Economic Outlook

Global

Third Quarter 2011
Economic Analysis

- **Strong global growth in the outlook** with politically-driven downside risks.
- **It is high time to address solvency concerns in Europe.** Positive measures taken on July 21 need to be advanced further, as financial tensions become more systemic.
- **A long-term fiscal consolidation plan in the US is needed.** Mostly short-term fixes are not enough.
- **Overheating woes still linger in emerging economies,** though recent headwinds have reduced them.

Index

Closing date: August 3, 2011

1. Summary: politics at the center of the global outlook

The global economy will continue growing strongly, after a soft patch in the first semester

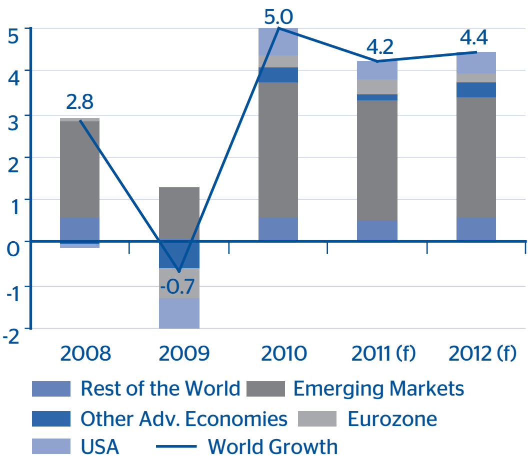
The global economy experienced a mild slowdown in the first half of the year, more pronounced in the US, but also in some emerging countries. Nevertheless, as the factors behind the slowdown are mostly temporary in nature (high oil prices, supply chain disruptions from Japan and bad weather), global growth is set to continue at a robust pace, at 4.2% in 2011 (slightly lower than in the previous Global Economic Outlook) and 4,4% in 2012 (Chart 1).

However, risks to the outlook are now more tilted to the downside. Although the slowdown in activity in the US should be temporary as oil prices stop climbing and international supply chains are restored, the recovery is still weak and may be prone to relapses, as expected in the aftermath of a financial crisis with highly leveraged consumers. The recent soft patch in the US has reminded markets of that, and may dent consumer and producers sentiment going forward.

Both in Europe and the US, fiscal concerns pose big challenges for policymakers. As solvency concerns have not been fully addressed, the sovereign debt crisis in peripheral Europe intensified (Chart 2), with the risk of it becoming systemic as market pressure spreads beyond Greece, Portugal and Ireland to Spain, Italy and could eventually claim Belgium. Although its solvency is not being put in doubt, the US also faces the challenge of a large near-term fiscal adjustment, with the risk that political negotiations turn just to short-term fixes but not to a long-term consolidation plan. This would increase the chances of a sudden spike in long-term yields in the US.

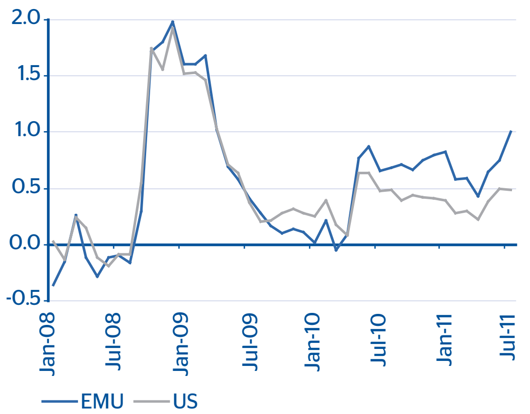
Finally, in emerging economies, overheating concerns have eased slightly as tightening measures continue to ease growth gradually in Asia and Latin America, although fiscal policies still remain mostly accommodative, thus overburdening monetary authorities, at a time when concerns over the appreciation of exchange rates in these economies remain.

Chart 1
Global GDP growth and contributions (%)



Source: BBVA Research and IMF

Chart 2
BBVA Financial Stress Index



Source: BBVA Research

It is high time to address solvency concerns in Europe, and that requires continued bold actions from EU politicians

In recent weeks a new round of financial market stress in Europe has extended to Spain and Italy, and thus has increased the chances of the crisis becoming systemic in all Europe (with spillovers beyond the EU). This was the result of the delay in providing a second package to Greece and the insistence that private bondholders should bear part of the cost of further financial aid to that country, together with the lack of a comprehensive solution to underlying solvency concerns in Greece. This lack of resolve in Greece spilled over countries with no solvency problems such as Spain and Italy, and as a consequence to the European financial sector, which quickly saw their liquidity dry up.

In this context, with so much at stake, the Eurogroup agreed on July 21 to deal with liquidity and solvency concerns. For, the former, it decided to improve the EFSF by allowing it to lend preemptively to solvent countries in distress –much like the Flexible Credit Line from the IMF– and to buy sovereign bonds in secondary markets. Regarding solvency, it softened the conditions of official loans to Greece (also extended to other program countries) and reached an agreement with the private sector for a reduction of net present value of their holdings of Greek debt by 21%, through debt swaps and buy-backs.

These have surely been big –and, in some cases, unexpected– steps in the right direction towards solving the financial crisis in Europe. But Europe is not out of the woods, and that has been reflected in only a moderated reduction in risk premia in peripheral countries. Apart from filling in the technical details of the July 21 agreements, there are still four main lines of action. First, the EFSF should be expanded and pre-financed according to its new capacity to buy bonds in secondary markets and as provider of liquidity (even preemptively) for countries beyond those under an EU/IMF program. Second, Europe needs to work towards a closer fiscal union, ending with the introduction of Eurobonds, together with fiscal rules and tight control of national budgets. Third, economic reforms should continue to be implemented credibly in program countries and credible reform agendas should be drawn up in the rest of the EU, especially those countries at risk of being shut out of financing by markets. Fourth, EU authorities should finally decide how they will bring Greece's debt to a sustainable level and end solvency concerns, be it by a public bailout, reaching a consensus with the private sector or agreeing on an orderly default.

Until these four steps are not taken, Europe will be confronted with elevated sovereign spreads (not just for peripheral Europe) and a bigger debt restructuring down the road. In the meantime, Europe will continue to be subject to "accidents" due to reform fatigue or bailout fatigue leading to a disorderly debt restructuring, which could have a global impact.

Thus, a political consensus is needed in which political parties and countries will have to make compromises. On one side, peripheral countries need to put forward fully credible plans to reduce its imbalances and undergo structural reforms to increase their potential growth. However, most likely credibility will only be achieved by forgoing some economic policy sovereignty to EU institutions. In exchange for these commitments, strong core Eurozone countries should back an expanded European Financial Stability Fund (EFSF) to act as a real backstop to threatened countries, now that is has been improved in its functioning and the creation of a Eurobond, which will have to include a reduction of fiscal sovereignty in countries that benefit from it.

This grand bargain between core and peripheral countries would surely entail costs but its benefits would surely be bigger and benefit all EU countries: greater financial stability and a more balanced and sustainable recovery.

Fiscal consolidation in the US also focuses the attention on politics

In the US, the political haggling between two opposite (and highly polarized) approaches to deficit reduction has added much noise, but so far has not increased market pressure on US rates. This reflected the belief that a solution to raising the debt ceiling would be found and default averted. . But an accord to raise the debt ceiling without a plan for long term fiscal consolidation will not address long-term sustainability concerns. In order to be sustainable and gain credibility, a deficit reduction plan will have to be (i) frontloaded; (ii) supported broadly by both parties and (iii) require Democrats accepting cuts in entitlement spending and Republicans agreeing to revenue increases. Here the risk also lies –as in Europe– in the temptation to kick the can down the road, postpone a solution after the 2012 elections and increase the chances of a spike in long-term interest rates.

Politics also holds the key to the outlook in many countries in Latin America

To a lesser extent, in Latin America, many countries also face uncertainty derived from the future course of politics. In some cases this is derived from perceived weakness by some governments as they are saddled by corruption charges or by massive protests. In other cases, it is the result of recent changes in governments or the uncertainty about the outcome of upcoming elections. Although it is true that the election cycle in the region has had less influence on the economic cycle in the last decade, it is crucial that this capital is not wasted by wide policy swings straying from continuing economic reforms.

Overheating concerns ease slightly in many emerging economies, but global risks and currency appreciation might turn policy tightening more cautious

Emerging economies continue to show risks of overheating, although as a whole they have receded somewhat given ongoing tightening measures and headwinds (in Asia) from higher commodity prices and the earthquake in Japan. Importantly, risks of a hard landing in China were reduced as Q2 growth showed only a slight deceleration, still on track for a soft landing. However, inflation in emerging economies remains a concern, and there is the risk of policymakers falling behind the curve, in some cases as they remain cautious about the global environment and in other cases as they worry about excessive currency appreciation.

2. It's high time to address solvency concerns in Europe

The sovereign debt crisis worsened since June, and risks turning systemic.

Governance reforms approved in the March meetings of the European Council provided only partial solutions to the crisis in the EU periphery and did not allow a reduction in financial stress. On the contrary, this stress increased due to the lengthy process to provide a second rescue package to Greece, which triggered a contagion effect to large countries in the Eurozone, such as Spain and Italy. In particular, the EU Council summits of 7 and 24 March designed the Euro Plus Pact to reinforce structural reforms in European countries, provided further steps in reforming the Stability and Growth Pact to strengthen the control over public deficits and especially to include the vigilance on other macroeconomic imbalances, and provided for the creation of the European Stability Mechanism (ESM) as a permanent stability fund to substitute the current EFSF as from mid-2013. But these steps did not reduce market strains, as the fear of a restructuring of private debt after 2013 persisted. On the one hand, the solvency problem of Greece was still open; on the other, the declarations of EU politicians and the measures taken related to the ESM made it clear that the intervention of the official sector would be accompanied with a private sector involvement (PSI) in any definitive solution to high debt levels in peripheral countries. The perspectives of a still-undefined haircut for private investors in the medium term left them unsure about countries whose solvency is in doubt –Greece and, to a lesser extent, Portugal and Ireland.

Over the past two months the situation worsened as the disbursement of the fifth tranche of the Greek aid program, scheduled for July, was in doubt. Two developments contributed to this. First, despite the very strong adjustment carried out in 2010, equivalent to 8% of GDP (the largest annual fiscal adjustment by any European country ever) Greece had missed part of its fiscal revenue targets, which were part of the quarterly examination of the progress of Greek reforms by the troika. Second, and more importantly, the original rescue plan for Greece envisioned its return to financial markets as soon as the first quarter of 2012, something that, one year after the beginning of the program, was seen as impossible under prevalent market conditions. As IMF rules allow it to disburse financial aid only when the financial needs of the recipient are covered for the following 12 months, the part to be covered by markets had to be substituted by a new EU/IMF package, clearly creating circularity that was difficult to break. It was finally solved through some forbearance on the side of the IMF, which approved the disbursement with a soft compromise by the EU to design a second rescue package for Greece.

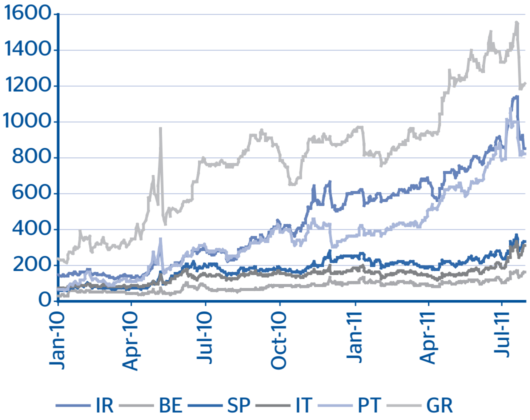
By the end of June the Greek parliament approved the new austerity laws to fulfill the new conditions needed for the troika to provide a second aid package. The new program incorporates an additional fiscal adjustment of 26 bn EUR until the end of 2014, together with a privatization program estimated at 50 bn EUR until 2015 (probably too optimistic in the valuation of assets, given current market conditions). The process of parliamentary approval was traumatic, and the laws were passed by a small margin of votes, after strong tensions both in the streets and among Greek political parties and government. The absence of an alternative plan (any plan to continue providing aid to Greece was conditional on the adjustment) resulted in strong contagion to other peripherals.

An additional stress factor during the first weeks of July was the delay by EU authorities to approve the new program for Greece, and the insistence in involving the private sector in their financing. Although it was clear that the troika would provide the necessary funds, the fuzzy details on the extent of private sector participation clouded the horizon. These included a possible default rating of Greek debt and even the possible trigger of a credit event in the CDS market (with the spectre of Lehman Brothers looming in the background).

In addition to this, the Italian government reacted accelerating the approval of the measures to reduce the deficit to zero by 2014. The fact that the bulk of the adjustment was delayed until 2013 and 2014 (after the elections), together with political uncertainties hitting the coalition government, was not well received by markets.

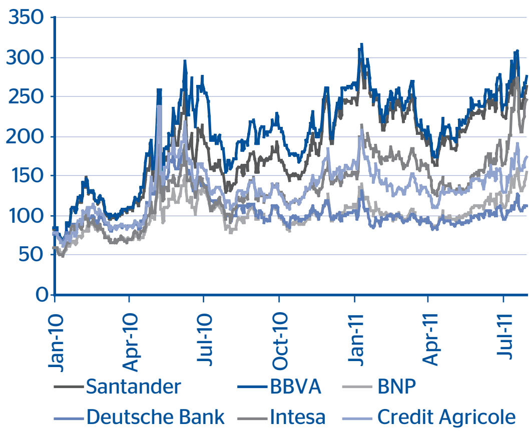
The end result was strong contagion to the rest of the periphery, including this time Italy and Spain, which implied the risk of a systemic crisis in Europe. The spreads of these two countries rose during July from a minimum of 183 and 235 bps, respectively, to maxima of 332 and 367 bps during the third week of the month (Chart 3). This increase in sovereign risk spilled immediately to the financial sector, which quickly saw their liquidity dry up (Chart 4).

Chart 3
Sovereign debt spreads
in Europe (bps, versus German 10y bonds)



Source: BBVA Research

Chart 4
CDS spreads (5Y) for big Eurozone banks (bps)



Source: BBVA Research

Measures agreed at the Eurogroup summit on 21 July are big steps in the right direction

By the end of July, the high level of financial stress led EU authorities to follow the second rescue package for Greece with a series of measures to address liquidity and solvency concerns in some countries in the euro zone. The main measures approved were:

1. A Second rescue package for Greece, with an official contribution of 109 bn EUR and continued IMF participation.
2. Softer conditions on official loans to Greece, Ireland and Portugal. Loan maturities are extended to between 15 and 30 years, and interest rates will be linked to those of the IMF's Balance of Payments Facility -currently around 3.5%- but never below EFSF's financing cost. In addition, there is a 10-year grace period for newly issued Greek debt. These conditions imply a very substantial improvement with respect to present conditions (maturities of 7.5 years and interest rates around 5%).
3. A substantial flexibilization of the EFSF, which will be able to buy bonds in secondary markets (in exceptional circumstances and under control of the ECB), including those of non-program countries (e.g. Italy and Spain). The EFSF can also lend preemptively to countries with limited conditionality, in a way similar to the IMF's Flexible Credit Line. It can also be used by all countries in the euro zone to prop up their banking system. Thus, the EFSF would in principle have the tools to act against contagion. Some of these measures had been until then rejected by Germany and other European countries.
4. Private sector involvement will be articulated through debt buy-backs, debt exchanges and rollovers, aiming at a reduction of 21% in net present value of private sector holdings of Greek debt. Participation will be voluntary, and is expected to reach up to 90% of bond holders. Overall, the participation of the private sector is estimated at around 50 bn EUR until 2014 and more than twice that until 2019. The private involvement will almost surely imply a declaration of selective default of Greek debt by rating agencies. For these bonds to be discounted by Greek banks at the ECB, the ESFS will provide the necessary collateral through guarantees.

One additional and important element of the communiqué is a clear commitment that private participation will apply only to the Greek case, which provides a signal that Europe considers the rest of peripheral countries have mostly liquidity, not solvency problems.

In our view this is a positive agreement, with steps taken in the right direction. The EFSF was improved beyond what was expected (but should have been done already in the March summits) and has now the legal framework to act against contagion to other countries. In addition, the new conditions for official loans are much more favorable tan before, on top of some reduction of Greece's debt burden.

However, sovereign debt problems are not completely solved, and the EU needs to take further action toward ensuring proper resolution of liquidity and solvency concerns

Notwithstanding these positive steps, Europe is not out of the woods, as reflected in only a moderated reduction in risk premia in peripheral countries in the aftermath of the summit. Apart from filling in the technical details of the July 21 agreements, there are still four main lines of action to close some unresolved problems. First, the EFSF should be expanded and pre-financed according to its new capacity to buy bonds in secondary markets and as provider of liquidity (even preemptively) for countries beyond those under an EU/IMF program. For example, the current size of the EFSF would be insufficient to deal with an eventual speculative attack on Spanish or Italian debt, and nothing is more tempting for markets than to test weak barriers. Second, Europe needs to work towards a closer fiscal union, ending with the introduction of Eurobonds –to cover up to a defined percentage of national debt–, fiscal rules and tight control of national budgets. The EFSF and its future substitute from 2013, the ESM, could constitute at some point the basis for this deeper fiscal integration in Europe, but an additional push needs to be undertaken by EU authorities to reach the next step. Third, economic reforms should continue to be implemented credibly in program countries and credible reform agendas should be drawn up in the rest of the EU, especially those countries at risk of being shut out of market finance. Despite the fact that during the summit an investment plan has been approved for peripheral countries (with no specifics on the funds committed) in order to alleviate the impact of fiscal consolidation on growth, the size of the adjustment still to be made by different countries is still very large. Fourth, EU authorities should finally decide how they will bring Greece's debt –still far from "safer" levels close to 100% of GDP– to a sustainable level and end solvency concerns, be it by a public bailout, reaching a consensus with the private sector or agreeing on an orderly default.

Until these four steps are not taken, Europe will be confronted with elevated sovereign spreads (not just for peripheral Europe) and a bigger debt restructuring in Greece down the road. In the meantime, Europe will continue to be subject to "accidents" due to reform fatigue or bailout fatigue, in the context of quarterly assessment by the troika of the Greek program, possibly leading to a disorderly debt restructuring, which could have a global impact (see Box 1).

Thus, a political consensus is needed in which political parties and countries will have to make compromises. On one side, peripheral countries need to put forward fully credible plans to reduce its imbalances and undergo structural reforms to increase their potential growth. However, most likely credibility will only be achieved by forgoing some economic policy sovereignty to EU institutions. In exchange for these commitments, strong core Eurozone countries should back an expanded European Financial Stability Fund (EFSF) to act as a real backstop to threatened countries –now that is has been improved in its functioning– and the creation of a Eurobond, which will have to include a reduction of fiscal sovereignty in countries that benefit from it.

This grand bargain between core and peripheral countries would surely entail costs but its benefits would surely be bigger and benefit all EU countries: greater financial stability and a more balanced and sustainable recovery.

The debt crisis in the periphery will have some impact on the recovery of the area

Our base scenario incorporates the assumption that stress levels in the Eurozone will take time to flex down, something that will happen once doubts on debt sustainability in the area start to dissipate. This will translate into financial restrictions somewhat higher than those projected three months ago, leading to a slight revision in our growth projections for 2012 for the Eurozone. However, the projections for Europe hide a strong decoupling in growth between core economies and peripherals. For the latter, par of the damage on growth from higher spreads has been done already, and that will be reflected in lower projected growth, mostly on 2012.

Box 1: Channels of global contagion in the event of a disorderly default in Europe

Over the last few months, the fragility of the decision-making process in Europe, including lack of resolve, different stances among EU governments, and a drawn-out decision-making process have put Greece on the brink of an "accident". Greece faces a tough calendar of maturities throughout the next years. In case that reform fatigue spreads in Greece (or, alternatively, in case bail-out fatigue spreads in core European countries) it is not unlikely that negotiations between Greece and the EU break with a disorderly default.

In that case, sovereign debt may face a restructuring process without all the necessary mechanisms in place to prevent or reduce the extent of contagion, that is, i) a plan and resources to recapitalize Greek banks, ii) time for European banks to rebuild their balance sheets, and recapitalization plans for European banking institutions in distress, iii) a clear map of cross-exposures in other financial institutions, from stress tests, and iv) a plan and sufficient resources to provide external financing to other peripheral countries which would face closed markets (including possibly Spain and Italy).

A disorderly restructuring would imply a sharp increase in sovereign spreads in peripheral countries and closed markets for many. As a consequence, increases in interbank spreads in the EMU may be expected and, even more, some countries susceptible to contagion could face a liquidity crisis derived from deposit runs from banks. A full fledged credit crunch may ensue in peripheral Europe,, with contagion to core Europe through bank exposures and counterparty risk. All this with limited monetary policy support given very low policy rates (just liquidity provision by ECB).

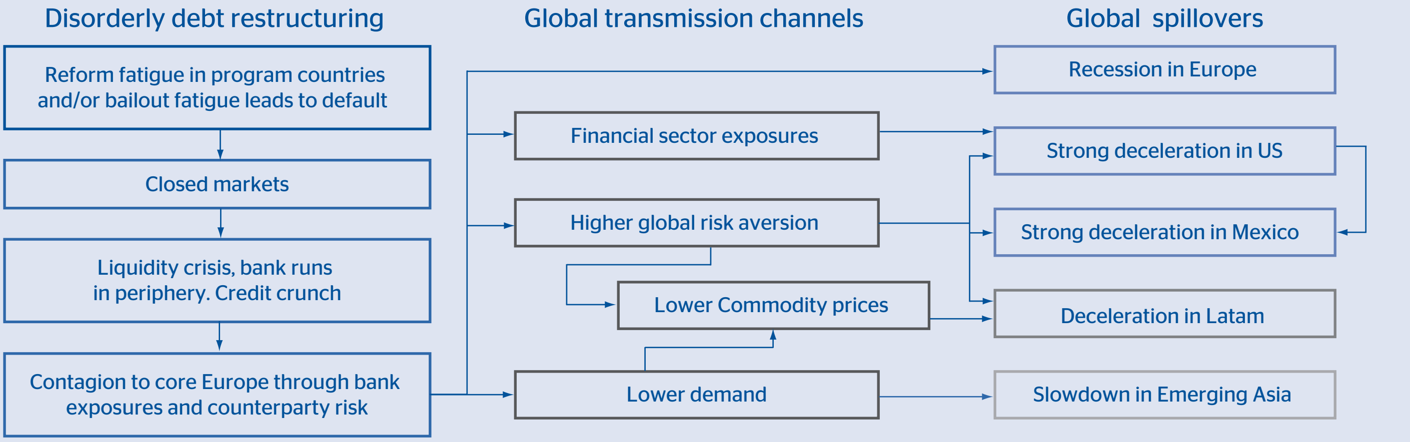
This scenario could generate a very strong negative effect on activity, with the Eurozone as a whole slipping back into recession.

The high impact of such scenario is likely to have global knock-on effects. Contagion outside the Eurozone would go through four main channels (Chart 5) . First, reduced external demand would be very relevant to countries close to Europe (Eastern Europe, Turkey and the MENA region). Second, increased risk aversion reduces demand for risky assets, with negative wealth effects on households in the US and reduced confidence on households and firms, reducing private sector demand.. At the same time, increased risk aversion and flight-to-quality would reduce capital flows to emerging economies, with significant effects on those more vulnerable to capital flow reversals or wide current account deficits (like Turkey, Brazil). Third, both lower European demand and higher risk aversion would lower commodity prices both from fundamentals as well as from reduced demand as another risky asset class. Fourth, exposure to the financial sector in Europe (especially to big banks in core countries) would reduce the supply of liquidity from money market mutual funds, affecting also US institutions being financed in that market segment. Finally, increased fiscal concerns in the Eurozone would bring attention to high fiscal deficits elsewhere, canceling some of the downward effect on US bond yields from flight-to-quality.

On the whole, Emerging Asia would be relatively resilient given its strong underlying fundamentals and policy space to offset some of the lost external demand and reduced private investment due to uncertainty, although a few of its smaller and more export-oriented economies could see much lower growth.. In developed economies the space for policy response is very limited to offset the negative effects of such scenario and thus the US would face a strong deceleration in GDP, with spillovers to Mexico, which would also decelerate sharply. Latin America will be hit both from increased risk aversion and lower commodity prices, leading to a moderate deceleration of growth.

In sum, a disorderly debt restructuring in Greece would have sizable global spillovers, especially in developed economies, at a time when the space for policy responses there is almost exhausted.

Chart 5
Channels of global transmission of a systemic crisis in Europe



Source: BBVA Research

3. Steering for the exit: tough policy decisions needed

In the US, policymakers face tough policy decisions on the exit from stimulus policies

Almost three years after the bankruptcy of Lehman Brothers, the US recovery has hit a soft patch in the past two quarters, with very disappointing growth data. Historical growth figures for the past 3 years were revised down in the last days of July. That included a very sharp downward revision of growth in the first quarter of 2011, from 0.5% quarter-on-quarter to 0.1%. This revision, together with a disappointing first estimate of 0.3% growth in the second quarter generates a very strong downward base effect on our projections for growth in 2011, which are revised to 2.1% from 3.0% three months ago. With the revised data the fall in GDP during the "grand recession" turns out to have been 5.1% (instead of 4.1% previously) and GDP at the end of the second quarter of 2011 was still below the peak of the fourth quarter of 2007. History suggests that the exit from financial crises is, on average, very slow –although there might be spurts of rapid growth following soft patches–, given the need for deleveraging of the private sector (especially households) and the protracted weakness of housing markets. Thus, the decision to end the policy stimulus (monetary and especially fiscal) is especially difficult, and depends on the ability to accurately forecast whether this soft patch is truly temporary or not. At present, on the fiscal side, attention should be paid not only to when and by how much the stimulus is reverted no to stall the recovery, but also to the consequences of further delaying the implementation of a credible fiscal consolidation plan to reduce the deficit and stabilize public debt (Charts 6 and 7). Lacking such an adjustment, the US could face a spike in long-term interest rates due to a negative market reaction. There is also a challenge on the monetary side, as the Fed faces a tough balancing act between temporary and structural factors behind the recent weakness of economic activity.

The Fed will maintain a wait-and-see approach at least for the near future, before deciding on further stimulus or an exit to normalization

The Federal Reserve's review of the economic situation focuses currently on two major issues: first, ongoing changes in both survey and market-based inflation expectations, and second, structural unemployment and wage pressures in a "softened" labor market. All talk about sequencing of exit does not necessarily mean hat the unwinding of monetary stimulus is imminent, especially after very disappointing GDP growth in Q1 and Q2. According to Bernanke, if deflationary risks re-emerge, the Fed may offer more explicit guidance on the target rate and balance sheet, conduct more securities purchases, and increase the average maturity of the Fed's holdings. All in all, given the fact that at least part of the very disappointing growth observed in the first half of 2011 is due to temporary factors, in our view the Fed will wait and see before taking the decision to withdraw the stimulus or embark in QE3. Thus, no change in policy is expected at least during the rest of 2011.

The US debt ceiling will most likely be raised, but a credible long-term fiscal consolidation will be more important and also more difficult to achieve

The U.S. political process to reach a sustainable path for public debt involves difficult negotiations between two opposite approaches to deficit reduction. In the end, fiscal consolidation will have to come from a combination of both a reduction of entitlements (and military spending) and from higher tax revenues. The political noise until that agreement is reached will only add more uncertainty into the markets, especially as the discussion on the debt ceiling brings opportunities to harden the negotiations.

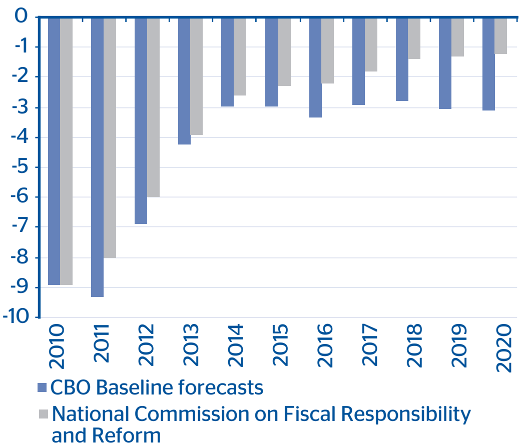
According to the Treasury the US would have reached its borrowing capacity sometime during the first two weeks of August. In any case, by that date both sides needed to struck a deal to increase the country's borrowing limit so that the government avoided a technical default. In the run up to the deadline, market reaction was relatively muted –compared with the major shock represented by a US technical default–, reflecting the belief that a solution to raising the debt ceiling would be found and default averted.

In the end, both parties reached an agreement to raise the debt limit sufficiently to park the issue until 2013. However no long-term solution to current fiscal deficits and increasing debt has been reached yet, although (once again) the path has been set. The agreement calls for a deficit reduction of $2.4 trillion USD over a decade, mostly on expenditure cuts and a big part of it (1.5 trillion) still to be identified by a special commission by November, or else taken automatically from entitlement programs. This is still below the 4 trillion Standard & Poor's suggested was needed to avoid a ratings downgrade of US debt, although it seems other rating agencies would probably not consider such a move.

A general consensus exists that a plan to shrink the deficit by about 4 trillion during the next decade could be sufficient to stabilize the country's debt-to-GDP ratio and put it on a more solid fiscal footing. But a deal of that size may not be achievable as democrats and republicans find it hard to agree on such a deficit-reduction strategy for several reasons. First, starting positions are far from being close between the two parties. Second, very powerful radical minority groups inside each party –very influential given the proximity of primary elections– make an agreement very difficult to achieve before the next presidential campaign of 2012. Third, the weak state of the economy makes it very hard to sell lower spending or higher taxes in the short run to their constituencies.

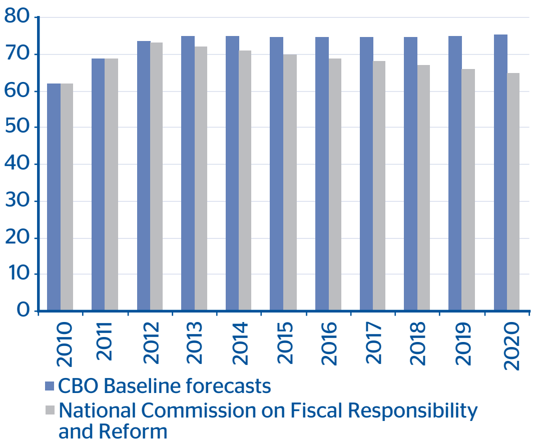
All in all, an agreement to raise the debt ceiling without a credible plan for long term fiscal consolidation will not address long-term sustainability concerns. In order to be sustainable and gain credibility, a deficit reduction plan will have to be (i) frontloaded; (ii) supported broadly by both parties and (iii) require Democrats accepting cuts in entitlement spending and Republicans agreeing to revenue increases. However, none of these conditions have been fully satisfied. Here the risk also lies –as in Europe– in the temptation to kick the can down the road and postpone a definite solution after the 2012 elections. As a consequence, the risk of "accidents" in future negotiations remains, as well as the chances of a spike in long-term interest rate.

Chart 6
US fiscal deficit (%GDP)



Source: BBVA Research and CBO

Chart 7
US public debt (%GDP)



Source: BBVA Research and CBO

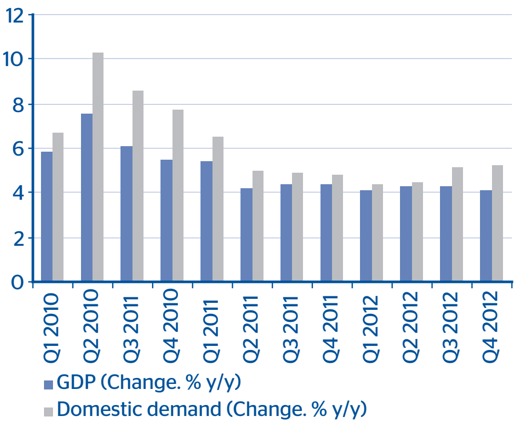
4. Controlled slowdown in emerging economies

Emerging economies in Asia and Latin America continue heading for a soft landing, although overheating concerns remain

In Latin America, the delay to see the start of an adjustment of domestic demand was increasing fears that inflationary pressures would mount and import growth would increase, jeopardizing the orderly convergence of growth closer to potential. However, data from the first and second quarter of this year have reduced those concerns somewhat, as domestic demand has started to decelerate and our forecasts point to growth rates similar to GDP by year's end (Chart 8).

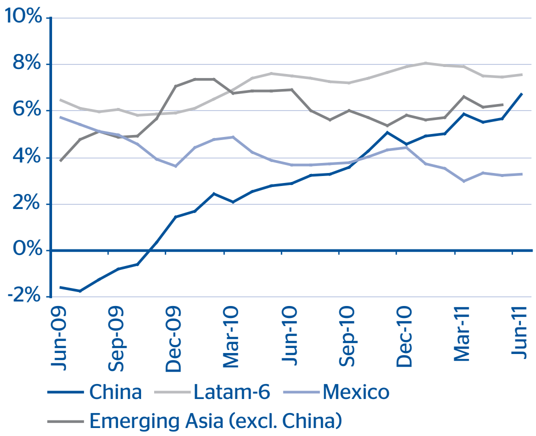
In Asia, growth is also moderating, as anticipated, evidenced by slowing activity indicators in Q2. This was the result of policy tightening measures, as well as headwinds from higher commodity prices and supply disruptions from the earthquake in Japan. Actually, markets were relieved when data showed that underlying growth in China remains strong, even as momentum moderates due to ongoing monetary tightening measures. In particular, second quarter GDP came in line with our projection of 9.5% year-on-year growth slowing only slightly from 9.7% in Q1. Other activity indicators were also strong, supporting our scenario of a soft landing for the Chinese economy during the remainder of 2011. Elsewhere in the region, evidence of a slowdown continues to mount. Nevertheless, we expect the region's momentum to pick up in coming months on lower commodity prices and as supply disruptions in Japan continue to ease.

Chart 8
Latam: GDP and internal demand



Source: BBVA Research

Chart 9
Inflation in emerging economies (% yoy)



Source: BBVA Research

However, in both regions, overheating concerns remain. In Latin America, even as domestic demand decelerates, inflation remains high in some countries and current account balances under pressure, while fiscal policy in many countries remains expansionary. In other countries like Brazil, tight labor markets make the economy vulnerable to possible wage-price spirals. In Asia, inflation also remains a concern (Chart 9). Despite signs that headline inflation may have peaked in some economies (such as China, Indonesia., Korea, and Singapore), underlying price pressures continue to mount across the region, as core inflation is trending up on domestic demand pressures, which could prompt the authorities to tighten monetary policy further in the months ahead. Moreover, asset price overvaluation remains a concern in some markets, although recent evidence suggests, for example, that real estate overvaluation in China is only moderate, and house prices will grow also moderately in the near term (Box 2).

Monetary policy in emerging economies continues to be confronted with difficult policy dilemmas between inflation and currency appreciation, with the background of high uncertainty about the global economy

Given continued inflation pressures in both regions, we expect monetary tightening to continue, but at a gradual pace given slowing growth and risks to the external outlook. Importantly, some central banks, especially in Latin America, might feel tempted to reduce the rhythm of monetary policy tightening, if they feel an excessive currency appreciation, although this is less likely in countries with an explicit inflation-targeting regime. It is therefore crucial that fiscal policy also takes part of the burden of policy tightening, which at present rests mostly on central banks.

Thus, in both regions there is the risk of policymakers falling behind the curve, in some cases as they remain cautious about the global environment and in other cases as they worry about excessive currency appreciation.

Political uncertainty also conditions the outlook in Latin America

Since the last Global Economic Outlook there have been a number of political surprises in Latin America, which will undoubtedly affect the economic performance of those countries. In some cases, political uncertainty is derived from recent changes in government or the possibility of a power vacuum, with doubts about the market-friendliness of new administrations still to be completely dissipated. In other cases, government weakness is the result of difficulties to reach agreements across party lines or due to strong political and social protests. In the end, these factors risk contaminating economics with the political cycle and slowing down the reform agenda.

Box 2: Is there a real estate bubble in China?

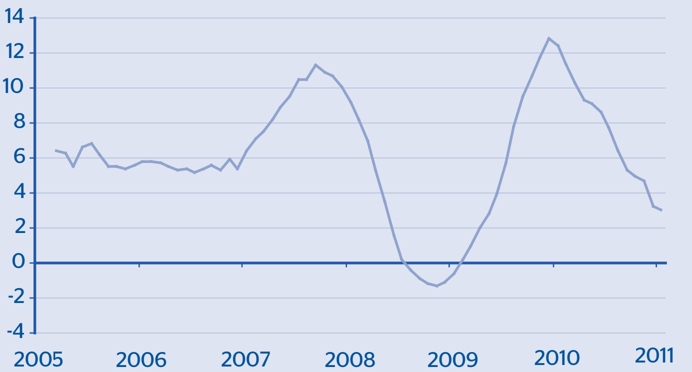
Investment in the property market has become an increasingly important driver of GDP growth and, given China's large contribution to global growth, it has become an increasingly significant determinant of the global outlook. In light of this, China's property sector has attracted intense interest, especially due to concerns of rapid price increases and overheating risks.

Property prices in China have continued to rise sharply over the past two years, propelled by rapid lending and liquidity growth. In order to forestall destabilizing price bubbles, the authorities have taken early action to cool the market by implementing monetary tightening and macro-prudential measures (loan restrictions, increase in mortgage rates and down payment requirements). These policy actions have resulted in a sharp fall in sales transactions and a moderation in price increases over the past year. In particular, the pace of housing price increases peaked in April 2010, at 13% nation-wide in year-on-year terms, before moderating steadily to just 3-4% as of June 2011 (Chart 10).

In the view of many observers, these price increases have generated risks of asset price bubbles that, if left unchecked, could threaten economic and financial stability. However, according to our estimates* from a supply-demand model intended to gauge misalignments between actual and equilibrium prices (Chart 11), the market in 2011 is only slightly overvalued (7%). The relatively small degree of overvaluation at present suggests that, at an aggregate level, housing price bubbles are not a serious problem (although they may be in certain segments of the market or in certain cities). Furthermore, the boom in property prices still does not look so large in comparison with international case studies of classic real estate bubbles, such the experience of Japan in the 1980's or more recently the cases of Spain and the US.. Going forward, we expect subdued price rises in the near term, as well as a modest downward correction in cities with large misalignments. There is, however, evidence that price increases are now shifting to China's smaller cities, and the authorities have just begun to expand cooling measures to them as well.

Over the medium term, however, prospects for China's property market are bright, given rapid income growth, high rates of urbanization, and favorable demographics.

Chart 10
China: Real estate price changes (%yoy)



Source: BBVA Research and CEIC

Chart 11
China: actual and equilibrium house prices* (index)

Average residential housing prices in China's 35 big and middle-size cities.
Source: CEIC and BBVA Research

* See the latest China Real Estate Outlook (July 2011) for details.

5. Tables

Table 1
Macroeconomic Forecasts: Gross Domestic Product

(YoY growth rate)	2008	2009	2010	2011	2012
United States	-0.3	-3.5	3.0	2.1	2.6
EMU	0.3	-4.1	1.7	2.0	1.3
Germany	0.7	-4.7	3.5	3.3	1.8
France	0.1	-2.5	1.4	1.9	1.5
Italy	-1.3	-5.1	1.2	0.8	0.7
Spain	0.9	-3.7	-0.1	0.9	1.3
UK	-0.1	-4.9	3.4	1.3	1.6
Latin America *	5.2	-0.6	6.6	4.8	4.4
Mexico	1.5	-6.1	5.4	4.1	3.8
EAGLES **	6.6	4.0	8.3	7.0	6.9
Turkey	0.7	-4.7	8.2	6.3	4.2
Asia Pacific	5.2	4.1	8.0	6.2	6.7
China	9.6	9.2	10.3	9.4	9.1
Asia (exc. China)	2.3	0.8	6.5	4.1	5.2
World	2.8	-0.7	5.0	4.2	4.4

* Argentina, Brazil, Chile, Colombia, Peru, Venezuela
** Brazil, China, Egypt, India, Indonesia, Korea, Mexico, Russia, Taiwan, Turkey
Forecast closing date: August 1, 2011
Source: BBVA Research

Table 2
Macroeconomic Forecasts: Inflation (Avg.)

(YoY growth rate)	2008	2009	2010	2011	2012
United States	3.8	-0.3	1.6	2.8	2.2
EMU	3.3	0.3	1.7	2.7	1.8
Germany	2.8	0.2	1.2	2.6	1.8
France	3.2	0.1	1.6	2.3	1.6
Italy	3.5	0.8	1.6	2.6	2.0
Spain	4.1	-0.3	1.9	3.0	1.4
UK	3.6	2.2	3.3	4.3	2.3
Latin America *	8.8	6.9	7.4	8.2	7.9
Mexico	5.1	5.3	4.2	3.4	3.8
EAGLES **	7.4	2.9	4.5	6.1	5.0
Turkey	10.4	6.3	8.6	6.5	6.0
Asia Pacific	5.7	0.3	2.7	4.8	3.6
China	6.0	-0.8	1.2	5.3	3.9
Asia (exc. China)	5.5	1.1	3.7	4.5	3.5
World	6.1	2.2	3.0	4.8	4.1

* Argentina, Brazil, Chile, Colombia, Peru, Venezuela
** Brazil, China, Egypt, India, Indonesia, Korea, Mexico, Russia, Taiwan, Turkey
Forecast closing date: August 1, 2011
Source: BBVA Research

Table 3

Macroeconomic Forecasts: Current Account (% GDP)

	2008	2009	2010	2011	2012
United States	-4.6	-2.7	-3.3	-3.4	-3.8
EMU	-0.5	-0.5	-0.5	-0.2	-0.1
Germany	6.7	5.0	5.1	4.7	4.6
France	-2.7	-2.9	-3.5	-3.9	-4.2
Italy	-3.2	-3.0	-4.2	-3.5	-3.3
Spain	-9.7	-5.5	-4.5	-4.0	-1.6
UK	-1.6	-1.7	-2.5	-1.2	-0.1
Latin America *	-0.7	-0.3	-0.8	-0.7	-1.7
Mexico	-1.6	-0.7	-0.5	-0.8	-1.1
EAGLES **	4.0	2.3	1.9	1.5	1.4
Turkey	-5.6	-2.2	-6.4	-10.8	-9.1
Asia Pacific	4.8	3.8	3.2	2.7	2.9
China	9.9	6.1	5.2	4.5	4.5
Asia (exc. China)	1.4	2.3	1.9	1.6	1.8

* Argentina, Brazil, Chile, Colombia, Peru, Venezuela
** Brazil, China, Egypt, India, Indonesia, Korea, Mexico, Russia, Taiwan, Turkey
Forecast closing date: August 1, 2011
Source: BBVA Research

Table 4

Macroeconomic Forecasts: Government Deficit (% GDP)

	2008	2009	2010	2011	2012
United States	-3.2	-10.0	-8.9	-9.5	-6.9
EMU	-2.0	-6.3	-6.0	-4.3	-3.4
Germany	0.1	-3.0	-3.3	-1.8	-1.0
France	-3.3	-7.5	-7.0	-5.7	-4.6
Italy	-2.7	-5.4	-4.6	-3.9	-3.1
Spain	-4.2	-11.1	-9.2	-6.0	-4.4
UK	-5.0	-11.4	-10.4	-8.8	-7.2
Latin America *	-1.1	-2.8	-2.0	-2.3	-2.7
Mexico	-0.4	-0.7	-0.8	-0.8	-2.7
EAGLES **	-1.8	-5.3	-2.9	-2.9	-2.8
Turkey	-1.8	-5.5	-3.7	-9.0	-8.5
Asia Pacific	-2.8	-5.1	-3.8	-4.2	-3.5
China	-0.4	-2.2	-2.5	-2.0	-1.8
Asia (exc. China)	-4.4	-6.5	-4.7	-5.7	-4.7

* Argentina, Brazil, Chile, Colombia, Peru, Venezuela
** Brazil, China, Egypt, India, Indonesia, Korea, Mexico, Russia, Taiwan, Turkey
Forecast closing date: August 1, 2011
Source: BBVA Research

Table 5
Macroeconomic Forecasts: 10-year Interest Rates (Avg.)

	2008	2009	2010	2011	2012
United States	3.6	3.2	3.2	3.3	4.0
EMU	4.0	3.3	2.8	3.2	3.5

Forecast closing date: August 1, 2011
Source: BBVA Research

Table 6
Macroeconomic Forecasts: Exchange Rates (Avg.)

US Dollar per national currency	2008	2009	2010	2011	2012
United States (EUR per USD)	0.68	0.72	0.76	0.71	0.75
EMU	1.47	1.39	1.33	1.40	1.34
UK	1.82	1.56	1.55	1.63	1.66
China (RMB per USD)	6.95	6.83	6.77	6.46	6.15

Forecast closing date: August 1, 2011
Source: BBVA Research

Table 7
Macroeconomic Forecasts: Official Interest Rates (End period)

	2008	2009	2010	2011	2012
United States	0.61	0.25	0.25	0.25	1.25
EMU	2.73	1.00	1.00	1.75	2.00
China	5.31	5.31	5.81	6.81	7.31

Forecast closing date: August 1, 2011
Source: BBVA Research

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