Widespread upward revision of growth forecasts in 2018

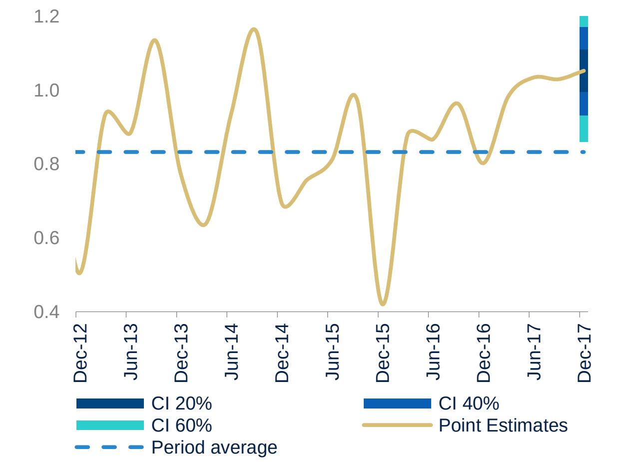
Global Macroeconomic Scenarios Unit

19 January 2018

Robust and sustained global growth in 2017

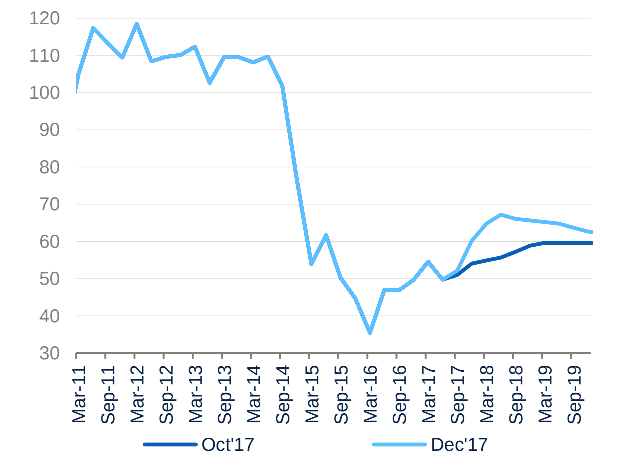
World economic growth consolidated in late 2017 at reasonably solid rates of around 1% QoQ (see Figure 1), reflecting improved results in all major areas and showing signs of continuing over coming quarters. Support from economic policy has fostered growth of the real economy, particularly in developed economies. Investment spending has gained traction with support from increased global demand and an upturn in international trade, allowing a recovery of the industrial sector. Private consumption continues to perform well in advanced economies and is gaining momentum in emerging economies. At the same time, an improved growth outlook and enhanced market confidence in many such economies have also been favoured by higher commodity prices (see Figure 2) and foreign capital inflows. Confidence indicators suggest that the economic expansion is set to improve, favoured by a sound economic performance and reduced short-term risks. In this context, we forecast **global growth to increase by 0.4 percent points to 3.7% in 2017**, 0.2% more than in our October projections.

Figure 2.1 World GDP growth (QoQ, %)
Forecasts based on BBVA-GAIN



Source: BBVA Research

Figure 2.2 Price of a barrel of Brent crude (Dollars)



Source: BBVA Research

Over the past three months, there have been **further reasons to remain optimistic in all the large areas**. Throughout 2017, recovery in the U.S. has been taking root, with slightly higher-than-expected growth rates and improvement in the labour market. The tax reform was finally passed and it might lengthen the cyclical recovery. However, we don't expect it to have a significant impact in the long-term. Recent Fed appointments suggest continuity in monetary policy management, which should be reflected by a very gradual normalisation. In China, the measures approved by the government have managed to stabilise the economy, while some structural reforms have been introduced and an economic strategy more focused on reducing economic imbalances -and less on meeting growth targets- has been adopted. Finally, the eurozone posted higher growth than expected on the back of an improved global outlook and stronger internal demand that is benefiting from a more reduced political uncertainty.

This scenario of increased growth and higher demand has been accompanied so far by **subdued inflation**, despite the expansionary measures adopted by major central banks and the gradual reduction in idle capacity in developed economies. Doubts remain as to whether factors underpinning the weakness of inflation are transitory or permanent. Globalisation, the flexibility of labour markets, low inflation expectations or increased productivity could lie behind the slower response of prices to increased economic activity. In this context, the degree to which inflationary pressure will remain contained is uncertain, at least for the time being. Continued economic growth and higher oil prices should push inflation up in the short-term, facilitating **advances in the normalisation of central bank policy in developed economies. Meanwhile, emerging economies still have room for manoeuvre for using monetary policy to bolster growth**.

Optimism in financial markets amidst the normalisation of central bank policy

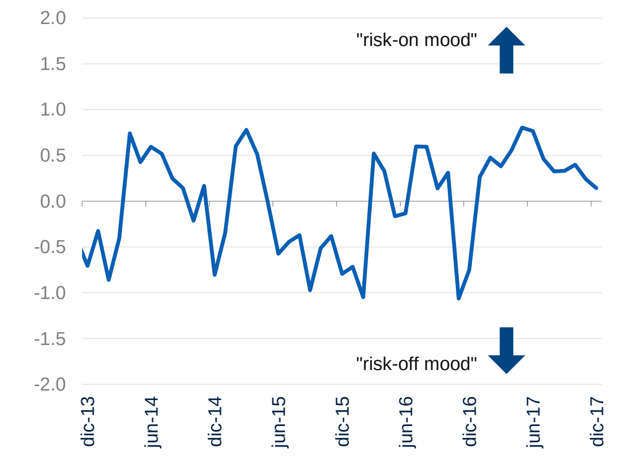
An optimistic mood has predominated in financial markets over the final quarter of 2017. In the absence of adverse global economic shocks, market fundamentals have continued to support risk taking by investors (see Figure 3). In particular, the upbeat economic environment has added to still accommodative monetary conditions -thanks to abundant liquidity in the system and interest rates at record lows- which has helped to maintain volatility at record lows while favouring again risky assets (as is the case of peripheral debt and emerging countries' assets). Yet, this is leading as well to **doubts about a potential overvaluation of certain assets**, including equities in advanced countries, which have maintained their upward trend. The **flattening of the US yield curve** due to low long-term interest rates and rising short-term rates following monetary policy decisions are another question marks hanging over financial markets as we enter 2018.

As regards to central banks, there have been no surprises. Nevertheless, **the strong pace of growth which characterises the current economic scenario is increasingly pointing to a normalisation of monetary policy**. This positive outlook has also triggered an upward revision of economic projections by the main central banks - the U.S. Fed and the ECB- and has also accelerated the process of scaling back the current monetary stimulus.

In December, the Fed increased interest rates to 1.25-1.5% for the fifth time since the beginning of the interest rate hikes in late 2015, and they have started reducing asset purchases. The Fed's adequate communication policy is also facilitating the transition towards the new phase of monetary policy **without causing major shocks in financial markets**. Moreover, they maintain their forecast of **three interest rate hikes of 25 basis points in 2018** -in line with our upwardly revised current expectation, adjusted after the introduction of the tax reform and its estimated impact on economic growth. Thus far, the dollar has not capitalised the new fiscal and monetary policy decisions (as it continues to trade at around $1.20 against the euro).

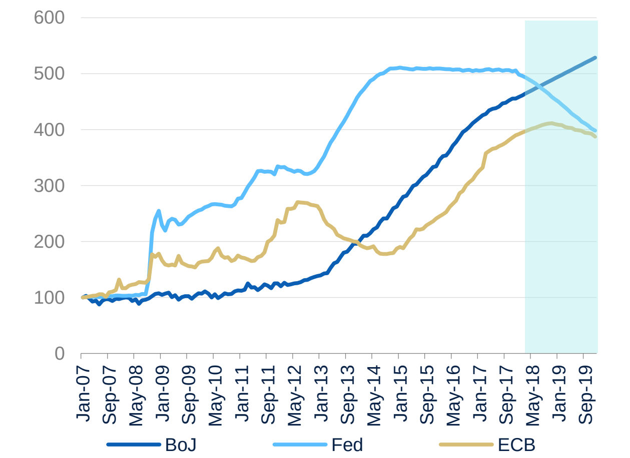
The **ECB**, as expected, will reduce quantitative easing in 2018, but with an approach that differs from the Fed's. **Asset purchases have been reduced substantially (up to half, to 30 billion euros per month)**, while in turn **the programme has been extended at least until September. In this setting,** the ECB is maintaining its commitment not to raise interest rates until sometime after the end of quantitative easing, **in order to anchor interest rate expectations**. **This means that ECB's quantitative easing** (QE) **will probably not end until Autumn this year**, and therefore **interest rate will not be raised until 2019** (we expect the first deposit rate increase in March and the repo rate to be lifted in June). All in all, it is likely that the debate on the ending of QE will intensify in the spring.

Figure 2.3 Risk appetite indicator
(overall factor based on EPFR flows)



Source: EPFR and BBVA Research

Figure 2.4 Central bank balance
(index 100 = January 2007)



Source: BBVA Research

Other central banks, such as the Bank of England and the Bank of Canada, **are taking steps in the same direction** (with one-off interest rate rises). The Bank of Japan has maintained its monetary policy unchanged, although it has slowed its asset purchases in line with major central banks. All in all, **financial markets will have to adapt** to a more "normal" monetary environment: **liquidity will be scarcer and financing conditions less accommodative** (see Figure 4).

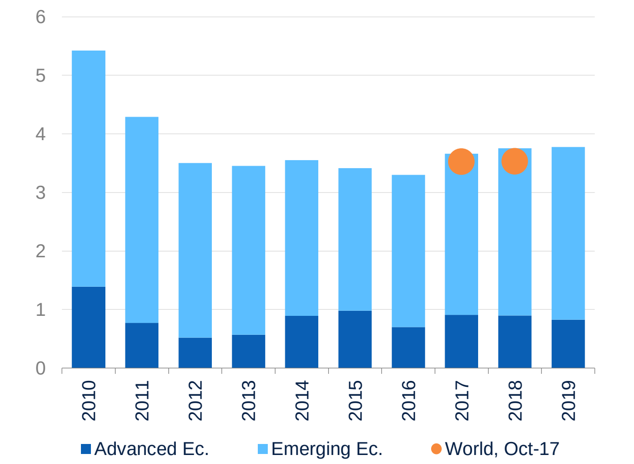
World growth will tend to stabilise in 2018-19

Our **forecasts point to global growth slightly accelerating the next two years by around one basis point to 3.8%** per year (see Figure 5). This represents an upward revision of 0.3% on our expectations three months ago in response to higher growth forecasts for the U.S, China and the Eurozone in 2018. This is mainly due a more buoyant economic activity than expected in past quarters, but also thanks to the aforementioned economic measures adopted in the first two key areas. In Latin American economies we now expect a somewhat stronger recovery this year, due to the upward revision of global demand and higher commodity prices. Despite the expected stability of world growth, **we still expect a mild moderation in developed economies in 2019,** while emerging economies will continue consolidating their recovery. On top of this, **there are still a number of political risks** that could drag economic confidence and impact financial markets. **These uncertainties are however less significant** than three months ago.

U.S: higher economic growth in the short term

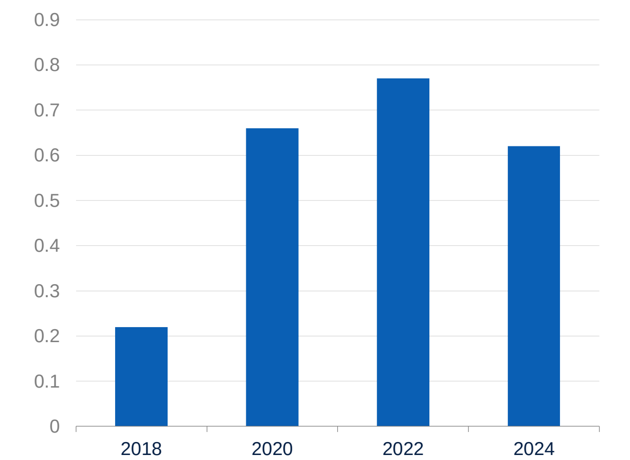
Economic activity surged once again by **slightly over an annual pace of 3% in the third quarter of 2017**. Although the most recent indicators suggest a certain slowdown over 4Q17, this appears to be transitory, and the consequence of rebuilding works after recent hurricanes and delays to investment pending the implementation of certain fiscal measures. **Various factors have bolstered the recent strengthening of the economy.** Higher oil prices and the depreciation of the US dollar have supported investment, while greater global demand favoured a further rebound in global exports. Consumer spending has also increased at a relatively stable and solid pace, in contrast to the more gradual recovery of the labour market, higher inflation and a slight tightening of financial conditions. Public expenditure made a very positive contribution to growth, despite Congress agreeing to increase caps over discretionary expenditure. As a result of all the above, GDP increased by around **2.2% in 2017**.

Figure 2.5 World GDP forecasts, area by area (%)



Source: IMF and BBVA Research

Figure 2.6 Impact of U.S. tax reforms on GDP (%)



Source: BBVA Research

Improved domestic and global fundamentals could lift 2018 growth by around 0.2pp. We also estimate the **tax reform** to further add another 0.2pp, **increasing our 2018 GDP growth forecast to 2.6%** (see Figure 6). The impact of lower taxes on personal income will not be too pronounced, as they will mainly affect those with the highest earnings –who are less inclined to consume-. The greatest impact will stem from cuts to corporate taxes, although here again, we expect that this will be relatively limited given the temporary nature of some provisions, the higher financing costs and a possible increase of savings -not investment. Taking into account all these factors, we estimate that the **accumulated effect of the tax reform on GDP could be around 0.6% up to 2024**. Although monetary policy will remain accommodative, the improved economic outlook will strengthen the process of normalisation started by the Fed. As a result, we expect growth to moderate 2.5% in 2019. **Despite a reduction of risks, these remain**

high, given the considerable amount of political tension and the threat of a pronounced shift towards protectionism, while some assets could be showing signs of overvaluation.

China: a more moderate slowdown

The most recent figures suggest that economic growth remained stable over the second half of last year, showing some resilience to measures adopted by the authorities to tackle financial vulnerabilities and to move towards an ordered deleveraging of the economy. As a result, **growth could have stabilised at 6.7% in 2017**, with a slight slowdown in both consumer spending and investment, compensated with positive net exports figures. Despite the good economic performance, **we still expect a growth moderation moving forward, albeit to a lesser extent** than in our previous forecasts due to an improved international outlook and the economic policy strategy presented at the 19_{th} Communist Party Congress.

The factors underpinning this scenario remain unchanged: **less support from economic policies**, with a more prudent monetary policy, the regulatory tightening, the end to industrial over-capacity and a less expansive fiscal policy. **Nevertheless, the withdrawal from a strict growth target suggests a greater focus on the reduction of structural imbalances, while the measures aimed at opening up the economy and the introduction of structural reforms could help to improve potential growth**. We now forecast that GDP to slow to 6.3% in 2018 (0.3% higher than three months ago) and to around 6% in 2019. Higher commodity prices will lead to an upward pressure on inflation, which had been subdued at the end of last year. However. this effect will be offset by a stronger currency and a stricter regulatory framework. As a result, we expect to see inflation pick up to 2.3% during 2018 (from 1.7% last year), rising to 2.5% in 2019. **The central bank is expected to keep benchmark interest rates at the current level all through this year**, discharging the precautionary approach of monetary policy to macro-prudential and regulatory tools.

The strategy put forward by the authorities and the more gradual slowdown of growth have **reduced domestic risks in the short term**. They nevertheless remain at high levels in the medium term, which adds to external risks related to increased protectionism.

Eurozone: upward revision of growth but slowing in 2018-19

The **recovery of the eurozone economy stepped up over 2017 to a surprising extent**, with GDP growth at a relatively stable rate of around 0.6% per quarter. There was a greater balance in terms of components, with growth more evenly spread across the member states. **The strength of internal demand and the positive contribution stemming from net exports have allowed a growth acceleration of 0.6 percent points to 2.4% in 2017**.

Moving forward, the favourable economic sentiment could be prolonged, though it will be difficult to maintain current growth pace - clearly above potential- all through the forecast horizon. **Recent figures, along with an increase in global demand and less uncertainty, have led us to revise up our GDP growth forecasts for 2018 by 0.4pp to 2.2%**, while we estimate growth at 1.8% for 2019.

The lower level of uncertainty after election results last year together with increased corporate profits should bolster a **recovery of investment, which will moderate somewhat in 2018-19** after the strong growth seen over the past two and a half years. The eurozone will also benefit from a significant **export growth momentum**, although these may experience a slowdown given the currency appreciation and the stabilisation of global growth. Job creation will lose some traction (down to 1% in 2018-19 from 1.6% in 2017), but will be sufficient to sustain household income and a **strong growth in private consumption**.

Inflation moderated towards the end of the year due to the base effect of energy prices. This trend is set to continue entering 2018, taking general inflation to around 1%. Nevertheless, **we now expect the price of Brent crude oil to increase by around 16% more than in our previous forecast**, meaning that the aforementioned base effect will fade from March onward. As a result, **we are increasing our headline inflation forecast by 3pp to 1.5% for 2018** and to 1.6% for 2019. Regarding **core inflation, we continue to forecast a gradual increase to 1.3% in 2018 and to 1.6% in 2019**, driven by strong domestic demand, a healthier labour market and the reduction of spare capacity.

Domestic risks for the eurozone as a whole are still downward biased, although they have diminished and are moderated. Despite the fact that the political outlook partially cleared in 2017, there are still latent risks, such as Italian elections in March and difficulties in strengthening the European project. Brexit negotiations have moved forward, although we are still far from ensuring that this will not be a disruptive event if a trade agreement is not reached by early 2019.

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