BBVA Research

Global Economy / Country Risk

Pure uncertainty

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Is this the beginning of the end? Fears that the answer may be yes, due to the US economy’s going into recession and a marked slowdown in China’s growth, both in 2020, explain the sharp correction in financial markets at the end of 2018. Historical experience shows the predictive power of falls on the stock exchange and especially of flattening interest rate curves to anticipate possible recessions, although this time around there are a few specific features that it is worth looking at more closely.

As regards the low slope of the interest rate curve, account must be taken of the effect of the strong preference for “safe” assets over long-term bonds yields, which is different from other low-slope phases. If the flattening were a reaction to an abrupt rise in Federal Reserve rates or a sharp decline in long-term rates, the concern would be greater.

To the extent that the financial markets have already factored in the expectations of lower economic growth, we could see financial volatility being contained, and this in turn would limit the potential negative impact of tighter financing conditions on the real economy. Based on this assumption, the financial markets will have anticipated some deterioration in the global activity, which the growth data will in due course reflect.

However, volatility tends to increase whenever there is real uncertainty, meaning that agents are not sure what to expect or how likely things are to occur. This kind of uncertainty is currently running particularly high, given the accumulation of risks affecting systemic countries all at the same time. The possible “pause” of the Federal Reserve and the “targeted” stimulus measures from the Chinese authorities may protect their respective economies from an abrupt adjustment in the short term, but the risk of this event exists, in a context by protectionist threats in an unfavourable and unpredictable political climate in the United States. The lower room for manoeuvre available to monetary policy for kick-starting the economy compared with previous recessions (the average rate cut was 5 points) is another element of uncertainty.

The probability of unexpected shocks occurring and heightening the financial tensions from the current level, with a negative effect on growth, has increased. The risks faced by the world are greater than in the past few years and, as in other similar situations, the central banks will have much to say.

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