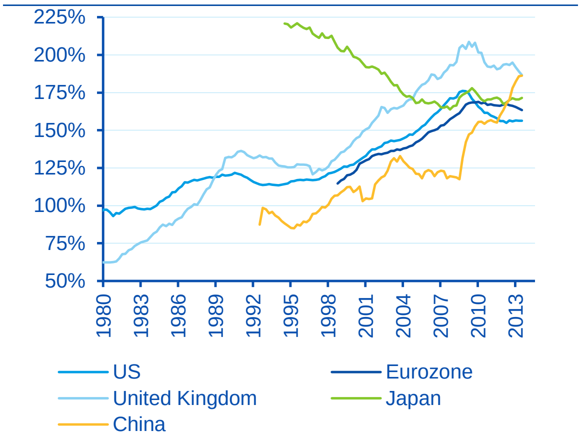
The anchoring of global financial tensions at near to all-time lows, supportive domestic demand policies and progress in banking union are improving the outlook in the eurozone. Leading indicators in the eurozone are consistent with a slight recovery in GDP, which should grow by around 0.3% in 2Q14 (vs. 0.2% in 1Q14), in line with our forecast of 1.1% for the year as a whole, the first annual growth since 2011. Sustained improvement in access to financial markets, particularly for more stressed economies on the periphery of the eurozone, is the main factor supporting the area's growth, together with the relaxation in public deficit targets in the short term and an external environment which, with the ups and downs and uncertainties described above, is nevertheless more positive. Ultimately, there are essentially two reasons for this virtuous circle. First, the confidence gained as a result of the decisions taken by the euro area authorities to strengthen the single market in the financial sector, and the ECB's reinforcement of monetary policy, which goes beyond what might have been foreseen just a few quarters ago. The ECB is aiming to anchor interest rates at low levels, support bank funding and, at the same time, open up credit availability for households and companies. Second is the anchoring of global financial tensions at minimum levels in a scenario dominated by the Fed, as described above. As well as all this, **the public accounts of the economies on the periphery** of the eurozone **have improved**, as a result both of being in a better stage of the cycle and of the consolidation measures introduced. In addition, **the reforms undertaken in the markets of productive factors in** some economies, designed to improve competitiveness, are another positive factor.

All in all, **although we are sticking to our growth forecasts of 1.1% in 2014 and 1.9% for 2015, the bias for these is to the upside** if the potential impact of the measures announced by the ECB is taken into account. **This impact on inflation would also be to the upside, as inflation remains too low**, far from the

ECB's target of price stability. The upwards influence on prices would come from both the cyclical improvement and from the effects of the monetary policy transmission mechanism, through the banking system and the availability of credit.

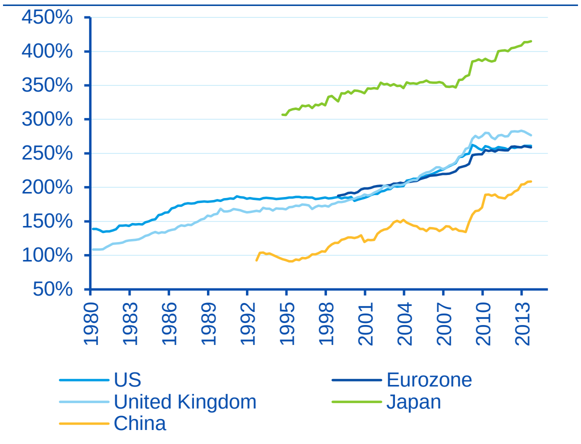
All of the above does not, however, **rule out the existence of risk to the downside** which could be triggered by **the worsening crisis in the Ukraine** and the knock-on effects of **economic sanctions imposed on Russia**, which the eurozone would be far from immune to, and in particular some of its principal countries.

Figure 2.7
Non-financial private sector debt
% GDP



Source: BIS, Haver Analytics and BBVA Research

Figure 2.8
Total debt (public and non-financial private sectors)
% GDP



Source: BIS, Haver Analytics and BBVA Research

Where is the global economic scenario heading? The repair of the balance sheets has to continue

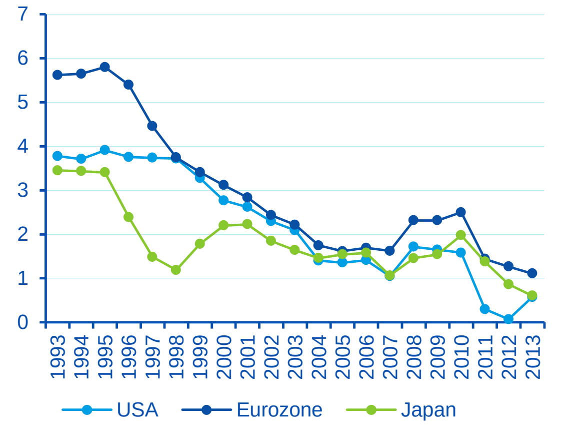
In our most likely scenario, the slowdown in global growth in the first part of 2014 has already ended. **The most recent indicators of cyclical confidence and financial volatility are consistent with a gradual improvement, which should enable worldwide growth to reach 3.3% in 2014, 30bp higher than in 2013**. Maintaining favourable global financing conditions and supporting economic demand policies will help growth to accelerate faster in 2015 at rates close to 3.8%, with an increase in the contribution made by the more developed economies, which could gradually start positioning themselves for the withdrawal of the exceptional stimulus of the last few years. The uncertainty within this baseline scenario continues to the downside because of the re-emergence of geopolitical risks and the doubts about the global impact on capital flows and asset prices caused by the proximity of interest-rate hikes in the US. But **this scenario, including its risks, is not the only possible one; there are alternative ones to a cyclical recovery. By areas, as well as the growth we have mentioned in the US, China and the eurozone, GDP growth is expected to hold in Japan at slightly above 1% in 2014 and 2015. In Latin America, we forecast an acceleration in activity to 2.5% in 2015 (1.6% in 2014) thanks to improvements expected principally in Mexico and in the Andean economies, supported by a favourable foreign environment worldwide.**

The situation in which the most important economies in the world find themselves in the current recovery phase has some original features, which may account for the limited intensity of the improvement in activity and the risks it faces. In general, **leveraging has not ceased in the most important economies.** Deleveraging in the private sector has been going on for some time in certain countries, such as the US, the

UK and Japan, while debt in the eurozone has stopped rising, with different situations by countries within the monetary zone (Figure 2.7). However, total borrowing, including that of the public sector, continues to rise in the economies mentioned and also in China, where non-financial private-sector debt is also rising fast (Figure 2.8). What is more, in this high debt scenario, **the speed of exit from the recession looks very moderate** in relative historical terms, and even more so given the intensity and duration of the monetary and fiscal policy support measures since 2009. Third, **inflation remains at very low levels,** with well-anchored and stable expectations**,** even below the price stability targets in some developed economies, such as the eurozone and Japan, which justifies the measures being taken by their respective central banks.

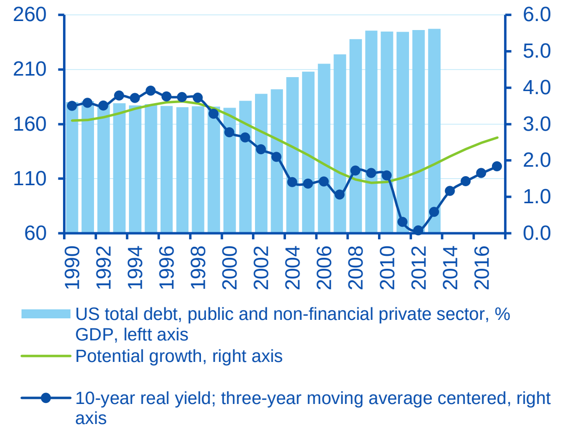
Consistent with the moderate growth, anchored inflation and the dominant role of central banks in the more developed economies in their support of the economic cycle, nominal interest rates remain at historical lows, both short term, as in the case of policy rates at zero, or longer-term rates that are also very low levels. **In real terms, long-term interest rates in the US, the eurozone and Japan were at their 20-year lows in 2013** (Figure 2.9), something which is in turn consistent with the increase in debt in the last two decades.

Figure 2.9
Real long-term interest rates%, nominal performance of long-term sovereign bonds, discounting inflation, moving 3-year average



Source: Haver Analytics and BBVA Research

Figure 2.10
US debt, GDP growth and interest rates



Source: BBVA Research

In summary, high levels of debt, low growth and low inflation (which makes it difficult for the debtor to deleverage), interest rates at all-time lows, together with central banks and fiscal authorities with generally little room for manoeuvre, or measures that have already been used very intensely, represent a combination of factors which do not point to a "rapid" return to growth, interest rates or inflation above current levels. Debt service is a heavy burden on spending decisions and the credit channel is currently under repair, at least in the eurozone. This means that **the repair of agents' balance sheet, which is still pending, may end up generating a scenario of prolonged stagnation**, especially if the economic reforms do not spur growth.

A scenario such as this, with no rises in interest rates both because of the lack of growth and because of the action of central banks in the developed economies, can end up distorting the decision-making processes affecting borrowing and investment, the relationship between risk and expected profitability, which could affect whether assets are correctly valued. **A situation of "prolonged stagnation" would be a challenge for economic policy management**, not only for developed economies, where we would see problems of low growth and stifled interest rates, but also in emerging economies, affected by indiscriminate inflows hunting for yield.

3 Tables

Table 3.1
Macroeconomic Forecasts: Gross Domestic Product

(End of period, YoY rate)	2011	2012	2013	2014	2015
United States	1.8	2.8	1.9	2.0	2.5
Eurozone	1.6	-0.6	-0.4	1.1	1.9
Germany	3.4	0.9	0.5	1.9	2.0
France	2.1	0.4	0.4	0.7	1.4
Italy	0.6	-2.4	-1.8	0.3	1.3
Spain	0.1	-1.6	-1.2	1.3	2.3
UK	1.1	0.3	1.7	2.9	2.5
Latin America *	4.1	2.6	2.4	1.6	2.5
Mexico	3.9	3.8	1.1	2.5	3.5
Brazil	2.7	1.0	2.5	1.3	1.6
EAGLES **	7.3	5.5	5.3	5.1	5.4
Turkey	8.9	2.4	3.8	2.5	4.2
Asia Pacific	6.1	5.2	5.2	4.1	4.1
Japan	-0.5	1.5	1.5	1.1	1.3
China	9.3	7.7	7.7	7.2	7.0
Asia (exc. China)	3.8	3.5	3.4	1.8	2.0
World	4.0	3.2	3.0	3.3	3.8

* Argentina, Brazil, Chile, Colombia, Mexico, Peru and Venezuela.
** Brazil, China, India, Indonesia, Mexico, Russia and Turkey.
Forecast closing date: 4 August 2014.
Source: BBVA Research and IMF

Table 3.2
Macroeconomic Forecasts: Inflation

(Annual average, YoY rate)	2011	2012	2013	2014	2015
United States	3.1	2.1	1.5	1.9	2.2
Eurozone	2.7	2.5	1.4	0.6	1.1
Germany	2.5	2.1	1.6	0.9	1.5
France	2.3	2.2	1.0	0.7	1.0
Italy	2.9	3.3	1.3	0.4	0.9
Spain	3.2	2.4	1.4	0.1	0.9
UK	4.5	2.8	2.6	1.7	1.7
Latin America *	8.0	7.6	8.9	12.2	10.9
Mexico	3.4	4.1	3.8	3.9	3.5
Brazil	6.6	5.4	6.2	6.4	6.1
EAGLES **	6.5	4.9	5.2	4.8	4.8
Turkey	6.4	8.7	7.6	8.3	5.8
Asia Pacific	4.9	3.4	3.5	2.9	3.0
Japan	-0.3	0.0	0.4	2.2	1.5
China	5.4	2.6	2.6	2.6	3.3
Asia (exc. China)	4.6	4.0	4.2	3.1	2.7
World	5.1	4.2	3.8	3.9	4.0

* Argentina, Brazil, Chile, Colombia, Mexico, Peru and Venezuela.
** Brazil, China, India, Indonesia, Mexico, Russia and Turkey.
Forecast closing date: 4 August 2014.
Source: BBVA Research and IMF

Table 3.3
Macroeconomic Forecasts: Current Account

(End of period, % GDP)	2011	2012	2013	2014	2015
United States	-3.0	-2.8	-2.4	-2.3	-2.1
Eurozone	0.1	1.2	2.3	2.2	2.1
Germany	5.7	7.0	7.5	6.7	7.0
France	-2.0	-2.3	-1.6	-1.7	-1.6
Italy	-3.1	-0.7	0.8	1.1	0.9
Spain	-3.7	-1.2	0.8	0.3	1.1
UK	-1.6	-4.6	-3.3	-2.8	-2.3
Latin America *	-1.0	-1.6	-2.5	-2.5	-2.3
Mexico	-1.1	-1.3	-2.1	-1.7	-1.9
Brazil	-2.1	-2.4	-3.7	-3.7	-3.5
EAGLES **	-0.2	-0.2	-0.2	0.1	0.3
Turkey	-9.9	-7.6	-7.0	-6.0	-6.0
Asia Pacific	1.4	1.1	1.5	1.9	1.9
Japan	2.0	1.0	0.7	1.5	2.0
China	1.9	2.3	2.1	2.5	2.8
Asia (exc. China)	1.0	0.3	1.1	1.4	1.2

* Argentina, Brazil, Chile, Colombia, Mexico, Peru and Venezuela.
** Brazil, China, India, Indonesia, Mexico, Russia and Turkey.
Forecast closing date: 4 August 2014.
Source: BBVA Research and IMF.

Table 3.4
Macroeconomic Forecasts: Government Balance

End of period, % GDP	2011	2012	2013	2014	2015
United States	-8.7	-6.8	-4.1	-3.0	-2.7
EMU	-4.1	-3.7	-3.0	-2.6	-2.1
Germany	-0.8	0.2	0.0	0.0	0.0
France	-5.3	-4.8	-4.3	-3.8	-3.0
Italy	-3.8	-2.8	-3.0	-2.7	-2.2
Spain *	-9.1	-6.8	-6.6	-5.5	-4.5
UK **	-7.8	-6.3	-5.8	-5.8	-4.4
Latin America ***	-2.2	-2.3	-2.7	-3.7	-2.9
Mexico	-2.7	-2.6	-2.3	-4.1	-3.6
Brasil	-2.6	-2.5	-3.7	-3.9	-3.4
EAGLES ****	-2.4	-2.9	-3.0	-3.4	-3.3
Turkey	-1.4	-2.1	-1.2	-2.2	-1.6
Asia Pacific	-3.7	-3.8	-3.6	-3.6	-3.4
Japan	-9.8	-8.7	-8.4	-8.5	-8.0
China	-1.3	-2.2	-1.9	-2.5	-2.5
Asia (exc. China)	-5.3	-5.0	-4.9	-4.3	-4.0

* Argentina, Brazil, Chile, Colombia, Mexico, Peru and Venezuela.
** Brazil, China, India, Indonesia, Mexico, Russia and Turkey.
Forecast closing date: 4 August 2014.
Source: BBVA Research and IMF.

Table 3.5

Macroeconomic Forecasts: 10-year government bond yield

(Annual average)	2011	2012	2013	2014	2015
United States	2.8	1.8	2.4	2.8	3.3
Germany	2.6	1.5	1.6	1.5	2.1

Forecast closing date: 4 August 2014.
Source: BBVA Research and IMF

Table 3.6

Macroeconomic Forecasts: Exchange Rates)

(Annual average)	2011	2012	2013	2014	2015
EUR-USD	0.72	0.78	0.75	0.74	0.78
USD-EUR	1.39	1.29	1.33	1.35	1.29
GBP-USD	0.62	0.63	0.64	0.60	0.59
JPY-USD	79.8	79.8	97.6	105.0	116.0
CNY-USD	6.46	6.31	6.20	6.15	6.02

Forecast closing date: 4 August 2014.
Source: BBVA Research and IMF

Table 3.7

Macroeconomic Forecasts: Official Interest Rates

(End of period)	2011	2012	2013	2014	2015
United States	0.25	0.25	0.25	0.25	0.50
Eurozone	1.10	0.75	0.25	0.15	0.15
China	6.56	6.00	6.00	6.00	6.00

Forecast closing date: 4 August 2014.
Source: BBVA Research and IMF

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