BBVA | RESEARCH

Economic Outlook

Global

Fourth Quarter 2011
Economic Analysis

- **Global growth slows down,** with risks strongly tilted to the downside, driven by the European sovereign and financial crisis.
- **Measures taken on the European October summits still leave key elements unresolved.** A quick normalization of financial tensions is needed to avert a recession.
- **Slight improvement within the structural weakness in the US,** but there are high risks from domestic politics and contagion from Europe.
- **Emerging economies are on track for a soft landing,** with strong headwinds from the external environment.

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Closing date: November 4th 2011

1. Summary: Global slowdown and risks tilted to the downside

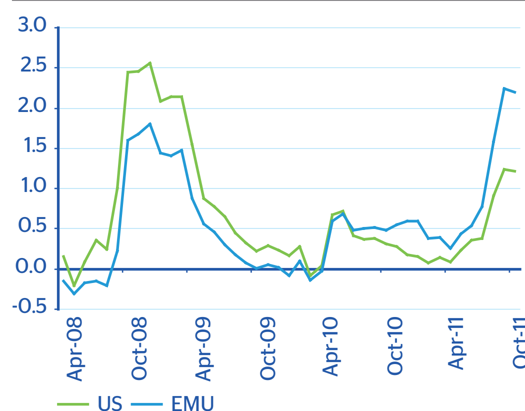
The global economy slows down and the outlook is heavily dependent on the resolution of the European debt crisis. Risks are strongly tilted to the downside

The outlook for the global economy has worsened over the past few months, driven mainly by four factors that are still exerting their influence. First, lower than expected economic growth mainly, but not only, in developed economies (data had been already disappointing in the US in the first half of the year, which led to some analysts to expect a double dip). Although growth increased in the US in the third quarter, economic activity in Europe, which held very well in the first quarter, is now on a clear decelerating path. Second, the sovereign debt crisis in Europe has intensified and turned more systemic. While decisions announced in the October summit go in the right direction, there are still key elements unresolved, especially regarding the real firepower of the mechanisms for providing sovereign liquidity (a leveraged European Financial Stability Fund or EFSF), the restructure of Greek debt held by private investors, and a clear roadmap for advancing European governance towards a fiscal union. Third, the feedback between sovereign concerns and the health of the European financial system has intensified, and financial tensions in Europe have reached levels in many respects higher that after the fall of Lehman Brothers in October 2008 (Chart 1). This increases the risks of a negative impact on economic activity (see Box 1), further feeding a real-financial vicious circle. Finally, higher global risk aversion has increased financial market volatility significantly, spilling over to most risky assets, including emerging economies for the first time since 2009.

In this context, we revise downward our global growth forecasts by 0,3pp in 2011 and 2012, relative to our previous Global Economic Outlook, mostly due to lower expected growth in advanced economies (US and Europe, compensated in part by Japan), although emerging markets will also grow slightly less than previously anticipated. Thus, the global economy would grow by 3.9% in 2011 and 4.1% in 2012, supported by solid growth in emerging economies against lackluster performance in advanced countries (Chart 2).

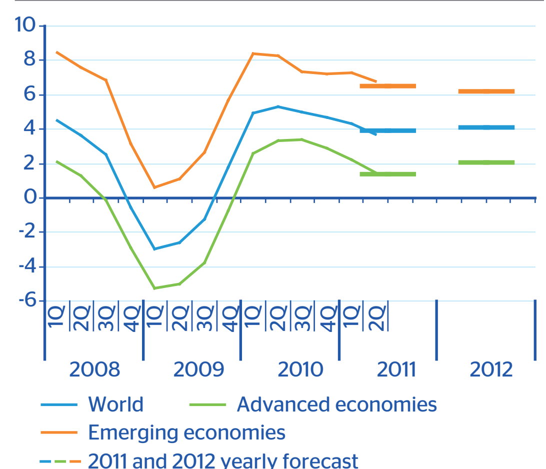
These are still robust growth rates, but risks to these projections are now strongly tilted to the downside, hinging in the short term on the evolution of the sovereign-financial crisis in Europe. In particular, a quick reduction of financial stress in Europe is needed to avoid a sharp effect on growth there and in other regions through financial exposures and global risk aversion.

Chart 1
BBVA Financial Stress Index



Source: BBVA Research

Chart 2
Global GDP growth (%yoy)



Source: BBVA Research and IMF

The October European summits have taken some steps in the right direction, but still leave key elements unresolved. This does not bode well for the reduction of financial stress in Europe

In our view, there were five main points that needed to be successfully addressed in the October EU summits: (i) tackling definitively the sustainability of Greek debt; (ii) erecting sovereign firewalls in the EMU; (iii) pushing for further reforms in peripheral countries; (iv) strengthening the banking sector; and (v) advancing euro area governance. Although some of the more technical details still need to be determined, the recent summits have taken important steps in the right direction, but have not addressed definitely most of these points. First, private bondholders of Greek debt are asked to take a voluntary haircut of 50% –much higher than agreed in July– but doubts still linger about participation in the exchange and, even with full participation, about the solvency of Greece, which is still strongly conditional on measures that need to be taken in this country. Second, the EFSF will be leveraged as an insurance mechanism and complemented with outside investors (including possibly the IMF, although the G20 meeting was inconclusive in this respect), but it is unlikely that any of the specificities of the functioning of the EFSF are ready before December. Thus, many weeks will be needed to ascertain its effectiveness vis-à-vis private investors, and hence the ECB will still be needed as a buyer-of-last-resort for sovereign debt, against the reticence of core European countries. Third, it is welcomed that more economic reforms are now on the agenda of some countries (notably Italy, where these will be monitored by the IMF), and that as the help of the EFSF will be triggered by a request from countries and against conditionality, the likelihood of those being implemented increases. At the same time, the recapitalization of the banking sector is being done inefficiently, compensating a moderate stress testing of banks' balance sheets –just using market prices for sovereign portfolios but not for so-called "legacy assets"– with a significant increase in capital requirements (9% core tier1 capital). This risks a sudden and sharp deleveraging of European banks, with negative effects on the supply of credit without cleaning the balance sheets of banks in the euro area. Moreover, a long term liquidity provision mechanism is not in place yet, even though this is extremely important for banks to obtain financing. Finally, there have been some advances in European governance, but there is no clear roadmap to a fiscal union or Eurobonds, in our view a key element to make the monetary union more credible in the long run.

As we have mentioned in the past, partial solutions will probably just help prevent a further escalation of financial tensions, but they will remain elevated, increasing downside risks for economic activity in the eurozone. The agreements still leave doubts whether the necessary structure to prevent contagion and a systemic event from a Greek debt restructuring is in place: a large enough EFSF with the ECB as debt-buyer-of-last-resort and cleaned and recapitalized banks' balance sheets with access to financing. Without all of them, markets will continue to factor increased fatigue for reforms in Greece and fatigue for further bailouts in core countries, which increases the probability of a risk scenario of a credit crunch and a recession in Europe, with global spillovers[1].

Some improvements in US growth in Q3, but structural weaknesses remain, including from political deadlock

More on the positive side, growth in the US seems to have reaccelerated in the third quarter, at least according to preliminary estimates. This is not saying much –growth in the first two quarters was very low and the output gap is still very high– but seems to have reduced market nervousness about a double dip. Nevertheless, the structural weakness of the US economy remains, as consumer and business confidence continue to be weak and the housing market could adjust further. This means lower resilience in the face of a possible shock coming from Europe. In addition, political deadlock could impede a "grand bargain" to (i) prevent an unintended fiscal contraction in the short run and (ii) push reforms towards a credible fiscal consolidation in the long run.

1: See "Channels of global contagion in the event of a disorderly default in Europe", Box 1 in the July 2011 Global Economic Outlook for an outline of the channels of transmission and global impact of a disorderly default in Europe.

Emerging economies are on track for a soft landing, but with increasing external headwinds

Emerging economies continue growing strongly, supported by the resilience of domestic demand. Still high commodity prices for Latin America and export growth in Asia –despite strong corrections in both cases– also contribute to a strong growth outlook, which is on track for a much awaited soft landing, which would be welcome in some countries. Renewed turmoil in Europe and the US already represent strong headwinds from financial markets in both regions –reflected in increased market volatility, depreciated exchange rates and reduced capital inflows–. However, many countries also enjoy sizable buffers –stronger public finances and better macroeconomic management than in the past– and are well positioned to introduce policy stimulus to counter weaker external demand. Overall, a more negative external environment has switched the focus in emerging countries from overheating to downside risks and, increasingly, the possible need for policy support.

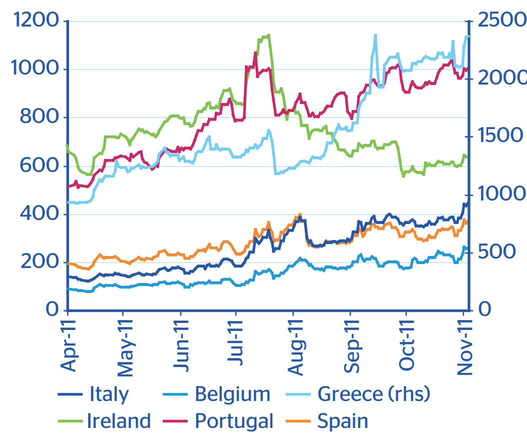
2. Still waiting for a definitive solution to the European crisis

The sovereign debt crisis in Europe intensified since August, and spilled into funding pressures in the financial sector. Economic activity also shows clear signs of deceleration

Despite the agreements reached at the July EU summit, sovereign debt markets remained under intense pressure since mid-August, including those of Spain and, crucially, Italy (Chart 3). At the heart of sovereign tensions were doubts about the pace of implementation of the agreements, including improvements in the EFSF (which was finally ratified by all countries in October) and the so-called private sector involvement (PSI), which in the end was superseded by deteriorating market valuation of Greek debt. In addition, the fact that sovereign tensions reached Italy in full force (with spreads above Spain for the first time since the beginning of the crisis) made it clear that the EFSF would be too small to prove an effective firewall to contagion from Greece.

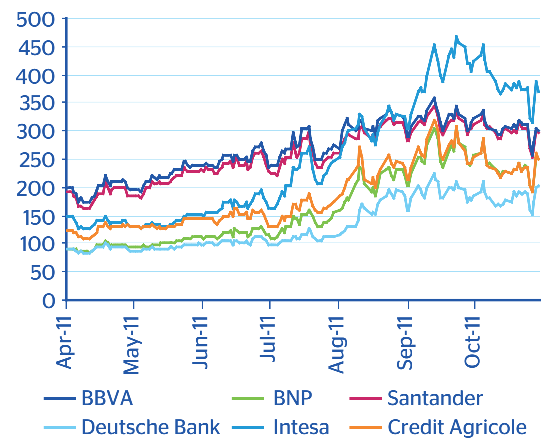
In addition, the sovereign debt crisis in Europe started to undermine confidence on European banks, many of which are heavily exposed to sovereign debt of peripheral countries. Banks were also affected on the liability side of their balance sheets as the quality of implicit government guarantees was eroded. Potential losses increased concerns about the solvency of some banks and led to a severe tightening of funding markets, even for some banks in core European countries. These pressures were reflected in a sharp increase in banks' CDS spreads (Chart 4) above those observed after the fall of Lehman Brothers.

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

The feedback between sovereign concerns and stress in financial institutions increasingly run the risk of starting to impact on economic activity in the eurozone (see Box 1). Funding pressures for European financial institutions –including in US dollars–, increased the risk of a deleveraging of bank balance sheets and a sharp reduction of credit, thus amplifying the effect of the shock on sovereign debt on economic activity. In fact, after a strong first quarter boosted by favorable weather, euro area economic activity in the second quarter decelerated markedly. Going forward, survey data seem to paint a more pessimistic picture than hard data (Chart 7), and activity most likely will remain flat in Europe in Q3 and Q4.

Box 1: Financial stress and growth in the US and Europe

This box analyses the possible impact on economic growth of heightened financial stress in the US and Europe. This higher stress is illustrated in chart 1 by our Financial Stress Index (FSI) which summarizes tensions in forex, liquidity and credit market (including sovereign and corporate debt)[2].

To measure the impact of financial stress on economic activity we used a vector autoregression model (VAR) including the FSI and GDP growth. Chart 5 shows that if the FSI experiences a shock, growth in Europe will fall over the following 12 months, highlighting the delayed effect on growth. The estimated effect on US growth is similar to that in Europe, both in terms of scope and duration.

We use this estimate to quantify the adverse effect on economic activity of the increase in financial stress since last April in both the US and Europe. We propose two scenarios for the future evolution of the current crisis in both regions. In the first scenario we assume that the shock will be temporary and that financial stress will ease from October, returning to April 2011 levels by December. Our second scenario involves a more persistent shock which would keep financial stress at current levels (in this case, until at least the end of 2012). To ascertain the cost in terms of growth we compare both scenarios with a shock-free scenario by holding the FSI steady at April 2011 levels.

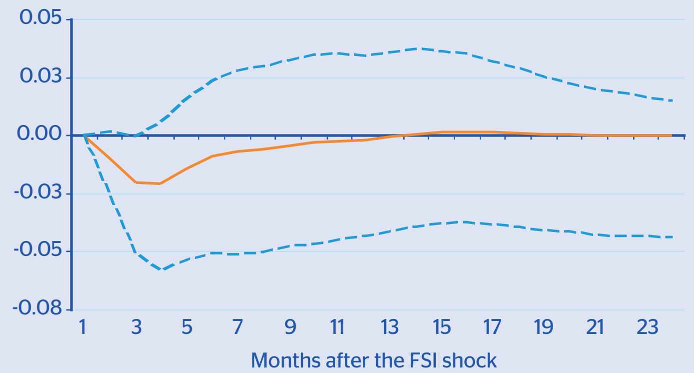
As we can see in Chart 6, the impact of increased financial stress on growth is greater in the EMU, in both the temporary and permanent shock scenarios. This is a direct result of the fact that market stress up to October has been significantly higher in Europe (see Chart 1). The greatest impact of the shock on growth would materialize in 2012 given aforementioned lags to affect economic activity.

Growth will of course be hit harder by persistent stress. The increase in stress since April 2011 would cause growth in Europe to decline by 0.2 percentage points in 2012 if the shock is temporary, while permanent stress would cause a 2.5 percentage point drop. It is important to point out that these estimated impacts do not represent the amount by which we may revise down our growth forecasts for both regions, as our current forecasts already factor in part of the effect.

For the permanent shock, it is possible that our estimated impact on growth might be somewhat optimistic. First, the model does not include any possible non-linear impacts which may occur in extreme situations. Another argument to bear in mind is that, in the current conext, governments' hands are somewhat tied when it comes to using monetary and fiscal policy to respond to a large-scale shock, unlike what happened in 2008 for example, which is one of the episodes we have based our estimates on. Finally, the adverse impact on growth could be greater if the cyclical position of the economy is as weak as the current situation.

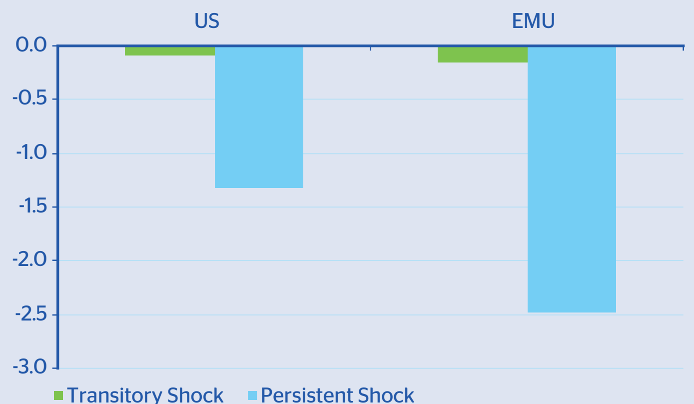
In short, the modelling results highlight the significant impact on growth of potential ongoing turbulence in the financial markets. Hence the need for a swift solution to lingering uncertainty as to whether EU authorities will prove capable of resolving the liquidity problems in some eurozone countries and the dangers of a weak recovery in the two major developed economies.

Chart 5
EMU: response of GDP growth to an increase in FSI by 0,1 units (in percentage points)



Source BBVA Research

Chart 6
Impact of the April-October 2011 shock to FSI on 2012 GDP growth (pp)



Source BBVA Research

2: For a more detailed description of our Financial Stress Index see our Economic Watch entitled "Financial stress and economic activity in the US and eurozone" dated 6 October 2011.

The solutions to the crisis proposed by EU authorities in October go in the right direction, but some of them are inefficient and leave several questions unresolved

European authorities have reacted to the stress in financial markets and the deterioration in Greece with a series of measures that try to address problems from several angles. Broadly speaking, they have tried to address the situation of the banking sector with a recapitalization plan for European banks, while Greece is still in the process to receive a second rescue package which implies a larger contribution by the private sector and tries to make Greek debt sustainable. Finally, EU authorities started to analyze the possibility of expanding the power of the EFSF to support sovereign debt markets, given the perceived lack of capacity of the current one to face doubts about Italian and Spanish debt.

This three element strategy crystallized in two EU summits October 23 and 26 where a broad set of measures was proposed (see Box 2). The overall evaluation of these measures is positive, in the sense that it tries to address the insolvency of Greece and considerably expands the firepower of the EFSF. The recapitalization programme reinforces the resilience of the banking system by forcing banks to raise their capital ratios, although it does it in an inefficient way and does not help to counteract market suspicions on the debt of sovereign countries that are solvent. Nevertheless, the agreements lack detail in many respects, leaving them for negotiations in coming months, in such a way that implementation risk is high and the jury is still out on their effectiveness.

Box 2: What was approved on the October EU/Eurozone summits?

There were five main elements included in the communiqués from the Eurozone October summits:

1. **On Greek debt:** A haircut of 50% to private investors, with credit enhancements by 30 bn euros, to bring Greek debt to 120% of GDP by 2020. Greek reforms will be monitored and controlled more closely, with in-site work of the Commission. The second rescue plan is postponed again to the end of 2011. The amount of official aid will be 100 bn euros until 2014.

2. **On other peripheral countries:** Recommendations of further actions to Spain and, especially, Italy. On Spain, it reiterates the recommendations on the three usual areas: fiscal adjustment, deepening labor market reform, with a special reference to wage bargaining system, and continuing to pursue the restructuring of the financial sector. The Council put special pressure on Italy, as the reforms plan presented by the Italian government to the summit was not very detailed. All these measures are part of strong peer pressure, and cannot be forced upon them yet, but it will be positive once the EFSF is operating.

3. **On the EFSF:** The EFSF firepower is expanded through an insurance scheme on bond issuance, with no details, with an expected leverage of 4 or 5 times (around 1 trillion euro). In addition an SPV will be funded which is supposed to attract also outside investors (possibly the IMF and others). Details are expected to be determined in November. Access to this liquidity tools will be subject to strict conditionality.

4. **On bank recapitalization:** A 9% minimum core tier 1 capital has to be reached before June 2012 with sovereign debt and loans to governments valued at market prices. In principle, banks will have to raise approximately 106bn euros by the end of June-12 (Graph 8). Institutions will have to obtain new capital from private sources, otherwise via national governments, and only after those two options are exhausted, via the EFSF.

   Additional measures on liquidity will be determined by the EU Commission in the future, such as guarantees for banks' issuance.

5. **On governance:** The document is full of references to the governance reforms already approved by European institutions (legislative package, European semester, Euro plus pact), and to further commitments to enhance economic and fiscal coordination and integration. Among the most substantive new elements, three stand out: (i) a reiterated request to President Van Rompuy to prepare a "limited" Treaty reform by December as a basis to reach an agreement to be sanctioned by March 2012; (ii) new powers to a special Commissioner to monitor fiscal plans, while the Commission will be able to make proposals to countries all throughout the national budgetary process, broadly in line with proposals for a minister for fiscal affairs in Europe; and (iii) no mention on Eurobonds, which would constitute a clear signal that fiscal integration is pursued and would reduce pressures on sovereigns.

The 50% haircut to private bondholders of Greek debt does not clear all doubts about its sustainability

The discount applied in the new program to private investors of 50% is in line with very recent statements by Angela Merkel, who gave that figure as a minimum. However, it probably strikes a middle ground where it is neither big enough to dispel doubts about the sustainability of Greek debt, nor small enough to ensure a sizable voluntary participation by private bondholders. Under the troika analysis, a 50% private haircut would bring the debt ratio to 120% of GDP by 2020. This is in line with the current Italian debt as it would have been politically difficult to set it below that level. This target is sustainable under some plausible assumptions, as is also corroborated by the troika analysis. However, the new debt path leaves many open questions.

First, the market may not believe that this level is sustainable, as such a high debt ratio is very sensitive to a change in fundamentals such as lower growth or fiscal adjustment. Given the recent volatility of Greek macroeconomic figures (including debt levels), markets will probably need a stronger debt reduction to escape the "bad equilibrium" with a feedback between doubts about sustainability and high interest rates.

Second, despite the relief to Greece of lower debt and lower interest payments, political and implementation risks remain high, as demonstrated by the threat to put the Greek programme up to vote on a referendum. The close intervention of the EU Commission in situ will help to enhance implementation, but could also be badly received by the Greek population. The fiscal adjustment ahead is still large. Indeed, most of the risks on Greece remain in the medium term, when the adjustment has to continue in a framework of economic recession. Once and if the adjustment of the deficit is made, the outlook for debt sustainability should be clarified.

Finally, there is still a risk that the voluntary participation in the PSI is low and thus the haircut would have to be involuntary, which would trigger a credit event in CDS markets.

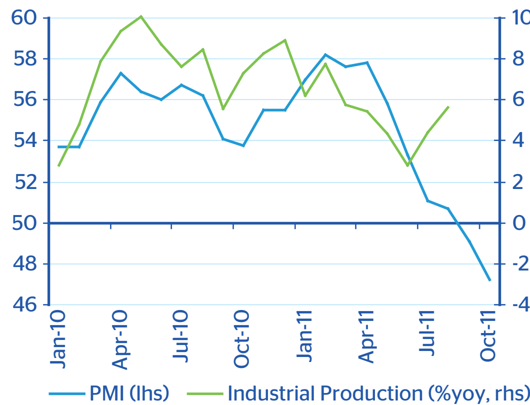
The EFSF will be leveraged as expected, but there are few details. Many weeks will be needed to ascertain its effectiveness

An EFSF leveraged 4 or 5 times to about 1 trillion euro would be sufficient to cover the financial needs of Spain and Italy for up to three years (near 900 bn, not including regular issuance of short-term notes), but is probably not the overwhelming response that would shut off market speculation. It will also be complemented by an SPV, to be able to attract additional funds from outside the EU, such as the IMF or directly from other countries, although there were no clear commitments out of the G20 summit. But a leveraged EFSF will not work as an immediate firewall for the rest of the periphery, as would have been desirable, and it remains to be seen whether this structure will entice private investors to increase demand for Italian and Spanish bonds. In this sense, the easiest way to counter market jitters on large sovereigns would be to reactivate the role of the ECB as bond-buyer of last resort. This is still a possibility in the case that stress continues, as the EU agreement has not closed the door to the SMP program by the ECB, as Germany originally wanted. The option of leveraging the EFSF directly with the ECB could also be open in the future.

A funding problem for banks is recognized, but focus is placed on inefficient bank recapitalization

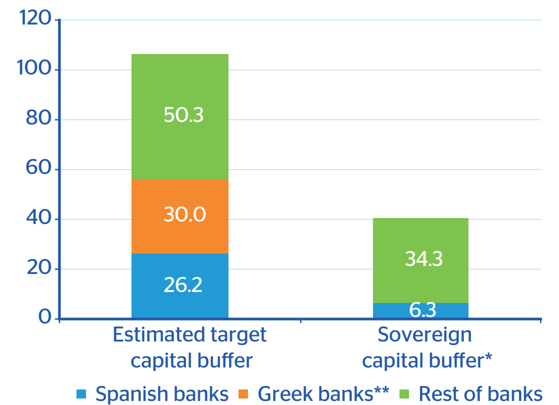
The recapitalization of the banking sector is being done inefficiently, compensating a moderate stress testing of banks' balance sheets –just using market prices for sovereign portfolios but not other legacy assets– with increased capital requirements (9% core tier1 capital, for an estimated total of 106 bn EUR, as shown in Chart 8). This risks a sudden and sharp deleveraging of European banks, with negative effects on the supply of credit: At the same time, the EU recognizes the key issue of severe funding problems, and a mechanism for guaranteeing bank's debt issuance will be put in place, but with dew details so far, apart from common European standards, which are welcome.

Chart 7
EMU industrial production (%yoy) and PMI



Source: BBVA Research and Haver Analytics

Chart 8
Capital needs of European banks after the October EU Summit (bn EUR)



* The sovereign capital buffer is indicative and can already be covered by existing CT1 capital if the CT1 ratio exceeds 9%.
** No information on the sovereign capital buffer has been provided by Greek banks, not to conflict with pre-agreed arrangements under EU/IMF programme.
Source: BBVA Research

Steps are taken towards more fiscal and economic integration, but without betting on neither a fiscal union nor Eurobonds

References to the governance reforms already approved by European institutions and to further action to enhance economic and fiscal coordination and integration (see Box 2) continue the German strategy of moving towards more integration through pressure on periphery countries, and that only once convergence is achieved in the fiscal and reform agenda the idea of Eurobonds could be raised. However, it cannot be discarded that the Van Rompuy recommendations follow the recent document by the Commission (Barroso proposals) that explicitly mentioned eurobonds ("stability bonds"). This would be a positive step as the crisis has shown that a fiscal union needs to accompany the monetary union to make it credible in the long run.

All in all, a positive step from the summit, but not a definitive solution to the crisis

Decisions have been taken on all fronts, but with many details to be sorted out. We are again pending on a tight agenda and still open negotiation process. The Greek problem is not fully solved despite a "voluntary" 50% haircut to investors. Greek debt will be sustainable in theory, but is subject to many shocks and could still face important challenges. The firepower of the EFSF is not enough to induce a virtuous cycle of credibility, as would have been the case had this task been taken by the ECB, although it could prevent a further escalation of the crisis for some time. Still, the door to an eventual leverage directly through the ECB has not been closed. It is a bullet that could still be used in the future.

On recapitalization, authorities have not curbed first the perception of sovereign risk in all peripheral countries, which was the underlying problem. By insisting on stress testing other sovereigns different from Greece and not approving a large enough EFSF, an opportunity has been lost to clearly separate Greece (insolvent) from the rest of the peripherals (illiquid). In addition, at this point it is paramount to solve liquidity problems in the banking system, and it is welcome that the Commission has been asked to explore the options to provide long term liquidity, such as guarantees for bank issuance.

Overall, these partial solutions will probably just help prevent a further escalation of financial tensions, but they will remain elevated, increasing downside risks for growth in the eurozone. The agreements still leave doubts whether the necessary structure to prevent contagion from a Greek debt restructuring is in place. Without it, markets will continue to factor that increased fatigue for reforms in Greece and fatigue for further bailouts in core countries increases the probability of a risk scenario with a disorderly default leading to a credit crunch and a recession in Europe, with global spillovers.

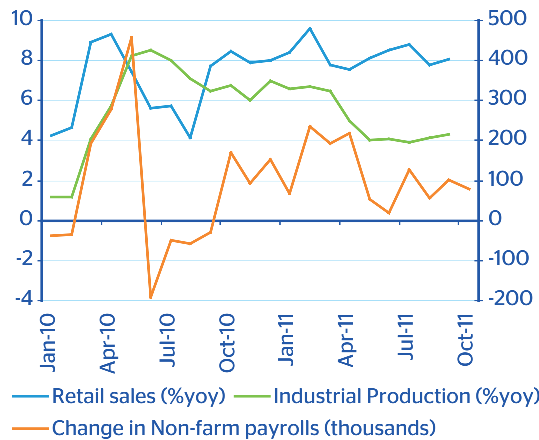
3. Slight improvement in the US, but structural weakness continues

Growth in the US has reaccelerated in the third quarter and reduced market nervousness about a possible double dip

After a stream of disappointing data starting with the release of GDP figures at the end of July and continuing during much of August and September, new data during the last weeks seemed to point to a reacceleration of economic activity in the US in the third quarter. Industrial production accelerated in September, and retail sales were stronger than consensus expectations, boosted by robust auto sales (Chart 9). However, the labor market remains weak: the September employment report showed an increase of only 103,000 jobs in September (about half excluding the effect of ending strikes), and 80,000 in October with some upward revisions to the July and August reports. The unemployment rate held constant at 9%, and the only reason the market responded well to the announcement seemed to be that prior expectations had been very low.

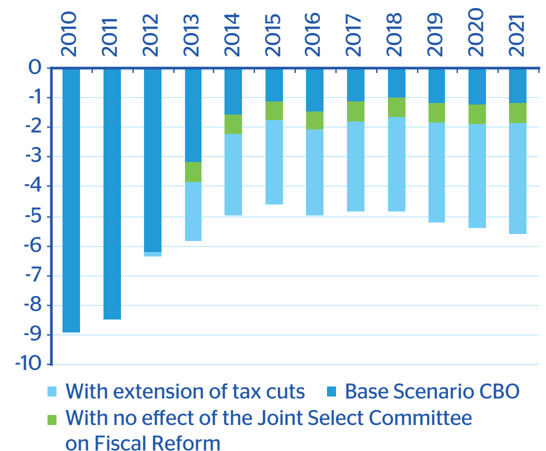
Indeed, first estimates of GDP growth in the third quarter show a 0.6% quarterly increase in economic activity, much stronger than in the previous two quarters. However, at an annual rate of 2.5%, growth in the third quarter is still below the average growth of 3.2% in the previous 60 years, and below the 4.3% growth rate for an average expansionary phase in the US. Nevertheless, given how low market expectations had been at the beginning of the summer, these were positive news for market participants and contributed to reduce market woes about a possible double dip in the US, which, in our view, was a low-probability event.

Chart 9
Employment (change), sales and industrial production (%yoy)*



* Employment (rhs) is the month-on-month change in non-farm payroll employment, in thousands
Source: BBVA Research, BLS and Federal Reserve

Chart 10
US Fiscal deficit (%GDP)



Source: BBVA Research and CBO

The Fed's operation twist will have a limited impact on activity, but the Fed is prepared to act again if growth prospects deteriorate

There are still many mixed signals on the US economy. In addition to a weak labor market mentioned above, consumer confidence fell to recession-era lows in October and the corporate sector is quite pessimistic about future economic prospects.

With policy rates near zero, the Fed's focus is on communication policy and its balance sheet. The positive effect on activity of recent easing measures should be very limited as long-term interest rates are exceptionally low and cannot be reduced much further. Core inflation may temporarily exceed the Fed's (implicit) target im the medium term, limiting the scope for tools that would both stimulate growth and raise inflation expectations.

The Federal Reserve may consider three main tools to boost economic activity if growth prospects deteriorate: (i) be more transparent about its policy goals to anchor market expectations; (ii) explicitly condition the normalization of monetary policy on the evolution of the unemployment rate; and (iii) further expand its balance sheet through another large scale asset purchase program. In fact, given the low probability of an additional fiscal stimulus (see below) and high unemployment, Fed officials seem already prone for further actions. But first they need to focus on building internal and external support given political resistance to further increases in its balance sheet and mounting internal disagreement in the FOMC.

All in all, structural weaknesses in the US economy remain, and downside risks to growth are still elevated

The slowdown in the first half of 2011 has reminded us that structural weaknesses in the US economy remain. This is not surprising as history tells us that the exit from a financial crisis (and a housing bubble) are inherently slow. We expect growth to remain moderate in the next quarters and in 2012, below the rhythm of previous recoveries, as outlined above.

Apart from the aforementioned weak labor market, the property market has continued to struggle with falling prices and a glut of foreclosed homes adding further downward pressure on them. These two, together with reduced household confidence risk accelerating the process of deleveraging of households' balance sheets. The weak cyclical position of the US economy also leaves it more vulnerable to the fallout from a possible intensification of the sovereign-financial crisis in Europe. All these elements add important downside risks to the baseline scenario for growth in the US.

In addition, political brinkmanship could lead to wrong and badly timed fiscal policy, adding downward risks to the economy

While the Fed is trying hard to improve the transparency and predictability of its policy, the opposite seems to be true of fiscal policy. Uncertainty is high on near-term relief measures and medium-term fiscal consolidation. The American Jobs Act most likely will not be adopted in full, but in bits and pieces precisely when the private sector is not yet ready to be taken off the support of policy stimuli.

While the political noise has abated since the debt limit standoff in late July, it could reignite again in the run-up to the November 23 deadline for the Joint Select Committee on Fiscal Reform to agree to a proposal for a 1.2 trillion dollar public debt reduction. Given strong disagreement about the importance of spending versus revenue measures, it is unlikely that a grand bargain will be reached. This increases the odds that a $1.2 trillion of automatic budget cuts will be triggered, but they would come into effect .at the beginning of 2013, when a new Congress may well choose to overturn that commitment.

All in all, credible fiscal consolidation plans for the long run are not gaining much support. This, even as the likely extension of existing (temporary) tax cuts would bring the budget deficit consistently between 4% and 5% of GDP in the next decade (Chart 10), with public debt following an increasing path.

4. Emerging economies: weathering external risks

Growth in emerging economies remains resilient in spite of global uncertainty. given robust domestic demand

The slowdown in advanced economies since the beginning of the year and the increase in global risk aversion in recent months have not taken yet a significant toll on emerging economies' growth yet due to domestic demand resilience. However, exports are weakening in the smaller, more export-oriented economies, such as Hong Kong, Singapore, and Taiwan.

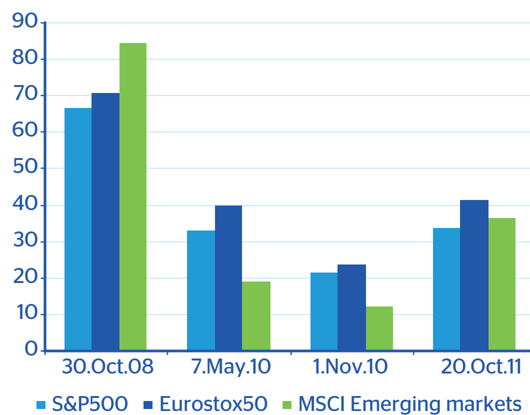
The increase in risk aversion has affected risky assets worldwide, but despite sizable drops, commodity prices have remained high and most countries enjoy continued access to international financial markets, albeit at somewhat higher prices. Therefore, conditions have remained supportive for growth in these regions.

In sum, growth in Latin America and emerging Asia is still robust and, in general terms, consistent with a soft-landing scenario. However, the less buoyant external environment since the summer in has brought to a halt (or is even starting to reverse), policy tightening measures that were being implemented by many emerging economies.

Emerging markets have already been hit by financial headwinds

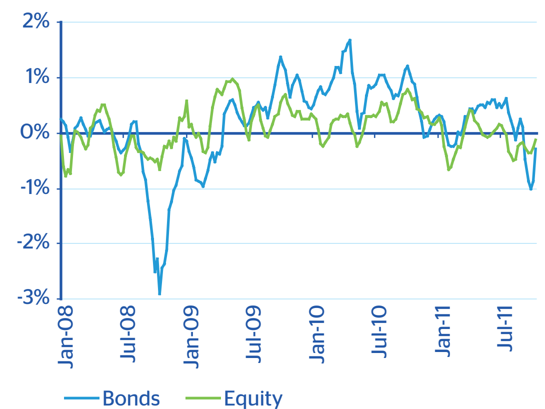
Although activity in the region remains strong, over the last few months emerging financial markets have suffered the effects of increasing global risk aversion, with significant exchange rate depreciation, stock market drops, increased spreads, and retrenchment in capital flows (see Charts 11 and 12).

Chart 11
Implied Equity volatility (VIX & V2X & MSCI)



Source: Bloomberg

Chart 12
Flow of funds to emerging economies as percentage of assets under management (4 week average)



Source: BBVA Research and EPFR

The focus has switched from overheating to sustaining growth in the face of a more challenging external environment

Some signs of overheating remain in these regions, although they seem much less severe than a few months ago. Nevertheless, progress on this front has been uneven. In Latin America, a few countries still show clear signs of overheating and remain vulnerable to external shocks. Some others, following more orthodox policies, have some room for counter-cyclical policies to offset slacks in demand.

The improvement has been clearer in Asia, although some pockets of high inflation remain. For example, in China inflation probably peaked and is expected to decline during the remaining year due to base effects and commodity price decreases. Moreover, credit and money growth have slowed due to policy tightening.

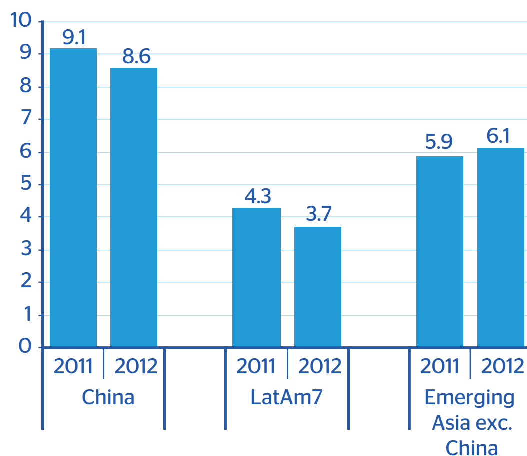
All in all, attention has shifted from overheating to the potential drag on emerging economies of a worsening in global economic conditions. As a consequence, further policy tightening is now unlikely. However, as far as domestic demand remains robust, at least in South America they are more likely to be reflected in a worsening of current account balances than on inflation. This might introduce tensions between monetary and the exchange rate policies in those countries perceived as the most vulnerable to the deterioration of the external environment.

The most likely scenario is a soft-landing in Asia and Latin America. However, risks remain, in particular if a worsening global environment lead to dampened confidence

Domestic demand conditions remain supportive even though activity has slowed over the last quarter. Looking ahead, confidence seems pivotal to the outlook for growth. To what extent confidence remains unaffected by financial turmoil may determine the degree of the slowdown in emerging economies.

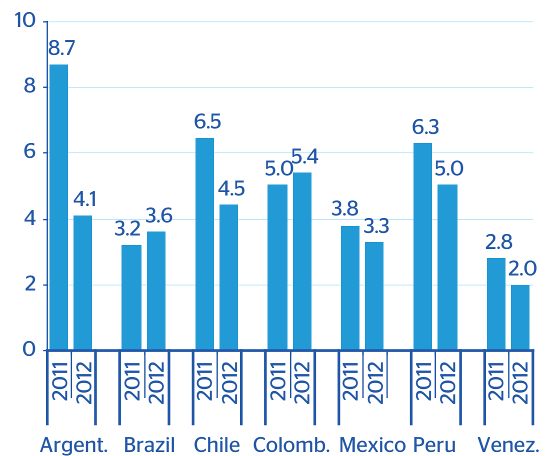
We maintain the broad picture of our scenario, with emerging economies undergoing a healthy slowdown towards more sustainable growth (Charts 13 and 14). Fears of overheating have mostly faded, although they have not disappeared. At the same time, reduced overheating fears imply that those economies with sound fiscal positions may have some margin for policies to be implemented in case the slowdown of advanced economies continues. In particular, as far as confidence remains unaffected, key Asian emerging economies will grow robustly and this will also support growth in Latin America.

Chart 13
Emerging markets GDP growth rate



Source: BBVA Research and IMF

Chart 14
Latam GDP growth rate



Source: BBVA Research and IMF

Risks are clearly tilted to the downside

There are three main sources of risk to the soft landing scenario we envisage. First, increasing global risk aversion may imply an abrupt halt to capital flows to emerging economies. Second, a sharp decline in global activity may add downward pressure to declining commodity prices, resulting in a drag for those economies most reliant on commodity exports, in particular in Latin America (see Box 3: A stress scenario for emerging economies). This would add to the effects from falling trade volumes. Third, weaker external demand may also feed through on export and GDP growth on those economies moer reliant on trade with advanced economies.

Furthermore, there are some local risks that are worth mentioning. First, some countries, for example Mexico, are strongly linked to the cycle of the advanced economies. Second, some countries in Latin America have already pushed their fiscal and monetary expansion to the limit and they are very vulnerable to a few commodity prices, both for fiscal and foreign exchange revenues. This means that those economies are more vulnerable to headwinds, in particular those that remain isolated from market funding. At the same time, some governments are facing political problems that may undermine their ability to respond to the challenges. Lastly, in China risks are growing, although they are still manageable. However, concerns about rapid "shadow bank" lending have been a hindrance to the containment of credit growth and could also result in financial strains on over-leveraged companies.

Box 3: A stress scenario for emerging economies

The external environment has been very favourable for emerging economies. High commodity prices, very low interest rates, and falling risk premia have been major contributors to the current expansion. However, we expect some increase in financial tensions and lower commodity prices stemming from the slowdown in advanced economies and from the European debt crisis.

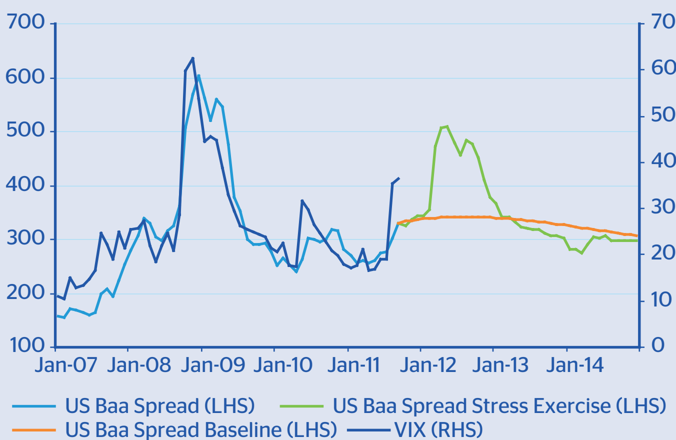
Although it is not a likely outcome, one cannot rule out a gloomier scenario, in which, for example as a result of failures to end the European crisis, advanced economies slip back into recession and a credit event fuels much higher global risk aversion (Chart 15) along with much lower commodity prices. In such a hypothetical scenario, growth in emerging economies would be significantly hit.

There are several channels of contagion from those events. The trade channel is an important one, but confidence and a sudden stop in capital flows from increasing global risk aversion can also hurt these economies. The banking channel that seems crucial in the outlook for European economies is not perceived as pivotal in emerging economies, except for some Eastern European economies.

In that case, and assuming an impact on global risk aversion and commodity prices similar to that seen during the fall of Lehman Brothers, the effect on growth would be similar to that in the aftermath of 2008's events. Those effects would include a sharp drop in growth (by around 4%-5%, see Chart 16), a reversal in the current account balance, and fiscal budget deterioration due to automatic stabilizers. The policy response would be limited and probably by means of a reduction in interest rates – that would allow for a depreciation in emerging economies' currencies – but not by fiscal stimulus.

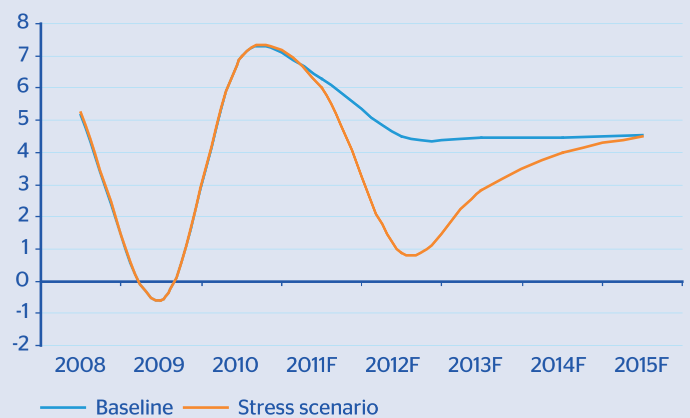
In any case, the consequences of that scenario would be uneven. Emerging Asia would show better conditions to cope with these events. On the other hand, even if it is true that some countries in Latin America have created fiscal buffers, some pockets of instability remain and external vulnerability has worsened in some countries.

Chart 15
Global risk aversion: US Baa Spreads (bps) and VIX (index)



Source: BBVA Research and Bloomberg

Chart 16
GDP growth in emerging markets (%)



Source: BBVA Research and Bloomberg

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	1.6	2.3
EMU	0.3	-4.2	1.7	1.7	1.0
Germany	0.8	-5.1	3.6	2.9	1.2
France	-0.2	-2.6	1.4	1.6	1.0
Italy	-1.3	-5.2	1.2	0.7	0.3
Spain	0.9	-3.7	-0.1	0.8	1.0
UK	-0.1	-4.9	3.4	0.9	1.3
Latin America *	5.2	-0.6	6.6	4.5	3.8
Mexico	1.5	-6.1	5.4	3.8	3.3
EAGLES **	6.6	4.0	8.3	6.7	6.5
Turkey	0.7	-4.9	9.2	7.5	4.5
Asia Pacific	5.2	4.1	8.0	5.9	6.4
China	9.6	9.2	10.4	9.1	8.6
Asia (exc. China)	2.3	0.8	6.5	3.7	4.9
World	2.8	-0.6	5.1	3.9	4.1

* Argentina, Brazil, Chile, Colombia, Peru, Venezuela
** Brazil, China, Egypt, India, Indonesia, Korea, Mexico, Russia, Taiwan, Turkey
Forecast closing date: October 31, 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	2.9	2.2
EMU	3.3	0.3	1.6	2.6	1.6
Germany	2.8	0.2	1.2	2.4	1.6
France	3.2	0.1	1.7	2.2	1.5
Italy	3.5	0.8	1.6	2.6	1.8
Spain	4.1	-0.3	1.8	3.1	1.2
UK	3.6	2.2	3.3	4.5	2.8
Latin America *	8.8	6.9	7.4	10.1	9.5
Mexico	5.1	5.3	4.2	3.5	3.5
EAGLES **	7.4	2.8	4.5	6.2	5.1
Turkey	10.4	6.3	8.6	6.5	6.0
Asia Pacific	5.7	0.3	2.7	4.8	3.7
China	6.0	-0.8	1.2	5.3	3.9
Asia (exc. China)	5.5	1.1	3.7	4.4	3.5
World	6.1	2.2	3.5	5.0	4.0

* Argentina, Brazil, Chile, Colombia, Peru, Venezuela
** Brazil, China, Egypt, India, Indonesia, Korea, Mexico, Russia, Taiwan, Turkey
Forecast closing date: October 31, 2011
Source: BBVA Research

Table 3

Macroeconomic Forecasts: Current Account (% GDP)

	2008	2009	2010	2011	2012
United States	-4.7	-2.7	-3.3	-3.2	-3.0
EMU	-0.5	-0.5	-0.5	0.0	0.2
Germany	6.3	5.6	5.7	5.5	5.0
France	-1.7	-1.5	-1.7	-2.2	-2.5
Italy	-2.9	-2.0	-3.5	-3.9	-3.5
Spain	-9.6	-5.2	-4.5	-4.5	-3.0
UK	-1.6	-1.7	-2.5	-2.3	-2.0
Latin America *	-0.7	-0.3	-0.8	-0.7	-1.7
Mexico	-1.6	-0.7	-0.5	-0.8	-1.1
EAGLES **	3.9	2.8	1.9	1.7	1.4
Turkey	-5.6	-2.2	-6.4	-9.9	-8.3
Asia Pacific	4.8	3.8	3.2	2.7	2.9
China	9.1	5.2	5.2	4.4	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: October 31, 2011
Source: BBVA Research

Table 4

Macroeconomic Forecasts: Government Deficit (% GDP)

	2008	2009	2010	2011	2012
United States	-3.2	-9.9	-8.9	-8.5	-7.1
EMU	-2.1	-6.4	-6.2	-4.5	-3.4
Germany	-0.1	-3.2	-4.3	-2.5	-1.5
France	-3.3	-7.5	-7.1	-5.8	-4.9
Italy	-2.7	-5.4	-4.6	-4.1	-1.9
Spain	-4.2	-11.1	-9.2	-6.5	-4.4
UK	-5.0	-11.5	-10.3	-8.3	-6.8
Latin America *	-1.1	-2.8	-2.0	-2.1	-2.4
Mexico	-1.6	-2.7	-3.4	-3.0	-3.0
EAGLES **	-1.8	-3.9	-3.0	-2.7	-2.6
Turkey	-1.8	-5.5	-3.7	-1.8	1.8
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: October 31, 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	2.8	2.5
EMU	4.0	3.3	2.8	2.7	2.6

Forecast closing date: October 31, 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	0.74
EMU	1.47	1.39	1.33	1.40	1.35
UK	1.82	1.56	1.54	1.60	1.57
China (RMB per USD)	6.88	6.83	6.74	6.42	6.16

Forecast closing date: October 31, 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	0.25
EMU	2.73	1.00	1.00	1.00	1.00
China	5.31	5.31	5.81	6.56	6.81

Forecast closing date: October 31, 2011
Source: BBVA Research

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This report has been produced by the Economic Scenarios Unit:

Chief Economist for Economic Scenarios
Juan Ruiz
juan.ruiz@bbva.com

Rodrigo Falbo
rodrigo.falbo@bbva.com

Alejandro Fernández Cerezo
alejandro.fernandez.cerezo@bbva.com

Jaime Martínez Martín
j.martinez.martin@bbva.com

Jorge Rodríguez Vález
jorge.rv@bbva.com

With the contribution of:

Europe
Miguel Jiménez
mjimenezg@bbva.com

BBVA Research

Group Chief Economist
Jorge Sicilia

Emerging Markets:
Alicia García-Herrero
alicia.garcia-herrero@bbva.com.hk

Cross-Country Emerging Markets Analysis
Álvaro Ortiz Vidal-Abarca
alvaro.ortiz@bbva.com

Asia
Stephen Schwartz
stephen.schwartz@bbva.com.hk

China

India
Sumedh Deorukhkar
deorukhkar@grupobbva.com

Latam Coordination
Joaquín Vial
jvial@bbvaprovida.cl

Argentina
Gloria Sorensen
gsorensen@bancofrances.com.ar

Chile
Alejandro Puente
apuente@grupobbva.cl

Colombia
Juana Téllez
juana.tellez@bbva.com

Peru
Hugo Perea
hperea@grupobbva.com.pe

Venezuela
Oswaldo López
oswaldo_lopez@provincial.com

Mexico
Adolfo Albo
a.albo@bbva.bancomer.com

Macroeconomic Analysis Mexico
Julián Cubero
juan.cubero@bbva.bancomer.com

Developed Economies:
Rafael Doménech
r.domenech@bbva.com

Spain
Miguel Cardoso
miguel.cardoso@bbva.com

Europe
Miguel Jiménez
mjimenezg@bbva.com

United States
Nathaniel Karp
nathaniel.karp@bbvacompass.com

Financial Systems & Regulation:
Santiago Fernández de Lis
sfernandezdelis@bbva.com

Financial Systems
Ana Rubio
arubiog@bbva.com

Pensions
David Tuesta
david.tuesta@bbva.com

Regulation and Public Policy
María Abascal
maria.abascal@bbva.com

Global Areas:

Financial Scenarios
Sonsoles Castillo
s.castillo@bbva.com

Economic Scenarios
Juan Ruiz
juan.ruiz@bbva.com

Innovation & Processes
Clara Barrabés
clara.barrabes@bbva.com

Market & Client Strategy:
Antonio Pulido
ant.pulido@grupobbva.com

Equity Global
Ana Munera
ana.munera@grupobbva.com

Global Credit
Javier Serna
Javier.Serna@bbvauk.com

Global Interest Rates, FX and Commodities
Luis Enrique Rodríguez
luisen.rodriguez@grupobbva.com

Contact details:

BBVA Research
Paseo Castellana, 81 – 7th floor
28046 Madrid (Spain)
Tel. + 34 91 374 60 00 and + 34 91 537 70 00
Fax. +34 91 374 30 25
bbvaresearch@bbva.com
www.bbvaresearch.com
Legal Deposit : M-31256-2000