BBVA Research

Economic watch

Global | More moderate and heterogeneous growth, with increasing risks

Global Economic Scenarios

19 October 2018

The global economy continues to show positive data, but in an environment of growing uncertainty. The inertia in world growth has continued in the last three months, prolonged by the effect of the fiscal stimulus on the US economy and certain stability in the Chinese and European economies in a context of deceleration. However, the protectionist escalation between the US and China has intensified, while the appreciation of the US dollar has been reflected in an increase in financial tensions in emerging economies which, although with a clear differentiation between countries, has meant a major adjustment in those that are more vulnerable (such as Turkey and Argentina). In this context, both the Federal Reserve (Fed) and the European Central Bank (ECB) continue to make progress in normalising monetary policy, which means a gradual tightening of monetary conditions that will continue to put pressure on emerging economies in the coming quarters. Despite this, it does not seem that we are facing a systemic crisis in these countries. Faced with a global scenario of relative continuity with a slight slowdown in 2019, the main risk in the short term is still protectionism, the effect of which could be felt in the coming year.

Slight moderation in global growth in the second half of 2018 and lower synchronisation

Data available up to September suggest that **global growth would have again slowed down in the third quarter of the year** (BBVA-GAIN: 0.92% QoQ after 0.95% in 2Q18) (see Figure 2.1) and **regional differences would have intensified**. The strength of the US economy contrasts with the moderation in China and the eurozone and, above all, with the significant adjustments observed in the emerging economies most vulnerable to the increase in financial tensions.

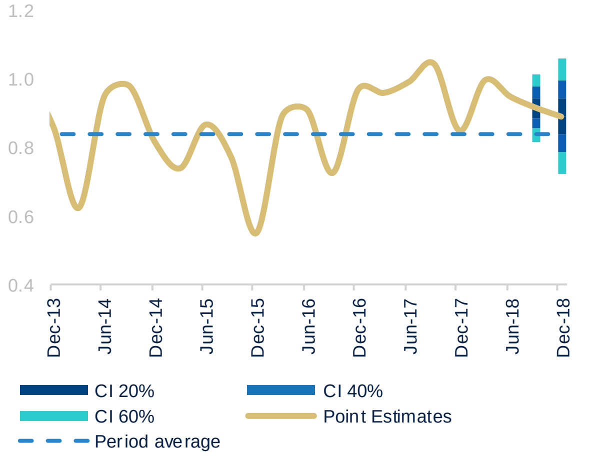
The **growth of the industrial sector is very moderate** and still does not recover from the poor performance at the beginning of the year. This behaviour **seems more to reflect the worsening outlook for domestic demand in emerging countries than the solid improvement in global trade** up to August, with the good export performance of Asia-Pacific countries being particularly noteworthy. However, it is still early for the trade data to reflect the possible negative effects of the protectionist escalation that has developed in recent months between the US and China; on the contrary, they may have been positively affected by the advancement of some trade exchanges in the face of the threat of new tariff increases.

Confidence indicators up to August also point to a gradual moderation in global growth, **although they remain at high levels**. The deterioration in confidence in the manufacturing sector is due to worsening employment expectations and foreign orders, affected by uncertainty about trade relations and the need for some emerging economies to reduce their external deficit levels and thus affect some advanced economies, mainly Germany and Japan. Expectations about the evolution of the services sector have also deteriorated, although they remain well above the historical average, partly supported by the strength of domestic demand in developed economies. In particular, retail sales suggest that the downward trend in household spending in recent months has come to a halt and continues to grow at a relatively robust pace, so **consumption will likely continue to support global growth**.

Creating Opportunities

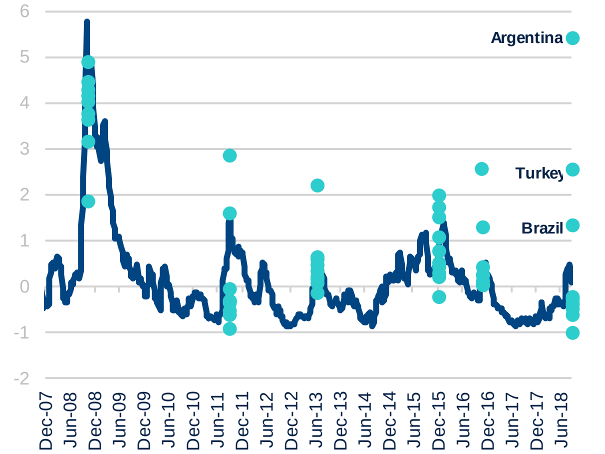
With regard to price trends, **the rise in inflation before the summer has moderated** more recently due to the evolution of commodity prices. **Core inflation remains contained**, but is expected to rise gradually as a result of robust domestic demand in advanced economies and the translation of currency depreciations to prices in emerging economies.

Figure 2.1 World GDP growth
(QoQ, %)



Source: BBVA Research

Figure 2.2 BBVA index of financial tensions for emerging economies



Source: BBVA Research

The normalisation of monetary policy, together with increased uncertainty, will keep on adding pressure on emerging economies

Despite confirming the signs of global economic moderation in the last quarter, **global inertia remains positive, especially in developed economies, and reinforces the** ongoing **normalisation process** of the main central banks in the coming quarters, which will further affect **financial conditions in emerging markets**. In this environment, the feeling of risk aversion among investors has continued for another quarter, **particularly affecting the most vulnerable emerging countries** (those with the greatest external financing needs and high foreign currency indebtedness) (see Figure 2.2), while developed countries continued to benefit from an environment generally free of financial tensions.

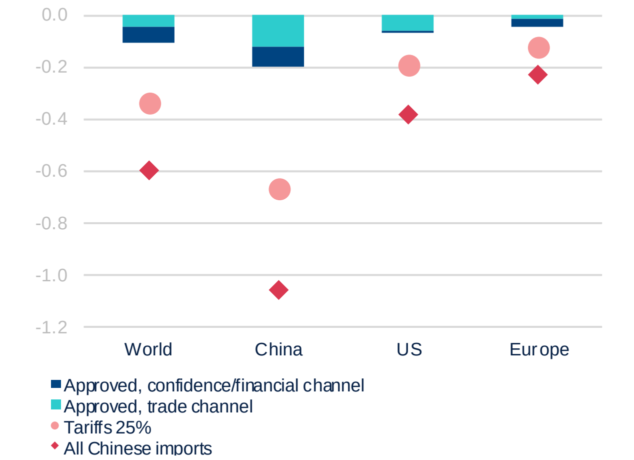
In this context, **Argentina and Turkey suffered in particular**, and their currencies depreciated by 30% and 24%, respectively, while their risk premia increased markedly. However, **tensions eased after monetary and fiscal measures were taken.** On the other hand, trade tensions continue, but with limited effects so far on markets during the quarter, which has been helped by the fact that **China has so far stabilised its currency and curbed the slowdown in growth** through economic policy stimuli. The other focus in the markets has been **Europe,** and for a twofold reason. Firstly, the **risk linked to Italy** increased during the summer and following the government's fiscal proposal - which deviates from the path marked by Europe - with the consequent extension of the Italian risk premium (up to 300 basis points), but with a very limited contagion in the other peripheral countries. Secondly, the ***impasse* at which the *Brexit*** negotiations are stuck has increased the likelihood of a non-deal exit from the EU.

The **tightening of global financing conditions will most likely continue over the forecast horizon**. On the one hand, **the Fed goes on with the normalisation of its monetary policy.** After the cumulative increase in its intervention rate of 75 basis points so far this year (currently at 2.25%), we expect a **rise of more than 25 basis points to 2.5% by the end of this year and to 3.25% by the end of 2019**. Concerning **the ECB, it has reaffirmed and begun its exit strategy** (see below). Coupled with this, **the upward pressure on the dollar against major currencies** has been maintained, driven by the flight to quality and an increasingly favourable interest rate differential.

Uncertainty about protectionist escalation remains high. Although trade tensions between the U.S. and some areas have eased for the time being, the agreement with Mexico and Canada has yet to be ratified and negotiations on the automotive sector with Europe will be reopened after the US mid-term elections in November. Meanwhile, **some of the US protectionist threats towards China have already materialised**, with their respective countermeasures by the Asian country. The US has approved a 10% tariff increase for Chinese imports worth US$200 billion, in addition to the US$50 billion worth of Chinese products with 25% tariffs. China, on the other hand, has reacted by increasing its tariffs to 10% for US imports worth US$60 billion dollars, in addition to the increase of tariffs up to 25% on products worth US$50 billion dollars. **The impact on GDP of these measures** (see Figure 2.3), together with those already approved for steel and aluminium imports, **through the trade channel is limited** (around 0.1% of GDP for China). However, to this direct impact, **other indirect effects** (lower confidence among economic agents, impact on financial markets) could **also be added**, especially for China and emerging economies. These are difficult to estimate but could additionally subtract around 0.1 pp from growth.

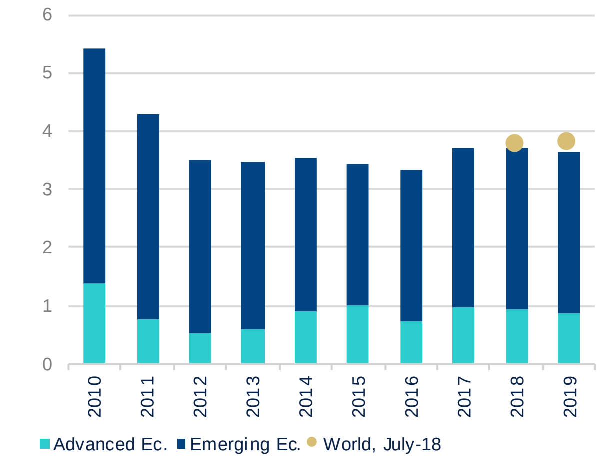
Negotiations with China are likely to resume by the end of the year, and if they do not meet US demands (particularly on intellectual property rights), **the 10% tariff approved in September could rise to 25% from January 2019 on**. In this scenario, and assuming that China reacts with the same rise, **the impact on growth would already be much more significant**, possibly subtracting around 0.7 pp from the growth of the Chinese economy and 0.2 pp from that of the US (and thus -0.3 pp from world GDP and around -0.1 pp from Europe's). While the Chinese authorities are willing to implement policies to support growth, a trade war affecting all their trade exchanges could derail the global recovery.

Figure 2.3 Effect on GDP growth due to US tariff hikes and the response of other countries (2018-19, pp)



Source: BBVA Research

Figure 2.4 Forecasts of world GDP growth (% YoY)



Source: BBVA Research

The ECB has reaffirmed its exit strategy and does not anticipate any rate increases until the second half of 2019

In line with expectations, at the two meetings held during the summer period the ECB reiterated that **the asset purchase programme** (APA) **will conclude in December** this year, given the progress towards a sustained adjustment of the inflation path, while keeping **intact the anchoring of interest rate expectations**.

The ECB made it clear that the bond purchase programme will continue to be activated until the end of the year at a monthly pace of €15 billion between October and December, when net asset purchases will end. With regard to interest rates, the monetary authority is maintaining the reference rate at 0% and the deposit rate at -0.40%, but reiterated that the reference rates will remain unchanged until at least summer 2019. Against this backdrop, with no change in the direction of monetary policy, our expectation of the **first rise in interest rates remains unchanged, with a first rise in the deposit rate in September (+15 bps) and the official reference rate (+25 bps) in December 2019**.

With the end of the asset purchase programme in sight, the focus in the **coming months will be on how the policy of reinvestment of the principal of securities acquired under the PPP purchase programme will be implemented and when and at what pace interest rates will rise**. So far, the ECB seems to be satisfied with market expectations (discounting a first rate hike in October 2019), and does not seem to be in a hurry to make any change in its forward guidance, although in the first part of 2019 we expect it to start giving clues about its interest rate *guidance*.

The downward revision of growth in emerging economies explains the expected moderation of global growth in 2019

The global growth forecast for 2018 has been revised downwards 0.1pp, both for 2018 and 2019, to 3.7% and 3.6%, respectively (see Figure 2.4), since we now expect the slight moderation in the second half of the year to further settle ahead. This slowdown in global activity is **mainly explained by the slower progress expected from some emerging economies**, especially those with greater vulnerabilities in a context of tighter global financial conditions.

In the US, the increase in consumption and the strength of investment keep providing support for the forecast of 2.8% growth in 2018-19. The strength of private consumption is still underpinned by the dynamism of the labour market and higher wage growth, which reinforces optimism in households. Regarding investment, it continues to benefit from favourable financial conditions and rising oil prices. Nevertheless, the acceleration of the economy in the second quarter seems transitory after the strong momentum of the foreign sector, and some moderation is expected in the coming quarters due to the appreciation of the dollar. In this context, the strength of domestic demand, partly driven by a more expansionary fiscal policy, and the rebound in oil prices have accelerated inflation so far this year, but it is already moderating, while core inflation remains stable at around 2%.

In China, the authorities are implementing more accommodative policies to try to curb the slowdown in domestic demand and counteract the rise of protectionism. The good performance of the economy in the first half of the year leads us to revise the GDP growth forecast slightly upwards by 0.2 pp to 6.5% in 2018, although the data observed so far show **clearer signs that progress is moderating**. On the fiscal side, tax reductions are being carried out, both for workers and companies, and the increase in infrastructure investment is being favoured. On the monetary policy side, the main measures are aimed at encouraging banks to extend credit to small and medium-sized enterprises and at stabilising the exchange rate. With all this, **the forecast of 6% growth for 2019 remains unchanged**.

In the euro zone, strong domestic demand and accommodative policies (both monetary and fiscal) **could compensate for increased uncertainty and moderation in global demand**. After the slowdown observed in the first quarter, growth seems to have stabilised so far this year, **maintaining the GDP growth forecast at 2% in 2018 and 1.7% in 2019**, although we now expect greater support from private consumption, underpinned by the improvement in the labour market, and investment, driven by favourable financial conditions and the absorption of the idle capacity of economies. The depreciation of the euro since the second quarter of this year, in conjunction with still-dynamic world trade, will continue to support exports, although it will not prevent a smaller contribution of external demand due to the dynamism of imports linked to investment. In this context, rising inflation has responded to the strong increase in energy prices, and should therefore moderate in the coming months if oil prices are maintained, while core inflation will increase only gradually, especially in 2019.

Protectionism and the Fed's exit strategy are still the most relevant risks on the forecasting horizon, while political uncertainty increases in Europe

The global scenario continues to be subject to mostly negative risks. On the one hand, the risk of a trade war remains unabated and could worsen after the November elections in the US, especially with China, but negotiations with the EU and Japan will also be reopened, mainly with threats involving the interests of important sectors in these regions, such as the automobile sector. While the direct impact of the measures would be limited, the risk of a trade war **could act as a drag on confidence, increase risk aversion in the markets and curb global flows of direct investment**, with the consequent impact on global growth potential. In addition, the escalation of oil price (due to the sanctions on Iran) is also a risk to be taken into account due to its potential asymmetrical impact by country.

On the other hand, in a more volatile financial environment and with a tightening of global financial conditions, **increased financial tensions in emerging economies could intensify**, especially in the most vulnerable countries, **and have an amplifying effect on global risks**. The combination of increased protectionism and accelerated normalisation of US monetary policy together with a possible slowdown in the global economy could lift the perception of risk in emerging financial markets, raising the likelihood of a halt in capital flows. In this context, the risk of an abrupt adjustment of the Chinese economy remains, as some measures to respond to a slowdown in demand and the effects of protectionist measures imposed by the US could limit or delay the process of deleveraging and restructuring its economy.

Lastly, **political risks in Europe have also intensified**. In Italy, the expected increase in the deficit could raise doubts about the sustainability of its public accounts, which could further raise the risk premium of the economy and lead to a potential resurgence of financial tensions in peripheral bond markets. And we cannot rule out a possible UK exit from the EU without a deal.

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