2. Global environment: more growth, higher uncertainty and long-term risks

The global economy improved in the last months of 2016 and is continuing to do so in early 2017. However uncertainty regarding the rest of the year is higher than it was three months ago.

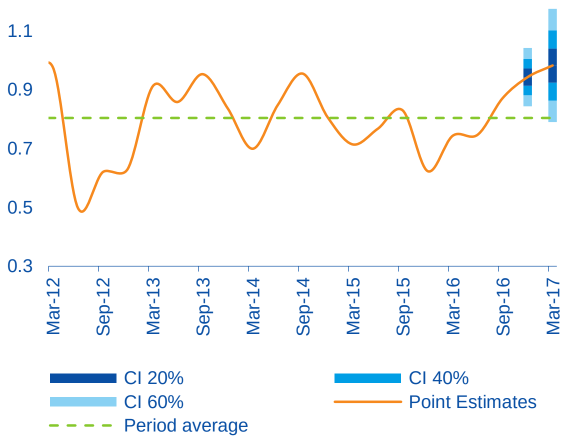
Global economy accelerates

Growth in global GDP accelerated in the last quarter of 2016 up to 0.9% QoQ, and **points to somewhat higher growth rates in the first quarter of this year**, contrasting with the rates below 0.8% that were observed during most of last year. Confidence indicators have clearly improved in all areas, and the industrial sector indicators are growing along with an incipient improvement in global trade.

The performance of the developed economies is behind this improvement, with the USA recovering in the second half of 2016 (after a very weak first half) and Europe consolidating growth rates of just over 1.5% YoY, above its potential. **China's economy also grew more than expected**, thanks to the monetary and fiscal stimulus measures put in place during the past year, which has partly served as a positive drag on other Asian countries. **In Latin American countries, the recent trends are more mixed.** Overall, the global economy was expected to have grown by 3% in 2016, below the 3.3% in 2015, but with an accelerating trend throughout the year.

Figure 2.1

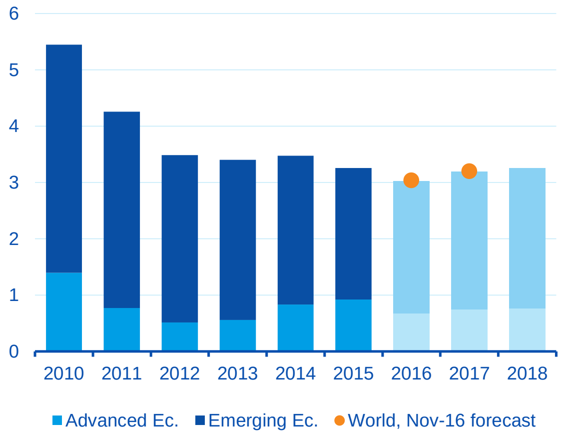
Growth of global GDP (% QoQ)*
Forecast based on BBVA-GAIN Model



Source: BBVA Research

Figure 2.2

Contributions to growth in global GDP (pp YoY)



Source: BBVA Research based on IMF

Despite this acceleration, **the outlook for 2017 and 2018 is fraught with uncertainties.** The main one is associated with the **economic policy of the new US administration**, which is still largely undefined. There have been announcements of **fiscal stimulus measures and deregulation in various sectors**, which were received positively by the markets after the elections. Since then, 10-year interest rates in the US have risen by 63 basis points up to 2.5%, with an overall drag effect (both in Europe and in the emerging markets); stock indices have risen globally (+6.6% in USA, +8.5% in Europe); and the dollar has appreciated by around 2.0% against other major currencies, including the euro. Emerging markets were negatively affected by the election results in the US, registering capital outflows and downward pressures on their currencies, particularly Mexico.

However, the announcement of protectionist measures (withdrawal from the TPP trade agreement in Asia, many doubts about the TTIP with Europe and requests for renegotiation of NAFTA, with advance announcements of possible tariff increases), **could seriously damage international trade in the medium and long term and affect confidence in the near future**, especially outside the US. **Regarding the fiscal stimulus, its extent and in what form it will materialise** (more spending on infrastructure or, more likely, cuts in corporation tax) **have yet to be defined** and, **above all, to what extent it can stimulate activity or generate more inflation**, given the proximity of the US economy to its potential growth. Therefore, since the beginning of the year, market optimism has moderated. Looking forward, the decoupling between the high uncertainty about economic policy and low volatility at aggregate level does not seem sustainable.

Uptick in inflation generates pressure over monetary policy

The magnitude of the inflationary pressures is another great unknown at global level. **Commodity prices have rebounded more than expected in recent months**, following the OPEC agreement and the improvement in activity. The price of Brent was around US$56 a barrel in early 2017, when a somewhat slower transition to its long-term equilibrium level (around US$60 per barrel) was expected. **Added to this, the base effects of energy prices are pushing YoY inflation** closer to the inflation targets set by central banks, **which has pushed up long-term inflationary expectations** discounted by the markets. If to this we add the size of the accumulated balances in recent years due to quantitative easing programmes and the prospects of fiscal stimulus, the result is that **the risks of deflation of just a few quarters ago have been replaced by inflationary pressures, generating a number of questions about the reaction of monetary policy.**

In principle, **the Federal Reserve is maintaining a cautious attitude and continues to point to a relatively slow normalisation of interest rates** (although it has recently revised its rate expectations slightly upwards, with three increases of 0.25% in 2017, to 1.5%). In its latest press releases, it acknowledges a slight improvement in the outlook for growth and inflation, based on expectations of fiscal expansion, while maintaining a balanced stance between upside and downside risks. Looking forward, **it is expected that two rate hikes will take place this year and another two in 2018**.

The **ECB** in late 2016 approved an extension of the programme of asset purchases until December 2017, albeit reducing the monthly purchase of assets from €80 billion to €60 billion from March and stressing that this does not mean a gradual withdrawal of the programme. However, **the pressures to advance the**

normalisation of monetary policy have already begun with the acceleration of German inflation and are expected to intensify in the coming months as inflation in the euro zone moves closer to 2% due to the effect of energy prices. Given the above, the ECB **is expected to begin to taper the purchase programme in early 2018 and to decide on the first rise in interest rates by the end of that year**.

Overall, **growth projections for 2017 have not been substantially revised**, although they are subject to **greater uncertainty than usual**. The base effect of higher growth in late 2016 and its inertial effect, together with the expected fiscal stimulus in the US, have meant a **very slight upward revision of forecasts for US and Europe, and a little more in China, while forecasts for Latin American countries are being revised downwards** mainly due to idiosyncratic factors.

The scenario is not exempt from risks, especially from protectionism's

The risks are mainly on the downside and are dominated by the aforementioned uncertainty linked to the possibility that protectionist measures will be implemented **in the US**, a less welcoming attitude towards immigration and the danger that fiscal stimulus policies will have no effect on growth and will generate inflation, or that the deregulation announced in various sectors will not be managed properly. Added to this is the **possible reaction of other countries or regions to these protectionist moves**. An unexpected rise in inflation could lead to the **tightening of monetary policy by the main central banks**, with global consequences. In the long term, the risks of **accumulation of imbalances in China**, together with the lack of structural reforms in public companies, could have an impact on capital flows, its currency and lead to a sharp rate of slowdown. **In Europe, the political risk is high**, in a year filled with elections and in which some parties gaining popularity are proposing the reversal of structural reforms or measures to leave the euro zone or the European Union. And in general, **geopolitical risks** remain significant.

United States: no big changes while awaiting the first economic policy measures

GDP growth in 2016 closed at 1.6%, after a second half of the year (annualized 3.5% in 3Q16 and 1.9% in 4Q16) clearly more positive than the first half (0.8% and 1.4%). **The likelihood** that the new administration could implement the **tax and regulatory reforms** it has promised and that **they could have a significant effect this year is not very high**, given their ambitious scope and the limited margin for growth above potential, **but they may be driving business confidence and investment in the short term**, so we have marginally revised our forecast upwards to 2.3% this year, and we expect 2.4% in 2018. Regarding inflation, we expect to exceed the target and reach an average of 2.3% this year, which will return to 2% in 2018.

China: slower than expected slowdown due to fiscal stimulus

Growth in the fourth quarter was 6.8% YoY, leading to its closing **2016 at 6.7%** on average, somewhat higher than expected. Several business activity indicators, including industrial production and retail sales, improved in December and suggested additional improvement at the beginning of this year. **For 2017 as a whole we expect growth around 6%** (revised up two tenths from our previous forecast) and **5.2% for 2018, given the vulnerabilities faced by the economy** and an economic policy more oriented towards ensuring financial stability than maintaining growth. Our inflation forecasts remain unchanged at 2.7% and 3.0% in 2017 and 2018 respectively.

Euro zone: resistance in the face of several shocks

Growth in 2016 closed at 1.7%, somewhat higher than expected, following a positive fourth quarter (0.5% QoQ) reflecting the recovery in industrial activity and, to a lesser extent, in exports. Confidence indicators are at relatively high levels, despite the political shocks experienced in recent months (Brexit and the Italian referendum on constitutional reform). **Similar growth rates (1.6% in both years) are expected in 2017 and 2018, above potential growth, supported by very relaxed monetary conditions, a depreciated euro and non-restrictive fiscal policies.** The factors working against stability are oil prices (slightly higher than expected) and the **political risks** affecting many countries in the region. **Inflation should in principle be kept well below the 2% target in both years, although it will peak in the early part of this year** close to that value, due to base effects and rising energy prices, then reverse slightly. **The key, in this regard, will lie in observing the evolution of core inflation**, currently stable below 1%, and which should approach rates above 1.5% at the end of the forecast period.

Emerging economies: the determining factor is the management of vulnerability due to domestic and external factors

In **Turkey**, inflationary pressures have increased due to the depreciation of the lira, which could lead to a tightening of monetary policy in 2017 in an environment of lower-than-expected growth, around 2.5% in 2016 and 2017, before regaining some traction in 2018. In **Mexico**, the progress of the economy moderated to just over 2% in 2016 and could moderate further to about 1% in 2017 due to the uncertainty associated with the trade measures that could be adopted by the US and the tightening of monetary policy to anchor inflationary expectations. By 2018, it is estimated that GDP growth could accelerate again to around 2%. For **South America** as a whole, GDP is expected to have contracted by more than 2% in 2016, although it should recover and grow by around 1% in 2017, thanks to the greater contribution of the external sector, the end of the contraction in Brazil, private investment in Argentina and public investment plans in countries such as Colombia.

5. Glossary

Acronyms

- AENC: Bipartite Inter-Confederal Agreement on Employment and Collective Bargaining
- APP: Asset Purchase Programme
- APR: Annual Percentage Rate
- BBVA: Banco Bilbao Vizcaya Argentaria
- BBVA – EAE: BBVA Economic Activity Survey
- BBVA – GAIN: BBVA Global activity index
- CDS: Credit Default Swaps
- CEOE: Spanish Confederation of Employers' Organizations
- CEPYME: Spanish Confederation of Small and Medium sized Enterprises
- CC. OO: Trade Union Confederation of Workers' Commissions
- CPI: Consumer Price Index
- EAGLES: Emerging and Growth-Leading Economies
- ECB: European Central Bank
- EMU: European Economic and Monetary Union
- EPU: Economic Policy Uncertainty Index
- EU: European Union
- Euribor: Euro interbank Offered Rate
- FCE: Final Consumption Expenditure
- FED: Federal Reserve System
- FTE: Full time equivalent
- GC: Governing Council
- GDP: Gross Domestic Product
- IC37: Group of Industrial Countries comprising the 28 EU members plus the US, Canada, Japan, Switzerland, Norway, Australia, New Zealand, Mexico and Turkey
- INE: National Institute of Statistics
- LATAM: Latin America aggregated including Argentina, Brazil, Chile, Colombia, Mexico, Peru and Venezuela
- LFS: Labour Force Survey
- ME and SS: Ministry of labour and social security
- MICA-BBVA: Factor Model of Economic and Financial Indicators for Short-term GDP Forecasting
- MINHAP: Ministry of Finance and Public Administration
- NAFTA: North American Free Trade Agreement
- OPEC: Organization of the Petroleum Exporting Countries
- PA: Public Administration
- QE: Quantitative easing
- ULCs: Unit labour costs
- US: United States
- UK: United Kingdom
- SMEs: Small and medium-sized enterprises
- SWDA: Seasonally and working day adjusted
- UGT: General Workers Union

Abbreviations

- Bps: Basic points
- CI: Confidence interval
- MoM: Month on month change
- Pp: Percentage points
- QoQ: Quarterly on quarter change
- YoY: Year on year change

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