Economic Watch

# Global Economy: Adjustment of world growth still gentle, but more uncertain now that it depends on certain political events and government decisions

**January 2019**

The global environment has deteriorated in the past few months, due both to worse economic data linked to industry and trade and to the sharp increase in financial tensions, especially in the developed economies. The deterioration in activity indicators has partly been a reaction to transitory factors, and to some extent the markets might be overreacting given the numerous sources of uncertainty about the global environment. But there have also been some fundamental factors behind the worsening environment, such as certain signs of slowdown in the US and Chinese economies, especially the uncertainty about protectionism, some signs from the Federal Reserve (later on reversed) that the normalisation of monetary policy would continue as envisaged, and the lack of progress in the UK on getting to grips with leaving the European Union. These risks are mainly of a political nature and have made the global scenario more uncertain. Although we expect many of these concerns to be dispelled in the second half of the year, we are revising our growth forecasts downwards across the board, reflecting above all a more obvious moderation now in the developed economies.

## Sharper deterioration of the global economy, but with signs of stabilisation at a pace that is still solid

Data available to December point to **global growth having stabilised at around 0.7% quarterly** at the end of 2018, following the sharp moderation seen at mid-year (see Figure 2.1), and **with more evident signs that it will be difficult to regain the strong growth of the last few years** of around 1% per quarter. Added to the worse economic performance in Europe and China is the drag effect on Asian economies and the cyclical deterioration in the United States, although activity seems to be recovering in other economies such as those of India and Russia.

Much of the downturn is explained by the **sharper and more generalised decline in global trade, especially with China, and in the manufacturing sector since mid-2018**, weighed down as it is by the slowdown in China and the **effects of mounting protectionism**, both through the trade channel and through reduced confidence in the face of uncertainty as to whether the trade disputes will be resolved. Nonetheless, the **direct effect of the measures approved so far seems limited** (about one or two tenths of a percentage point of GDP) **and both trade and the manufacturing sector showed some signs of stabilisation at year-end**.

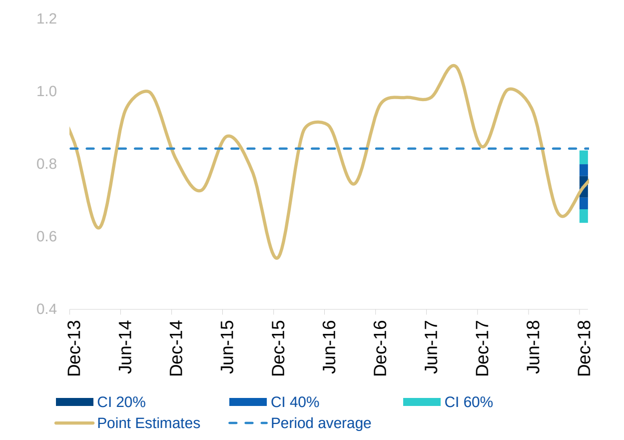
These relatively poor economic data are **depressing confidence generally**, both that of consumers and of the service sector, and point to **greater caution about consumption**. Despite this, retail sales picked up at the end of last year, partly underpinned by the **strength of certain domestic factors in the developed economies and by the easing of inflation thanks to the fall in oil prices**, as a result of which retail sales continue to grow at a robust pace and point to **private consumption continuing to support global growth**. The still **favourable financial conditions, the reduction in idle capacity and the stimulus measures in certain economies still offset the negative effect of the increase in uncertainty about investment**.

Sharp increase in risk aversion in the developed economies

## Sharp increase in risk aversion in the developed economies

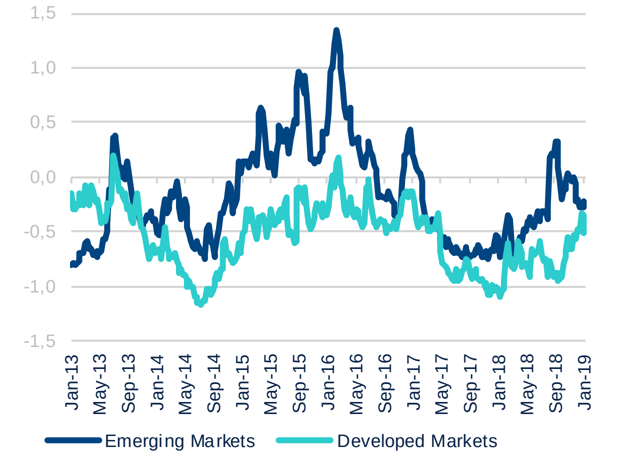
These disappointing economic data in the major regions accentuated the **risks to global growth** from the negative effects of a possible escalation of trade tensions and the increased probability of recession in the United States once the effects of the fiscal stimulus dissipate, **in a context of heightened political uncertainty**. This, together with an environment of **high asset prices and normalisation of monetary policies, triggered strong risk aversion and exacerbated financial tensions in developed markets** (see Figure 2.2), especially in the United States, which had previously withstood the turbulence relatively well.

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 Federal Reserve raised interest rates by 25 basis points in December, to 2.50%, bringing the total increase in 2018 to 100 basis points. The ECB for its part brought an end to its asset purchase programme, although it reaffirmed that interest rates would be kept low at least until the summer. And on top of this is increasing political uncertainty. In the United States the partial government shut-down and in Europe the continuing logjam over the United Kingdom's exit from the European Union, together with the doubts about Italy's budget (now apparently dispelled) combined to increase investors' caution.

In this environment, stock exchanges and credit markets saw sharp corrections, particularly in the market for leveraged loans and in other relatively high-risk credit segments, which had grown significantly in recent years thanks to the low interest rates. All this had a feedback effect on caution in the market and drove volatility up. Federal Funds futures went from showing additional interest rate hikes to reflecting some probability of cuts in 2019. In this situation, investors sought refuge in sovereign bonds, which led to sharp falls in long-term interest rates in the United States and Germany. The dollar held steady, since the lowering of expectations of Federal Reserve rate hikes was offset by inflows seeking refuge in a context of heightened risk aversion. The euro failed to capitalise on the end of the ECB's asset purchase programme, remaining under pressure from the slowdown in growth and the political uncertainty in the United Kingdom and Italy.

In contrast with this, and also with what we saw in much of 2018, downward corrections in emerging market assets were more contained this time around. Even the most vulnerable countries, which had been severely penalised in the previous quarters, seem to be stabilising and are even showing some improvement following the adoption of measures. Nonetheless, the correction in commodity prices, particularly oil, due to both demand and supply factors, penalised Latin American currencies relative to Asian ones.

## The Federal Reserve's hitting the pause button has contained tensions, which are still likely to remain high for a few quarters, until the uncertainty on a number of political fronts is dispelled

The **caution shown by central banks** in the face of deteriorating economic data and the sharp increase in financial tensions has been reflected in market expectations as to the Federal Reserve, which assign some probability to **interest rates cuts in 2019**. Recent comments by Federal Reserve members, as well as the minutes of the last meeting, point to the Fed's being patient and **rate hikes depending on how the economy evolves**. In this context, we expect a **pause in the first half of this year before a resumption of the cycle of federal funds interest rate hikes in June** (25 basis points), **reaching 3% in December 2019 and bringing the current cycle of increases to an end** (see Figure 2.3).

In Europe, following the end of the asset purchase programme at the end of 2018, the **ECB will remain present in the debt market through the total reinvestment of maturing assets for a period estimated at more than two years** (beyond the start of the interest rate hikes). As regards interest rates, although the central bank has not altered its discourse (interest rates will remain at current levels at least until the summer), it might do so in the next few months. We consider that in view of the slowdown of the eurozone economy and the increased risks, the ECB will exercise extra caution and will delay the increase in rates, both of the deposit rate**, with an initial hike of 10 basis points in December 2019** (three months later than planned) **and of the official rate, with an increase of 25 basis points in June 2020** (six months later than previously envisaged) (see Figure 2.3). As regards liquidity, the next few months are likely to see the announcement of a new liquidity auction to ensure a smooth transition for the maturing Targeted Longer-Term Refinancing Operations (TLTROs).

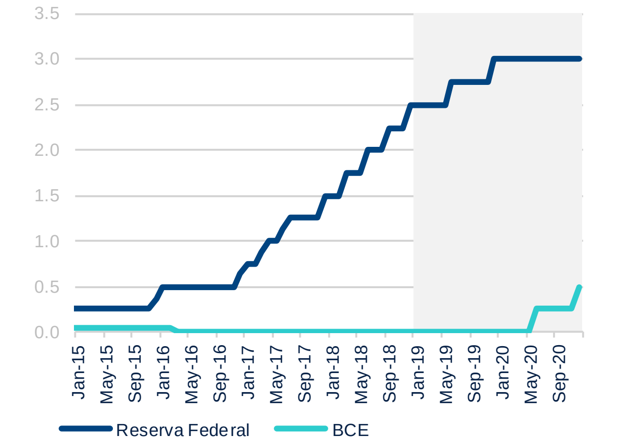
The pause in the Federal Reserve's cycle of rate hikes has been key to containing the sharp increase in financial tensions in the past few months, but volatility will remain high in the first quarter, depending on how the **trade negotiations between the United States and China** evolve. The signs seem positive, with China committing to buy more US products and making an effort to meet demands that it respects intellectual property and technology transfer rights. The conflict on these more structural matters will take some time to resolve, but the clearer evidence of the negative impact of protectionism on activity and the turbulence in the financial markets make it more likely that **some kind of agreement** will be reached **at the end of March, thus avoiding additional increases in US tariffs on Chinese goods**.

In Europe, the resolution of the United Kingdom's leaving the European Union will be key. At the moment, the process remains blocked by the strong opposition to the draft agreement negotiated between the UK government and the European Union, and although there is no clear alternative, a majority in parliament is equally opposed to a no-deal Brexit. In this context, it seems necessary to extend Article 50 (i.e. postpone Brexit) beyond March, and the scenarios remain open, ranging from an agreement to stay in the customs union to a no-deal or "cliff-edge" exit, as well as an early general election or a second referendum. Nonetheless, **the probability of a disorderly exit by the United Kingdom from the European Union remains low**.

The other source of concern at global level is the economic slowdown in China. In this regard, **the Chinese authorities continue to take measures** aimed at supporting growth, from tax cuts and increased investment in infrastructure to monetary policy support to encourage lending to SMEs. All this **should allow a smooth adjustment to growth** in China without neglecting the aim of reducing the excessive indebtedness.

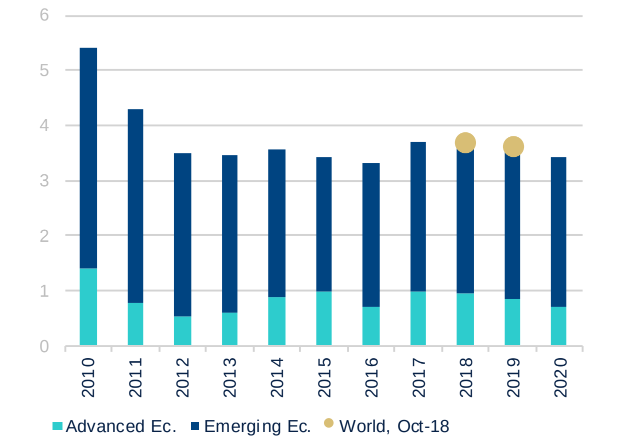
The **satisfactory resolution of these eminently political events in the first half of the year, together with the patience and caution of the major central banks, is key to ensuring the smooth adjustment of the world economy.**

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

## Downward revision of growth across the board, with clearer moderation in the developed countries and in those of emerging Asia

**Global growth may have held relatively steady at 3.6% in 2018**, although we expect that **going forward the slower growth rate seen in the second half of last year will consolidate**, in an environment of greater uncertainty which will not be dispelled at least until the second half of this year, so we are **revising growth for 2019 down from 3.6% to 3.5%** (see Figure 2.4). This downward revision is across the board, although **the moderation of activity will be more evident in the developed countries and those of emerging Asia**, while Latin American countries will continue to recover, albeit somewhat more slowly than foreseen three months ago. **For 2020, we expect this pattern of soft landing of the global economy to continue, with growth of around 3.4%**.

In the **United States, GDP growth accelerated strongly in 2018, by half a percentage point to 2.9%, buoyed by the fiscal stimulus**, but **in the second half of the year** we started to see certain **signs of moderation** such as the flagging performance of external demand, the appreciation of the dollar and the figures for private sector investment, which does not seem to have benefited much from the government's fiscal package. **In a context of greater uncertainty** both at home and abroad, **and with the dissipation**, probably sooner than hitherto foreseen, **of the effect of the fiscal stimulus measures, this dynamic will translate into a slowdown of growth to 2.5% in 2019 and 2% in 2020**. Despite the strength of domestic demand, and with an unemployment rate below 4%, inflationary pressures remain contained, so the fall in oil prices will bring inflation down from 2.5% in 2018 to 2.2% in 2019 and 2.1% in 2020. In this scenario of slowing growth, and with inflation tending towards 2%, the increase in downside risks will affect the attitude of the Federal Reserve, presumably making it more cautious.

In **China, the slowdown in growth intensified in the second half of 2018** due to the increased trade tensions with the US and the impact of the government's measures to reduce indebtedness. In this context, **the authorities are adopting more stimulus measures**. On the fiscal side taxes are being reduced, for both workers and businesses, and other measures are being taken to ease the pressure on businesses most exposed to the external sector and to promote increased investment in infrastructure. As for monetary policy, the main measures continue focused on encouraging banks to lend to SMEs, while at the same time trying to maintain a balance between easing and consolidating the reduction in indebtedness. Lastly, structural reforms and measures to open up the economy are also being adopted to meet the demands of the US in the trade negotiations. With all this, we continue to expect a **gradual slowdown in economic growth, from 6.5% in 2018 to 6% in 2019 and 5.8% in 2020**.

In the **eurozone**, **the pace of growth slowed more than expected in the second half of 2018 due in part to transitory factors** such as the change in regulations on car emissions, which may temporarily have affected the sector's production and also its export sales, and the protests in France, **although it might also have been affected by the fall in global demand**, especially from China. Nonetheless, **our scenario envisages a smooth adjustment of this economy and of global demand, and together with the depreciation of the euro** in the past year this should avoid a sudden decline in exports, which have been supporting growth. **Domestic fundamentals remain solid**, with improvements in the labour market which, together with the moderation of inflation, will continue to underpin growth in private spending, while the favourable financial conditions (with the rate hikes being put off) and the absorption of idle capacity will continue to sustain recovery in investment. The reduced support from the external sector and the fall-off in confidence might be offset in part by increased public spending deriving from a **somewhat more expansive fiscal policy**. For these reasons we now expect a **faster moderation of GDP growth towards its potential, from 1.8% in 2018 to around 1.4% in 2019-20**. The downside domestic risks have increased, particularly the political risks, although they should dissipate in the next few months once the UK's orderly exit has been resolved and providing the doubts about Italy's debt remain limited. **Inflation will fall significantly in the next few months** due to the lower oil prices to a rate of around 1.4% in the second half of the year (1.8% in 2018, 1.6% in 2019-20), **while we continue to expect a very gradual increase in core inflation** (1.2% in 2018, 1.4% in 2019 and 1.6% in 2020).

## Protectionism, the increased likelihood of recession in the United States and greater adjustment to growth in China are the most significant risks at the forecast horizon

The **global scenario remains subject to mainly negative risks and is increasingly uncertain**, given the political nature of many of these risks. On the one hand, **the risk of a trade war,** especially between the United States and China, although the threats to other strategic sectors such as the automotive sector could also significantly affect Europe and Japan. A further increase in trade tensions **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 the United States, the risk of recession at the forecast horizon has increased appreciably** due to a combination of several factors: the sharp correction in the financial markets in an environment of over-valuation of certain assets, the increase in corporate spreads in a sector with high levels of debt, the earlier-than-expected dissipation of the fiscal stimulus, and the numerous political controversies, which seem to have intensified following the elections (such as the government shut-down and the difficulties in approving the debt ceiling this year), which could also impede the adoption of more support measures (such as infrastructure). At the global level, the negative impact of a recession in the United States would be significant.

**In China**, the slowdown of the economy in the second half of last year increases the risk of a **more abrupt adjustment to growth if the trade war intensifies**. Although the authorities have room to implement more stimulus measures, there are growing doubts about how effectively monetary policies are transmitted to the real economy; moreover, additional expansive policies could **delay the adjustment to the excessive indebtedness** of the economy and so also increase medium term risk.

Lastly, **the political risks in Europe remain high**. The most immediate one continues to be Brexit, where the logjam persists, and a **possible no-deal exit of the United Kingdom** from the European Union still cannot be ruled out. The **political uncertainty in Italy remains** high, despite the recent agreement with the European Commission on the budget, and doubts about the sustainability of public debt and of the banking sector could again come to the fore, with possible contagion to the periphery. Moreover, political polarisation in the majority of countries makes it difficult to imagine the European project being boosted following the spring elections.

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