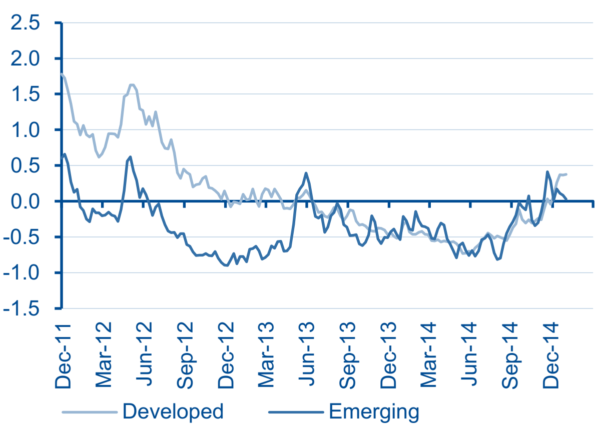
2. Moderate global growth with increasing divergence among economic areas

The world economy will have finished 2014 growing a similar pace to that in 3Q14,[1] close to 0.8% QoQ, according to our estimates, and slightly stronger than in the first half of the year. A dynamic economic performance in the US has been offset by the weakness of the recovery in Japan and the euro area, and the progressive deceleration of China and other emerging economies.

In the EM block, the divergence between industrial activity and services indicators continues. The gradual improvement in private consumption, on the back of the stabilisation or increase in employment, has continued to feed through into the figures for retail sales and the confidence indices in the services sector. Meanwhile, the relative improvement in world trade in the first two months of 4Q14 has not yet translated into a substantial increase in industrial production. In general, the EMs are seeing the fall in commodity prices in a scenario where there is already a trend towards more moderate growth in China. Altogether, we estimate that global GDP will have grown 3.3% in 2014, 10bp more than in 2013, with a slight increase in the DMs' contribution vs. the three previous years, and the EMs continuing to decelerate.

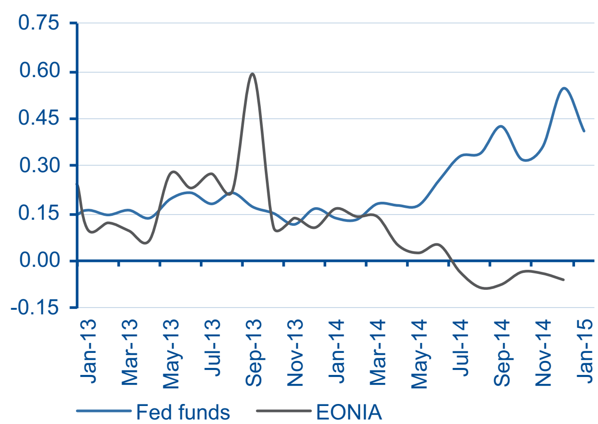
One of the novelties in the global economic scenario in recent months is the very sharp fall in the oil price and its uneven impact on different countries, depending on whether they are net importers or exporters. Overall, we think the global impact of cheaper oil should be positive in terms of growth, inasmuch as the reduced burden on household and corporate income in oil-importing countries (such as the US, the euro area and China) offsets the reduced activity in the principal producer countries. However, even lower prices or levels like those at present for Brent, around USD50/bbl, for an extended period could generate geopolitical and/or financial tensions that might compromise global stability.

Figure 2.1
BBVA Research Financial Tensions Index



Source: BBVA Research and Bloomberg

Figure 2.2
Monetary policy expectations: 12M forward interest rates (%)



Source: BBVA Research and Bloomberg

In fact, the increased volatility in financial markets, which has now reached the same level as in mid-2013 according to the BBVA Financial Tensions Index, is another of the highlights of the quarter, and one the EMs and the DMs have in common as a consequence of two factors. First, the combination of the geopolitical crisis between Russia and Ukraine with the fall in commodity prices, which has raised doubts on the economic preformance of many EMs. Second,

[1] Estimate based on the BBVA Research GAIN indicator; for details of the methodology, see: http://bit.ly/1nl5RIn

the uncertainty around the Fed's rate-hiking cycle, especially when the ECB is introducing QE measures and there is an increasing political debate on the most appropriate balance of policies to strengthen the region's recovery.

The correction in the oil price also accentuates the risks of a global scenario of too low inflation, at least until the second half of 2015. In addition to the recent general decrease in inflation, common to all the principal geographies (the average for the US, the euro area, Japan and China was 1% in 2014), there has been the steep fall in industrial production and import prices. Although so far the translation of the fall in energy prices to core inflation and salaries appears to be contained, the sharp adjustment in medium-term inflation expectations and the all-time lows in long-term interest rates reveal the degree of uncertainty that exists about the rate of recovery of the global cycle and the capacity of the central banks to restore inflation to levels compatible with their objectives.

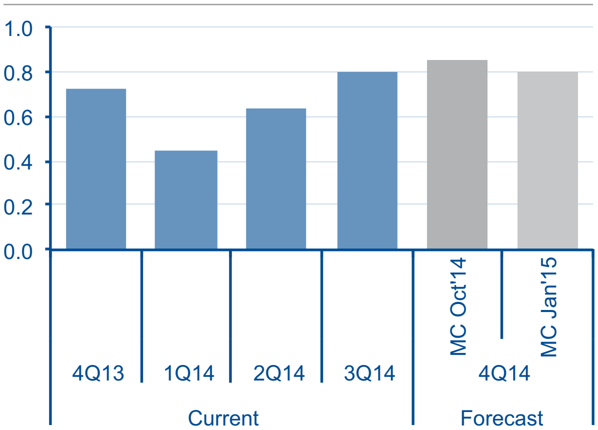
In this context of low inflation and moderate economic growth, monetary policies remain accommodative in tone, although the biases differ (with the Fed and the Bank of England on the one side, and the ECB and the PBoC on the other).

The new oil-price scenario gives the most important central banks room for manoeuvre to delay or reduce the intensity of the upward path of benchmark interest rates. In the case of the ECB, negative inflation prints have been the catalyst prompting the decision made in January to announce an expansion of the bank's asset purchase programme, this time to include purchases of public debt. The PBoC could introduce further cuts in the discount rates to cushion the deceleration of activity while tightening controls over private and local authority borrowings. In the EMs, those countries that are benefiting from cheaper commodity prices, reflected inter alia in an improvement in their external balances (for example India or Turkey), are also opting for more lax monetary policies in spite of the Fed's potential interest-rate hike in 2015.

The convergence of US growth towards 3% over the course of 2015, together with the progressive normalisation of the Fed's monetary policy, should translate into a gradual increase in the yield on the long bond. We expect yields on German public debt to rise more slowly, as a reflection of our expectation of slower nominal growth in the euro area and the impact of the ECB's above-mentioned purchases of sovereign assets. The different rates of growth anticipated for the US and the euro area and, above all, the change in expectations of monetary policy in the two areas, have been reflected in the evolution of EURUSD, with a significant appreciation of the dollar in recent months. This has sent the pair back to around 1.15, and we think it could continue to trade around this level for the rest of this year, on average.

Figure 2.3

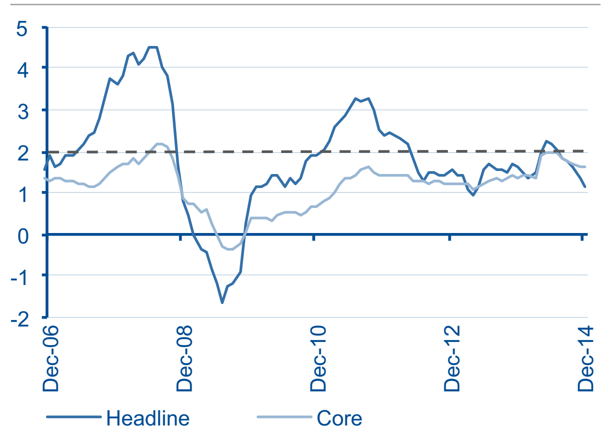
Global GDP based on BBVA-GAIN, %, QoQ



Source: BBVA Research

Figure 2.4

Global inflation*, %



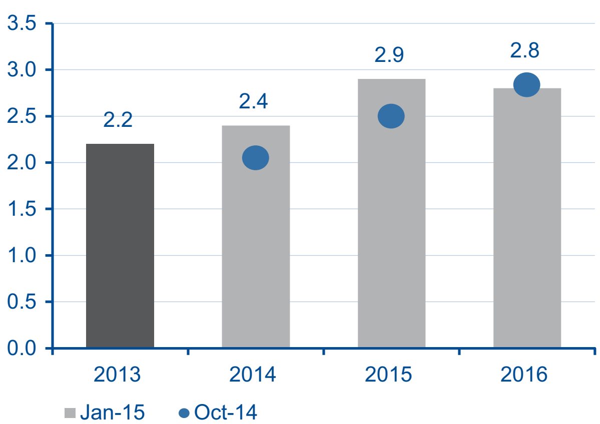
* Calculated as the simple average of inflation in the US, the euro area, Japan and China
Source: BBVA Research and Haver Analytics

Altogether, and in spite of the support offered by economic policies and lower oil prices, the risks to world growth in 2015 remain to the downside. The risks presented by geopolitical tensions have been joined by risks associated with the effectiveness of the monetary policies introduced to increase inflation expectations and – in the case of the Fed in particular - to establish a strategy for withdrawing stimulus that does not erode the EMs' financing conditions to such an extent that this restricts their growth.

Momentum in the US recovered over the course of 2014, and particularly in 2Q and 3Q, with QoQ GDP growth slightly above 1%. The strength of domestic demand and the stabilisation of residential construction are key to the US growth model. With net job creation of around 200k a month and an unemployment rate at year-end 2014 of 5.6%, wage increases will continue to support household consumption. The lower oil, and eventually, fuel prices are also helping to free-up disposable income for spending on other consumer goods.

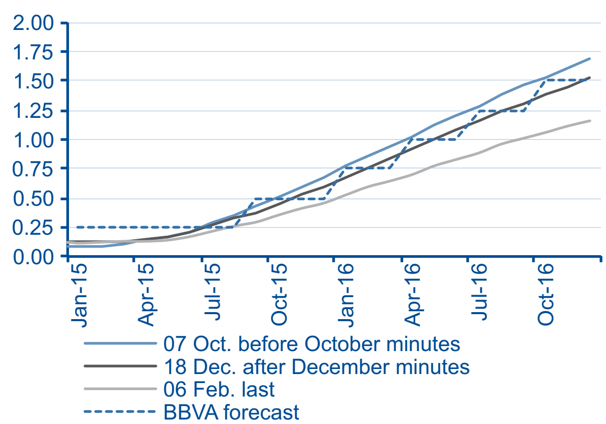
As a result of the good performance in previous quarters, and in spite of a more moderate figure for GDP growth in the fourth quarter, US growth could reach 2.4% in 2014 and up to 2.9% in 2015, in both cases beating the mid-year targets. The combination of stronger growth and lower inflation (the headline rate will be below 2% until 2016) will accentuate the Fed's dilemma when it comes to start its monetary normalisation process, in a context in which the global appreciation of the dollar favours more moderate inflation. Our forecast for the first increase in the fed funds rate remains in 3Q15.

Figure 2.5
U.S., economic growth, % YoY



Source: BBVA Research

Figure 2.6
U.S., expectations for the Fed funds rate, %

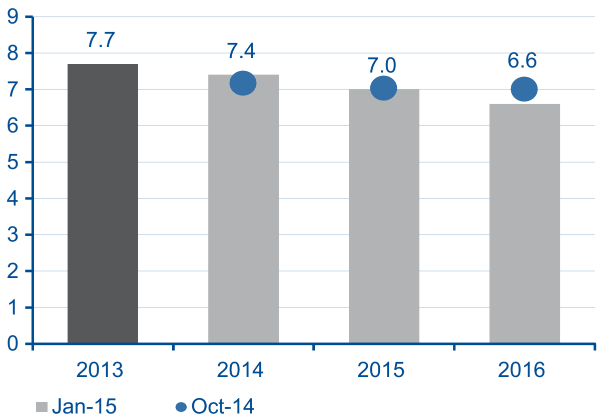


Source: BBVA Research and Bloomberg

In China, the slow deceleration in activity continued throughout 2014. The flash GDP estimate for 2014 as a whole puts it at 7.4%, which would imply the YoY rate for the fourth quarter at around 7.2%, the slowest since 2009. The macroeconomic dynamics in China are explained by the loss of momentum in fixed capital investment and the deterioration in external competitiveness which was driving yuan appreciation, together with the correction in the real estate sector.

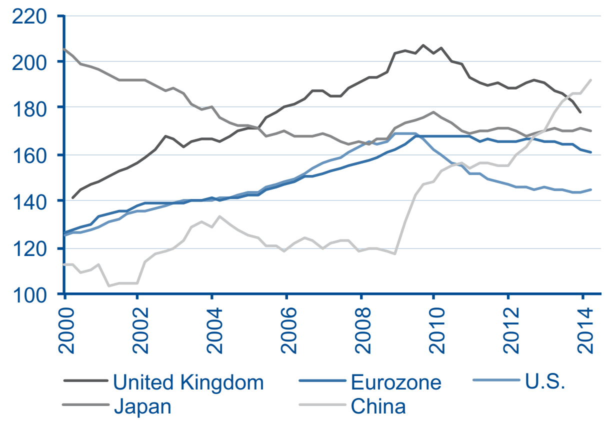
Although we have left our forecast for growth in 2015 unchanged at 7%, the risks are clearly biased to the downside as a reflection of the magnitude of accumulated financial imbalances, the uncertainty over the evolution of the real estate market and the uncertainties regarding the capacity for policies to achieve a correction in the present imbalances with economic liberalisation underway. The authorities have started to show more tolerance towards economic deceleration, as long as job-creation is consistent with the behaviour of the active population, while simultaneously betting on a redirection of the growth model towards less dependence on investment. This will allow them to combine an increase in monetary policy laxity with the adoption of fiscal control measures that contain debt, both at the private-sector and public administration levels (in the last decade, non-financial private-sector debt in China increased by 67bp of GDP).

Figure 2.7
China, economic growth, % YoY



Source: BBVA Research

Figure 2.8
Private non-financial sector debt as % GDP

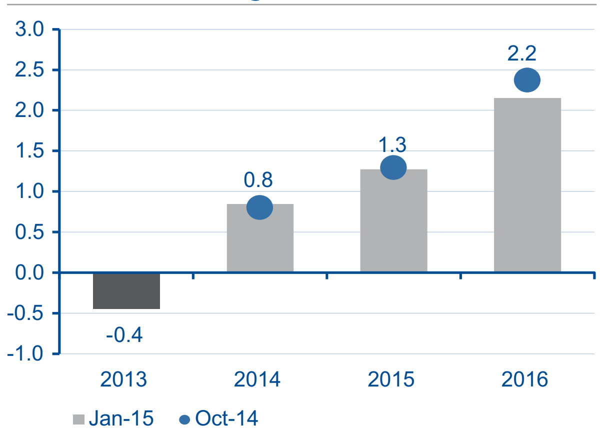


Source: BBVA Research and BIS

Of the large economic areas, the eurozone is the one which is most likely to have to deal with a scenario of inflation that is too low for too long. In addition to the negative surprises on consumer prices, the area has only a moderate economic growth profile, in line with expectations. Assuming GDP growth reaches around +0.2% in 4Q14, supported by a similar increase in activity in Germany and France and a better relative performance in Spain, our estimate for the eurozone is +0.8% YoY.

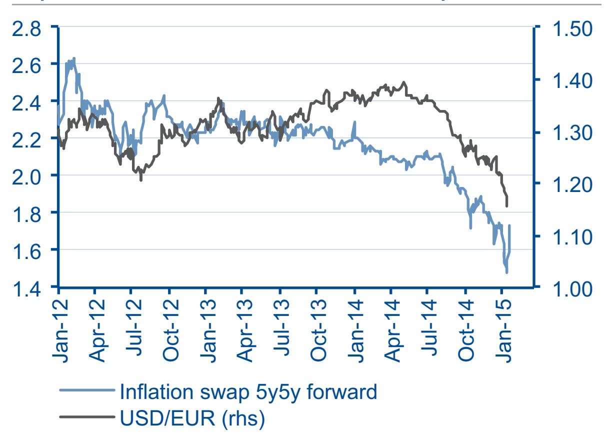
Altogether, we maintain our forecast for growth of 1.3% for 2015, supported by the fall in the price of oil, the accumulated depreciation of the euro in recent months and the relaxation of monetary conditions thanks to ECB actions. The less restrictive nature of fiscal policy in the peripheral countries is also an element to take into account, as well as the so-called "Juncker Plan", designed to favour investment, and the first fruits of which are expected in the second half of this year.

Figure 2.9
Eurozone, economic growth, % YoY



Source: BBVA Research

Figure 2.10
EURUSD and medium-term eurozone inflation expectations (5Y/5Y fwd inflation swap, %)



Source: BBVA Research and Bloomberg

Some threats arise, including the potential impact of increased tensions in Russia's sphere of influence, both in commercial and (more importantly) financial terms, given the heavy exposure of European banks to those countries. A second risk factor is the uncertainty generated by the divergences between some national authorities and the EU institutions as to the most appropriate supply-side reform, the pace of fiscal consolidation and the support of the ECB to foster growth. Finally, another risk is that medium-term inflation expectations continue to fall, discouraging consumption, and leading to a negative feedback loop.

To deal with the latter, the ECB has extended its asset purchase programme to public debt and increased the monthly purchases to EUR60bn. However, although a plan has been established for absorbing any losses (a high proportion of the risk of losses on the public bonds purchases is assumed by the national central banks), this does not resolve the problem of financial fragmentation in the bosom of the eurozone, the size of the programme or, above all, the commitment to leave it in place until the path of inflation converges with the ECB's objectives, it does represent a significant step in that direction.

There are three main transmission channels to the economy of the recently announced QE. First, a reduction of the financial burden on both public and private sector, and thus more disposable income for consumption or investment; second, euro depreciation and support for exports; and, lastly, reducing risk aversion in a context of very low long-term interest rates. The eventual impact of all of these on the real economy and the flow of credit will be key to the path of inflation expectations in the medium and long term, although not alone: the definition of credible fiscal consolidation strategies are also fundamental, given the scenario of low nominal growth and the maintenance of reform policies in sectors or markets important for the reactivation of potential growth.

DISCLAIMER

This document and the information, opinions, estimates and recommendations expressed herein, have been prepared by Banco Bilbao Vizcaya Argentaria, S.A. (hereinafter called "BBVA") to provide its customers with general information regarding the date of issue of the report and are subject to changes without prior notice. BBVA is not liable for giving notice of such changes or for updating the contents hereof.

This document and its contents do not constitute an offer, invitation or solicitation to purchase or subscribe to any securities or other instruments, or to undertake or divest investments. Neither shall this document nor its contents form the basis of any contract, commitment or decision of any kind.

Investors who have access to this document should be aware that the securities, instruments or investments to which it refers may not be appropriate for them due to their specific investment goals, financial positions or risk profiles, as these have not been taken into account to prepare this report. Therefore, investors should make their own investment decisions considering the said circumstances and obtaining such specialized advice as may be necessary. The contents of this document is based upon information available to the public that has been obtained from sources considered to be reliable. However, such information has not been independently verified by BBVA and therefore no warranty, either express or implicit, is given regarding its accuracy, integrity or correctness. BBVA accepts no liability of any type for any direct or indirect losses arising from the use of the document or its contents. Investors should note that the past performance of securities or instruments or the historical results of investments do not guarantee future performance.

The market prices of securities or instruments or the results of investments could fluctuate against the interests of investors. Investors should be aware that they could even face a loss of their investment. Transactions in futures, options and securities or high-yield securities can involve high risks and are not appropriate for every investor. Indeed, in the case of some investments, the potential losses may exceed the amount of initial investment and, in such circumstances, investors may be required to pay more money to support those losses. Thus, before undertaking any transaction with these instruments, investors should be aware of their operation, as well as the rights, liabilities and risks implied by the same and the underlying stocks. Investors should also be aware that secondary markets for the said instruments may be limited or even not exist.

BBVA or any of its affiliates, as well as their respective executives and employees, may have a position in any of the securities or instruments referred to, directly or indirectly, in this document, or in any other related thereto; they may trade for their own account or for third-party account in those securities, provide consulting or other services to the issuer of the aforementioned securities or instruments or to companies related thereto or to their shareholders, executives or employees, or may have interests or perform transactions in those securities or instruments or related investments before or after the publication of this report, to the extent permitted by the applicable law.

BBVA or any of its affiliates´ salespeople, traders, and other professionals may provide oral or written market commentary or trading strategies to its clients that reflect opinions that are contrary to the opinions expressed herein. Furthermore, BBVA or any of its affiliates' proprietary trading and investing businesses may make investment decisions that are inconsistent with the recommendations expressed herein. No part of this document may be (i) copied, photocopied or duplicated by any other form or means (ii) redistributed or (iii) quoted, without the prior written consent of BBVA. No part of this report may be copied, conveyed, distributed or furnished to any person or entity in any country (or persons or entities in the same) in which its distribution is prohibited by law. Failure to comply with these restrictions may breach the laws of the relevant jurisdiction.

This document is provided in the United Kingdom solely to those persons to whom it may be addressed according to the Financial Services and Markets Act 2000 (Financial Promotion) Order 2001 and it is not to be directly or indirectly delivered to or distributed among any other type of persons or entities. In particular, this document is only aimed at and can be delivered to the following persons or entities (i) those outside the United Kingdom (ii) those with expertise regarding investments as mentioned under Section 19(5) of Order 2001, (iii) high net worth entities and any other person or entity under Section 49(1) of Order 2001 to whom the contents hereof can be legally revealed.

The remuneration system concerning the analyst/s author/s of this report is based on multiple criteria, including the revenues obtained by BBVA and, indirectly, the results of BBVA Group in the fiscal year, which, in turn, include the results generated by the investment banking business; nevertheless, they do not receive any remuneration based on revenues from any specific transaction in investment banking.

BBVA Bancomer and the rest of BBVA Group who are not members of FINRA (Financial Industry Regulatory Authority), are not subject to the rules of disclosure for these members.

"BBVA Bancomer, BBVA and its subsidiaries, among which is BBVA Global Markets Research, are subject to the Corporate Policy Group in the field of BBVA Securities Markets. In each jurisdiction in which BBVA is active in the Securities Markets, the policy is complemented by an Internal Code of Conduct which complements the policy and guidelines in conjunction with other established guidelines to prevent and avoid conflicts of interest with respect to recommendations issued by analysts among which is the separation of areas. Corporate Policy is available at: www.bbva.com / Corporate Governance / Conduct in Securities Markets".

This report has been produced by the macroeconomic unit of Mexico:

Chief Economist
Carlos Serrano
carlos.serranoh@bbva.com

Principal Economist
Arnoldo López
arnoldo.lopez@bbva.com

Javier Amador
javier.amadord@grupobbva.com

Iván Martínez
ivan.martinez.2@bbva.com

Juan Carlos Rivas
juancarlos.rivasvaldivia@bbva.com

Fco. Javier Morales
francisco.morales@bbva.com

With collaboration of:
Economic Scenarios

BBVA Research

Group Chief Economist
Jorge Sicilia

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

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

Asia
Xia Le
xia.le@bbva.com.hk

Mexico
Carlos Serrano
carlos.serranoh@bbva.com

Latam Coordination
Juan Ruiz
juan.ruiz@bbva.com

Argentina
Gloria Sorensen
gsorensen@bbva.com

Chile
Jorge Selaive
jselaive@bbva.com

Colombia
Juana Téllez
juana.tellez@bbva.com

Peru
Hugo Perea
hperea@bbva.com

Venezuela
Oswaldo López
oswaldo_lopez@bbva.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@grupobbva.com

Financial Systems
Ana Rubio
arubiog@bbva.com

Financial Inclusion
David Tuesta
david.tuesta@bbva.com

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

Recovery and Resolution Strategy
José Carlos Pardo
josecarlos.pardo@bbva.com

Global Coordination
Matías Viola
matias.viola@bbva.com

Global Areas:

Economic Scenarios
Julián Cubero
juan.cubero@bbva.com

Financial Scenarios
Sonsoles Castillo
s.castillo@bbva.com

Innovation and Process
Oscar de las Peñas
oscar.delaspenas@bbva.com

BBVA Research Mexico
Avda. Universidad 1200
Colonia Xoco
C.P. 03339 México D.F.
Publications:
E-mail: bbvaresearch_mexico@bbva.com

These and other BBVA Research publications are available in English and in Spanish at: www.bbvaresearch.com

Other publications: