Global economy

Steady global growth, but risks intensify

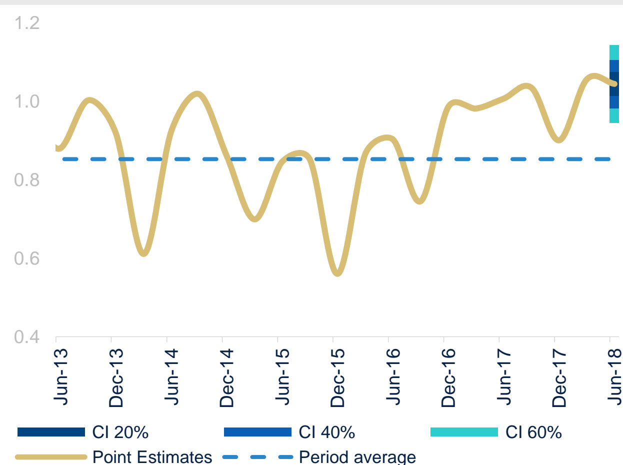
Global Economic Scenarios

The international economy continues to be subject to tensions of disparate forces between the good economic performance in recent quarters, now prolonged by the fiscal stimulus of the US economy and the stability of the Chinese economy, and several potentially negative factors that have been generated gradually in the first half of this year but which so far have not been directly reflected in activity. Both the Federal Reserve (Fed) and the European Central Bank (ECB) have taken a further step towards normalisation of monetary policy, which suggests somewhat less accommodative conditions, although the increasing financial tensions that have been generated in emerging economies as a result of the appreciation of the dollar seem to correspond more to a reassessment of risk than to a systemic threat. Oil prices have stabilised after a marked increase so far this year. The main risk is protectionism, which has increased in recent weeks with the measures and countermeasures that have been announced, and whose effect on activity could manifest in the second half of the year.

Stable growth in the first half of 2018, although with doubts about its persistence and with differences between the main areas

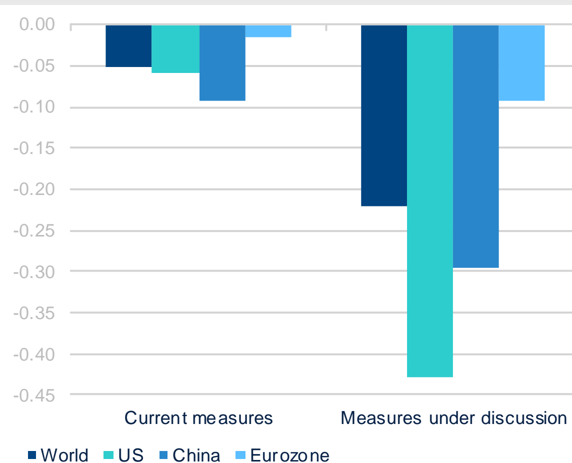
Data available up to May suggest that **global growth could have slowed slightly in the second quarter of the year** (BBVA-GAIN: 1% quarterly after 1.1% in 1Q18) (see Figure 2.1) and show **mixed signals for both areas and sectors**. Although the pace of expansion remains solid, it is occurring in a **less synchronised** manner, with accelerating growth in the US that contrasts with certain signs of moderation in China and some emerging economies and in a more pronounced way in the Eurozone.

Figure 2.1 World GDP growth (QoQ, %)



Source: BBVA Research

Figure 2.2 Effect on GDP growth due to US tariff hikes and the response of other countries (2018-19, pp)



Source: BBVA Research

The trend in the **industrial sector continues to cause concern**, as its activity has not recovered from the poor performance recorded at the beginning of the year, especially in emerging economies and **despite the positive data in global trade up until May**. However, these data do not yet reflect the possible negative effects of the protectionist escalation in recent months, unlike the confidence data for the industrial sector, which continued to deteriorate up until June. All this information points to **an ongoing recovery of the industrial sector, but at a more moderate pace, and it will be difficult to see it gaining traction in the coming quarters**.

The **confidence of the service sector has been more resilient**, with an increase in the emerging economies (especially those in the Asia Pacific region) that offsets a somewhat more disappointing trend in the developed economies. However, the trend in other indicators of domestic demand is more moderate, such as the **poor performance of retail sales up until May in the emerging economies that contrasts with a tentative recovery in the developed economies.** In any case, they suggest that the support from one of the main drivers of recovery in recent years could be stabilising or moderating.

In this context, **core inflation has risen very gradually in developed economies and has tended to stabilise in emerging economies** beyond the general rise in headline inflation, as a result of the increase in energy prices.

The oil supply shock and the first protectionist measures have led to an increase in uncertainty

The **increased growth of the US economy,** driven by fiscal measures **and the recovery of global trade** at the beginning of the year, continues to sustain the strength of the global recovery. **However, some of the supports** to growth have been fading in the last few years, **while uncertainty has increased**.

The first factor is the withdrawal of the United States from the nuclear agreement with Iran, which caused a supply ***shock*** **in the oil market that has increased the price of oil** by around 20% so far this year. Although prices seem to have stabilised in the wake of the increase in production by the OPEC countries, we now expect them to stabilise around US$70 per barrel in the forecast horizon, which suggests an upward revision in the forecasts of the oil price of around 10% this year and next with respect to those considered in the last quarter.

This will **place additional upward pressure on inflation and has already encouraged the central banks to take another step towards the normalisation of monetary policy**. This is particularly the case with the Fed, which so far this year has accumulated a rise of 50 basis points in its reference rates to reach 2% and plans to raise them to 2.50% by the end of the year and to 3.25% by the end of 2019. The interest rate differential and favourable growth in the US compared to the rest of the world has resulted in a **widespread appreciation of the dollar**.

An additional factor of uncertainty during the last few months is associated with the increase in trade tensions. It is still too early to know which measures will finally prevail of those already approved by the US administration and those that were previously announced, and the possible countermeasures from their trading partners. Nor is it easy to discern their impact on trade and activity. In principle, **the direct effect through the trading channel of the measures announced until now would be limited**. In particular, the increase in tariffs on imports of steel, aluminium and on those on a long list of Chinese exports covering US$50 billion, together with the countermeasures announced by the affected countries, is expected to yield a negative impact of **less than 0.1 pp on global growth** (around 0.1 pp on China's growth and virtually zero in the US and the Eurozone). Nevertheless, additional measures by the US are currently being discussed: on the one hand, the imposition of much higher tariffs on imports from the automotive sector, with tariffs of between 20% and 25%; on the other, the extension of tariffs on imports of Chinese products up to a value of US$200 billion (or more). This protectionist escalation, together with possible retaliation for similar amounts by the trading partners, would have a significant negative effect on the growth of both the US (-0.4 pp of GDP) and China (-0.3 pp). This effect would be somewhat lower in

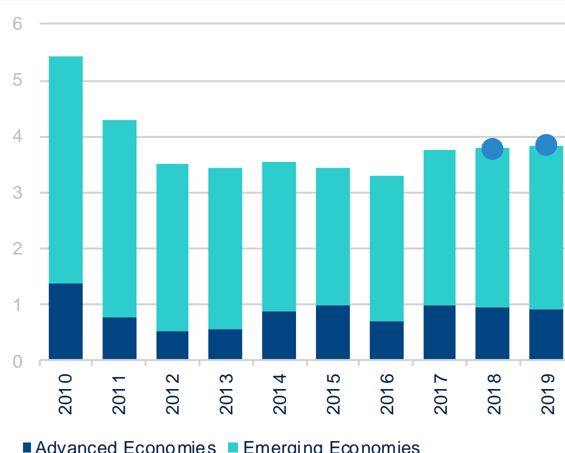
the Eurozone (-0.1 pp) although it differs per country, with Germany and the Central European countries being the most affected. Taken together, **the direct effect of these measures under discussion could subtract around 0.2 pp from global growth** (see Figure 2.2), **to which we should add potential indirect effects on the confidence of financial markets and economic agents** as a function of the magnitude of the trade conflict.

As a consequence of these uncertainties, there has already been a **readjustment in the perception of global risk, especially in the emerging countries**. Financial tensions in emerging countries have widespread (see Figure 2.3), due to the depreciation of currencies and the widening of risk premiums, although countries with higher external financing needs have been the most negatively affected. For this reason, the central banks in many of these economies (with the exception of China) have also tightened their monetary policies to avoid the depreciation of their currencies. **In Europe, the political risk in Italy** has resulted in a notable increase in the Italian risk premium (up to 250 basis points) but with a limited contagion to the rest of the peripheral countries. In addition, **uncertainty over protectionist measures has begun to have an impact on equity markets**, especially in Asian countries with China at the forefront, and on the demand for safer assets (US and German treasury bonds).

Figure 2.3 Euro-dollar exchange rate and BBVA index of financial tensions in emerging markets

Fuente: BBVA Research a partir de Bloomberg

Figure 2.4 World GDP growth forecasts (% YoY)



Fuente: BBVA Research

The ECB is wrapping up the asset purchase programme in December and will not raise rates at least until the second half of 2019

As expected, **the ECB** at its meeting in June **announced that the asset purchase programme** (APP) **will be concluding in December** of this year given the progress towards a sustained adjustment of the inflation path, while at the same time **strengthening the anchoring of expectations regarding interest rates.**

The ECB reiterated that the bond purchase programme will remain active, at a monthly pace of €30 billion per month until September, and €15 billion between October and December, when the net purchases of assets will end. With regard to interest rates, the monetary authority is maintaining the reference rate at 0% and the deposit rate at -0.40% but announced that the reference rates will remain unchanged at least until the summer of 2019, which is longer than expected**.** In this context, our expectation of the first hike in interest rates is being delayed, with a **first increase of the deposit rate in September and the official reference rate in December 2019.**

In summary, the ECB at this meeting adopted important measures for the process of normalisation of its monetary policy. Once the end of the asset purchase programme has been approved, the phase of emergency measures will be **gradually closed in order to make way, once again, for a more conventional monetary policy, more focused on interest rates.** The focus in the coming months will be on knowing when and at what pace rates will rise.

World growth forecasts remain unchanged, supported by solid US growth despite the slowdown in other areas

The global forecasts for the next two years remain at 3.8% (see Figure 2.4). Nevertheless, the lower degree of synchronisation observed recently is reflected in a **downward revision in the growth expected for 2018-19 for both the Eurozone and South America** (mainly Argentina and Brazil), while we **maintain the forecasts for the coming years in US and China**, after recording a good economic performance in the first part of the year and with the fundamentals still being solid for domestic demand.

In the Eurozone, after the negative surprise in GDP growth in the first quarter, we now expect a faster convergence towards more moderate growth rates. In particular, we revised the growth forecast for 2018 downwards by 0.3 pp to 2%, while we continue to expect a moderation of the cyclical momentum in 2019, reaching 1.7%. This downward revision in the forecasts is mainly explained by lower trade and higher inflation (due to the rise in the price of oil), to which we must add the growing political uncertainty. However, despite the above, domestic demand will continue to contribute to growth both this year and next, supported by employment growth, a still accommodative monetary policy, and a slightly expansive fiscal policy.

The downside risks linked to political uncertainty, vulnerabilities in emerging economies and above all protectionism are intensifying

The global scenario continues to be subject to mostly negative risks, which in recent months have increased. On the one hand, **the risk of a trade war has intensified** in the wake of the latest measures adopted by the United States and the response from China, mainly, and to a lesser extent, the rest of the countries affected. Added to this are new protectionist threats that would involve the interests of important sectors in other regions, such as the automobile sector in Europe, Mexico, Canada or Japan. While the direct impact of the measures, as discussed above, would be limited, **the risk of a trade war could act as a drag on confidence, increase risk aversion in the markets and curb global flows of direct investment**, with the consequent impact on the potential of global growth.

In addition, **in a more volatile financial environment, systemic risk would increase in emerging economies**. The combination of a greater protectionist risk added to those posed by a more accelerated normalisation of monetary policy in the United States and a possible slowdown in the global economy could trigger the perception of risk in emerging financial markets, raising the likelihood of a *sudden-stop* of capital flows. In this context, the risk of an abrupt adjustment in the Chinese economy remains, since some measures to respond to a possible trade war could limit and delay the process of deleveraging and restructuring the Chinese economy.

Lastly, **political risks in Europe have also intensified**. To the risks in Italy, we need to add those of governance in Germany, with potential direct consequences on the integration process of the Eurozone.

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