BBVA Research

Global

Economic Outlook

Third Quarter 2010

Economic Analysis

- The effect from the fiscal adjustment on growth in Europe will be lower than commonly assumed. The positive impact on credibility will almost compensate the negative effect from reduced public demand. Conversely, medium-term risks from unsustainable fiscal positions in other developed regions are probably underestimated.
- The main risk to the global outlook is still coming from financial markets. Stress tests have had positive –though asymmetric– impacts throughout Europe. Although risks have been reduced, the potential fallout from renewed tensions is still sizable.
- Increasing divergence in monetary policy strategies. Heightened uncertainty will prompt the Fed and ECB to postpone the exit from accommodative policies. On the contrary, tightening has resumed across much of Asia and Latin America.
- The global economy is on track for a mild and differentiated slowdown. In China and elsewhere in Asia, a moderating growth trend should reduce the risks of overheating. However, in the US private demand will remain weak without policy support, whereas in Europe confidence will be negatively affected by the fallout from the financial crisis.
- Although there were some steps in the right direction, going forward the necessary global rebalancing of demand and the narrowing of global imbalances is still pending.

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Index

Closing date: July 31, 2010

1. Reassessing the risks for the global economy

The effect from the fiscal adjustment on growth in Europe will be lower than commonly assumed. The positive impact on credibility will almost compensate the negative effect from reduced public demand. Conversely, medium-term risks from unsustainable fiscal positions in other developed regions are probably underestimated

One of the most important channels through which the fiscal crisis has affected the European economy has been the loss of confidence, and a prerequisite to restore confidence is fiscal prudence, given the high public deficits experienced in many of these countries. Consolidation plans in Europe are being implemented according to schedules presented to the EC at the beginning of 2010. Fiscal consolidation in Europe needs to focus on the structural side, but a positive factor is that the planned adjustment is fast and tilted towards reducing expenditure, which will boost confidence and almost compensate the negative effect on growth from reduced public demand. Thus, as long as the determination on fiscal consolidation is maintained, the impact on European economic activity will be limited and transitory. On the other hand, other advanced economies, where fiscal impulses have been substantial and debt levels have increased at a pace similar to that in Europe, are relatively slow in coming to grips with reducing deficits and –at least– stabilizing debt levels. This is a medium-term risk that is being underestimated, as experience shows that the effect of lax fiscal policy on interest rates is highly non-linear, and there is a risk –with uncertain timing– of a sudden increase in long-term rates and a displacement of private demand; exactly the opposite effect intended by the fiscal stimulus packages.

The main risk to the global outlook is still coming from financial markets. Stress tests have had positive –though asymmetric– impacts throughout Europe. Although risks have been reduced, the potential fallout from renewed tensions is still sizable

Financial risks, which stemmed from sovereign debt concerns, formed a feedback loop that ended up increasing market risk and drying up liquidity, especially in Europe. Nonetheless the sharp increase in financial tensions in Europe in the second quarter is starting to abate (see Chart 1). The release of European stress tests results has had positive effects on lowering tensions, although there has been a clear differentiation across countries. In particular, it may act as a powerful driver for removing uncertainty surrounding the Spanish financial system, as the implementation of the exercise looks rigorous and the outcome seems credible and is very informative. Undoubtedly the risk to Europe and the global economy coming from financial markets is still the main source of concern.

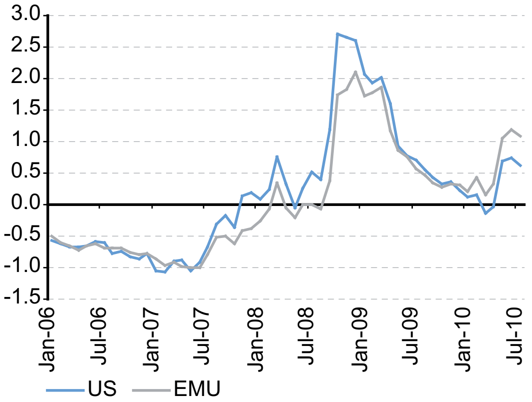
Increasing divergence in monetary policy strategies. Heightened uncertainty will prompt the Fed and ECB to postpone the exit from accommodative policies. On the contrary, tightening has resumed across much of Asia and Latin America

Financial strains in Europe and uncertainty about the pace of recovery in the US will prompt central banks in both regions to postpone their first rate rises and keep very low policy rates for an extended period. Inflationary pressures in both areas will remain subdued, allowing them to keep lax monetary policies. Nonetheless, a faster recovery in the US will mean that the monetary exit will be earlier there than in Europe, and both factors will weigh down on the euro. Although both central banks will postpone monetary tightening, communication and the assessment of risks continue to differentiate both institutions, limiting the ECB's relative capacity to react, in particular to deflationary risks. On the other hand, in emerging economies monetary tightening is resuming, after a pause (especially in Asia) as the European debt crisis unfolded. This will help reduce inflationary pressures in Asia –where they were starting to build– and prevent potential pressures from developing later in the year in South America. An important exception is Banco de México, likely to hold rates until the second quarter of 2011. Even when inflation edges up in the last months of this year, it will remain within Banxico's forecasted range and long-term inflation expectations are still well anchored.

The global economy is on track for a mild and differentiated slowdown. In China and elsewhere in Asia, a moderating growth trend should reduce the risks of overheating. However, in the US private demand will remain weak without policy support, whereas in Europe confidence will be negatively affected by the fallout from the financial crisis

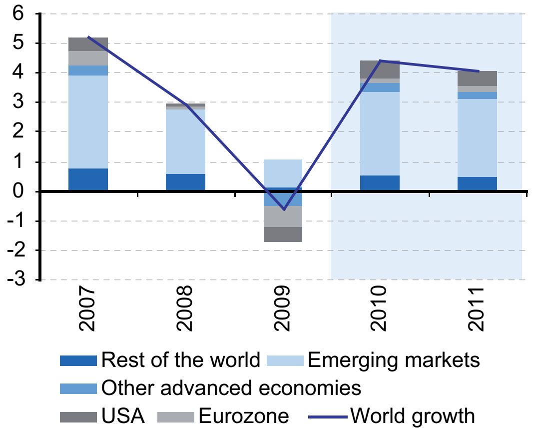
Spillovers from the European financial crisis to other geographical zones have been relatively limited. Nonetheless, the global economy will slow down going forward (see Chart 2). The severity of financial tensions in Europe will affect confidence and reduce growth in the second half of 2010 and the beginning of 2011. Moreover, external demand will not be as strong as it was in the first half of the year, although it will provide some support for economic activity. In the US, the recovery is likely to lose momentum on account of softening labor and housing markets. This shows the limits of private demand taking over as an autonomous driver of growth. In China, slowing GDP growth in the second quarter and moderating activity indicators are evidence that the authorities' tightening measures are being effective to steer the economy toward a soft landing in the second half of the year. Latin America will also slow down in 2011, but keep robust growth rates going forward. Therefore divergences will continue to widen both between advanced and emerging economies and within each of those groups.

Chart 1
Financial Stress Index*



* Composite indicator of financial tensions in 3 credit markets (sovereign, corporate and financial), liquidity strains and volatility in interest rate, foreign exchange and equity markets
Source: BBVA Research

Chart 2
Contributions to Global GDP growth



Source: BBVA Research based on national accounts

Although there were some steps in the right direction, going forward the necessary global rebalancing of demand and the narrowing of global imbalances is still pending

The medium-term rebalancing of the Chinese economy towards more internal demand (particularly consumption) has begun, and the recent renewal of currency flexibility should help. However, further reforms are needed to help boost consumption toward regional levels. Other advanced surplus countries also need to implement reforms to increase domestic demand, most notably in the service sector. On the other hand, the US and other countries with substantial external financing needs need to switch from a consumption-led growth model to investment, especially in tradable sectors. The recent financial crisis has shown the limits to foreign financing of growth. Economies with high external financing needs are highly vulnerable to an upsurge of international financial tensions, and the resulting sudden movements in exchange rates risk undermining global financial stability.

2. A mild fallout from fiscal consolidation in Europe

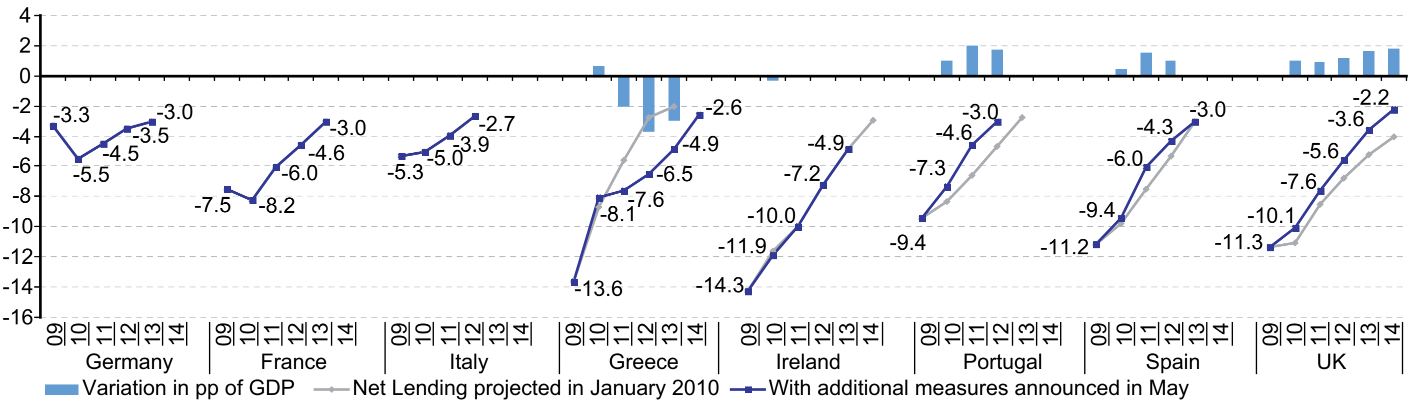
One of the most important channels through which the fiscal crisis has affected the European economy has been the loss of confidence, and a prerequisite to restore confidence is fiscal prudence, given the high public deficits experienced in many of these countries. Consolidation plans in Europe are being implemented according to schedules presented to the EC at the beginning on 2010, and they need to focus on the structural side

In the context of unprecedented deficits in peacetime, fears of an uncontrollable situation on the fiscal front have come to the fore, increasing sovereign credit risk and undermining confidence on the financial health of institutions suspected of holding sizable amounts of sovereign assets. This has led many of these countries to design and implement fiscal consolidation plans before the recovery is complete in order to restore market confidence.

These consolidation plans had already been presented to the European Commission in late 2009. The aim was to bring deficits down below 3% by 2013 or 2014, but postponing the bulk of the adjustment until after the end of 2010 (Chart 3). Since the outset of the sovereign crisis, two of the countries most affected by the lack of confidence from markets (Spain and Portugal) have announced additional measures to bring the adjustment forward, whereas the United Kingdom has presented a whole new programme after the May elections that also results in a faster adjustment –something which was badly needed, given that previous plans presented to Brussels failed to include a target below 3% even by 2014. In the case of Greece, consolidation efforts have been actually spread out over a longer horizon in the context of the IMF/EC/ECB program, making them more credible than the excessively tight adjustment projected in the original plan presented by the Greek government. For other countries, despite the flurry of news in recent months on fiscal consolidation, deficit-reduction paths are unchanged, and instead some details have been announced on what exactly will be done, especially for the 2011 budget. The fact remains that for the largest Eurozone economies the adjustment will only start in 2011, whereas for those countries with weaker starting points deficit cut measures have already started to bite.

Chart 3

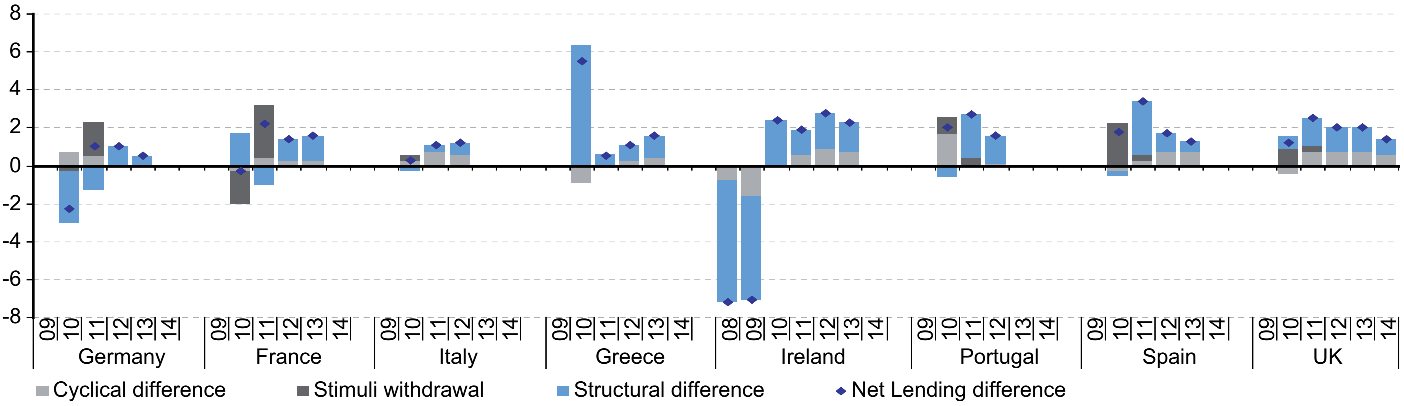
Europe: projected deficit plans



Note: National Government plans sent to EC January 2010, announcement in May and June. UK figures refer to Treaty deficit
Source: BBVA Research and EC

Fiscal stimulus programmes approved at the end of 2008 and implemented during the last year and an half implied, on their own, an increase in public deficits which was manageable in principle: the size of the stimulus in all European countries was below 2% of GDP and the cyclical deterioration of public accounts has not added in general more than 2 percentage points of GDP to the deficit. However, there has been an additional deterioration of structural deficits, mostly due to the permanent loss of revenues derived from the burst of asset price bubbles. This has translated into very high deficits in several southern European economies, Ireland and the United Kingdom. The fact that a sizable share of the increase in fiscal deficits can be attributed to an increase in the structural deficit calls for consolidation plans that focus on the structural side. And that is, in fact, what plans presented to the EC envision (see Chart 4). Nevertheless, as we stress above, most consolidation plans still lack crucial details about how that structural adjustment is to be made, especially after 2011, which risks undermining the credibility of the exercise.

Chart 4
Europe: size and composition of consolidation: year on year difference



Source: BBVA Research and EC

The planned adjustment is fast and tilted towards reducing expenditure, which will boost confidence and almost compensate the negative effect on growth from reduced public demand. Thus, as long as the determination on fiscal consolidation is maintained, the impact on European economic activity will be limited and transitory

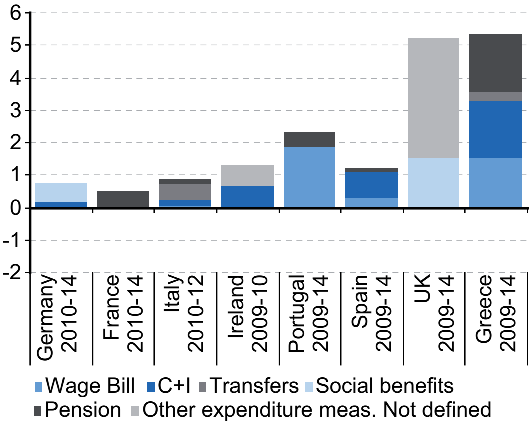
Fiscal consolidation will end up having a limited impact on economic growth if it is accompanied by the right policies and if the uncertainties currently besetting international financial markets recede significantly. Specifically, empirical evidence shows that, after decisive fiscal consolidation some countries actually experienced economic growth as rising private demand more than made up for falling public consumption. This positive wealth effect and resurgent confidence tend to be higher when the process of fiscal consolidation (i) is perceived as a “change in regime”, that is, when it is accompanied by a string of structural reforms designed to enhance economic growth and thus fiscal sustainability; (ii) relies heavily on reducing public expenditure, more than increasing revenues (and thus the distortions associated with increased taxation); (iii) is sizable and perceived as permanent, thus increasing credibility, for example focusing on spending cuts, including legislation that creates binding multi-year targets and strengthening fiscal institutions, and (iv) is implemented in an economy that has reached extreme levels of macroeconomic instability, for example due to increasing levels of public debt or balance-of-payments difficulties.

It is important to highlight that plans approved so far in Europe, although lacking detail (especially for 2012 and beyond) are mostly based on spending cuts, notably in Germany, Italy and Ireland (see Charts 5 and 6). In other countries, partly because of the large effort needed, tax measures have been also approved or planned, as in Portugal, Spain or especially Greece. France has a mixture of both, while the United Kingdom has approved higher taxes for 2011 and left a large share of the more difficult to implement spending cuts for 2012 and beyond. In all cases, it must be borne in mind that fiscal plans after 2011 are only intentional, and most of them have to be spelled out and approved, which implies that they could be subject to substantial changes in coming years.

Regarding the short- and long-run effects of deficit-reduction programs on economic activity, Chart 7 shows that the drag on growth of a reduction in the cyclically adjusted primary deficit is tempered (and can even be reversed in the long run) when such reduction is done in the context of a consolidation program (defined as a reduction of the deficit of at least 1% of GDP). Furthermore, the beneficial effects of a fiscal consolidation are stronger when started from a high level of public debt, in line with the discussion above. The particular cases of fiscal reform in Ireland (1985-1989), Denmark (1983-1986) and Spain (1993-1999) are good examples of how a credible fiscal adjustment accompanied by an improvement in the macroeconomic environment can ensure that increased private consumption, investment –both resulting from improved expectations– and net exports more than offset declining public expenditure and, therefore, have a growth-generating impact even in the short term.

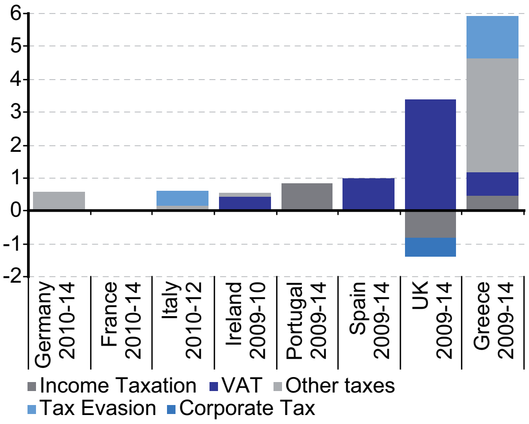
All in all, the fact that in most countries the adjustment will be fast and sizable (see Chart 3), tilted more towards lower spending than higher taxes (Chart 5 and 6) and –in some countries– is accompanied by structural reforms shows clearly that policy makers have internalized the lessons from the past. These features increase the plans' chances of success and minimises their long-term impact on economic growth. Thus we expect the effect of fiscal consolidation in Europe to be limited and transitory, much lower than usually assumed.

Chart 5
All detailed expenditure measures as % of GDP



Source: BBVA Research

Chart 6
All detailed revenue measures as % of GDP



Source: BBVA Research

On the other hand, other advanced economies, where fiscal impulses have been substantial and debt levels have increased at similar pace as in Europe, are relatively slow in coming to grips with reducing deficits and stabilizing debt levels

In the particular case of the US, the fiscal deficit as a share of GDP will reach a maximum at -10.7% in 2010. Afterwards, we expect the gap to narrow but the ratio will remain elevated compared to Europe (see Chart 8). A slow recovery will weight on fiscal revenues as higher unemployment results in lower income tax receipts. By the same token, a weak economic environment will prompt government to continue spending at a relatively fast rate. In fact, government outlays as a share of GDP will remain at 25% during 2010 and 2011, one of the largest shares in US history.

Nonetheless, risks to this projection are tilted to the downside. On the one hand, a stubbornly high unemployment rate will delay the expected upturn in revenues, increasing the probability of extending the tax cuts. In fact, in mid-July unemployment benefits were extended. A second factor is related to the fiscal difficulties experienced by several state economies such as California and Illinois. Many states are expected to run huge shortfalls in coming years as the federal fiscal stimulus comes to an end. Since it is mandatory for states to balance their budgets, the lack of federal money will force them to trim down resources for schools, hospitals and public infrastructure. Thus, the federal government could end up injecting more money into state economies to alleviate the crisis.

This is a medium-term risk that is being underestimated, as experience shows that the effect of lax fiscal policy on interest rates is highly non-linear, and there is a risk –with uncertain timing– of a sudden increase in long-term rates and a displacement of private demand; exactly the opposite effect as intended by the fiscal stimulus packages

There are three main channels through which higher budget deficits could increase long-term interest rates. First, very high and rising public debt levels end up raising inflation expectations, leading to an increase in nominal bond yields. Adding to this, mounting pressure on central banks to accommodate higher fiscal deficits might increase the inflation risk premium, pushing interest rates even higher.

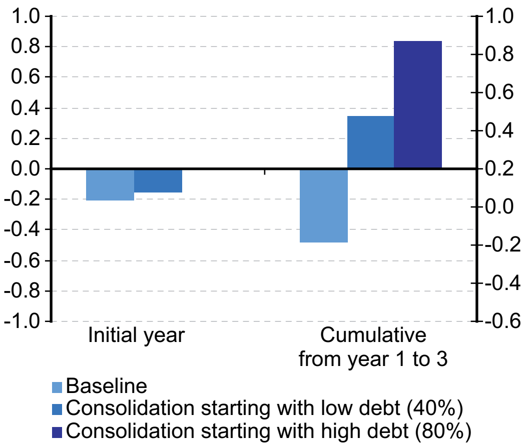
Second, aggregate national savings are reduced, resulting in a shortage of funds available to meet investment needs and, in turn, forcing real interest rates to adjust upwards. To be sure, part of this effect – the crowding-out of investment – might be mitigated via capital inflows, and in the case of developed economies that means increasing reliance on emerging market economies' savings. The third channel is the risk premium channel, that is, an increase in default risk on government bonds, particularly if high debt levels are expected to create persistent financing pressures.

Global real yields have remained low for quite some time due to a number of factors: (i) a rise in global savings; (ii) weak private sector demand for investment; (iii) increased demand for government bonds from banks due to regulatory changes, and (iv) continued growth in foreign exchange reserves invested in government bonds. Each of these has dampened the impact of rising government debt levels on bond yields. Inflation expectations in the United States and the euro area remain low, suggesting that investors are not particularly concerned about inflation risks. However, the risk premium channel runs through market expectations of the government's ability to service its debt in the future, and the evidence generally suggests that its effect on interest rates is highly non-linear, prone to contagion and potentially self-fulfilling if investors suddenly become reticent to roll over existing debt. The non-linear relationship between changes in the stock of public debt and interest rates becomes stronger as a country's debt grows above a certain threshold level. Thus, an apparent benign market environment can turn around quickly as a country approaches its debt ceiling and even the US can get to that point if it does not stabilize its public debt.

Indeed, results from a number of empirical studies suggest that, for the US, a 1 percentage point increase in the projected budget deficit to GDP ratio raises long-term nominal bond yields by about 25 basis points. In term of debt-to-GDP ratios, a 1 percentage point increase in this ratio raises bond yields by 3–4 basis points. This last result suggests that the projected increase of about 40 percentage points in the US debt-to-GDP ratio from 2007 to 2015 would eventually translate into 1–1,5 percentage points increase in long-term interest rates, with substantial negative effects on private sector demand.

Chart 7

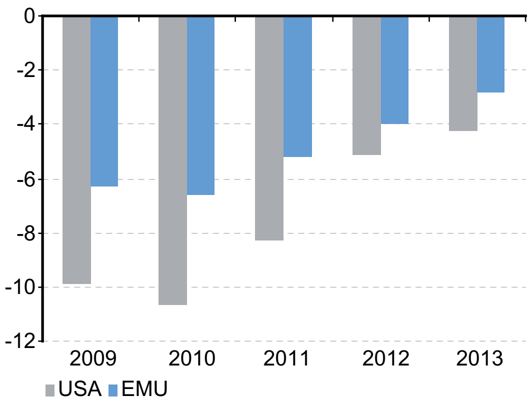
Response of GDP growth to an increase of cyclically adjusted primary surplus of 1% of GDP



* Coefficients from a panel regression of 15 European countries from 1970-2010, including 63 consolidation episodes, defined as years where the cyclically adjusted primary deficit was reduced by at least 1% of GDP.
Source: BBVA Research

Chart 8

US vs. EMU: Fiscal deficit paths



Source: BBVA Research

3. Financial tensions ease, but still the main risk

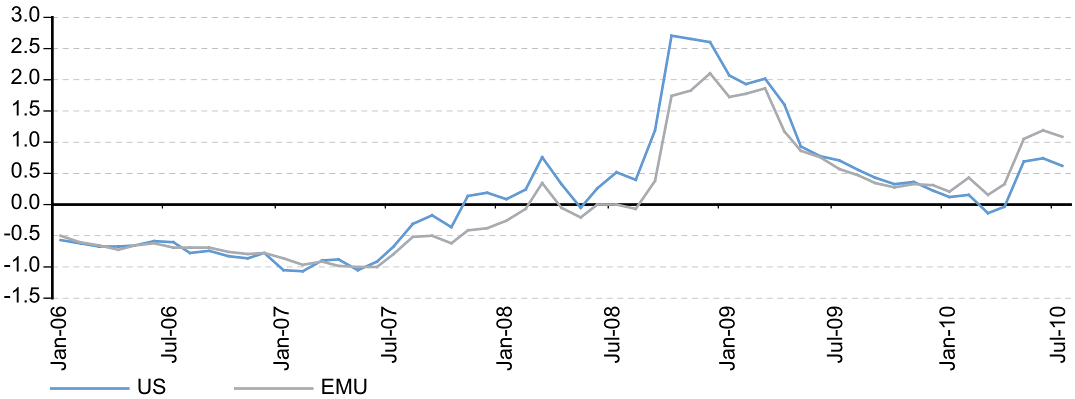
Financial risks, which stemmed from sovereign debt concerns, formed a feedback loop that ended up increasing market risk and drying up liquidity, especially in Europe. Nonetheless the sharp increase in financial tensions in Europe in the second quarter is starting to abate

The reassessment of sovereign credit risk in the eurozone was translated to increasing financial market strains during most of the second quarter. In part, public bond market pressures reflected significant rollover needs and, in turn, these pressures had potent spillovers to financial institutions, through exposure of European banks to sovereign debt –not just domestic–. Conversely, the impact on government balance sheets of the likely need to support weak banks also generate spillovers from financial sector strains to public debt woes. These two-way spillovers increased the risk of an adverse negative feedback loop between difficulties in the financial and sovereign sector and were reflected in strong co-movements of sovereign and banking CDS spreads since the beginning of the year. Cross-border bank exposures are the channels through which tensions in some European countries started spreading to other banking systems in Europe and –to a lesser extent– beyond European borders.

Increased tension in financial markets has been mostly confined to Europe, with limited spillovers to other regions. Our Financial Stress Index (FSI) on Chart 9, shows that the level of tensions is much higher in Europe than in the US, but, at the same time, it remained below the extreme stress levels witnessed in the aftermath of the Lehman Brothers' collapse in 2008. As the FSI is a composite indicator of strains in seven financial market segments we can also examine in detail where stress has been concentrated this time around. Chart 10 shows that current tensions have been mostly concentrated in European sovereign and financial credit markets, as opposed to the 2007-8 crisis, where sovereign woes were relatively absent –including in Europe– and generalized liquidity strains were also more prominent, especially before decisive and somewhat coordinated actions taken by the main central banks.

Chart 9

Financial Stress Index (FSI)*



* Composite indicator of financial tensions in 3 credit markets (sovereign, corporate and financial), liquidity strains and volatility in interest rate, foreign exchange and equity markets
Source: BBVA Research

Chart 10
Level of tensions in each component of the FSI

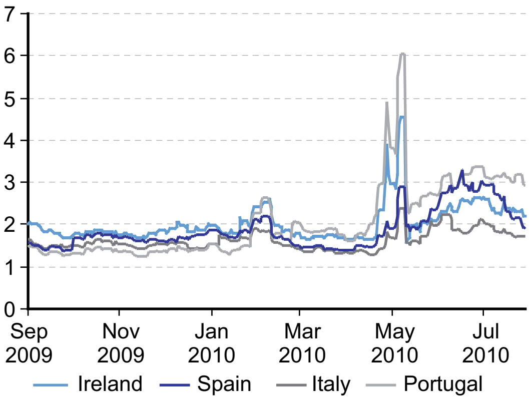
	US			EMU		
	2007	2008	2010	2007	2008	2010
Sovereign credit	Low	Medium	Medium	Low	Medium	High
Corporate credit	Medium	Extreme	Medium	Medium	Extreme	Medium
Financials credit	Medium	Extreme	Medium	Medium	High	High
Liquidity	High	Extreme	Low	Medium	Extreme	Low
Equity volatility	Medium	Extreme	Medium	Medium	Extreme	Medium
Interest rate volat.	Low	High	Medium	Low	High	High
FX volatility	Low	Extreme	Medium	Low	Extreme	Medium
Overall (FSI)	Medium	Extreme	Medium	Medium	Extreme	High

Source: BBVA Research

Three additional factors point to the fact that this latest crisis has not transformed itself into a systemic event, and resembles more the crisis of 2007 than the Lehman episode of 2008. First, the degree of leverage in the financial sector is currently much lower than in 2008, which implies a lower risk of contagion and forced sales. Second, cross correlations in financial markets (especially in credit instruments, a good indicator of how systemic are financial tensions) are much lower than in the aftermath of the crisis of 2008. Finally, the effect on emerging markets has been quite limited, both on prices –spreads have increased by a small amount, much lower than in 2008– and on portfolio flows, where reversions have been partial and smaller than during increased tensions in 2007 or 2008. In fact, emerging countries have faced the uncertainty of whether tensions in Europe decrease the willingness of foreign investors to bet on the region –due to a generalized increased in risk aversion–, or whether flows to emerging markets resume as an alternative to more volatile markets in peripheral European countries. Going forward, this means increased volatility of capital flows to emerging economies around a generally upward trend.

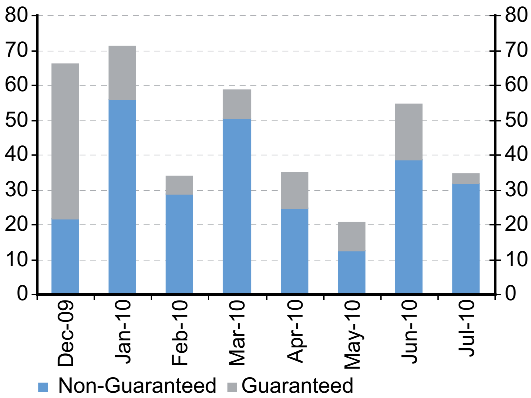
Starting in July, financial tensions have receded somewhat in the Eurozone (Chart 9) and specially in Spain (Chart 11), as capital markets are partially re-opening for European peripheral countries and European financial firms (Chart 12) and stress tests' results are being well received by market participants.

Chart 11
Europe: yields on 2-year sovereign bonds



Source: Bloomberg and BBVA Research

Chart 12
Debt issuance by EMU banks



Source: Bloomberg and BBVA Research

The release of European stress test results has had positive effects on lowering tensions, although there has been a clear differentiation across countries. In particular, it may act as a powerful driver for removing uncertainty surrounding the Spanish financial system, as the implementation of the exercise looks rigorous and the outcome seems credible and is very informative

As Spain and peripheral Europe have been central to the development of the financial crisis, it is important that there have been decisive steps taken in the right direction. Apart from embarking on immediate fiscal consolidation, in Spain there have been advances on labour market reform, and in the restructuring of the financial system, especially on institutions that are not publicly traded, reducing to some extent the barriers for their recapitalization. But surely the most important trigger has been the publication at end-July of Europe-wide stress test results, aimed at increasing transparency and reducing uncertainty about individual bank exposures, including to sovereign debt.

Stress tests have provided a positive differentiation for Spain –compared to other EU countries– that will help restore confidence in its financial system and reduce market tensions. There are four key elements that generate this positive differentiation. First, the overall macroeconomic scenario is robust and detailed enough to be credible. Indeed, the macro scenario is severe in line with that conducted in the US. The accumulated fall of the European GDP before the stress test is greater than in the US. However, the cyclical momentum is clearly different between both stress test exercises: at present, the global economy is facing a recovery, which prevents the additional fall in EU's GDP from being more aggressive. Moreover, the exercise for Europe includes an additional specific shock to the yield-curve, based on the sovereign debt crisis, which results in a more adverse scenario. The scenario is clearly more severe for Spain, where the overall fall in GDP is slightly above the total fall considered in the US and includes a sizable adjustment in the real estate sector –much bigger than in other countries and much larger and swifter than the average past housing bubbles–.

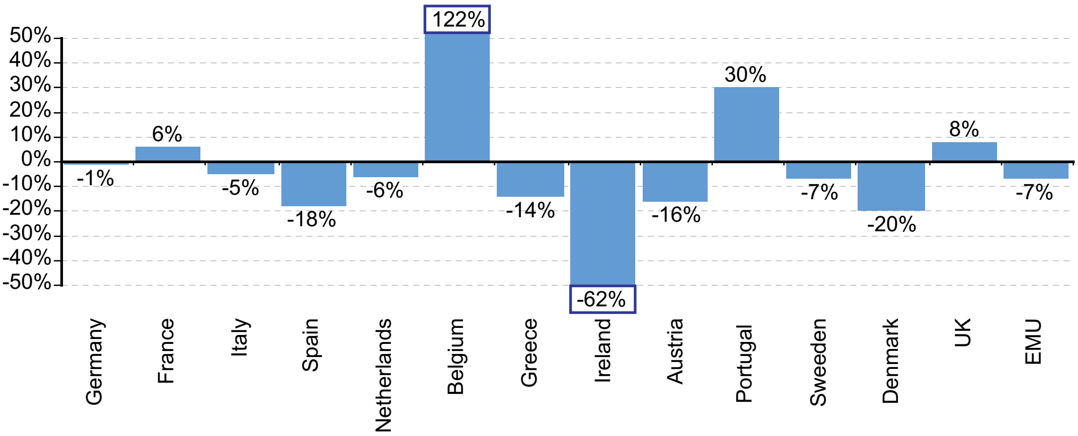
The second element of favourable differentiation for Spain concerns estimations of pre-impairment income. This is the critical issue in this exercise as there is a lot of discretion in its assessment, leading to significant differences across countries. In fact, in the Spanish financial system, aggregate pre-impairment income is reduced 18%, a severe assumption in line with our own estimations, whereas it increases 6% in France or remains quite stable in Germany (see Chart 13). A more rigorous approach in Spain can explain these differences, which should serve to dispel market concerns over capital needs in the Spanish financial institutions.

Third, there is a broader coverage of the exercise in Spain than in other countries, reaching almost 100% of the financial system, which explain why it is the country with more potential losses revealed in the financial system –not a sign of weakness but of greater transparency–.

The fourth element is greater differentiation in Spain between entities, with saving banks (cajas) showing lower pre-impairment income and higher impairments and losses than commercial banks.

All in all, capital needs for Spain are manageable and losses and margins reasonable, reinforcing the solvency of the Spanish financial system.

Chart 13
Stress tests:
pre-impairment income - Average annual change between 2010-2011 and 2009



Source: BBVA Research and CEBS.

Undoubtedly the risk to Europe and the global economy coming from financial markets is still the main source of concern, as the potential fallout from renewed tensions is still sizable
Even as tensions in financial markets have eased somewhat during July, the potential for an adverse loop between fiscal woes and financial sector strains is still high. This confluence of sovereign and banking risks could rapidly spill over to economic activity through further restrictions on private sector financing or even an additional forced fiscal tightening to try to restore confidence. Moreover, strains have the potential to rapidly be transmitted to other regions through losses from impaired assets and generalized uncertainty about how exposed to them are financial institutions. This would be a scenario with very high costs that needs to be avoided by continuing with credible progress on fiscal consolidation and financial sector restructuring.

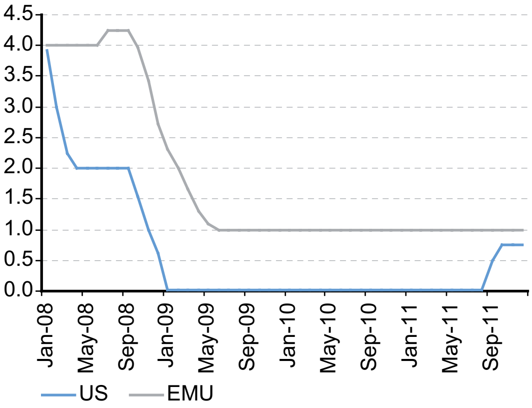
4. Increasing divergence in monetary policy strategies

Financial strains in Europe and uncertainty about the pace of recovery in the US will prompt central banks in both regions to postpone their first rate rises and keep very low policy rates for an extended period. Inflationary pressures in both areas will remain subdued, allowing them to keep lax monetary policies

It is becoming increasingly evident that substantial economic slack will remain in the US as growth will ease in the second half of 2010. Consumer spending will lose momentum dragged by a weak labor market and its dependence on fiscal policy support, in the context of a still ongoing deleveraging process. Additionally, tight credit conditions will weigh on investment. Thus we have postponed the date of the first rate hike to the end of 2011 and expect gradual increases thereafter (see Chart 14). Bernanke's latest speeches confirmed that the Fed sees increasing risks and is taking a much more cautious approach. The persistence of high unemployment remains a primary concern for the Fed, and this is a key reason for it to keep interest rates low for more time, given that the elevated level of excess capacity will keep inflation expectations anchored in medium term and core inflation subdued through 2012. Furthermore, the risks that have emerged due to the EU's sovereign debt problems have added substantial uncertainty to financial markets and the economic outlook. In fact, it is highly possible that the Fed could restart quantitative easing measures if downside risks increase further. Market participants have also recognized this delay in the normalization of US monetary policy and expected Fed funds rate hikes have been pushed forward in time.

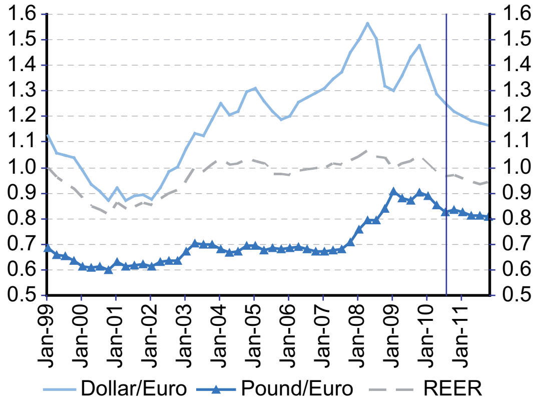
Of course, high uncertainties regarding the resolution of the European debt crisis have a strong impact on the ECB. Although financial tensions have receded somewhat in the Euro zone in July, the uncertainties are still very high and growth will remain sluggish in the medium-term, so the ECB will maintain its official interest rate at historically low levels at least until the end of 2011.

Chart 14
Official Interest Rates in the US and EMU



Source: BBVA Research

Chart 15
Euro exchange rates



Source: Datastream and BBVA Research

Nonetheless, a faster recovery in the US will mean that the monetary exit will be earlier there than in Europe, and both factors will weigh down on the euro

As growth perspectives are better for the US than the Euro zone and financial risks are higher in the EMU, monetary policy normalization will be earlier in the US. As a consequence, interest rate and growth differentials will increasingly weigh on the euro. Moreover, the Euro zone has embraced earlier fiscal consolidation, which will also tend to weaken the common currency. In addition, the euro is still above its long-run equilibrium level. All these factors will steadily weigh on the euro and push it to depreciate against the dollar, reaching the 1.21 USD/EUR mark by the end of 2010 (see Chart 15).

Although both central banks will postpone monetary tightening, communication and the assessment of risks continue to differentiate both institutions, limiting the ECB's relative capacity to react, in particular to deflationary risks

The ECB implementation of its mandate to maintain price stability has some drawbacks related to its asymmetric assessment of risks to inflation and its communication strategy. These shortcomings to address some risks –especially those tilted toward deflationary pressures– have become more noticeable as the financial crisis has unfolded. On the first point, the ECB seems more reluctant to admit deflationary than inflationary risks, and therefore it seems less flexible than the Fed to confront scenarios of weakening economic activity and reduced inflation. Contrary to the Fed, it has neither openly set interest rates very close to zero nor openly used non-conventional monetary policy to lower rates beyond the impact coming from a reduced official rate. Regarding communication, the ECB has failed to communicate neither a "very low for very long" message to markets nor the real purpose of asset purchases and other liquidity providing tools –which is to lower rates beyond what the zero bound for official rates allows–. Going forward, these differences between the ECB and the Fed imply higher deflationary risks in the Euro zone than in the US.

On the other hand, in emerging economies monetary tightening is resuming, after a pause (especially in Asia) as the European debt crisis unfolded. This will help forestall inflationary pressures in Asia –where they were starting to build in some countries– and prevent potential pressures from developing later in the year in South America. An important exception is Banco de México, likely to hold rates until the second quarter of 2011. Even when inflation edges up in the last months of this year, it will remain within Banxico's forecasted range and long-term inflation expectations are still well anchored

In general, emerging countries have been relatively isolated from European financial tensions, but some signs of contagion in late May and early June prompted some central banks to delay or soften their monetary tightening cycle. However, recent data show resilient growth in many countries, especially in Asia, where inflationary pressures have emerged in some countries, prompting the resumption of monetary tightening, as the recent hike in Indian official rate shows. China appears to be on track to achieve a soft landing for the economy as the authorities' recent tightening measures appear to be successful in reining in rapid credit growth and containing property price bubbles. In South America, despite Brazil's central bank decision to hike the official rate by 50bp instead of the expected 75bp the region is generally in the process of rapidly changing their monetary stance, which still remains highly accommodative. With the receding of financial tensions in Europe, a further cycle of monetary tightening is expected in these high-growth emerging economies. The exception will be Banco de México, which will maintain rates on hold at least until the second quarter of next year. Even when inflation edges up in the last months of this year, it will be within Banxico's forecasted range and long-term inflation expectations are still well anchored.

5. A heterogeneous slowdown ahead

Spillovers from the European financial crisis to other geographical zones have been relatively limited. Nonetheless, the global economy will slow down from the rebound at the end of 2009 and beginning of 2010

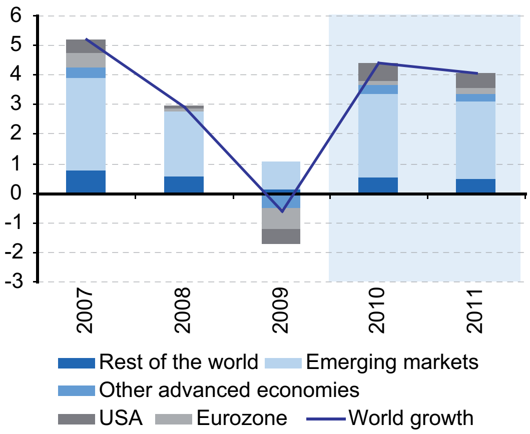
The recent turbulence in financial markets has cast a cloud over the recovery in Europe, and has increased downward risks to the global outlook. The financial crisis will spill over to growth in Europe through a number of channels, most importantly through increased uncertainty and reduced household and firm confidence, weighing on private consumption and investment. In principle, negative growth spillovers to other countries and regions could be substantial because of trade and financial links. Lower risk appetite could reduce capital flows to emerging and developing economies and negatively affect asset price valuations globally.

Importantly, on the main regions outside Europe these negative effects have been felt only to a limited extent. As mentioned in the previous section, financial contagion to other regions has been concentrated on particular asset classes, and the disruption in capital flows to emerging and developing economies will be small and temporary. Moreover, so far there has been little evidence of negative spillovers to real activity at a global level.

Thus, our forecasts remains mostly unchanged with respect to our previous Global Outlook three months ago. Global growth will experience a mild global slowdown from 2010 to 2011 but still grow above 4% both years (see Chart 16), on account of a healthy reduction of growth rates in China and the rest of emerging Asia towards more sustainable levels. The slowdown in the US and Europe cannot be seen on this positive note, however, as they reflect still weak demand without policy support in the US and the negative effect on confidence in Europe due to financial stress on the first half of the year. This mild global slowdown also implies that international trade will grow slightly more moderately, after the rebound from the troughs of 2008-2009 wears out in 2010 (see Chart 17).

Chart 16

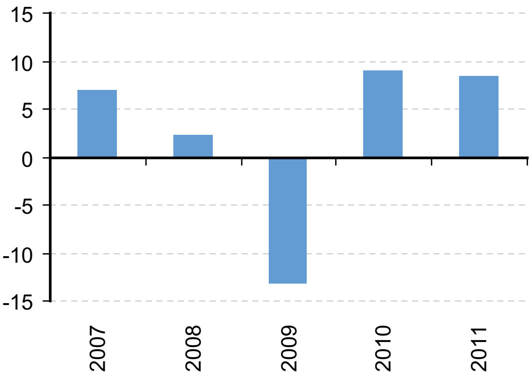
Contributions to Global GDP growth



Source: BBVA Research based on national accounts

Chart 17

World trade growth

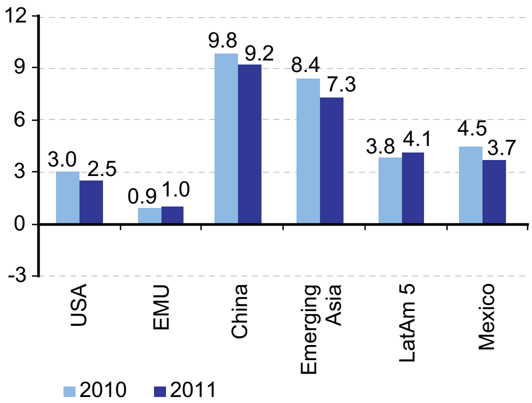


Source: BBVA Research

The severity of financial tensions in Europe will end up affecting confidence in the region and result in lower growth in the second half of 2010 and the beginning of 2011. Moreover, external demand will not be as strong as it was in the first half of the year, although it will provide some support for economic activity

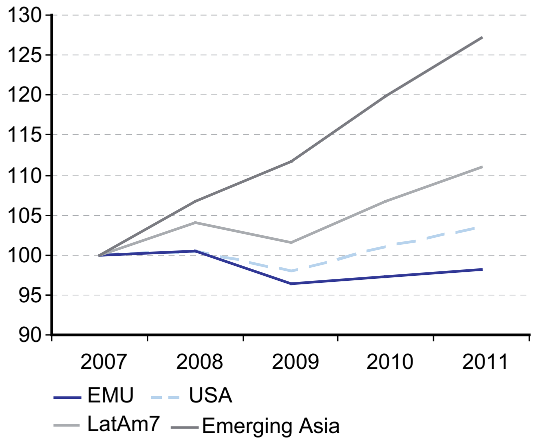
Despite the relatively strong growth expected for the second quarter of the year in the Eurozone, which has been boosted by exports, the outlook for the rest of 2010 and for 2011 continues to be of a slow recovery in the area (see Chart 18). Adding to the impact of fiscal retrenchment (which despite being moderate is likely to pull down activity, nonetheless) the effect of the sovereign crisis will keep confidence relatively subdued and maintain high uncertainty in the financial system, even if we expect financial stress to remit after the summer. Domestic demand continues to be flat, and we expect it to remain so in the second half of the year, while the strength of export demand is likely to be more moderate despite the delayed effects of the recent euro depreciation. All in all, growth is likely to slow down in the second half of the year, and to accelerate slowly in 2011 to 1%, when net exports will continue to be the main driving force in the area, with all components of domestic demand still sluggish.

Chart 18
Growth forecasts 2010-2011



Source: BBVA Research based on national accounts

Chart 19
GDP levels: 2008=100



Source: BBVA Research

In the US, the recovery is likely to lose momentum on account of softening labour and housing markets, showing the limits of private demand to take over as an autonomous engine of dynamism for economic activity

Economic indicators in the US continue to show mixed results, highlighting the uncertainty surrounding the sustainability of the recovery and the fact the policy stimulus (both fiscal and monetary) continues to be crucial to support economic activity. In this environment, the recovery process will continue if businesses increase capital spending and labor demand, which is essential to support private consumption. However, this process is not occurring at a pace consistent with a fast recovery and in some sectors it is still a long way from being reality. Firms are hesitant to invest and thus, a sustainable private-led economic recovery is not assured. The lack of stronger private investment reflects increased uncertainty and high risk aversion related to global economic conditions, potential regulatory changes, future tax policy, a weak recovery of real estate asset prices and fragile financial conditions.

Challenges remain in the labor market as demand is not yet robust, uncertainty remains around the future business outlook and financing options are still limited for small businesses, which have historically been a source of job creation during recoveries. Therefore, the recovery will be slow and prone to adverse shocks and the unemployment rate will remain above 9% in 2010. The housing market is also softening after the end of tax credits. The associated decline in housing demand and the stock of unsold houses has depressed builders' confidence, which points to a fresh retreat of residential investment in the third quarter of 2010.

In China, slowing GDP growth in the second quarter and moderating activity indicators are evidence that the authorities' tightening measures are steering the economy toward a soft landing, to reduce the risk of overheating and property price bubbles. Latin America will also slow down in 2011, but keep robust growth rates going forward

Economic growth in China is moderating in line with our soft landing scenario. After peaking at 11.9% (y/y) in the first quarter, growth moderated to 10.3% y/y in the second quarter as tightening measures by the authorities have worked to slow credit and investment growth. The moderating trend has reduced the risks of overheating in the near term. Moreover, the authorities' recent efforts to restrain rapid lending growth and contain property price bubbles appear to be working. There has been a significant decline in the volume of property transactions, and the pace of housing price increases has moderated. We expect the authorities to keep a watchful eye on property price developments, and we would not rule out further measures to cool the market. Our medium-term outlook continues to incorporate a gradual rebalancing of growth toward private consumption. The authorities have taken steps in this direction through policies to boost domestic consumption, improvements in the social safety net (which would reduce the need for precautionary savings), and currency appreciation which will help to foster growth toward domestic sources.

In South America, growth will slow down slightly –closer to potential– from the strong performance in 2010 (most notably in Brazil), as the expected withdrawal of policy stimulus (both fiscal and monetary) will weigh on domestic demand. Mexico will also adjust slightly downwards, heavily influenced by the US cycle, though benefiting from scant spillovers from Europe and its commitment to sound and predictable fiscal policy.

Therefore, divergences with continue to widen both between advanced and emerging economies and within each of those groups

The previous discussion highlights that the global economy will continue exiting the crisis at different speeds (see Chart 19). This will generate tensions for monetary policy in emerging economies, wary of letting their exchange rates appreciate too rapidly vis-a-vis the main currencies or afraid of volatile capital inflows. But perhaps more importantly, it will strain efforts for international policy coordination that were started after the crisis of 2008 in the context of an urgent need to respond to a synchronized fall in economic activity. Now that the sense of urgency is lost, a staggered rebound will add another stumbling block to the G20 process.

Taking a longer perspective, to the extent that different growth rates reflect a process of income convergence between emerging and developed economies, this is a most natural and welcomed development. However, when this divergence also shows up between two similar developed regions such as the US and the EMU, it points out the need to embark on substantial reforms on factor and product markets in the EU, to remove the limits to potential growth in Europe.

6. Tables

Table 1
Macroeconomic Forecasts: Gross Domestic Product

(YoY growth rate)	2007	2008	2009	2010	2011
United States	2.1	0.4	-2.4	3.0	2.5
EMU	2.8	0.4	-4.1	0.7	1.3
Germany	2.6	1.0	-4.9	1.1	1.3
France	2.3	0.1	-2.5	1.2	1.3
Italy	1.4	-1.3	-5.1	0.7	1.1
UK	2.6	0.5	-4.9	1.4	1.7
Latin America *	5.8	4.0	-2.4	5.2	4.2
Asia	7.6	4.2	2.0	6.4	5.5
China	14.2	9.6	9.1	9.8	9.2
Asia (exc. China)	5.2	2.2	-0.7	5.1	4.1
World	5.3	3.0	-0.6	4.4	4.1

Forecast closing date: 31st July 2010
* Argentina, Brazil, Chile, Colombia, Mexico, Peru, Venezuela
Source: BBVA Research

Table 2
Macroeconomic Forecasts: Inflation (Avg.)

(YoY growth rate)	2007	2008	2009	2010	2011
United States	2.9	3.8	-0.4	1.6	1.8
EMU	2.1	3.3	0.3	1.3	1.2
Germany	2.3	2.8	0.2	0.9	1.1
France	1.6	3.2	0.1	1.6	1.4
Italy	2.0	3.5	0.8	1.5	1.6
UK	2.3	3.6	2.2	3.0	2.5
Latin America *	6.0	9.0	7.4	8.1	8.4
Asia	2.8	4.9	0.3	2.9	2.8
China	4.8	5.9	-0.7	2.9	3.3
Asia (exc. China)	2.1	4.6	0.6	2.8	2.6
World	4.1	6.1	2.0	3.5	3.3

Forecast closing date: 31st July 2010
* Argentina, Brazil, Chile, Colombia, Mexico, Peru, Venezuela
Source: BBVA Research

Table 3

Macroeconomic Forecasts: Current Account (% GDP)

	2007	2008	2009	2010	2011
United States	-5.2	-4.9	-3.0	-3.7	-3.9
EMU	0.1	-0.9	-0.6	-0.5	-0.2
Germany	7.9	6.6	5.0	4.8	4.8
France	-2.3	-3.3	-3.0	-3.4	-3.6
Italy	-2.4	-3.1	-3.1	-2.9	-2.6
UK	-2.7	-1.3	-1.1	-1.6	-1.3
Latin America *	0.9	-0.4	-0.2	-0.7	-1.5
Asia	5.6	4.1	3.9	3.3	2.9
China	10.9	9.6	6.0	5.6	5.0
Asia (exc. China)	3.6	2.1	3.1	2.3	2.0

Forecast closing date: 31st July 2010
* Argentina, Brazil, Chile, Colombia, Mexico, Peru, Venezuela
Source: BBVA Research

Table 4

Macroeconomic Forecasts: Government Deficit (% GDP)

	2007	2008	2009	2010	2011
United States	-1.2	-3.2	-9.9	-10.7	-8.5
EMU	-0.6	-2.0	-6.3	-6.8	-5.5
Germany	0.2	0.0	-3.3	-5.4	-4.8
France	-2.7	-3.3	-7.5	-8.3	-6.6
Italy	-1.5	-2.7	-5.3	-5.1	-4.2
UK	-2.8	-4.9	-11.5	-10.0	-8.3
Latin America *	-0.7	-1.1	-3.2	-2.4	-2.3
Asia	-0.3	-2.4	-5.5	-5.6	-5.0
China	2.2	-0.4	-2.2	-2.8	-2.8
Asia (exc. China)	-1.3	-3.8	-7.2	-5.8	-5.5

Forecast closing date: 31st July 2010
* Argentina, Brazil, Chile, Colombia, Mexico, Peru, Venezuela
Source: BBVA Research

Table 5

Macroeconomic Forecasts: 10-year Interest Rates (Avg.)

	2007	2008	2009	2010	2011
United States	4.6	3.6	3.2	3.4	3.7
EMU	4.2	4.0	3.3	2.8	3.0

Forecast closing date: 31st July 2010
Source: BBVA Research

Table 6

Macroeconomic Forecasts: Exchange Rates (Avg.)

US Dollar per national currency	2007	2008	2009	2010	2011
United States (EUR per USD)	0.7	0.7	0.7	0.8	0.8
EMU	1.4	1.5	1.4	1.3	1.2
UK	2.0	1.8	1.6	1.5	1.4
China	7.6	6.9	6.8	6.7	6.4

Forecast closing date: 31st July 2010
Source: BBVA Research

Table 7

Macroeconomic Forecasts: Official Interest Rates (End period)

	2007	2008	2009	2010	2011
United States	4.3	0.6	0.3	0.1	0.8
EMU	4.0	2.5	1.0	1.0	1.0
China	7.5	5.3	5.3	5.6	6.1

Forecast closing date: 31st July 2010
Source: BBVA Research

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