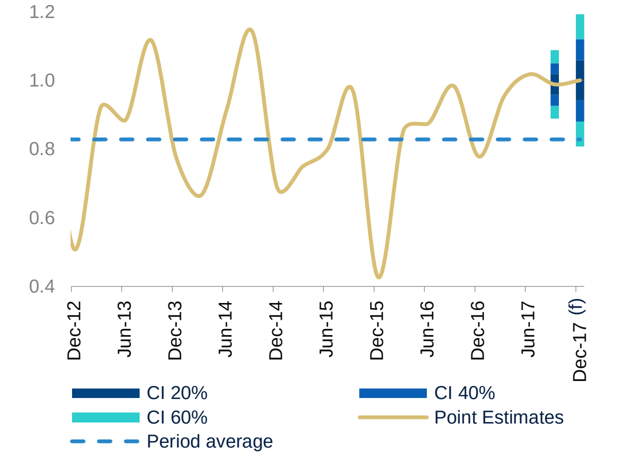
2. Consolidation of the positive global environment

Robust, stable global growth, with recovery more synchronized across areas

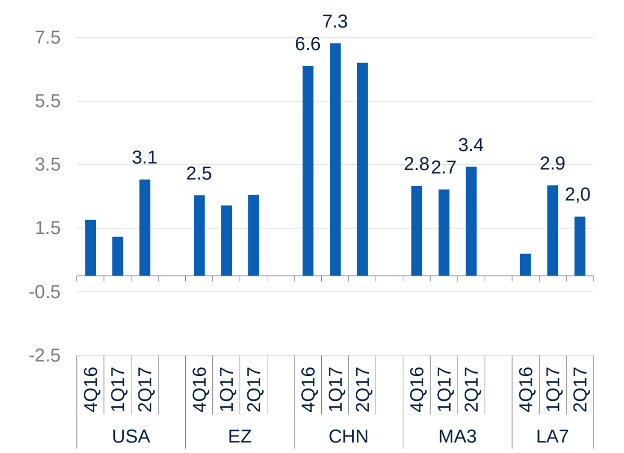
World economy growth stabilised at around 1% QoQ mid-way through the year, and the indicators available thus far suggest that this progress is continuing in the second half of the year (see Figure 2.1). **Global confidence indicators have, once again, improved**, in both advanced and emerging economies, pointing to a brighter panorama than the activity indicators, which have slowed down at the beginning of the third quarter. Nonetheless, **world trade growth remains solid and the recovery of the manufacturing sector continues apace.** This underpins the upturn in investment, while the **strength of private consumption** holds out, despite the weaker tailwinds.

Figure 2.1 World GDP growth
(Forecasts based on BBVA-GAIN, % QoQ)



(f) forecast.
Source: BBVA Research

Figure 2.2 GDP growth by region
(SWDA, % YoY)



Source: BBVA Research

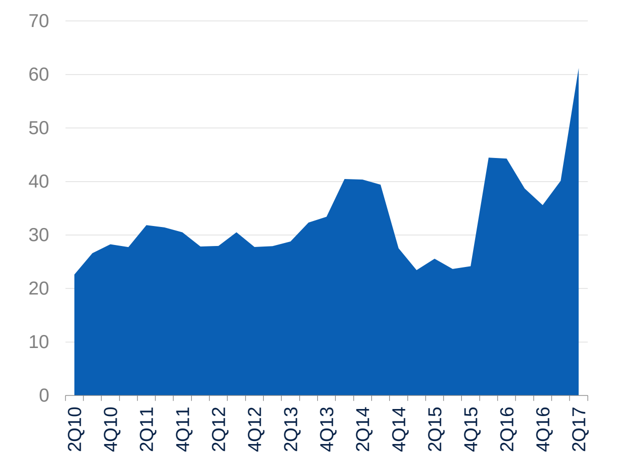
This upbeat dynamic reflects a stronger economic performance in all areas (see Figure 2.2). In advanced economies, US GDP rebounded in the second quarter, and held relatively steady in the third, which reduces the doubts about the sustainability of moderate growth in the next few quarters. In Europe, the positive surprise was due to the increased strength of domestic factors. Among emerging economies, stabilising growth in China will continue to shore up the rest of Asia, which, in combination with the favourable conditions of the financial markets, is also allowing growth in Latin American countries to gain traction. Finally, the recovery of Russia and Brazil has stopped hampering world growth. Therefore and unlike other expansionary phases that followed the financial crisis (in early 2013 and mid

2014), **the current recovery is the most synchronised** according to the BBVA cyclical synchronisation index[1] illustrated in Figure 2.3.

So far, this growth environment has been accompanied by **moderate levels of inflation**, also generalised by regions, despite the abundance of liquidity in the markets. Furthermore, there are no clear signs of inflationary pressures building up. In the case of the emerging economies, the strengthening of their currencies, brought about by the weak dollar and firmer commodity prices, has helped inflation to continue to moderate. In developed economies, the fall in inflation comes from the disappearance of the base effect of energy prices (especially in Europe) and certain transitory factors (mainly in the US). Although **core inflation remains low,** doubts persist as to whether the factors behind this are of a passing or lasting nature. Be that as it may, the context of low inflation gives **central banks in emerging economies greater room for manoeuvre** in continuing to use monetary policy to support growth **it also allows monetary authorities in advanced economies to remain cautious in implementing normalisation**.

Other factors contributing to the positive global performance, such as **generally neutral or expansive fiscal policies** and moderate commodity prices, look likely to remain at the forecast horizon. Furthermore, financial markets have been relatively complacent and have not suffered persistently from the sources of political stress.

Figure 2.3 BBVA cyclical synchronisation index*
(Base on the time variance of GDP)



Source: BBVA Research
*: see footnote 1

Figure 2.4 Financial tension index. USA vs. EMU (normalised)

Source: BBVA Research

1: The synchronisation index is the result of inverting the standard deviation of quarterly growth observed in countries. The index therefore associates less (more) growth volatility among countries with a higher (lower) degree of synchronisation worldwide.

Favourable environment in the financial markets and normalisation of monetary policies

As shown in Figure 2.4, **the market dynamic has remained unchanged so far in the second half of the year, despite episodes of stress**, particularly of political nature, such as the debate on the debt ceiling in US domestic politics and the North Korean situation internationally. These events have caused certain refuge effect for bonds, which has sent long term interest rates back to the lower end of the contribution range. However, its effect has been transitory.

In an environment of healthy growth, and with no inflation surprises on the downside, **central banks continue with the gradual process of withdrawing monetary stimulus measures**. Specifically, **the US Federal Reserve has announced the start of the reduction of its balance sheet from October**. This will take the form of a passive adjustment, by allowing a portion of public and private bonds to simply expire. Having been clearly signalled, it has not led to market stress. Furthermore, the Federal Reserve still expects to implement a series of rate hikes, even though the markets have systematically shown themselves to be more dovish. In this regard, **we expect a 25 bp hike in official rates in December this year and then two further hikes up to 2% in 2018**. That said, uncertainty over the course of the hikes has been heightened, not only because inflation is still at low levels, but also because of **the changes at the Fed** following the departure of a substantial number of its members.

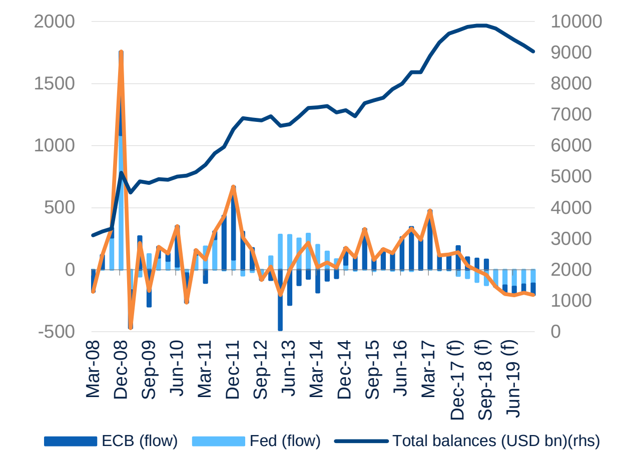
In October, the European Central Bank **(ECB) announced a scaling down of its asset purchase programme**, which will start to implemented in January next year. The withdrawal of the stimulus measures will be gradual: the volume of monthly purchases will be reduced from the current €60 billion to €30 billion, falling to zero in September. For all that, the BBVA Research scenario envisages **rate hikes to be delayed until mid-2019,** largely because of the ECB’s growing concerns about the appreciation of the euro and its potential impact on inflation.

With the latest recalibration of the asset purchase programme (APP), the ECB is sending several messages. Firstly, one of increased confidence that inflation is moving closer to the target, justifying a somewhat less accommodative monetary policy. Secondly, one of caution, since it is extending the programme for a further nine months, and so far without an end date. In fact, given that Draghi stressed that the programme would not be ended abruptly, it could be extended into 4Q18. What is more, once the APP has ended, the ECB intends to remain present in the debt market for an extended time by reinvesting as bonds mature.

In this meeting the ECB faced a major challenge: gradually adjusting monetary conditions to the favourable economic environment while avoiding market overreaction, in particular as regards the euro. In fact, in the last quarter, the strength of the currency represented a differential factor, in view of its potential impact on the prospects of inflation in the medium term and financial conditions in the euro zone. Thus, despite the reduction in stimulus measures, the ECB is seeking to avoid upsetting the markets by using communication policy, especially forward guidance.

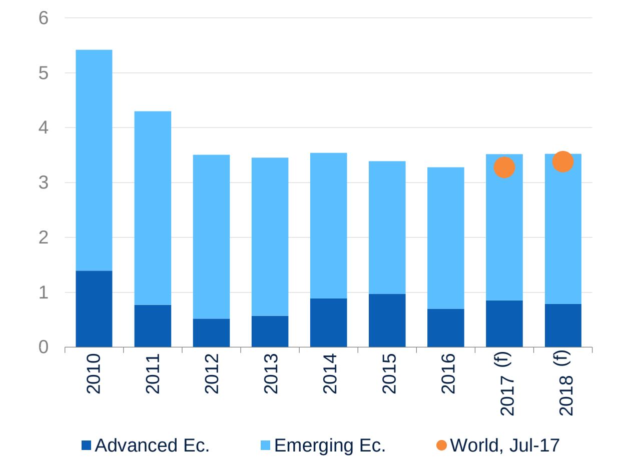
As in the previous quarter, the combination of low volatility, low rates and dollar weakness have set the scene for a **favourable environment for emerging markets**. **Strategies to seek out profitability have been conducive to strong inflows**, particularly in debt, as well as currency appreciation.

Figure 2.5 Balance sheets of the Federal Reserve and the ECB (level and quarterly changes, US$ billions)



(f) forecast.
Source: BBVA Research

Figure 2.6 World GDP growth by region (% YoY)



(f) forecast.
Source: IMF and BBVA Research

Higher global growth upward revision in Europe and China

After reaching 3.2% in 2016, **global growth will accelerate to 3.4% in 2017-18**, representing an upward revision of 0.2 pp this year relative to the July scenario (see Figure 2.6). **The underlying factors contributing to the uptick and steadying of world growth will remain present, although some might gradually fade** in the coming quarters. The most immediate one will be the normalisation of monetary policy by the Federal Reserve and the ECB (see Figure 2.5), which will lead to a gradual reduction in global liquidity and less support for capital flows into emerging economies.

China: a more promising panorama in the short term

The support of the Chinese authorities, especially through fiscal policy favourable to growth, has led to **slightly better than expected economic performance so far this year**, with very gradual moderation in GDP growth, to 6.8% YoY in 3Q from the 7% posted in 1Q. Furthermore, **measures are being taken to address financial vulnerabilities and promote orderly deleveraging**. Specifically, tougher regulation of shadow banking and the real estate market is being combined with: a more prudent monetary policy;a less expansionary fiscal policy; and, the removal of certain controls on the forex market. At the Communist Party congress, the authorities confirmed that they will continue to move ahead with most of the reforms announced in the past five years as regards the structural changes needed to adjust the growth model and open up the economy. In particular, growth will be focused more on qualitative than on quantitative objectives, giving priority to (i) low unemployment, (ii) bringing growth of per capita income more into line with that of GDP, (iii) a more equitable distribution of income and (iv) lower environmental costs. Nonetheless, there is uncertainty as to how these directives will be implemented and about their prioritisation once the objective of economic growth has been excluded.

As a result of the recent improved performance, we have revised **our GDP growth forecast upwards by 0.2 pp to 6.7% in 2017**, slightly more than the authorities' target of 6.5%, **while maintaining our prediction of a slowdown in 2018 to 6%**. Since mid-year the available indicators have been showing signs of more moderate economic growth, and could be reflecting the impact of more prudent demand-side policies, but also the negative effect on activity of regulatory tightening, the elimination of businesses' excess capacity, and, currency appreciation. On the other hand, the regulatory toughening and a stronger currency ought to continue to contain price trends, for which reason we **are keeping our inflation forecast at 1.7% in 2017 and 2% in 2018**.

The authorities' strategy and the more gradual slowing of growth have **reduced the risks at the forecast horizon, but they continue to increase in the medium term.** Indebtedness continues to grow, with debt service indicators at high levels, while adjustments to state enterprises are postponed.

Euro zone: increased growth due to strong domestic demand

The **euro zone economy** has been moving ahead at a quarterly rate of **around 0.6% since the end of last year.** Sustained global demand continues to underpin exports, while the impact of a stronger euro has been limited. The currency's strength partly reflects the **more benign phase of the cycle for the euro zone economy, driven by the solidity of domestic fundamentals,** which have favoured increased dynamism of both consumption and investment. Although economic performance is rather better than expected so far this year, the weakness of core inflation is keeping the ECB wary. Although the debt purchasing programme will start to be scaled down at the beginning of 2018, monetary policy will continue to underpin growth by holding interest rates unchanged beyond the forecast horizon. Moreover, fiscal policy will be slightly expansive in 2017-18, favoured by the positive impact of the cyclical recovery on the public accounts. For these reasons, **we have revised forecast GDP growth for 2017 upwards by 0.2 pp to 2.2%**, which represents above-potential growth for the third year in a row. This makes it hard to imagine a higher acceleration rate in the short term. In addition, **some of the tailwinds from the past are somewhat losing strength** or reverting (euro appreciation, rising oil prices and stabilisation of world growth), which explains **the forecasted decelaration to 1.8% in 2018**.

Headline inflation has held relatively steady in the third quarter, with lower energy and food prices being offset by a rise of around 0.1 pp in core inflation (to 1.3%). Beyond the volatility and seasonality of certain components of inflation, the strength of domestic demand, the improvement of the labour market and the incipient wage increases should start to exert upward pressure on prices in the coming quarters.However, **the impact of the recent euro appreciation on prices of imported products leads us to revise the forecast for headline inflation downwards**

by about 0.1 pp in 2017 to 1.5% and by 0.2 pp in 2018 to 1.2%, while **leaving the forecast of a gradual increase in core inflation unchanged** (1.1% this year and 1.4% in 2018).

The **domestic risks in the euro zone as a whole still have a downward bias, but are moderate.** And most of them are political, such as stumbling blocks in the Brexit negotiations, the unresolved banking problems in certain countries, the political tensions in others and the possible lack of support for moving ahead with the European project following the results of the German elections.

US: sustained growth despite political uncertainty and natural disasters

GDP growth recovered from the significant moderation recorded at the end of 2016, and after rebounidngto 3% YoY in the second quarter, it held steady in the third quarter. Although uncertainty remains high, on account of both natural disasters and economic policy, the **economic fundamentals are consistent with the sustained growth of around 2%** which has been recorded over the past two and a half years. The **net economic impact of the hurricanes will be limited at national level**, given that the 0.2 pp that we estimate could have been pared from growth in Q3 should be offset by the reconstruction efforts in the final stretch of the year. Moreover, the agreement between the government and the Democratic Party has **extended the deadline for approving the budget and raised the debt ceiling**. With respect to economic policy, the government is now focusing on **tax reform, but this is still short on essential details** and offers only limited options for enhancing efficiency. **Even if it ends up being approved, the tax cuts are unlikely to give a significant boost to economic growth** given the cyclical situation of the economy, which is very close to full employment.

Therefore, the forecast of GDP growth is maintained at 2.1% in 2017 and 2.2% in 2018. The strenght of global growth, the dollar depreciation, and expectations of sustainable oil prices and the slight improvement in the construction sector should favour an **upturn in investment.** On the other hand, the more gradual improvement in the labour market and higher inflation point towards a **moderation in private consumption** at the forecast horizon. However, the slowing rate of price increases in the past few months and the absence of clear signs of inflationary pressures suggest that **the process of monetary policy normalisation will continue slowly**.

Even so, **the risks to this scenario continue to be downside** due to the unknowns regarding the implementation of economic policy measures announced and the accumulation of financial vulnerabilities, favoured by the long period of cyclical expansion and loose demand-side policies, which could trigger a recession in the medium term.

BBVA | Research

LEGAL NOTICE

This document, prepared by BBVA Research Department, is informative in nature and contains data, opinions or estimates as at the date of its publication. These derive from the department's own research or are based on sources believed to be reliable, and have not been independently verified by BBVA. BBVA therefore makes no guarantee, express or implied, as to the document's accuracy, completeness or correctness.

Any estimates contained in this document have been made in accordance with generally accepted methods and are to be taken as such, i.e. as forecasts or projections. The historical evolution of economic variables (positive or negative) is no guarantee that they will evolve in the same way in the future.

The contents of this document are subject to change without prior notice for reasons of, for example, economic context or market fluctuations. BBVA does not give any undertaking to update any of the content or communicate such changes.

BBVA assumes no responsibility for any loss, direct or indirect, that may result from the use of this document or its contents.

Neither this document nor its contents constitute an offer, invitation or solicitation to acquire, divest or obtain any interest in assets or financial instruments, nor can they form the basis of any contract, commitment or decision of any kind.

In particular as regards investment in financial assets that may be related to the economic variables referred to in this document, readers should note that in no case should investment decisions be made based on the contents of this document; and that any persons or entities which may potentially offer them investment products are legally obliged to provide all the information they need to take these decisions.

BBVA Research

This report has been produced by the Spain and Portugal Unit.

Chief Economist for Spain and Portugal
Miguel Cardoso
miguel.cardoso@bbva.com
+34 91 374 39 61

Ignacio Archondo
ignacio.archondo@bbva.com
+34 673 70 60 36

Joseba Barandiaran
joseba.barandia@bbva.com
+34 94 487 67 39

Giancarlo Carta
giancarlo.carta@bbva.com
+34 673 69 41 73

Juan Ramón García
juanramon.gl@bbva.com
+34 91 374 33 39

María Gómez de Olea
maria.gomezdeolea@bbva.com
+34 91 537 79 11

Antonio Marín
antonio.marin.campos@bbva.com
+34 648 600 596

Myriam Montañez
miriam.montanez@bbva.com
+34 638 80 85 04

Virginia Pou
virginia.pou@bbva.com
+34 91 537 77 23

Camilo Rodado
camilo.rodado@bbva.com
+34 91 537 54 77

Pep Ruiz
ruiz.aguirre@bbva.com
+34 91 537 55 67

Angie Suárez
angie.suarez@bbva.com
+34 91 374 86 03

Camilo Andrés Ulloa
camiloandres.ulloa@bbva.com
+34 91 537 84 73

With the collaboration of:

Global Economic Scenarios
Agustín García
agustin.garcia@bbva.com

Global Financial Markets
María Martínez
maria.martinez.alvarez@bbva.com

Financial Systems
José Félix Izquierdo:
jfelix.izquierd@bbva.com

BBVA Research

Chief Economist BBVA Group
Jorge Sicilia Serrano

Macroeconomic Analysis
Rafael Doménech
r.domenech@bbva.com

Global Macroeconomic Scenarios
Miguel Jiménez
mjimenezg@bbva.com

Global Financial Markets
Sonsoles Castillo
s.castillo@bbva.com

Long-Term Global Modelling and Analysis
Julián Cubero
juan.cubero@bbva.com

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

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

International Coordination
Olga Cerqueira
olga.gouveia@bbva.com

Digital Regulation
Álvaro Martín
alvaro.martin@bbva.com

Regulation
María Abascal
maria.abascal@bbva.com

Financial Systems
Ana Rubio
arubiog@bbva.com

Financial Inclusion
David Tuesta
david.tuesta@bbva.com

Spain and Portugal
Miguel Cardoso
miguel.cardoso@bbva.com

United States
Nathaniel Karp
Nathaniel.Karp@bbva.com

Mexico
Carlos Serrano
carlos.serranoh@bbva.com

Middle East, Asia and Geopolitical
Álvaro Ortiz
alvaro.ortiz@bbva.com

Turkey
Álvaro Ortiz
alvaro.ortiz@bbva.com

Asia
Le Xia
le.xia@bbva.com

South America
Juan Manuel 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
Julio Pineda
juliocesar.pineda@bbva.com

ENQUIRIES TO: BBVA Research: Calle Azul, 4. Edificio de la Vela - 4ª y 5ª plantas. 28050 Madrid, Spain. Tel. +34 91 374 60 00 y +34 91 537 70 00 / Fax +34 91 374 30 25 - bbvaresearch@bbva.com www.bbvaresearch.com

Legal Deposit: M-31254-2000