BBVA Research

Global Economic Risk Outlook

3Q18

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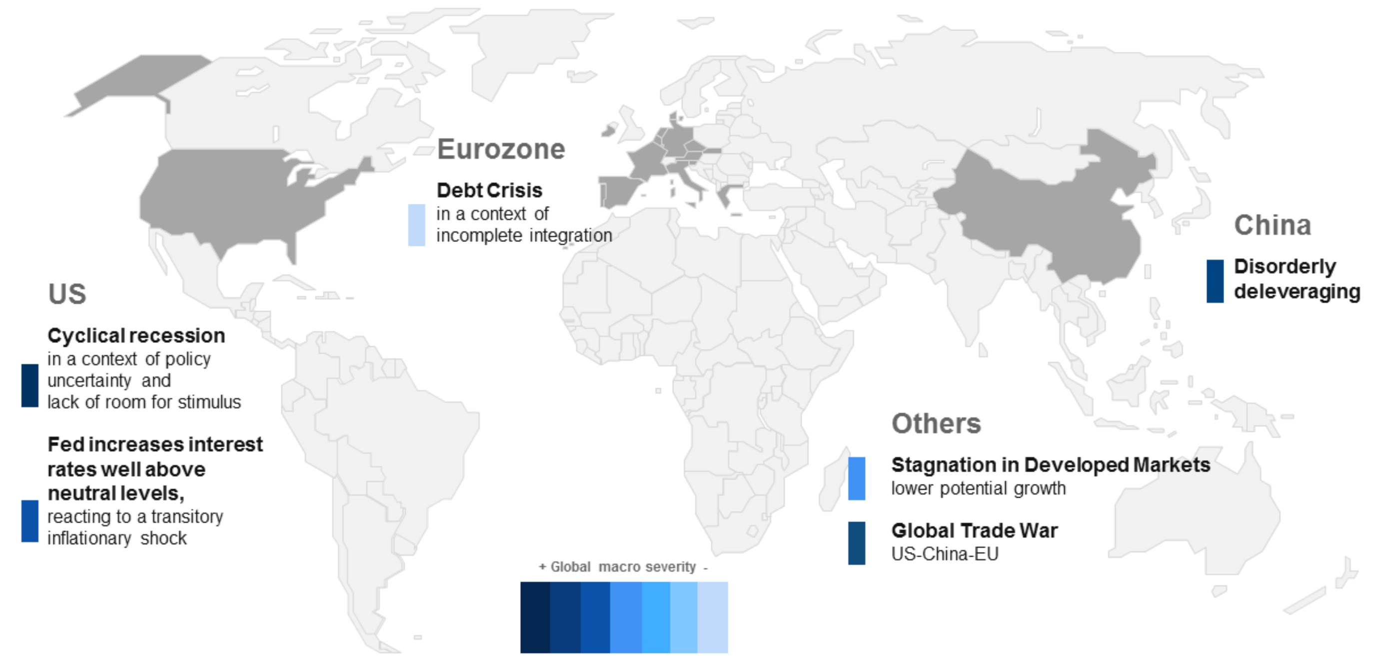
Creating Opportunities

Overview

This report diagnoses and analyzes the main global risks currently perceived as feasible by market participants and economic observers that could generate a sizable deviation from our baseline global macroeconomic scenario. Though these are usually events of low probability, their feasibility and adverse effects are large enough to require monitoring. As such, this report complements BBVA Research's Country Risk Report, which focuses on key warning indicators of macroeconomic and financial risk at the country level. What you will find in this report is a characterization of how these events could materialize and propagate across selected areas.

Main global macro-financial risks to the global economy (severity in terms of macroeconomic impact)



Source: BBVA Research

Our analysis concludes that the main global risk events are the following:

1. **Global trade war**: trade policy has been at the cornerstone of US Administration's rhetoric, although its manifestation has been changing through time. Initially, the focus was placed on a hypothetical US withdrawal from NAFTA, while recent events have gravitated towards restrictive measures against China and the EU. These 'policy-swings' have eventually given rise to material decisions on tariffs and announcements of "more to come" which have increased the uncertainty of the measures and countermeasures that could be taken. The main risk lies on a generalized increase of tariffs between the main economic blocks, driven by US, entailing fairly strong retaliation from China and the EU, which would shatter the reduction of global bilateral trade costs registered since the 1990s.

2. **Cyclical recession in the US amidst policy uncertainty and lack of room for stimulus**: in a context of high policy-driven uncertainty, trade tensions and high exposure of the private sector to financial price fluctuations, an economic slowdown in the US stands as a disruptive global economic event. The lower room of maneuver from monetary policy, along with higher fiscal constraints, would exacerbate the negative impact of a slowdown on consumer and investment expectations, and thus on domestic demand.

3. **Fed increases interest rates well above neutral levels, reacting to an inflationary shock**: beyond the current economic momentum, the Fed's reaction function could be influenced by the potential impact of the recent fiscal impulse. Its potential effects on inflation expectations could make the Fed hike rates more

aggressively (*overshooting*). Such a tightening in funding conditions, in a context of signs of overheating in some financial assets, could catch many investors off guard, provoking a global financial shock, probably in a similar manner as in the 'taper tantrum' episode.

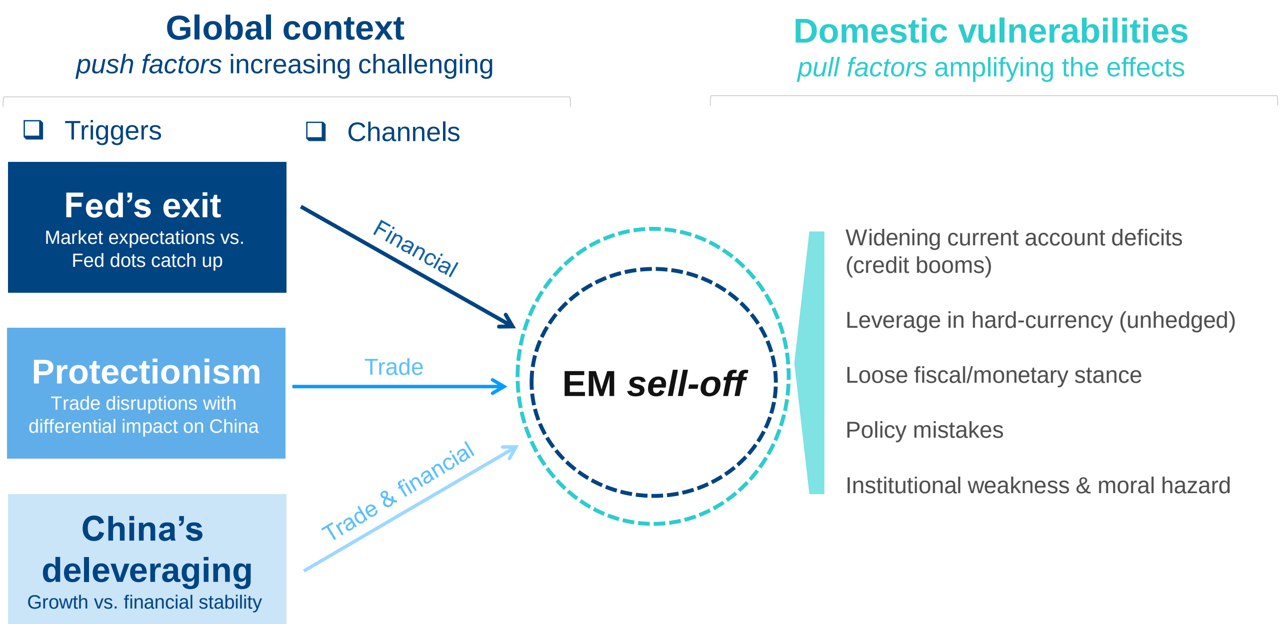
4. **A disorderly deleveraging process in China**: the policy-driven period of private sector indebtedness in which China embarked upon after the Global Financial Crisis poses a significant risk to the global economy if the necessary deleveraging process were to happen in a disorderly fashion. A disruptive event (that would require a faster clean-up of the financial system) would lead to a credit squeeze, with differential impact on firms dependent on shadow-banking funding, and a potentially sharp economic slowdown.

5. **Eurozone debt crisis in a context of incomplete integration**: policy measures taken by the ECB and EU leaders have strengthened the financial stability in the eurozone. Peripheral risk premia have steadily fallen in a context of low interest rates and surge of 'search of yield' strategies. However, fears of a risk scenario, driven by concerns on debt sustainability in some countries, have not truly vanished, especially after the relevance gained for euro-skeptical parties in the political arena.

6. **Economic stagnation in main developed countries**: although 2017 saw a year of solid global growth, the symptoms of secular stagnation have been around for much more than a decade, making it too soon to discard this scenario, especially given the puzzlingly tepid response of core inflation to the demand improvement in a context of closing output gaps. Against this background, GDP growth and inflation in DM would decelerate towards historical disappointing rates (around 1%).

Regarding the **current sell-off in Emerging Markets** (EM) assets, **we consider that this event cannot be classified as a global risk event by itself**. The correction of financial prices (mainly, exchange rates) in most of EM is the consequence of the partial realization of the global risk events described above, in particular those associated to the Fed's normalization (funding channel), the escalation of trade disputes (trade channel) and China's pending deleveraging (funding and trade channels). Even in the case of further deterioration across emerging countries and assets, with negative spillovers at global range (second round effects in terms of lower global growth and higher financial risk aversion), such a scenario would still be the consequence of global risk events.

In order to consider a global risk event triggered purely by an EM crisis (excluding China), it would be necessary to observe a synchronized adjustment in major economies (Brazil, India, Russia) **provoked by idiosyncratic factors in the absence of additional deterioration in the global outlook.**



Global trade war involving US, China and EU

Trade policy has been at the cornerstone of the US Administration's rhetoric, although its manifestation has been changing through time. Initially, the US withdrew from Trans Pacific Partnership (TPP) and left the negotiation of Transatlantic Trade and Investment Partnership (TTIP) on standby, shifting interests on a hypothetical withdrawal from NAFTA. However**, recent events have gravitated towards restrictive measures against China**. These 'policy-swings' have materialized in higher uncertainty (especially, given the difficulty to nail down the measures that will eventually be deployed), which highlights the relevance of this risk scenario.

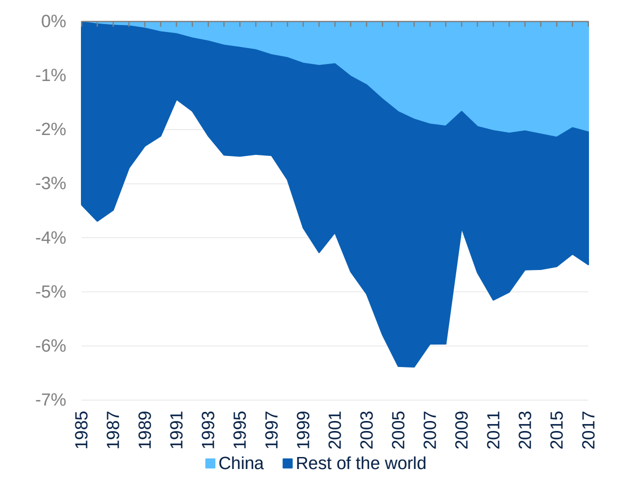
On the pretext of a harmful trade deficit in goods, the US Government started to impose a series of tariffs on steel and aluminum sectors, the overall impact of which is expected to be negligible considering the relatively small size of these sectors. Recently, trade disputes have focused on China, increasing sequentially the bulk of goods affected by higher tariffs. Although measures against the EU automotive sector remain on the back burner, they constitute a key source of concern. Hence, **the main risk lies on a generalized increase of tariffs adopted by the US against the main economic blocks, entailing fairly strong retaliation from China** (in line with recent actions) **and the EU** (full-on trade war), which would shatter the reduction of bilateral trade costs registered since the 1990s.

In the case of China, its retaliation strategy could go beyond rising tariffs, given the low margin it possesses to match one by one higher tariffs from the US (and considering its high integration in global value chains), and be focused on geopolitical pressures, direct administrative intervention against US firms, letting the RBB depreciate and/or dumping US sovereign debt (the latter has a very low probability). As for the **EU**, entering the tariff-game **could have significant impact on the US due to the high interconnection that both economies share**.

Global trade, therefore, **would see a major relapse**, forcing countries to reassess their role on current global value chains and players would shy away from investment. Likewise, **commodity prices would experience a remarkable correction**, given the fall on global demand. From a financial standpoint, such an environment of heightened uncertainty would transmit across the markets through **higher volatility and a sell-off of risk assets**.

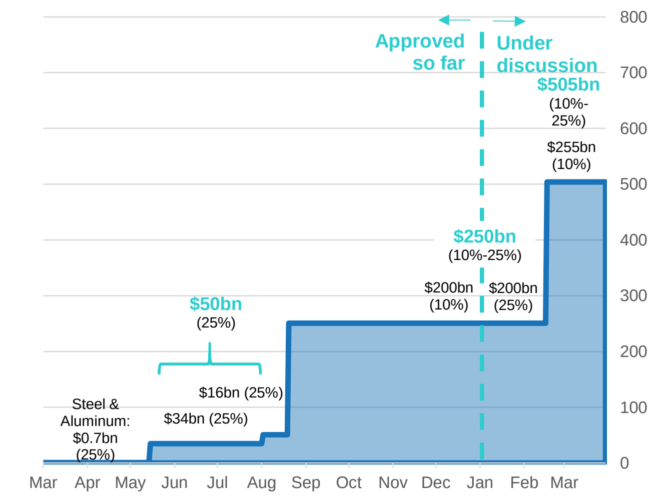
China would be one of the most affected countries among the main economic blocks (high dependence on US imports and trade openness), **driving the global economy into a slowdown**. Rising trade costs would **also hurt the US and the EU, although to a lesser extent** if a certain import substitution effect takes place. **Emerging Markets (EM) would suffer both from the real channel** (commodity prices and trade fall) **and from tighter funding conditions** (appreciatory pressure on the USD and EMBI spread rebound). It is worth highlighting that **such a negative environment may be long lasting** given the difficulty to rearrange production, becoming a drag for world GDP in the medium-term. Economic policies room of maneuver would rely on slowing down monetary normalization in the Developed economies (DM).

Figure 1 US trade balance in goods by partner (%GDP)



Source: Haver Analytics and BBVA Research

Figure 2 Chronogram of protectionist measures ($bn)



Source: BBVA Research

US cyclical recession amid policy uncertainty and lack of room for stimulus

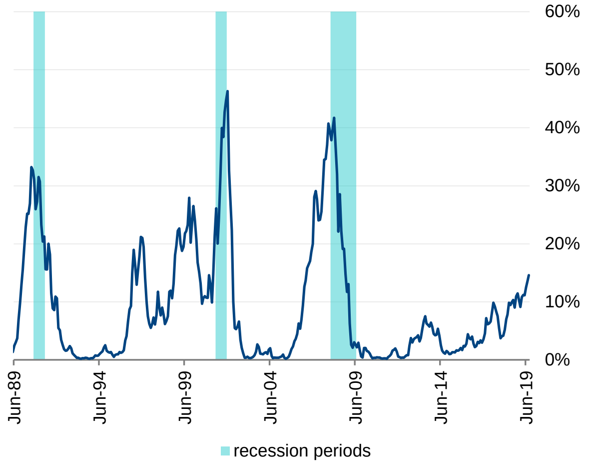
In a context of high policy-driven uncertainty, trade tensions and high exposure of private sector to financial price fluctuations, **an economic slowdown in the US** stands as a **disruptive economic event with global range**. Labor market and output gap suggest that the economy is in its late-stage expansion, being more vulnerable to a negative shock. In addition to this, the expected impact of the recent fiscal stimulus packages on the public deficit and debt sustainability could restrain the private sector spending decisions in anticipation of higher tax payments in the future. Although recent rate hikes offer the monetary policy some margin to cushion a slowdown, this continues to be lower than in other recessionary episodes (average reduction of fed funds during previous recessions was 3.5pp compared to actual 2.0%). The **lower room for maneuver from monetary policy**, along with **fiscal constraints** (higher after recent measures), would exacerbate the negative effect on consumer and investment expectations (through the confidence channel), taking its toll on domestic demand.

Signs of overvaluation in some financial assets also increase the vulnerability of the private sector to an economic recession. In the case of households, 30% of their financial wealth comes from corporate equities and mutual funds shares (highest level since the ‘dot-com’ bubble), and their savings ratio has falling down to 3.5% over the last years. Corporates also show higher leverage (at historical highs in terms of GDP) that has provoked a sharp deterioration of debt servicing despite low borrowing costs, especially in more cyclical sectors and small firms. A fall in revenues would make it difficult to repay the debt, increasing the probability of default events.

Some recession probability models for US, such as that developed by the New York Federal Reserve[1], place the probability of entering recession in the next 12 months close to 14%. The **reduction in the US demand for goods and services would translate into a fall in world trade and a sharp correction in commodity prices**. Such a drop in global activity would increase global financial volatility. An increase in demand for safe-haven assets would coexist with **bulky capital outflows from EM**, which translates into an increase in sovereign risk premia and currency depreciations.

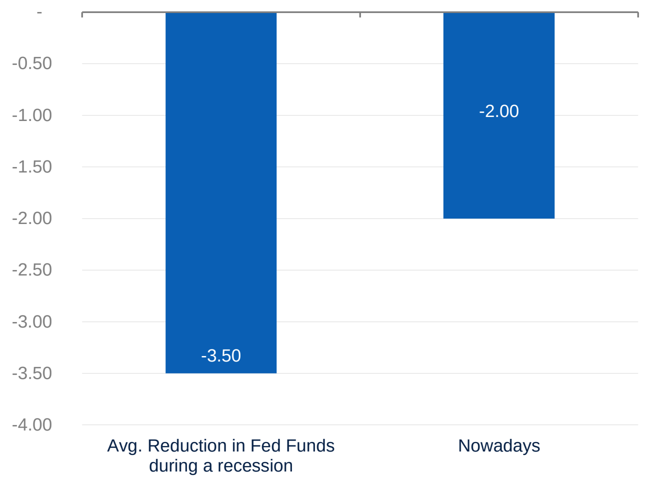
The macroeconomic impact would be more severe in those economies with higher trade openness (specifically, with greater exposure to the US) and dependence on exports of raw materials. Against this backdrop (recessionary effect and downward pressures on inflation), **monetary stimulus implemented by DM** (not ruling out new liquidity-providing and/or asset purchase programs) **would contain the increase of global financial risk**. Both factors, recessionary environment and downward pressures on inflation, would provide EM central banks some leeway for gradual interest rate cuts, prioritizing activity support.

Figure 3 One-year-ahead New York Fed recession probability for the US



Source: Haver and BBVA Research

Figure 4 Average reduction of fed funds in recessionary episodes (1980-nowadays)



Source: Haver and BBVA Research

1: https://www.newyorkfed.org/medialibrary/media/research/capital_markets/Prob_Rec.pdf

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Fed increases interest rates well above neutral levels, reacting to a transitory inflationary shock

The sustained improvement of the US macro conditions (solid economic growth, tight labor market and stabilization of inflation around the monetary policy target) **supports the process of ongoing monetary normalization by the Federal Reserve**. Financial markets have readjusted their expectations, pricing in two additional hikes in 2018 (our baseline scenario). The median of FOMC projections has also moved upwards, setting the level of fed funds expected for 2019 slightly above 3%.

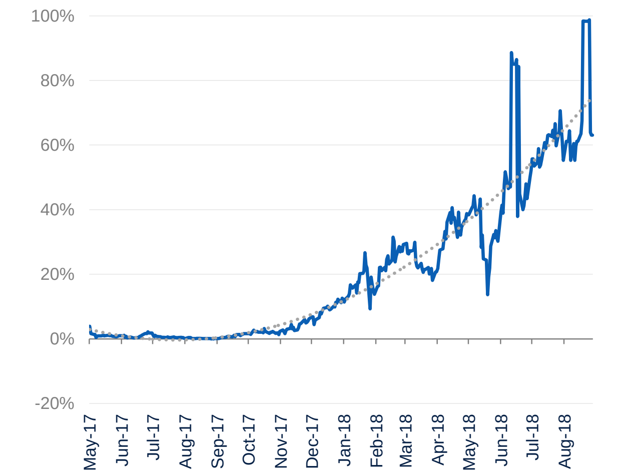
Beyond the current economic momentum, **the Fed's reaction function could be influenced by the impact of the recent fiscal impulse** (tax reform and expenditure deal) on inflation. Although the fiscal multiplier is expected to be lower than in other episodes (as a consequence of the stage of the cycle – output gap almost closed–), its potential effect on inflation expectations **could make the Fed to hike rates more aggressively (*overshooting*)**. Such a tightening in funding conditions, in a context of signs of overheating in some financial assets, could **catch many investors off guard**, provoking a financial shock in a similar fashion as in the 'taper tantrum' episode.

As was the case, **the main contagion channel would come from the financial side. The impact would be more significant in those economies with higher external imbalances and more exposed to portfolio flow dynamics** (mainly EM with current account deficits and high dependence on external debt denominated in hard-currency). In this regard, it is advisable to monitor the corporate sector position, given the substantial increase registered in the indebtedness level in the most economies during the last decade.

A transitory and sharp spike in the US sovereign 10y rates would reverberate across financial markets, as it has been brought up in less dramatic but recent episodes. Higher cost of funding would also be a burden for the US economy itself, dragging down GDP growth. **The combination of slightly lower growth and higher interest rates in the US would hurt global trade and commodity prices in the short-term**.

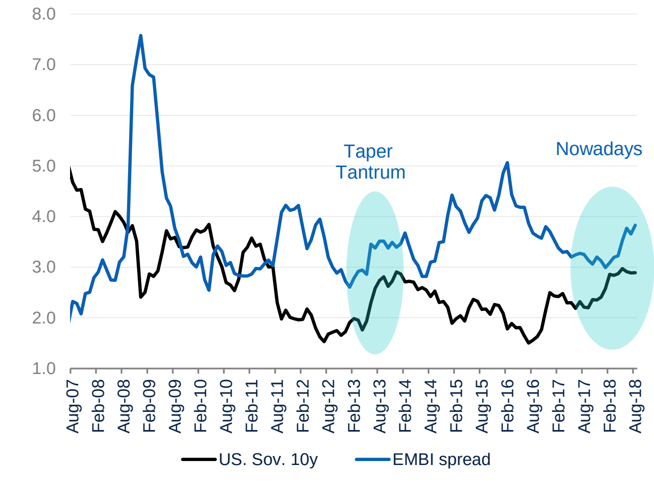
Against this backdrop, **EM central banks would be forced to increase interest rates** (following the Fed's tightening path) **to contain capital outflows and anchor inflation pressures**. Unlike in the aforementioned risk scenarios (more recessive), the pass-through effect would be higher in this case: the effect of currency depreciations would not be offset by the drop in demand. As regards the Eurozone, **the ECB would keep its normalization path, but delaying the first interest rate hike in response to the financial turmoil**.

Figure 5 Fed probability of 4 or more hikes in 2018



Source: Haver and BBVA Research

Figure 6 UST 10y and Global EMBI spread (%)



Source: Bloomberg and BBVA Research

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A disorderly deleveraging process in China

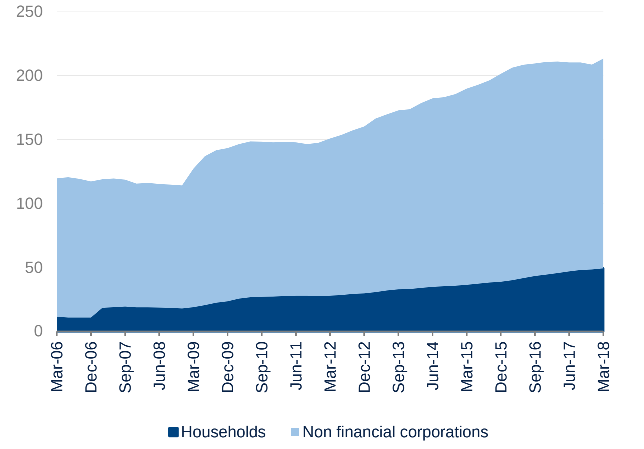
The policy-driven path of private indebtedness in which China embarked upon after the Global Financial Crisis poses a significant risk to the global economy if the deleveraging process were to happen in a disorderly fashion[2]. A disruptive event (faster clean-up of the financial system) would lead to a credit squeeze, with differential impact on firms dependent on shadow-banking and a sharp economic slowdown.

Economic momentum and regulatory changes contributed to contain the non-financial private sector debt to GDP ratio in 2017, but recent credit easing measures to face the protectionist threat may reverse this path, in line with most recent data. According to BIS, **private debt reached 212% in 1Q18 (+4.7 points higher than end-17)**, well above its long-run trend (the 'credit gap' stood at 14.9 points in 1Q18, 8 points less than the previous year). As a consequence, our early-warning banking crisis models[3] keep China in a high risk zone. Measures adopted to curb the financial leverage and the 19th Party Congress outcome, make a smooth deleveraging more likely. In fact, our baseline scenario (GDP growth transits from 6.9% in 2017 to 5.5% in the medium term) involves a reinforcement of the structural reforms to achieve a successful 'soft landing'. To do so, **the Government needs to tackle SOE deleveraging**[4] **and deepen the reduction of overcapacity in some sectors, while managing the ongoing financial liberalization** without compromising the capital account stability.

To sum up, **the risk of a disorderly deleveraging event demands to be closely monitored**, especially given the recent upward trend in household debt, lower fiscal space and the implications of protectionist threat (potential source of financial instability). The **main channel of global contagion would lie on the real economy**: the contraction of Chinese demand would drag down global trade and commodity prices, in line with the pattern exhibited in recent episodes of financial stress in China (summer 2015, Jan-2016). On the financial front, a global **risk re-pricing** would take place, increasing EM sovereign risk premia and capital flight to 'safe-haven' assets.

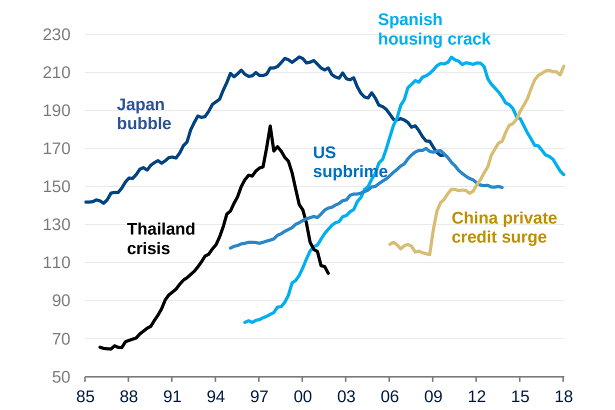
The **macroeconomic impact** would be **more severe for economies more open to world trade**, particularly those **highly dependent on commodity exports and/or closely linked to China**. For net commodity-importers, the fall in prices could cushion the recessionary effect and create deflationary pressures. It is worth highlighting that the impacts on DM would be greater than expected by historical experience due to the lack of room for maneuver to adopt counter cyclical policies. In any case, the expected response of DM policy makers to the risk scenario would diverge from that of EM: the former would implement accommodative monetary policies; the latter, however, would react to the strong capital flight, currency depreciations and likely inflation pressures (pass-through effect) by rising interest rates (at least, in the short term).

Figure 7 China: non-financial private sector debt (% GDP), 1Q18



Source: BIS and BBVA Research

Figure 8 Non-financial private sector debt (% GDP), 1Q18



Source: BIS and BBVA Research

2: https://www.bbvaresearch.com/wp-content/uploads/2017/12/EW-Deleveraging-after-the-burst-of-a-credit-bubble.pdf
3: https://www.bbvaresearch.com/en/publicaciones/country-risk-quarterly-report-third-quarter-2018/
4: https://www.bbvaresearch.com/wp-content/uploads/2017/09/201709_ChinaWatch_Deleveraging_edit.pdf

Eurozone debt crisis in a context of incomplete integration

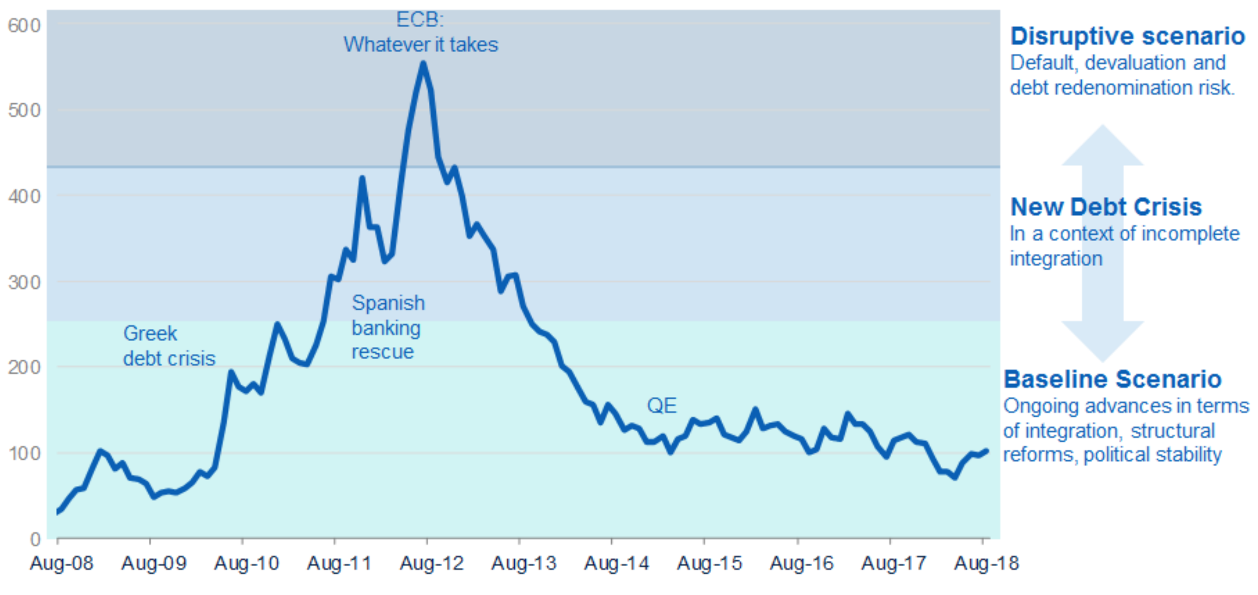
Financial stability in the eurozone has improved significantly since 2012 as a result of policy measures taken by the ECB (last-resort lender) and EU leaders (advances in terms of banking union), together with the efforts of fiscal consolidation and the implementation of structural reforms by those countries at a riskier position. Peripheral risk premia have steadily fallen in a context of low interest rates and surge of 'search of yield' strategies. **However, fears of a debt crisis have not vanished, especially after the relevance gained by euro-skepticism in the political arena**.

Anti-euro political parties are nothing but the distorted reflection of a skeptical society. In this sense, **the 'spark' of euro-skepticism could linger so long as the economic and political integration is fulfilled**. The euro has already survived a number of scares since its inception in 1999, with the mainstream political parties, economic elites and citizens willing to support the currency union. **The definition of this risk scenario lies on a resurface of debt sustainability concerns that, eventually, do not materialize as long as there is a prudent fiscal behavior and the authorities advance towards further integration** (European budget, bonds with common guarantee, compensatory funds for social purposes, etc.). Cross TARGET-2 positions reveal the size of the direct channel of contagion among the major Eurozone countries under a risk scenario. The **ECB's role** (public debt holdings) should prevent peripheral risk premia from reaching 2012 levels.

The main channel of contagion would arise from a sharp deterioration in funding conditions in the Eurozone, a general event that can be exemplified by the rebound of peripheral sovereign long-term spreads and a negative feedback loop between banks and the real economy (liquidity tensions, credit crunch), all of it **with negative spillovers on global financial volatility**. Although the ECB would keep its current stimulus programs, their effectiveness would be lower than in other stress episodes (lower margin to surprise markets). The global channels of contagion would come from global trade slowdown and commodity prices fall, due to subdued demand growth in the Eurozone. From the financial side, Germany would act as a 'safe-haven' with its sovereign 10y yields around 0% and **the euro would depreciate sharply against the USD**. There would be **a significant contagion to EM currencies** and a tepid rebound of EMBI spreads.

In the short term, the deterioration in financial conditions would impact on the **Eurozone** domestic demand remarkably. **Economic growth would register an intense slowdown in the short-term**, but the consequent advances in the process of fiscal integration would help to support the economic recovery afterwards.

Figure 9 Spanish risk premium as an example (bp)



Source: Bloomberg and BBVA Research

Economic stagnation in main developed countries (US & EMU)

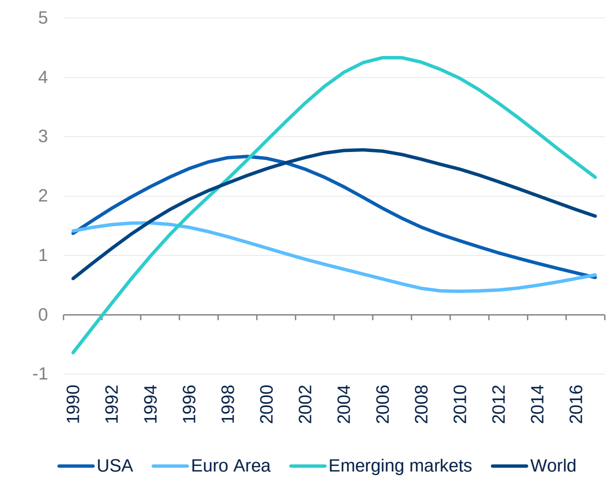
It's been four years since former Treasury secretary Larry Summers, drawing from a concept coined by Hansen, invoked the so-called 'Secular stagnation' [5] hypothesis into the debate about the puzzling economic outlook inherited from the Global Financial Crisis. Such a hypothesis stated that because of a variety of factors, mainly from **demand shortages, but also due to supply constraints**, some developed countries (in particular, US and Eurozone) could enter into a lower growth regime where the neutral interest rate is much lower than it had been. Although 2017 saw a year of solid global growth, the symptoms of secular stagnation have been around for much more than a decade, making it too soon to discard this scenario, especially given the tepid response of core inflation to the demand improvement in a context of closing output gaps.

Looking forward, structural factors such as adverse **demographic developments** (ageing), lower pace of **technological innovation (or at least not visible in the data)**, rise in **savings rates**, **scarcity of safe assets** and increasing income **inequality may continue to exert downward pressures on growth and real interest rates**. Therefore, a risk scenario where GDP growth and inflation in DM decelerates towards historical disappointing rates (around 1%) should not be ruled out.

It is worth mentioning **the lessons obtained from Japanese 'two lost decades' experience** as a case study. After the burst of the 'bubble economy' in 1991, Japan has experienced sluggish growth (between 1991 and 2017, the real GDP grew at an average rate of 1.0% vs. 4% in the 80s) and disappointing figures of total factor productivity. Since the early 2000s, Japan has largely resolved the clean-up of non-performing loans and repaired the damage in banking balance sheets, but economic growth has hardly accelerated even with a ultra-expansive monetary policy, supporting the structural view that a chronic lack of demand, ageing population and decline in productivity are the factors underpinning the economic performance.

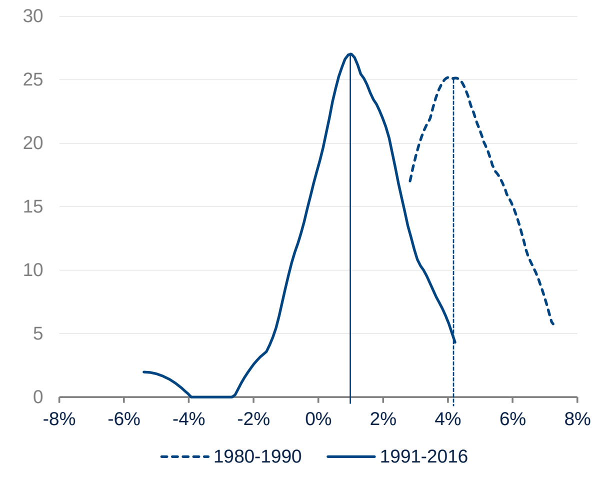
In this context, stagnant levels of growth in developed economies would entail **downward pressures on prices, global trade moderation and contained commodity prices at lower levels**. The slowdown in global economy would translate into a deterioration of global funding conditions despite **countercyclical policies by DM central banks** (interest rates would halt the normalization process and long-term interest rates would remain subdued). A more accommodative monetary policy in DM and low inflation would allow EM central banks to reduce policy interest rates without compromising their financial stability.

Figure 10 Trend growth of Labor productivity (output per person) using HP filter*



*Assuming lambda=100.
Source: Conference Board and BBVA Research

Figure 11 Japan: distribution of real GDP growth (# quarters)



Source: Haver and BBVA Research

5 Why stagnation might prove to be the new normal

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