Global Economy

Global growth remains firm but risks intensify

Global Economic Scenarios

The global economy is currently being subject to divergent forces. The new fiscal stimulus measures approved by the US administration will prolong the favourable phase of the world economic cycle, which has so far been supported by high levels of confidence and the positive tone of industrial activity and international trade, which also benefit China and Europe. On the other hand, the increased vulnerability of the US public accounts brought about by these fiscal stimulus measures, combined with the prospect of financial markets facing greater volatility than in 2017, make this scenario more uncertain. Added to this is the ratcheting up of protectionist rhetoric in the US, which has started to find expression in specific measures. All this in a context of normalisation of monetary policies following years of exceptional stimulus measures, which may also give rise to additional doubts.

Stable growth at the beginning of 2018, with greater dynamism in emerging economies and some signs of moderation in developed countries

Data available for the first two months of the year suggests that **global growth in the first quarter will show a similar rate to the average for 2017 (1% QoQ)**. Specifically, our BBVA-GAIN model predicts that world GDP growth in 1Q will have reached 0.97% QoQ, meaning that activity will have resumed its trend following the stumble recorded at year-end 2017 due to slowing growth in the three main regions (China, the euro zone and more particularly the US).

This growth is favoured firstly by the **good performance of world trade**. According to our BBVA-Trade indicator in January[1], and especially during February, trade in real terms grew significantly, regaining the dynamism seen in 2016 after the moderation observed last year. The main contributor to this development was export growth in the emerging economies, and in particular - in February - in the Asian countries (mainly China and India). A second factor underpinning 1Q growth is the **sustained solid expansion of industrial output**. Here too, the emerging countries stand out, led by China and India, with Latin America also showing acceptable growth despite the hiccups in its two biggest economies, Mexico and Brazil. In the developed countries, the US gained traction, though this was partly offset by the weakness of the euro zone.

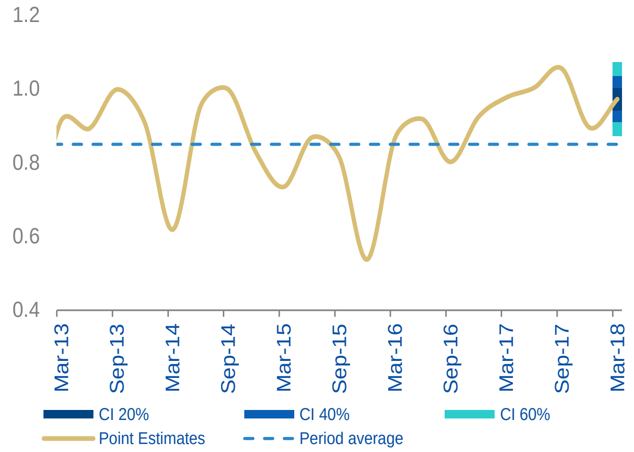
However, **retail sales measured in real terms weakened in December and January**, in both developed and emerging countries, undoing the fledgling recovery of the previous two months[2] and confirming the scenario of a slow recovery in consumption. As for the more leading indicators of confidence, **PMIs, both manufacturing and services, are close to their all-time highs, although we are starting to see signs of limitations to further expansion**, mainly in the manufacturing sector.

This scenario plays out in a context in which inflation, especially the **core measure, has increased very gradually.** We are likely to see greater pressures, though still contained, in the next few months.

1: This is also verified by the CPB World Trade Monitor, January 2018, prepared by CPB Netherlands Bureau for Economic Policy Analysis - https://www.cpb.nl/en/figure/cpb-world-trade-monitor-january-2018
2: The limited data available for February suggest that retail sales in developed countries will have held steady or fallen again, whereas emerging markets could show some growth since China and the rest of emerging Asia show signs of a slight uptick during the month.

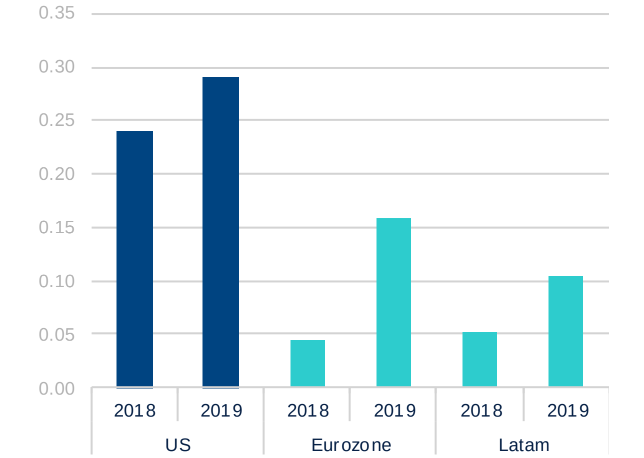
As for commodities, **oil prices paused their rising trend in the face of both higher volatility on the financial markets and higher expectations for production in the US**, although they recently settled in a range of US$60 to US$65 a barrel. Despite the foregoing, **market fundamentals do not suggest significant changes**, so we are holding our forecasts for the average price of oil at US$60 a barrel for WTI and US$65 for Brent, for this year and next. On the demand side, global economic growth will continue to support higher prices; but against this, the expected increase in non-OPEC production will make it difficult to keep prices above US$60 a barrel for too long. **In the medium term, uncertainty comes mainly from the impact of reduced investment in the sector** and its effect on future supply capacity, which might likely provide greater support for prices.

Figure 1 Global GDP growth
(Forecasts based on BBVA-GAIN, % QoQ)



(e) Estimate; (f) Forecast.
Source: BBVA Research

Figure 2 Impact of greater growth in the US
(pp)



Source: BBVA Research

Increased growth in the US may prolong the expansive cycle at the global level

In February, the US Congress approved an increase in public spending which, together with the raising of the debt ceiling and a financial aid package for natural disasters, **amounts to around US$350 billion** (approximately 1.7% of GDP) in the next two years. Although there is great uncertainty as to the impact of these stimulus measures, in principle they should have a moderate effect on growth in the short term (mainly through spending on defense and infrastructure), since the US economy is already very close to full employment and the increased levels of deficit and debt may exert upward pressure on interest rates just at the time when the Federal Reserve is in the process of normalisation. For all these reasons, we estimate that the new fiscal stimulus measures will have a small multiplier effect on activity (of around 0.4), **which would involve an upward revision in GDP of around 0.2 to 0.3pp in both 2018 and 2019**.

These new stimulus measures**, together with the tax reform approved at the end of last year** (US$1.5 billion, or around 7.7% of GDP, over the next ten years) **will lead to even further deterioration of the fiscal situation in the next few years**. Specifically, in the absence of compensating measures, the large fiscal deficits forecast (average 5.2% of GDP in the period 2018 to 2027) will take the public debt ratio from its current 76.7% to around 90% of GDP in 2027, and would be added to the fiscal pressures deriving from the ageing of the population and the reduced growth in the active population. Thus, although the improved growth outlook for the next few years and the process of monetary policy normalisation should exert upward pressure on the dollar, the increased uncertainty about the US economy associated with the deterioration in the public accounts **could more than offset this effect.**

In fact, we foresee the dollar continuing to depreciate against the euro at the forecast horizon, to 1.26 at the end of 2018 and 1.28 at the end of 2019.

That said, in the short term the US fiscal stimulus will have a certain positive effect on the world economy, prolonging the cyclical recovery and leading to an increase in demand at the global level. Thus, even by taking into account the dollar's weakness and of moderating growth in China, our estimates indicate that the increased growth in the US in 2018-19 (of about 0.2 to 0.3 pp each year) **could boost GDP growth in both the euro zone and the Latin American economies** by about a tenth of a percentage point per year at the forecast horizon. However, this effect will be countered in our scenario by the increase in global volatility or by the resurgence of greater political uncertainty in some areas, **as well as by the possible negative effect of the uncertainty associated with protectionist measures**.

Evolution of the financial markets: the return to an environment with more volatility

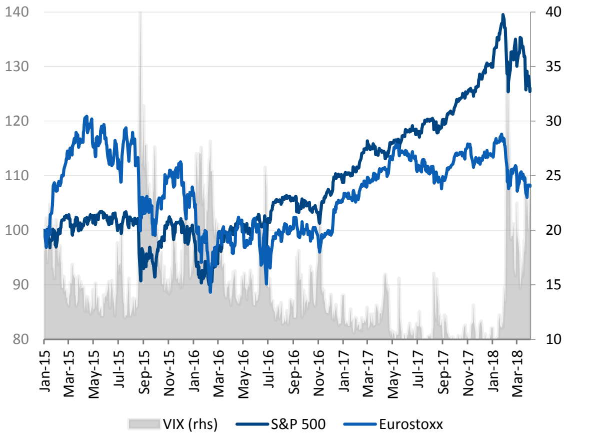
Following a year dominated by optimism and risk taking in the financial markets, the first quarter of 2018 showed **a more cautious tone.** On the one hand, financial conditions, which have been highly accommodative, have started to adjust. And above all, volatility, which has been unusually low, seems to be in transition to a more "normal" situation (higher volatility and possibly more persistent volatility shocks).

Global financial conditions are tightening as the central banks withdraw stimulus and long-term interest rates rise. Monetary policy continues to be normalised, in line with the positive environment of economic growth. The ECB, as expected, is smoothing the way towards ending its asset purchase programme and preparing its communication for the subsequent interest rate hikes. **In the case of the US Federal Reserve, we expect that the process may even speed up a little** (four 25-bp hikes in the reference rate in 2018, as against the three hikes previously forecasted) following the fiscal boost. Furthermore, long-term interest rates are settling at higher levels, especially in the US, due to the increased growth and fiscal deterioration, which implies greater financing needs, adding a risk premium to the financing of the US Treasury.

Apart from this, the spate of volatility at the beginning of February[3], which triggered a sharp correction on stock markets, may be a first sign that **the low volatility environment is a thing of the past**. Although this phenomenon was concentrated in the equity market and spillovers to other segments has so far been limited, **the withdrawal of stimulus measures by central banks will leave markets more exposed to any shocks, and these shocks are likely to be more persistent in nature**. In fact, two months after the February episode, we can see that volatility (VIX) has not returned to its previous levels and is even settling at levels higher than its historical average**.**

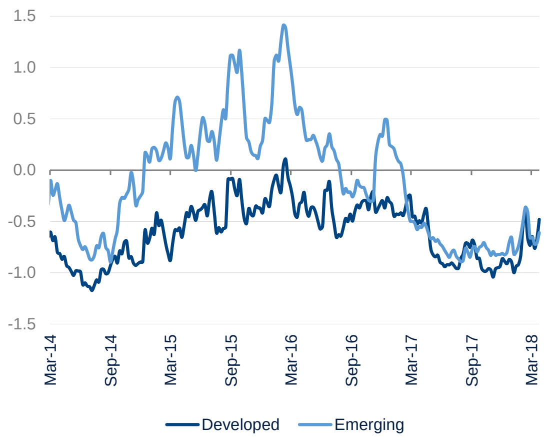
3: In this episode, the VIX, the measure of volatility of the US stock markets used as an indicator of risk aversion in the markets, surged above 40 points. Part of the rise was due to technical issues - investors' positioning in derivative products linked to volatility. See BIS, Quarterly Review, March 2018.

Main stock market indices and volatility (VIX) (base 100 June 2015, VIX in %)



Source: BBVA Research

Figure 4 BBVA Financial Stress Indicator



Source: BBVA Research

All this has contributed to **raise our financial stress indicator in both developed and emerging economies.** Our simulations indicate that a permanent increase in financial stress similar to that at the beginning of the year could subtract near three tenths of a percentage point from US GDP growth in 2018-19, around one tenth of a percentage point from that of the euro zone and four tenths of a percentage point from that of Latin America. The impact would be greater in economies that are more dependent on external financing.

We are maintaining our forecasts for global growth, with some adjustments among regions

The global outlook is generally favoured by a high level of confidence and the improvement in global trade, despite an environment more challenging by threats of protectionism. **Overall, we kept our forecast for world growth at 3.8% for the period 2018-19.** However, this scenario account for an **upward revision in growth prospects for both the US and the euro zone,** offset by a slightly lower dynamism in emerging economies, especially in South America.

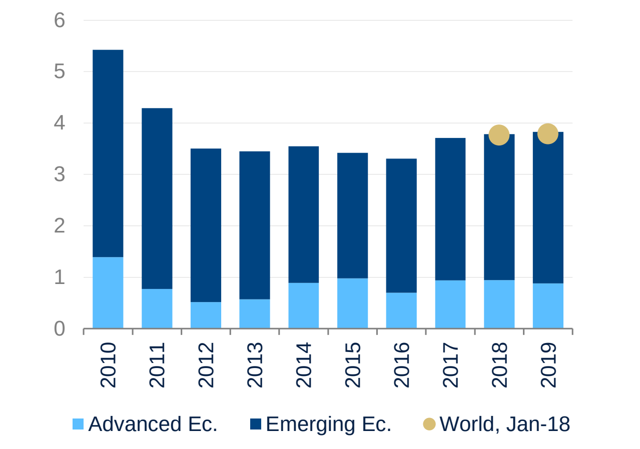
In the case of the US, the **positive figures for activity and external trade** of the past few months come on top of the **aforementioned short-term effects of a more expansive fiscal policy,** which combines both tax cuts approved in December (already factored into our previous forecasts) and the new fiscal stimulus measures. As a result, **US growth is estimated at 2.8% for both 2018 and 2019** (involving upward revisions of 0.2pp and 0.3pp respectively).

In Europe, the **solid figures for exports and fixed investment last quarter,** together with resilient private consumption, lead us to maintain the growth forecast **for the euro zone (revised slightly upwards to 2.3% in 2018)**. For 2019, we continue to project a moderation in economic activity, with growth of around 1.8%, given a degree of exhaustion in the cyclical drivers, as already anticipated by confidence leading indicators. Even so, the euro zone economy should continue to close its output gap, given that its potential growth is somewhat below 1.5%.

In China, we are maintaining our growth forecast at 6.3% and 6.0% for 2018 and 2019 respectively. The majority of recent data show that **momentum in both domestic demand and exports** is holding up. All the indications suggest that growth will remain high in the first quarter of the year (at 6.8% YoY), although **we foresee a moderation in the second half of the year**, in a context of convergence between consumer price and production prices inflation. The declaration of an economic policy approach that combines cautious monetary policy with expansive fiscal policy, together with the approval of restrictive financial regulation measures make us **somewhat more optimistic about the domestic risks associated with China's economy**.

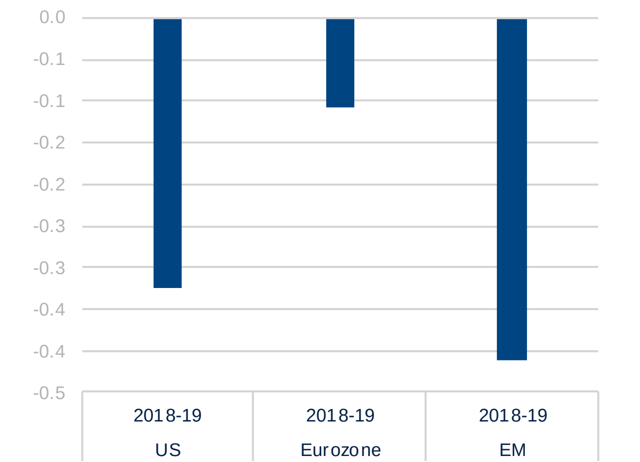
Although we are leaving our forecasts for China unchanged, we expect **the bloc of emerging countries to expand slightly less,** affected by idiosyncratic factors (mostly in the case of South America). Added to the weak activity data for the past few months is the materialisation of certain political risks in some cases and supply shocks in the agricultural sector in others, which together end up offsetting the higher growth expected in advanced countries. **Despite this, the economies of Latin America will continue to show recovering growth rates relative to previous years**, underpinned by the dynamism of external trade and improved terms of trade thanks to increased commodity prices.

Figure 4 World GDP growth forecast (YoY, %)



Source: BBVA Research

Figure 5 Impact of an increase in uncertainty (such as that seen at the beginning of the year) on GDP growth (pp)



Source: BBVA Research

The risks surrounding our scenario have grown due to protectionist threats

This economic scenario is affected by a number of risks, which continue to be predominantly negative, and which in some cases have intensified. The greatest of them is the increase in protectionist measures triggered by the increase in import tariffs proposed by the US administration, which comes on top of past actions such as the US withdrawal from the TPP, the suspension of negotiations on the TTIP and the renegotiation of NAFTA with Mexico and Canada. The US administration initially approved an increase across the board in import duties on steel and aluminium, to 25% and 15% respectively, although the increases were subsequently suspended temporarily for a number of countries (Mexico and Canada while NAFTA is being renegotiated, and the for the EU, Argentina, Australia, Brazil and South Korea until 1 May, subject to alternative measures being negotiated). Subsequently, the US also announced that it would slap tariffs on a long list of products imported from China, to which China retaliate with its own similar measures, albeit for a lesser amount. Although the impact of the measures adopted has so far been limited (though not for certain countries and sectors), the mere fact of announcing them raises uncertainty about a possible escalation of trade restrictions, pushing to a tit-for-tat policy strategy among the major economic regions - including Europe - that could end up discouraging investment worldwide.

Beyond the risk of protectionism, which has intensified in the past few months, other sources of uncertainty persist. The normalisation of monetary policies, especially a faster-than-expected withdrawal by the US Federal Reserve associated not with increased growth but with an unexpected surge in inflation, is one of the most significant, in a context in which financial markets are highly vulnerable to increases in financing costs. The risk associated with a sudden sharp adjustment of China's economy has diminished somewhat, following the measures approved as a result of the NCCPC in past October and the signs of gradual containment of indebtedness. Finally, the political risk persists in Europe following the Italian elections, which could affect the process of integration in the euro zone, a discussion that should be reactivated in the next few months.

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