

2 Low and fragile economic growth, dependent on developments in China

Available data for the first quarter of 2016 confirm our forecasts of **stabilisation of world GDP growth still at reduced rates but slightly higher than at the end of 2015**. Our BBVA-GAIN¹ index puts the quarterly increase of world GDP at 0.6% (2.9% annualised rate), considerably lower than the average recorded between 2010 and 2015. A pace of growth that could accelerate slightly in the second quarter if the signs of lower deterioration anticipated by the available indicators of production, trade and business confidence are consolidated, but still **not sufficient for the annual increase to reach around 3.2%** (our forecast for 2016 as a whole).

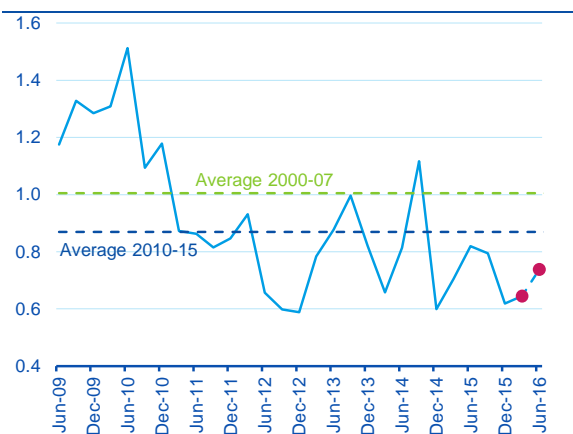
For our forecast to be correct, bearing in mind the progressive slow-down in China and the weakness in the activity cycle in the major emerging countries, it will be **necessary to witness a substantial improvement in economic growth in the US and Japan**, two developed economies where industrial production and export of goods have seen year-on-year falls as a result of the adjustment in the energy sector and the accumulated appreciation of the dollar, on the one hand, and lower Asian demand and the revaluation of the yen on the other. **Resilience in the production of services in the developed block**, which in recent months has lost steam due to the manufacturing adjustment, **is also a necessary condition**.

The sharp increase in financial volatility observed between December 2015 and February 2016, as well as responding to the actual deceleration of global activity, threatened to accentuate it if it continued at the same intensity and translated into a contraction of demand decisions. Since then, financial tensions, as well as the probability of the occurrence of a stress scenario on a global scale, have subsided. **The better than expected balance of economic indicators from China**, lower downward pressure on the value of the yuan, **the recovery of raw material prices and the moderation of expectations on interest rate rises by the Fed** have been determining factors.

The strengthening of stimulus policies, both monetary and fiscal, by the Chinese authorities has contributed to ease the effects of the readjustment in the manufacturing sector on aggregate production and, consequently on the country's trade flows with the rest of the world. In the short term, the implementation of counter-cyclical measures may facilitate a more gradual slow-down of the economy than expected; nevertheless if it is accompanied by a **delay in the correction of fundamental imbalances** such as high leverage in the corporate sector or excess installed capacity in some industries and construction, **the financial vulnerability of China in the face of shocks like the one seen in the summer of 2015 would increase** and, with it, its destabilising potential on the rest of the world.

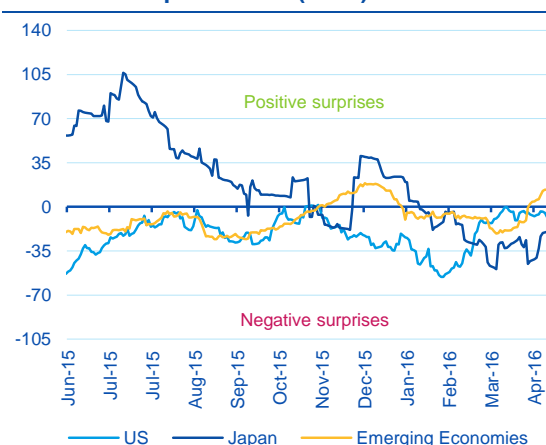
1: See <https://www.bbvaresearch.com/en/publicaciones/global-gdp-growth-to-benefit-from-a-less-stressed-financial-outlook/>

Figure 2.1
World GDP, % q/q. Q1 and Q2 forecasts 2016
based on BBVA-GAIN



Source: BBVA Research

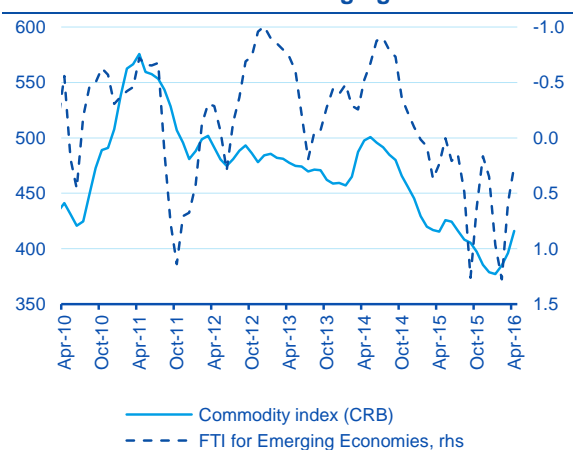
Figure 2.2
Economic Surprise Index (CESI)



Source: BBVA Research and Haver

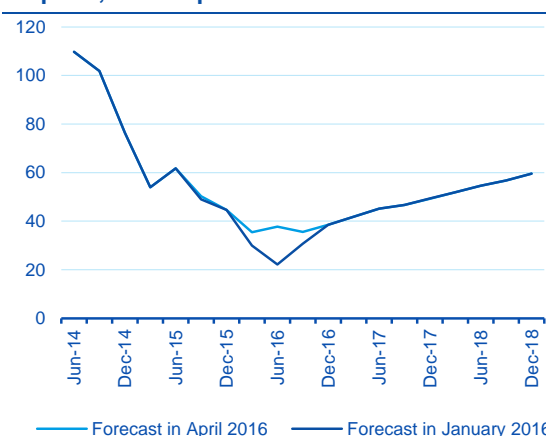
The stabilisation of activity in China partly explains the **recovery of prices of the major raw materials** from the minimum levels reached in January. In the particular case of oil (the WTI barrel price increased by 10 dollars to achieve levels of 43), the increase was due, to a large degree, to greater supply restriction than forecast (reduction in US production, supply cuts in countries such as Iraq and Nigeria, and expectation of an agreement between the OPEC countries to freeze their production)² and to the depreciation of the dollar.

Figure 2.3
Synthetic index of raw materials and BBVA index
of financial tensions for Emerging Economies



Source: BBVA Research, Bloomberg and Haver

Figure 2.4
Oil price, dollars per barrel. Forecasts



Source: BBVA Research

The relative weight given by financial agents to the deterioration of the international environment in the reaction of the Fed explains the **delay and moderation in expectations about the next interest rate rise**. In the face of the two increases forecast by the members of the FOMC for 2016, the market has put off the second increase until early 2017. The response of the dollar, depreciating despite the relatively good performance still shown by US domestic demand, and the drop of the US long term sovereign yields have contributed to alleviating financing restrictions on the **emerging world**, as reflected in: (i) **the BBVA index of financial tensions for this region, which has corrected all the rise seen in the first few months of 2016**

2: Oil price forecasts have been adjusted upwards for the middle quarters of 2016 in relation to the January scenario but reproduce the same dynamics as then for the future.

(the improvement has been more gradual in LatAm, conditioned by the idiosyncratic behaviour of Brazil), and (ii) the **reactivation of the inflows of foreign capital** (emerging assets have received net capital inflows since mid-February due, in part, to the search of yield and the capital reallocation towards more profitable financial instruments).

Furthermore, in so far as the developed central banks maintain the monetary policy direction of recent months (strengthening or maintaining stimuli in the case of BCE and the Bank of Japan; caution in normalisation of interest rates on the part of the Fed), **the authorities of emerging economies will have more flexibility to prioritise, among their objectives, the economic recovery, without ignoring the possible accumulation of imbalances**. The gradualness expected by the Fed (a factor that supports flows of capital into the region) and the recent recovery of currencies (a restraint on the potential increase in inflation through price rises for imported goods) reduce the need to tackle aggressive interest rate rises.

Given all this, **the relative improvement in the world economic outlook in the last quarter continues to be fragile and dependent on how the Chinese economy evolves, the resolution of hot spots of instability around Europe (geopolitics, "Brexit", payment of the Greek debt) and a possible slow-down in the US**. In any case, it is not ruled out that episodes of financial volatility can repeat like those at the beginning of this year (of greater or lesser intensity) in a context of heightened uncertainty over the ability of the emerging world to avoid a downturn and of the central banks of developed economies to promote growth.

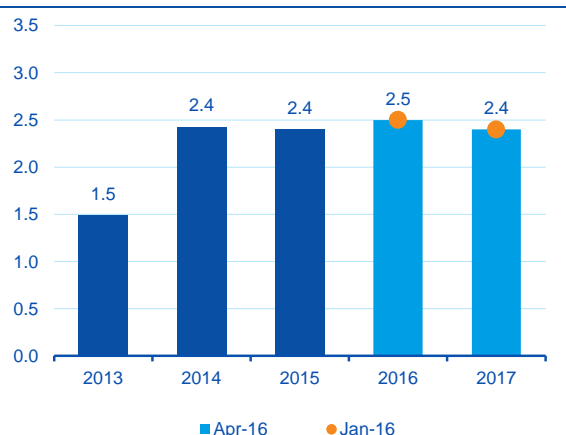
US: moderate growth and downwards risks condition the Fed's response

The US economy has suffered again at the beginning of 2016, as in the two previous years. According to the first official estimate, GDP would have risen barely 0.5% (annualised quarterly rate) in the first quarter, a similar figure to the same period in 2015 which gives continuity to the road to moderate growth seen in the US since then. **The dynamism of private consumption**, which has also begun to moderate, **and the support of the public expenditure are not sufficient to compensate for the fall in exports of goods and the weakness of private capital investment** (despite the improvement in the residential sector, total investment in fixed capital could register in the first quarter of 2016 the first annual correction since 2011). The adjustment of activity in the energy sector and its impact on other dependent industries continue to affect domestic spending on investment.

Leading signals offered by sentiment indicators for the second quarter reinforce the divergence between the evolution of industry (the manufacturing PMI for April shows the lowest figure since 2011, slightly above 50 points) and services, in favour of the latter (business confidence continues to point towards expansion of activity in this sector). **The expectations of economic recovery for next quarters are based on the support of consumption** (the job market is keeping the strength of the past few months, with the pace of job creation stabilising at 200,000 people per month) **and the possible relief brought about by the recent depreciation of the dollar for exports**. To realise **our expectation of 2.5% annual GDP growth** in 2016 (in line with that of 2015 and the January estimate), we will need to witness annualised quarterly advances of the same order in the future.

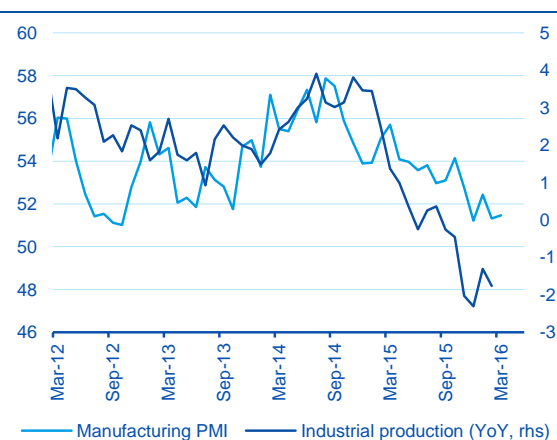
This forecast shows a downwards bias bearing in mind the risks mentioned for the global economy and the behaviour of domestic investment. **Likewise for the reduction in forecasts for reference interest rates during 2016 and 2017 by the members of the FOMC**. As in the central scenario of BBVA Research, **they are now expecting two new rate rises this year and four next years; a path of more aggressive hikes than that discounted by the market and whose bias is also downside** in so far as general inflation is progressively converging towards 1.5%, and the core rate hovers around 2%.

Figure 2.5
USA: GDP (annual change, %)



Source: BBVA Research and Haver

Figure 2.6
US industrial production (%) and business confidence



Source: BBVA Research and Haver

China: stabilisation of activity in the short term and greater risks in the medium term

The increase in financial tensions since mid-2015 due to uncertainty over the future evolution of the yuan and the acceleration of capital outflows, have pushed the Chinese authorities into prioritising the stabilisation of economic activity, trying to avoid a sharp downturn of GDP that would compromise the achievement of economic growth targets.

The strengthening of measures of fiscal support (the public deficit could reach 3% of GDP in 2016), **the keeping of the scheme of liquidity injections into the banking system and the relaxation of some regulatory standards** applied to the central bank and local governments make up the package of stimuli which, up to now, and according to official figures, **are facilitating a very gradual moderation of Chinese activity**. GDP grew by a year-on-year 6.7% in the first quarter of 2016 and **our forecasts improve on the expected annual growth for 2016 by 0.2 points to 6.4%, settling at 5.8% for 2017**. Inflation could be somewhat higher than the forecasts made in January, reaching 2.3% in 2016 and 2.7% in 2017.

Nevertheless, and independently of this improvement forecast for the short-term growth figures, **the risks lie in the impact that the delay in the programme of structural reforms could have in terms of financial stability and capacity for economic growth in the medium term**. Despite the process of reorientation of production in which the country finds itself (manufacturing sector confidence continues to be in the contracting zone in April, industrial production is growing at rates close to 6% year-on-year, well below those recorded for 2014-2015, and prices of production, though not so pronounced, have continued to fall relentlessly since 2012), **debt has not stopped growing**. According to BIS data, non-financial private sector debt exceeded 205% of GDP in the third quarter of 2015; a tendency for increase which has foreseeably been maintained until now bearing in mind the volume of new debt operations (in particular those arising from bank loans).

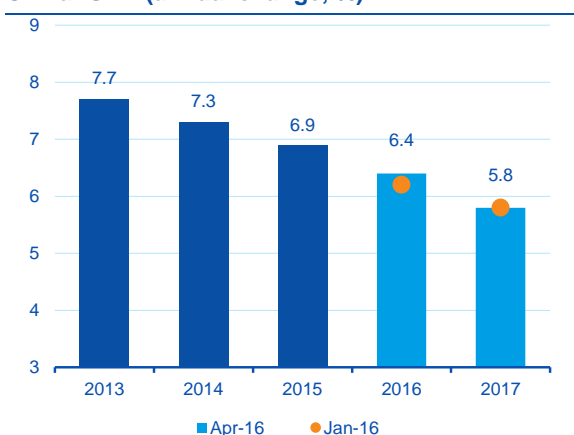
The longer the restructuring of semi-public companies linked to high-overcapacity areas of activity is postponed (in the Five-year Plan presented last March there was no a concrete plan heading in this direction), **the greater the negative impact will be on the profitability and quality of bank assets** and, therefore, on the economy as a whole in the medium term. Among the options under consideration to address the management of corporate debt with the greatest risk of default, are a programme of debt

conversion to capital (*Debt to Equity Swap*)³ and the securitization of outstanding debts as marketable securities. For these initiatives to be successful, as well as overcoming the associated implementation restrictions, they need to be accompanied by a comprehensive action plan, focus on the restructuring of viable firms and benefiting from the participation of the banks to speed up the identification of non-performing loans; a strategy that, for the moment, does not seem to be in place.

As regards the management of monetary policy, the central bank may carry out new cuts in reference interest rates, though more restrained than those foreseen at the beginning of the year (4.1% and 3.6% are the estimated levels to be reached this year and next, as against 4.35% at the close of 2015), given the other current stimulus schemes. The yuan, after the recent appreciation, may possibly lose value again to levels of 6.8CNY/USD towards the end of 2016

Figure 2.7

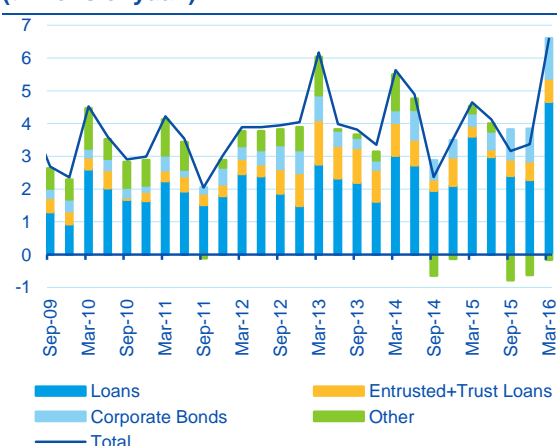
China: GDP (annual change, %)



Source: BBVA Research and Haver

Figure 2.8

China: debt, new operations by instrument (trillions of yuan)



Source: BBVA Research and Haver

Eurozone: downwards revision of growth forecasts. Political events are the main risk in the short term

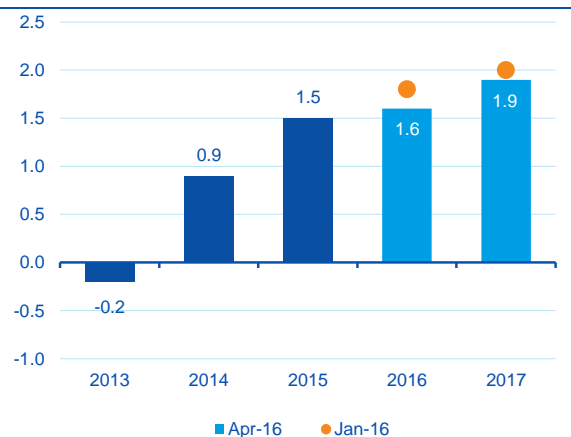
After a second quarter 2015 of moderate growth (quarterly GDP rates of 0.3%), **the Eurozone economy would have accelerated its pace of growth in the first quarter of 2016, with an increase in GDP, according to the preliminary indicator, of 0.6%.** The best relative performance expected for France and Germany (with growth rates in the order of 0.5-0.6%) and the dynamism of Spain (increase of 0.8% for the third quarter in a row) would be behind the improvement for the whole area at the start of this year. **The strength of private consumption**, which has recovered to pre-crisis levels, **continues to be the key to the pattern of growth** of the Eurozone, although the recent fall in agent confidence and the level of household debt of some peripheral countries limit the scope of additional support to the aggregate activity.

This, combined with the **modest recovery shown by the capital investment** (in a context of raised external and political uncertainty, and downward pressures on business profits) and the **weakness of external trade** (the effect of the depreciation accumulated by the euro since mid-2014 has begun to diminish, especially in latter months with the currency recovering to levels of 1.15 against the USD), justify the **downward revision of our growth forecasts for 2016 and 2017.** Eurozone GDP could grow this year by 1.6% (0.2pp lower than forecast in January) and by 1.9% in 2017 (-0.1pp).

3: See https://www.bbva.com/wp-content/uploads/2016/04/April-2016_China-Equity-for-Debt-Swap.pdf

Figure 2.9

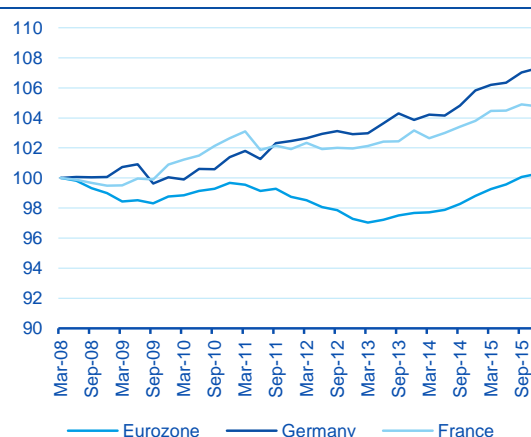
Eurozona: GDP (annual change, %)



Source: BBVA Research y Haver

Figure 2.10

Eurozona: private consumption (base 100=2008)



Source: BBVA Research y Eurostat

In our opinion, **the support for activity that the new stimulus measures by the BCE⁴ may produce and the slightly expansive nature of fiscal policy** in the main countries of the zone **will not be enough to compensate for the negative impact of the aforementioned factors and of the political uncertainty** (referendum on the UK remaining in the EU, electoral processes open or foreseen for 2017, etc.) on private sector confidence and spending decisions. Additionally, it is not ruled out for the proximity of important debt payments on the part of Greece to create tensions in the markets if the agreement being negotiated with public creditors is not reached beforehand.

As regards inflation, we maintain practically unchanged the January forecasts which put the average general rate for 2016 at 0.2% and at 1.3% for 2017. The increase observed in oil prices may alleviate downward pressure on the energy component of the CPI in the shorter term, but in the absence of a sustained increase in the prices of the core items (stable at rates of 1%) general inflation will not meet the ECB's price stability target until 2018.

4: See <https://www.bbva.com/wp-content/uploads/2016/04/ECB-Watch-Minutes-April162.pdf>

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